The Accidental Entrepreneur – Part III

Tax Benefits and Possibilities of The Optimal Corporate Set Up

Part II of this series introduced a new recommendation for business owners and investors regarding the ideal corporate setup for existing or new small business owners. Part II provided a broad overview of the benefits of the recommended structure. The recommended structure is a limited partnership with a corporate general partner. The corporate general partner controls the management and administration of the limited partnership. This article focuses with greater scrutiny on the potential tax benefits of the structure.

I have always admired the tenacity and perseverance of Wile E. Coyote in his endless and often reckless pursuit of his target, the Roadrunner. His commitment to his supplier, Acme, Inc. could also be a lesson in customer loyalty. Law schools have engineered a lawsuit against Acme for defective product liability. Many taxpayers are business owners without even realizing it. For example, a corporate executive may own several rental properties and trade his own investment portfolio has two businesses.

The plumbing contractor that owns rental real estate along with several laundromats while trading stocks has three different businesses. Many Americans sat at home during the pandemic and became day traders chasing the record setting level of market performance. Many Americans have multiple past time gigs that frequently contractor relationships. Congratulations, you are a new business owner!

This article “drills down” on some of the potential tax benefits of the proposed structure. Existing business owners may find the structure beneficial for tax and asset protections benefits. Many taxpayers who have never considered themselves to be business owners may embrace the structure when they see the ability to convert non-deductible personal expenses into tax deductible business expenses. My point is that there is something for everyone in this structure.

What is the Optimal Corporate Set Up?

The proposed basic structure is a limited partnership that has a corporate general partner. The business owner forms a new limited partnership (LP) and a new C corporation to serve as the corporate general partner. The business owner owns 100 percent of the shares of the new C corporation or shares ownership with a spouse. These shares could also be owned by the business owner's revocable living trust. The C corporation serving as the sole general partner owns a 1-2 percent interest in the new limited partnership from inception on Day 1. The business owner personally initially owns a 98-99 percent interest in the new limited partnership. These limited partnerships can subsequently be gifted to children or trusts for various family members. These gifts may create an opportunity to shift income into lower tax brackets for income tax purposes. The business owner should consider creating a new limited liability (LLC) company for each separate business or real estate activity. These new LLC interest and any existing LLC interests are assigned to the limited partnership.

What About S Corporations?

If you have an existing operating business, consider restructuring the S corporation have the corporation taxed as a LLC. The potential tax consequences of the conversion from S status to LLC status must be considered. The liquidation of the S corporation may trigger a capital gains tax on any appreciated assets owned by the S corporation.

Despite a tax consequence, the restructuring may be a better idea in the long term. One of the limitations of S corporations is the limitation on permissible shareholders and the limitation to a single class of stock. The limited partnership cannot be a shareholder in the S corporation. A non-tax benefit favoring LLCs is “charging order” protection which exists in virtually every state’s limited liability statute. Under the "charging order" protection of most states, a creditor of a debtor-member of an LLC does not just get the member’s interest in the LLC, the creditor only gets the charge against the economic interest of the member.

This legal right does not confer on the creditor any management or voting rights, but simply diverts the debtor-member’s distributions and allocations to the creditor. If no distributions are made to the member, the creditor will be taxable on any income allocated (but not distributed) to the member. This phenomenon is referred to as "Ko'd by the K-1."

Tax Summary of the Benefits of the Ideal Corporate Set Up

One of the benefits of the suggested limited partnership format is the opportunity to eliminate the need to contribute to FICA and Medicare due to a special provision in IRC Sec 1402(a)(10) which exempts limited partners from FICA and Medicare taxes. This exemption from withholding is statutory unlike S corporation shareholders who frequently take little or no salary to avoid FICA and Medicare withholding. Over the course of a business career, the level of FICA/Medicare savings invested over twenty-five years at 7 percent amounts to approximately $1.4 million over that time. The maximum limit on earnings for self-employment withholdings for social security and Medicare is $137,700 in 2020. The self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

The general partner of the limited partnership should be structured as a regular corporation (C corporation). The general partner retains management control of the limited partnership's operations. From a tax planning perspective, an important planning benefit of the corporate general partner format is the ability to select a tax year end other than the traditional calendar year end (12/31) / creating staggered year ends for tax purposes.

Using our planning structure, the corporate general partner elects a corporate year end that is not a calendar year end (12/31). Individuals, limited liability companies, partnerships and S corporations are generally required to have a tax year ending on December 31st each year. Professional service corporations are also required to have a calendar year end. The proposed structure provides an interesting vehicle to create a tax deferral vehicle at the corporate general partner level through the selection of a staggered year end by electing a year end other than a calendar year end. The corporate general partner's tax return is due three months after its year end with the ability to secure a six-month extension. A corporate general partner with a November 30th year end could defer the payment of income paid by the limited partnership as a management fee for approximately 18 months.

An additional planning opportunity is the ability for the corporate general partner to create a Qualified Self-Employment Health Reimbursement Account (QSEHRA) which would allow the corporate general partner to establish a Health Reimbursement Account. These payments are tax deductible to the corporate general partner. These payments can be used to make payments for the business owner's health insurance premiums and reimbursement of medical expenses that are subject to deductibles and copayments or otherwise are not covered by the health insurance plan.

The annual limit for a family in 2020 is $10,600 or $883.33 per month. The annual limit for a single taxpayer is $5,250 or $420.83 per month. This is an important benefit for taxpayers who otherwise currently pay health insurance premiums with after-tax dollars as well as copayments and the medical expenses subject to a deductible with after-tax payments. The QSEHRA can cover bona fide medical expenses that are not covered by the business owner's health insurance plan.

A corporation is generally able to deduct all necessary and ordinary expenses for tax purposes. One planning measure for consideration is the transfer of the personal vehicle that you own or lease to the corporate general partner. Following the transfer of the vehicle, the vehicle becomes a company owned car making all the vehicle's expenses associated with the vehicle tax deductible.

The corporate general partner has the option to create a qualified retirement plan at the corporate general partner level. This plan could include a defined benefit plan as well as a 401k and profit-sharing plan. The limited partnership makes a management fee payment each year to the corporate general partner. This management fee constitutes revenue to the corporate general partner. Aside from having the ability to defer taxation because of tax election to have a year-end for tax purposes that is not a calendar year end, payments to benefit plans such as a retirement plans are tax deductible to the corporation. The combination of pension plans provides an enormous opportunity to make large tax-deductible contributions with the inclusion of a defined benefit plan.

Children might be added as employees at the corporate general partner level so that they can participate in the corporate general partner's 401k or Roth 401k. the contribution level per employee in 2020 is $19,500 per employee. A future article will articulate how this type of arrangement can benefit the children's savings for college or the down payment of a house or "seed capital" for a new business. I should mention that the rules under IRC Sec 72(t) allow for early distributions that are exempt from the ten percent penalty for higher education expenses.

For those of you who have read prior articles, you know that I am a planning proponent of the Loan Method of Split Dollar life insurance. The corporate general partner could easily facilitate participation in a Split Dollar arrangement with a Spousal Lifetime Accent Trust (SLAT) to that the policy is owned outside of the reach of the business owner's personal and business creditors while remaining a discretionary tax-free income beneficiary during the business owner's lifetime. Tax compliance is simplified. Earlier we addressed the lack of FICA and Medicare withholding for limited partners. Single member LLCs assigned to the limited partnership do not file separate tax returns for a single member LLC. In all likelihood, the limited partnership will have two limited partners, the corporate general partner, and the business owner as a limited partner in his individual capacity.

Strategy Example

Wile E. Coyote has his attorney create a new corporate structure. He creates WEC, Inc. to serve as the corporate general partner of a new limited partnership, WEC Family, LP. Wonka, Inc. is wholly owned by Wile E. Coyote. WEC Inc. owns a one percent interest in Wonka LP. Wile E. Coyote also owns a 99 percent interest in Wonka LP. WEC Inc. has a corporate year end of November 30th. Wonka LP has a year end of December 31st. Wile E. Coyote assigns ownership of three separate LLCs owning real estate to the limited partnership. He also creates a separate LLC for his investment trading activities. He creates a new consulting company in a single member LLC that will also be owned by the limited partnership. The consulting company is focused on new techniques for catching roadrunners.

WEC, Inc. establishes a new QSEHRA which will allow the corporate general partner to make a tax-deductible contribution to the Plan up to $10,600 in 2020. The payment is tax deductible to the corporate general partner and non-taxable to Wile E. Coyote personally. The plan may be used to reimburse medical expenses and pay health insurance premiums.

The limited partnership proposes to make a management fee payment to the corporate general partner in December 2020. The corporate general partner's year end is November 30th. The corporate general partner will have 18-20 months to pay taxes on its income assuming the company seeks a filing extension. The company may also use the revenue generated through the management fee to fund a qualified retirement plan – cash balance defined benefit plan and 401k/profit sharing plan.

The corporate general partner is also the sponsor of a Split Dollar arrangement with the WEC Family Trust, a Nevada Trust. The arrangement uses the Loan Method of Split Dollar. The policy is owned by the Trust and will provide tax-free income to Wile E Coyote during his lifetime while keeping the policy beyond the reach of personal and business creditors. He also adds some of his children to the company payroll and includes them in the qualified retirement plan.

Wile E Coyote transferred his personal auto to the corporation and now deducts all the auto's mileage and expenses as a company owned car.

Summary

The proposed corporate and business structure has many benefits for business owners regardless of the level of income. If you own some rental real estate and have an investment portfolio, consider the arrangement. Corporate executives with side "gigs" should consider this arrangement. The medical reimbursement plan and the ability to make expenses that are currently paid with after-tax dollars into tax deductible expenses is a planning opportunity for many taxpayers. The ideal corporate structure is simple in its format but offers powerful tax benefits.