WILL LIMITED LIABILITY COMPANIES LEAD TO A SINGLE BUSINESS TAX?

BY CHARLES HERBST

CHARLES HERBST ANALYZES TWO RECENT LLC REVENUE STUDIES AND CONSIDERS WHETHER THE SINGLE BUSINESS TAX MIGHT BE ADOPTED BY JURISDICTIONS CONCERNED ABOUT PERCEIVED LOST REVENUES RESULTING FROM THE GROWTH OF LLCS.

Along with generally prosperous times, many state governments are enjoying a surplus. Tax collections are at record highs and tobacco settlement funds have been another significant boost for state revenue. Rather than seeking new sources of money, several state legislatures have had the pleasant prospect of deciding what to do with all of that surplus cash.

Of course, as the economy ultimately weakens, states will once again be looking for new sources of revenue. In addition, Internet-based threats to sales tax revenue and the general shift to a service economy are beginning to compromise sales tax collections, a traditional source of state revenue. As a result, many states gradually are relying more heavily on personal income tax for revenue. This dependency will make state finance more vulnerable in recessionary times.

Another potential revenue threat comes from passthrough entities. Although many states recognize S corporations, others do not,[1] and the LLC has represented the first easy way in those states to avoid state corporate income taxes and preserve limited liability. At least two states have studied the problem of lost revenue because of limited liability companies: California and Tennessee. Both have take action to control the red ink. If legislators in other states begin to view the LLC as a threat to the state treasury, Michigan's Single Business Tax could well become the future model of state business entity taxation.

LLC Revenue Studies in Tennessee and California

In Tennessee, Public Chapter 421 of 1997 mandated a study by the Tennessee Department of Rev-

enue as to the tax impact of permitting LLCs in Tennessee. The preliminary finding of this report, prepared by Stanley M. Chervin, while director of research for the Tennessee Department of Revenue, was that LLCs have an annual negative impact on Tennessee tax collections of between $5.4 and $10.1 million.[2]

TENNESSEE TAX STRUCTURE

Tennessee is rather unusual, as it lacks both lottery revenue and a personal income tax on wages. As a result, Tennessee is more dependent on its sales and corporate taxes. Tennessee corporations pay a franchise tax equal to .25 percent of net worth, and an excise tax equal to six percent on Tennessee net earnings. S corporations are not recognized for Tennessee purposes and pay the same taxes as a C corporation. Partnerships, individuals, and other unincorporated entities pay a "Hall Income Tax"[3] of six percent on dividends, bond interest and similar instruments. Fifty-five percent of Tennessee's revenue is from its sales tax.

Because Tennessee has a narrow tax base, its fisc has not benefited from prosperous economic times as much as other states have. As a result, Tennessee is running a severe deficit and the legislature spent much of 1999 looking at implementing new taxes. Last May, the franchise and excise tax were extended to a variety of entities, including LLCs, effective for tax years beginning on or after July 1, 1999. Only general partnerships and proprietorships are exempt.[4] Tennessee has also been considering the adoption of a personal income tax on wages.

IF LEGISLATORS IN OTHER STATES BEGIN TO VIEW THE LLC AS A THREAT TO THE STATE TREASURY, MICHIGAN'S SINGLE BUSINESS TAX COULD WELL BECOME THE FUTURE MODEL OF STATE BUSINESS ENTITY TAXATION.

Methodology. The Tennessee Department of Revenue study was commissioned before the extension of the franchise and excise tax to LLCs. To gather data for the study, the Tennessee Department of Revenue sent a questionnaire to LLCs that were organized in Tennessee as of February 1998. A second mailing was sent in July 1998. Responses were received from 10,542 of approximately 16,000 Tennessee LLCs.

The study reveals that approximately 81 percent of Tennessee LLCs are taxed as partnerships, and about seven percent are taxed as corporations for federal tax purposes.

About 77 percent of the businesses operated by the LLCs did not exist prior to organization as an LLC. These new entities were asked how they would have organized, if the LLC form had not been available. Twenty-four percent stated they would use an S corporation, 16 percent a limited partnership, five percent C corporation, four percent general partnership, and four percent chose proprietorship.

Of the businesses that did previously exist, 40 percent were proprietorships, 26 percent were partnerships, nine percent were S corporations and six percent were C corporations.

Economic Impact. To determine the revenue impact of LLCs on Tennessee, the report focused on four factors:

1. The 352 Tennessee LLCs that had previously been corporations, had, during their last year as corporations, paid corporate excise taxes of $1,173,000 and franchise taxes of $866,000. Adjusting these amounts for the size of the survey sample, the annual franchise and excise tax loss from entities that had previously been subject to Tennessee excise and franchise taxes ranges from $2 million to $2.9 million.
2. Of the 8,206 new businesses identified, 6,732 said they would have formed in Tennessee anyway, even if the LLC had not been available. Based on the percentage that would otherwise have elected to be corporations, 1,657 would have been subject to Tennessee franchise and excise taxes. The estimated franchise tax loss for this group is $3.4 million to $4.9 million. The estimate for the excise tax is $5.5 to $7.9 million.
3. Because entities taxed as partnerships are subject to the Hall Income Tax, that Tax raised an estimated $269 thousand to $384 thousand in revenues.
4. Limited Liability Companies are subject to substantial secretary of state fees ranging from $300 to $3,000 per year, depending on the number of members. These fees yielded $5.2 million.

Offsetting the revenue losses from the first two factors against the income from the last two factors, the net annual loss to the

state is approximately **$5.4 to $10.1 million.**

The current Tennessee state budget for fiscal 1999-2000 is **$8.3 billion** dollars. The revenue loss caused by LLCs is less than 0.1 percent of the overall state budget.

Finally, the Tennessee report also pointed out that some LLCs were formed in Tennessee that would not otherwise have done so and represent new economic development, increased employment, and additional business activity. This economic activity means increased revenue for the state in the form of sales and other taxes. Nine hundred ten respondents stated that they would not have started a business in Tennessee if the LLC form had not been available. The report does not estimate the value of this increase, but notes that it should be taken into account in evaluating the impact of LLCs on Tennessee tax collections.[5]

In California, Section 17943 of the Revenue and Taxation Code requires the Franchise Tax Board (FTB) to annually determine whether the Beverly-Killea LLC Act results in a net gain or loss for the state income and franchise tax revenues. The first such study was recently completed and based on 1996 revenues.[6] The study concluded that LLCs are costing California $6.7 million in lost revenue.[7] Upon completion of each annual study, the limited liability company income fee is adjusted to fully offset the revenue loss of allowing California LLCs to operate.

CALIFORNIA TAX STRUCTURE

Although rates are higher then average, California's tax system is similar to many states. California subjects C corporations to 8.84 percent tax on state net income. S corporations pay a tax of 1.5 percent of state net income. A limited partnership pays a minimum tax of $800. General partnerships are passthrough entities, and treated similarly to the federal model. California's personal income tax provides 42 percent of state revenue and sales tax an additional 29 percent.

Methodology. Unlike the Tennessee study, the California study assumes that, absent the ability to operate as an LLC, all California LLCs would still choose to do business in California, but as some other type of entity, defined as an "alternative entity." Four types of alternative entities were considered: C corporations, S corporations, general partnerships and limited partnerships. (At the time, California did not allow single-member LLCs, so proprietorships were not considered.)

The California study defines the cost of permitting LLCs as the difference between the total fees and taxes the LLC pays as an LLC, versus what it would have paid as an alternative entity.

Because California taxes an LLC annual franchise fee based on its income, California was able to more accurately determine the operating income of LLCs operating in California. California chose a sample of 1,090 LLC tax returns. To determine what type of alternate entity would have been chosen by the LLC, newly formed LLCs were assigned to an alternate entity based on the probability that an entity of a certain size and industry would chose such an entity as based on the entire population of business entities. If an LLC was formed by liquidating another business entity, it is assumed that the liquidation would not have taken place and that business entity would have retained its old form. Because the assignments were made randomly, to reduce the error that a single estimate might seriously overstate or understate the results, the estimation was repeated 10 times using Monte Carlo statistical techniques. The result is the median-value estimate from the 10 iterations.

Economic Impact. Treating the LLCs as their respective alternative entities and adjusting for the sample size, the study concludes that the alternative entities would have paid an aggregate of $15.9 million dollars in additional California taxes. During this period, LLCs paid LLC fees of $9.2 million. This difference of $6.7 million is determined to be the cost of permitting LLCs in California during 1996. To eliminate this perceived revenue loss, the LLC fees for taxable years beginning in 1999 have been increased 73 percent.

The current California 1999-2000 state budget is **$61 billion** dollars. This revenue loss caused by LLCs is less than 0.1 percent of the California budget.

ANALYSIS

Both the California and Tennessee studies employed different methodologies to establish the cost of permitting LLCs to operate in their respective state as passthrough entities. Both of the studies clearly illustrate that, in terms of lost revenue, allowing LLCs to operate as passthrough entities had an insignificant effect on the overall state budget. In the case of Tennessee, with a $372 million shortfall, an extra $5 to $10 million in revenue would eliminate less than five percent of the revenue gap.

For a number of reasons, it is very difficult to define and precisely measure the tax cost of a policy such as passthrough tax treatment of closely held entities. First, statistical methodology employed in such a study often relies on the intuition of the researcher, particularly when the question is ambiguous and the target is moving.

Second, as the Tennessee study notes, different tax policy could adversely affect business activity and formation in a particular state. If Tennessee and California are perceived by mobile entrepreneurs to be a poor value or hostile to small business, these companies might seek other jurisdictions with lower taxes, such as Nevada, for all or part of their operations. Such a decision has a cascading effect both on state revenues and state economic development. Accurately measuring this variable is speculative at best. Both of these studies declined to measure this phenomenon.

[S]TATE LEGISLATORS SHOULD BE CAUTIOUS ABOUT PURSUING ACTION THAT COULD POTENTIALLY RETARD SMALL BUSINESS GROWTH.

Third is the selection of the "alternative entity" that the LLC might otherwise form. Typically LLCs are formed by tax-savvy clients who have sought professional advice. Asking those who have formed LLCs or comparing them to other entrepreneurs may not produce an accurate vision of which entities the LLCs would have otherwise been. For example, the owners of these LLCs may decide to forgo liability protection entirely and operate as proprietorships or general partnerships. Insurance or asset protection schemes may be perceived as adequate and less expensive than another layer of taxes.

An important consequence of these studies is that, despite the relatively small revenue effects, taxes on LLCs were increased in both states. In both states, legislators were persuaded that LLCs had a tax cost to the state that should be recovered. This is in contrast to the economic development policies of both states, which allocate millions of dollars in tax incentives to attract large corporations to locate or expand their business within the state's borders. For many years, small, closely held businesses, the principal users of passthrough entities, have been the chief source of business development and new job growth.[8]

Assuming no corporate tax integration, the question becomes which businesses should be subjected to a second tax, typically the corporate income tax. At the federal level, the answer to that question has changed. Prior to the development of the S corporation in the 1950s, the corporate tax was assessed for the privilege of limited liability. Establishing the S corporation election, the liberalization of S corporation provisions, publicly traded partnership rules and the "check-the-box" rules now provide the framework for the current rule, which is that the corporate tax is assessed for the privilege of being publicly traded. Although most states follow this federal rule, there is significant variation.

If a state legislature perceives that either revenue is being lost or it is bad policy that some businesses are not paying a second tax, the legislators must decide specifically which group of businesses should be subjected to the second tax. A state might assess the tax for the privilege of being publicly traded, for the privilege of limited liability, or it might simply assess the tax for the privilege of doing business in the state. Michigan has chosen the latter rule and assesses its Single Business Tax on all businesses, including proprietorships.

Is Michigan's Single Business Tax the Way of the Future?

NATURE OF THE MICHIGAN SINGLE BUSINESS TAX

Rather than an income tax, Michigan's Single Business Tax ("SBT") is a tax on the privilege of doing business in Michigan. It applies not only to corporations, but also to passthrough entities and sole proprietorships. The calculation of SBT is based upon the value added to goods and services by the taxpayer; hence it is classified as a valued added tax ("VAT").[9] Currently, Michigan is the only state to have a VAT, although VAT is common throughout Europe.

Michigan has been experimenting with VAT since the 1950s. This latest tax, the SBT, was instituted in 1976.[10] The tax rate is currently 2.2 percent and, interestingly, the tax is scheduled to be phased out at the rate of 0.1 percent over the next 22 years.[11] This phaseout is highly unlikely not only given the long phaseout period, but the 0.1

percent annual phaseout is effective only in years in which the state has a $250 million surplus.[12]

A significant advantage of Michigan's SBT is that it is essentially based on gross receipts rather than income. As Michigan's economy traditionally has been based on heavy manufacturing and motor vehicle production, it is very cyclical. In recessionary times, the SBT generates considerably more revenue for Michigan than an income tax would. This is because even a money-losing business typically has gross income, and thus, SBT liability.

SHOULD SBT REPLACE CORPORATE INCOME TAX?

Initially, the SBT appears to be an enticing way to force all businesses to pay the same amount of tax, regardless of business entity choice. In a state with an individual income tax, it is generally not possible to impose a second income tax on proprietors on the same income. Thus, unless the corporate income tax is replaced with a VAT, there will always be a group of entrepreneurs who will escape paying a business tax.

The question of a corporate income tax versus a VAT is a much broader question than who should pay a business tax. Implementing a VAT represents a fundamental tax policy change. SBT works well for Michigan because it tends to avoid large swings in the amount of tax revenues caused by a cyclical economy. However, this aspect of SBT would be true even if the tax were applied only to either publicly-held entities or entities with limited liability.

Unfortunately, the SBT causes inequities of its own. Although the wisdom of implementing a VAT is beyond the scope of this article, the special problems faced by multistate businesses should be noted: A business that is paying income tax to another state often cannot take a credit for SBT payments to Michigan, because Michigan's tax is not an income tax. Depending on the states and apportionment formula in question, this can cause a business to be forced to pay a business tax on the same income to two different states. A number of companies have avoided or do reduced business in Michigan because of this problem.[13]

Conclusion

Given the incredibly small revenue impact that passthrough treatment of LLCs is having on state tax collections, state legislators should be cautious about pursuing action that could potentially retard small business growth. If the scope of business income tax is expanded or VAT is enacted in a state, it may still be possible to minimize the tax bite. Planners should design their vehicles in such a way as to accommodate changes in form of entity or domicile, should a formerly friendly jurisdiction turn hostile. When expanding the scope of business income taxes to passthrough entities is proposed, opponents should point out that an expanded entity-level business tax is not likely to solve the state's revenue shortfalls, and, indeed, such a tax may make the shortfall worse by driving away much-needed entrepreneurship and investment.

ENDNOTES

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1 Jurisdictions that currently do not recognize S corporations include Connecticut, District of Columbia, Louisiana, Michigan, New Hampshire, Tennessee and Texas.

2 Tennessee Department of Revenue, *The Impact of LLCs on Tennessee Revenues.*

3 The "Hall Income Tax" was enacted by Ch. 86, Laws 1929, as a supplement to the property tax. It taxed the income from stocks and bonds, but exempted corporations otherwise taxed. This law was rewritten by Ch. 20, Laws 1931, Second Special Session.

4 Tax Revision and Reform Act of 1999, Acts 1999, ch. 406.

5 Tennessee Department of Revenue, *The Impact of LLCs on Tennessee Revenues,* at 8.

6 California Franchise Tax Board, *Calculation of the Adjustment to the Limited Liability Company Fees for 1999,* Jan. 1999.

7 *Id.* at 3.

8 Small Business Administration, News Release 97-32, Jan. 26,1998.

9 *See, e.g., Town & Country Dodge, Inc. v. Dept. of Treas.,* 420 Mich 226, 362 NW2d 618 (1984) and *Wismer & Becker Contracting Engineers v. Dept. of Treas.,* 136 Mich App 690, 382 NW2d 505 (1985).

10 Act 228, Laws 1975.

11 Mich. Comp. Laws §208.31(5).

12 *Id.*

13 *Report Says SBT 'Costly,'* DETROIT NEWS, Nov. 3, 1995.