A “New” Asset Location:
The Family Corporation

Robert N. Gordon

There is a new piece in the asset location puzzle. The recent tax legislation has opened up a new avenue for analysis when deciding where an asset may best be held to be most tax efficient: the tax-paying C type corporation. The new law lowered the tax on these entities to 21% from 35%. With the corporate rate now considerably below the individual rate, families need to consider what assets, if any, would be better held in a C corp.

EVERYTHING THAT WAS OLD IS NEW AGAIN

There have been other times in U.S. tax history where the tax rate on corporations was considerably below the tax rate on individuals. The gap was never larger than it was about 100 years ago, when the disparity incentivized families to create what were commonly called “pocketbook” corporations. The idea was to capture income at the lower corporate rate and then leave the after-tax income in the corporation.

The government has established rules to try and limit the benefits of forming “incorporated pocketbooks” that can take advantage of the tax rate discrepancy. These include the personal holding company and accumulated earnings tax rules.

The accumulated earnings tax (AET) was put in place first. The concept of the AET is that a corporation should not be stockpiling cash that will not be used in a business and that the cash should instead be paid out to the stockholders as dividends. Monies found to be in excess of what the business “needed” would either have to be distributed out or the AET would kick in.1 This applies to all corporations but is rarely levied on public corporations. The current AET is 20%.

In 1934, with “incorporated pocketbooks” still all the rage, the government put in place the personal holding company (PHC) rules. Here, if five or fewer related persons own more than 50% of a company that receives more than 60% of its adjusted ordinary gross income from passive sources,2 then all undistributed PHC income would get hit with the 20% PHC tax.3 PHC income includes after-tax dividends, interest, short term gains, certain royalties, annuities, rents, and personal service contracts.4 After-tax long term capital gains do *not* have to be distributed. If the corporation is a PHC, it does not have to worry about the AET. However, if a family corporation passes the PHC test by virtue of either ownership or income type, it will still have to contend with a possible AET.

THE ADVANTAGES

The new law made investing through a C corp more attractive by creating a maximum tax rate of 21% for C corps while at the same time making investing in a taxable account less attractive by limiting or eliminating the deductions that individuals could take. But these same deductions are fully deductible by C corps. Thus, a C corp can fully deduct state and local taxes and management fees where the individual could not. These expenses and the cost of running the corporation will reduce both taxable income and the amount of income that would need to be distributed rather than be hit with the 20% PHC tax.

THE MATH ON INTEREST INCOME AND SHORT TERM GAINS

The PHC rules were meant to force pocketbook C corps to distribute most types of income to their shareholders or face a PHC tax. If income is taxed at 21% at the C corp level and then what's left is taxed again at the individual maximum level on qualified dividend income of 23.8%, a net tax of 39.8% is paid.6 Slightly lower than the 40.8% the individual would have been taxed on interest income or short term gains. It seems plausible that even if the PHC distributes, the C corp is beneficial.

STATE TAX ISSUES

The corporation could be headquartered in a state that does not tax corporations. If is not, then state taxes must also be accounted for at the corporate level. Further, some families live in states with no state taxes (or hold their investments through NINGs or DINGS located in states with no state taxes).7 These examples assume no state taxes at either level.

If the family lived in New York (which frowns on incomplete grantor trusts), however, and the corporation was in NY, then the math would be less advantageous than the prior example. Here, the C corp would pay a 21% federal tax and a state tax of 5.135% tax (after deducting state taxes paid against federal taxable income). The 73.865% of interest income that is left must be distributed to avoid the PHC tax. That dividend distribution would be taxed to the individual taxpayer as qualified dividend income at both the federal and state level. Thus, PHC distributed interest income pays a total 48.515% tax rate if held in the C corp versus a 47.3% (40.8 + 6.5) total if one was holding the interest-bearing investment in the taxable account. This, of course, assumes that there are no other deductions (such as management fees) that would reduce the C corp's income and make the C corp route more favorable by reducing the amount of income necessary to be distributed. If the corp were established in a no-tax state and state tax was only levied at the individual level, the PHC route attracts a total of 45.1% tax versus 47.3% if held by the individual.

THE MATH ON LONG-TERM CAPITAL GAINS

For investments that will produce long-term gains, the C corp structure may not prove attractive. If a long-term gain asset could be held in the taxable account until death there would be no tax on the gain at all. If the asset were disposed of before death, the C corp could be advantageous only if one was sure that one could hold the C corp shares until death. In this scenario, the C corp would pay a 21% tax versus the family paying 23.8%. Again, state taxes should not be ignored.

THE MATH ON QUALIFIED DIVIDENDS

Qualifying dividends are taxed at 23.8% for individuals. A C corp pays a 10.5% tax on qualifying dividends it receives, leaving 89.5% in the C corp. If that amount was distributed, the family would pay a 23.8% tax on that income, creating a total tax of 31.8%, which is more than they would have paid if held in the taxable account. The corporate tax is a pure additional tax. If the C corp share were held until a step up in basis, the total tax would only be 10.5%

THE MATH ON FLOW-THROUGH VEHICLES

The new law granted a deduction equal to 20% of the income coming from REITs and MLPs.8 This creates a maximum federal tax of 33.4% for individuals. C corps do not get the benefit of the 20% tax exclusion, and thus these investments should probably be held in taxable accounts unless one is sure the C corp shares will be held until death.

BEST-CASE SCENARIO

The most tax-efficient strategy would be to distribute as little as possible and hold the C corp shares until death, thereby getting a step up in basis. *This would mean that the income was only taxed once at the C corp level*. If this can be achieved, even dividend-producing assets might best be held in a family corporation; the key is the step up in basis on the C corp shares.

ENDNOTES

- ↵[1]See IRC Sec. 531.
- ↵[2]Adjusted ordinary gross income does not include gains from the sale of capital assets or gains from the sale of assets that are treated as capital under a IRC Sec. 1231.
- ↵[3]See IRC Sec. 541 and IRC Sec. 542.
- ↵[4]See IRC Sec. 543(a).
- ↵[5]See IRC Sec. 541.
- ↵[6]21 + (79 × 23.8%) = 39.8.
- ↵[7]See http://www.twenty-first.com/newsletter/newsletter_summer2014-3.htm for more on NINGs and DINGs.
- ↵[8]REITs = real estate investment trusts; MLPs = master limited partnerships. See IRC Sec. 199A.