

May 2004

## Taxing Limited Liability Companies: A Loophole Out of Control?

### What is an LLC?

In 1993, the North Carolina General Assembly officially recognized Limited Liability Companies (LLC's) as legitimate business entities. An LLC is a hybrid form of a corporation, recognized as a separate legal entity, a partnership. In the case of LLC's the tax benefits flow-through to its members and it has the statutory flexibility granted to sole proprietorships. However, unlike corporations, an LLC does not owe North Carolina corporate income or franchise tax and unlike corporations and sole proprietorships, members are not personally liable for debt associated with the LLC. For federal tax purposes, an LLC is treated like a partnership unless it affirmatively opts to be treated as a corporation. Mom and Pop operations and professional groups, such as attorneys or accountants, have taken advantage of the LLC label.

### The Making of a Tax Loophole and Its Results

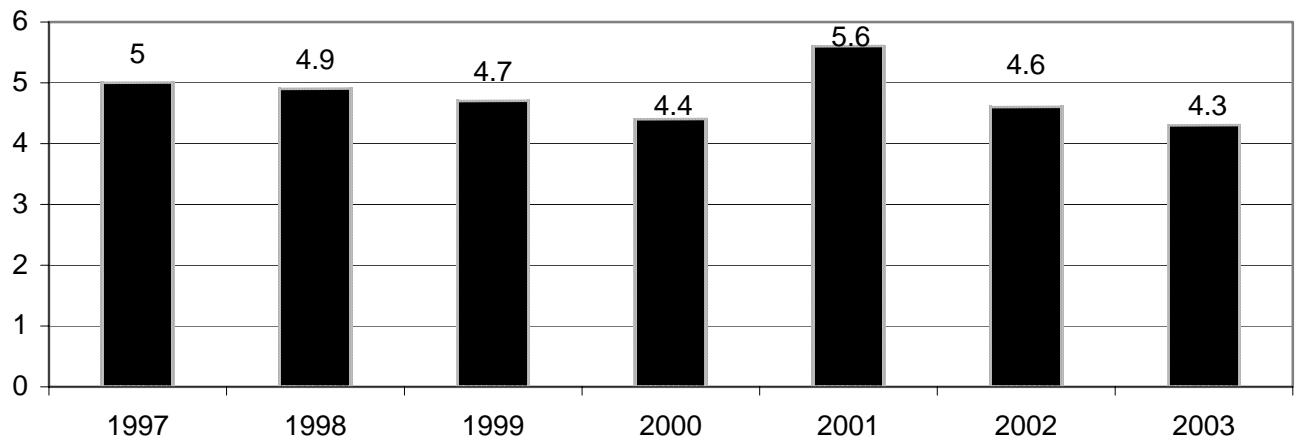
In 1997, the North Carolina legislature authorized the formation of a single-member LLC. Today, many states and the federal government recognize single-member LLC's. This amendment, in part, opened an avenue to tax evasion because it allowed corporations to transfer assets tax-free to an LLC, and thus avoid paying franchise tax.

Not surprisingly, the rise of LLC's has resulted in a number of important consequences to the state – particularly since the 1997 amendment. While the number of LLC's has exploded (from 29,935 in 2000 to 78,166 in 2003), the number of corporations paying income and franchise taxes has declined. In fact, 33,840 fewer corporations registered with the Secretary of State office in 2003 than in the previous year.<sup>i</sup> Tax revenues have declined accordingly. In 2003, the franchise tax produced the lowest percentage of total tax revenue in the last ten years (see Figure 1).<sup>ii</sup>

### Reining in the Loophole – A Cat and Mouse Game

State officials have taken several “swings” at the LLC loophole in recent years in an effort to revive state business tax revenue.

**“Strike One”** – Legislation was passed in 2001 that required corporations to pay the franchise tax if at least 70% of the LLC's assets were indirectly owned by the corporation or affiliated corporations. Partly as a result of the law change, franchise tax revenues as a percentage of total tax revenues grew from 4.4% in 2000 to 5.6% in 2001 (see Figure 1). However, corporations began to set up intermediate entities between the corporation and the LLC to evade paying the franchise tax on assets held by the LLC.

**Figure 1: Franchise Tax Revenues as % of Total Tax Revenues**

**“Strike Two”** – To address *this* loophole, in 2002, the General Assembly authorized legislation to force related members of the corporation to pay their share of franchise taxes on assets held by the LLC. However, the definitional boundaries of a related member did not encapsulate all intermediate entities, and thus, the loophole survives, though to a lesser extent.

**“Batter Up: Strike Three?”** – The Revenue Laws Study Committee of the General Assembly has met between legislative sessions and proposes to once again tackle the LLC tax loophole. The committee is considering a bill that reduces the requirements for paying franchise tax for some entities while broadening the requirements for paying franchise tax for others. Primarily, the committee’s focus is to ensure that only tax evading corporations pay the franchise tax, not all LLC’s.

### Another Option: Go for the Home Run

Policymakers may wish to consider one question before moving forward. The franchise tax is a corporate tax on the right to do business in the state. Why should corporations pay franchise tax, but not LLC’s? Good tax policy is formulated by broadening the tax base in order to reduce the tax rate, not by permitting selective entities to legally avoid paying tax. As a principle of tax fairness, all LLC’s should be required to pay the franchise tax, because after all, they meet the fundamental purpose of the franchise tax by doing business in the state. In addition, the franchise tax, which is \$1.50 per \$1,000 with a \$35 minimum, is quite nominal, compared to the corporate income tax rate of 6.9%. Plus, the legislature can make the decision to end the inequitable treatment in the annual report fee between LLC’s, which pay \$200, and corporations, which pay \$20, by granting a franchise tax credit for the annual report fee. This tax credit would aid small businesses registered as LLC’s while upholding the intent of the franchise tax; thus ensuring that companies that do business in the state pay franchise tax.

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<sup>i</sup> North Carolina Secretary of State.

<sup>ii</sup> North Carolina Office of State Budget and Management.