CHAPTER 3

THE CHOICE-OF-ENTITY CHALLENGE

A. INTRODUCTION

A primary planning challenge for all businesses is to select the best form of business organization. Too many planning lawyers mistakenly assume that this challenge is limited to new ventures. Many mature businesses have a need, albeit often unrecognized, to re-evaluate their business structure from time to time to maximize the benefits of the enterprise for its owners.

Some perceive the "choice of entity" analysis solely as a tax-driven exercise. Although taxes are vitally important, there are many important non-tax factors that can impact the ultimate decision. The rules of the game have changed in recent years. Some factors, once deemed vitally important, no longer impact the final outcome, and there are new issues that now must be factored into the mix. In most situations, the analytical process requires the client and the planner to predict and handicap what's likely to happen down the road. There usually is a need to consider and project earnings, losses, capital expansion needs, debt levels, the possibility of adding new owners, potential exit strategies, the likelihood of a sale, the estate planning needs of the owners, and a variety of other factors. For this reason, the decision-making process is not an exact science that punches out a single, perfect answer for every client. There is a need to weigh and consider a number of factors, while being sensitive to the consequences of the alternative options.

The complexity of the challenge often is enhanced by the need to use multiple entities to accomplish the objectives of the client. Multi-entity planning is discussed in Chapter 16. Multi-entity planning can be used to protect assets from liability exposure, limit or control value growth, scatter wealth among family members, segregate asset-based yields from operation-based risks and yields, shift or defer income, enhance tax benefits from recognized losses, facilitate exit strategy planning, satisfy liquidity needs, and promote a structured discipline that helps ensure that all financial bases are covered. It complicates the process, but the benefits usually far outweigh any burdens of added complexity. From the client's perspective, often the use of multiple entities actually promotes an understanding of the different planning challenges and

objectives because each entity is being used for specific purposes. The entity options are not limited to the business entity forms reviewed in this chapter; they also include a broad menu of different trusts that can be used to promote targeted objectives. More on this topic in Chapter 16.

B. THE CHECK-THE-BOX GAME

A mammoth choice-of-entity burden was eliminated in 1997 when the Internal Revenue Service decided to abandon the difficult corporate resemblance tests used for classifying unincorporated businesses and instead adopted an infinitely easier and more certain "check-the-box" regime. The analytical challenge of selecting the best entity form was not made any easier, but the planner could now know for certain that the choice, once made, would stick. Prior to 1997, often there was a nerve-wracking uncertainty that some detail might trigger a retroactive tax reclassification of the entity by the Service – a disastrous result in nearly every situation. Great care was required to protect against this uncertainty. Often it required that less favorable substantive provisions be included in the governing documents in order to protect the entity's tax classification.

A corporation subject to the provisions of Subchapter C of the Internal Revenue Code is defined as including "associations."[1] There is no "associations" definition. Before 1997, the tough challenge was determining when an unincorporated business, such as a partnership or a limited liability company, was to be deemed an "association" taxable as a corporation under Subchapter C. In rare instances, the taxpayer desired corporate tax treatment, and the Service sought to deny "association" status. The most common example of this was the professional service organization that desired certain corporate tax benefits (such as lower rates, fringe benefits, and enhanced retirement plan options), but was not allowed to incorporate under state law.[2] The conflict ultimately prompted all states to render the issue moot by authorizing the formation of professional service corporations. But the far more common situation was the partnership or limited liability company that planned on the pass-through and other benefits of Subchapter K of the Code (the partnership provisions), only to find the Service arguing for "association" status.[3]

Although the pre-1997 classification regulations lacked an "association" definition, they provided that "an organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust."[4] The regulation listed six corporate characteristics: (1) Two or more associates; (2) an objective to carry on business and share profits; (3) continuity of life; (4) centralization of management; (5)

1. I.R.C. § 7701(a)(3).
2. See, e.g., United States v. Kintner, 216 F.2d 418 (9th Cir. 1954) and Morrissey v. Commissioner, 296 U.S. 344 (1935).
3. See Rev. Proc. 89-12, 1989-1 C.B. 798, Rev. Proc. 91-13, 1991-1 C.B. 477, and Larson v. Commissioner, 66 T.C. 159 (1976).
4. Reg. § 301.7701-2(a)(1), before amended in 1997.

limited liability; and (6) free transferability of interests.[5] For analytical purposes, the first two characteristics – associates and business purpose – were ignored because they were always common to both corporations and partnerships. The focus was on the last four, which were weighted equally. The entity was classified as a corporation if it possessed three of the last four characteristics. For planning purposes, this required a careful structuring of the organization to ensure that at least two of the last four characteristics were flunked. Since limited liability was an overriding objective in many cases, the focus often was on the need to destroy continuity of life, centralized management and free transferability of interests. This is why so many pre-1997 organizational documents contain tough provisions on these issues that never reflected the business objectives of the clients. It's a classic example of the tax tail wagging the dog.

This all changed in 1997. The Service threw in the towel on the difficult corporate characteristics test and opted for a simple "check-the-box" system. The new system provides certainty and, unlike the prior system, contains default provisions that greatly reduce the likelihood of the uninformed being punished. The regulations apply to any business entity that is separate from its owner and that is not a trust.[6] Following is a brief description of the key provisions of the "check-the-box" system:

1. CORPORATIONS. Any entity organized under a federal or state statute that uses the words "incorporated," "corporation," "body corporate," or "body politic" is taxed as a corporation.[7] Thus, all corporations formed under state law are taxed as corporations, either under Subchapter C or Subchapter S of the Internal Revenue Code.

2. UNINCORPORATED ENTITY. An unincorporated entity with two or more owners (i.e., a partnership, limited partnership, or limited liability company) is taxed as a partnership under the provisions of subchapter K unless the entity elects to be treated as a corporation for tax purposes.[8] Any such election may be effective up to 75 days before and 12 months after the election is filed.[9] The election must be signed by all members (including any former members impacted by a retroactive election) or by an officer or member specifically authorized to make the election.[10]

3. SINGLE-OWNER ENTITY. An unincorporated single-owner entity, such as a single-member limited liability company, is treated as a disregarded entity unless a corporate status election is made. Thus, the default is taxation as a sole proprietorship. A single-owner entity will never be subject to the partnership provisions of Subchapter K.[11]

4. PRE-1997 ENTITIES. With one exception, pre-1997 entities retain the

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5. Id.
6. Reg. §§ 301.7701-1(a), 301.7701-2(a).
7. Reg. § 301.7701-2(b)(1).
8. Reg. §§ 301.7701-2(c)(1), 301.7701-3(a), 301.7701-3(b)(1).
9. Reg. § 301.7701-3(c)(1)(iii).
10. Reg. § 301.7701-3(c)(2).
11. Reg. §§ 301.7701-2(a), 301.7701–2(c)(2), 301.7701–3(a), 301.7701–3(b)(1).

same tax status they had under prior regulations unless a contrary election is made. The exception is for single-owner entities that were taxed as partnerships; they are now taxed as sole proprietorships unless a corporate election is made.[12]

5. CHANGES. A classification election, once made, cannot be changed for 60 months unless the Service authorizes a new election or more than 50 percent of the ownership interests are acquired by persons who did not own any interest in the company at the time of the first election.[13] A change in the number of owners does not affect a classification unless the change results in a single-owner unincorporated entity (in which case it will be taxed as a sole proprietorship) or changes a single-owner unincorporated business into a multi-owner entity (in which case the entity will go from being taxed as a sole proprietorship to being taxed as a partnership).[14]

6. ELECTION TAX CONSEQUENCES. If an entity that is taxed as a partnership elects to be taxed as a corporation, it will be deemed to have contributed all its assets and liabilities to the corporation in return for stock and then to have distributed the stock to the partners in liquidation of their partnership interests.[15] If an unincorporated entity that is taxed as a corporation elects to be taxed as a partnership, it will be deemed to have distributed its assets and liabilities to the shareholders, who, in turn, will be deemed to have contributed the assets and liabilities to a newly formed partnership.[16] Similar rules apply to a single-owner entity that elects corporate status or that elects sole proprietorship status after having elected and maintained corporate status for at least 60 months.[17]

C. THE ENTITY CANDIDATES

1. SOLE PROPRIETORSHIP

Sole proprietorships are for soloists who operate simple businesses and do not want the hassles of dealing with a separate entity. Everything is reflected through the individual owner's tax return. Its greatest virtue is its simplicity, but it offers few other benefits. For this reason, it generally is confined to small one-owner businesses that create no significant liability concerns for their owners.

2. C CORPORATION

The C corporation is a regular corporation that pays its own taxes. It is a creature of state law and is recognized as a separate taxable entity. Its earnings and losses are not passed through to its shareholders. It may have different classes of stock and any number of shareholders. It offers its shareholders personal liability protection from the liabilities of the business and a host of tax benefits. It is a popular choice for many toiler organizations, big fish organizations, emerging public companies, and operating companies that need to

12. Reg. § 301.7701-3(b)(3).
13. Reg. § 301.7701-3(c)(1).
14. Reg. § 301.7701-3(f).
15. Reg. § 301.7701-3(g)(1)(i).
16. Reg. § 301.7701-3(g)(1)(ii).
17. Reg. § 301.7701-3(g)(1)(iii) & (iv).

retain modest earnings each year. Any corporation that does not qualify and elect to be taxed as an S corporation will be taxed as a C corporation.

3. S CORPORATION

The S corporation is the preferred choice for many. It is organized as a corporation under state law and offers all corporate limited liability protections. But it is taxed as a pass-through entity under the provisions of Subchapter S of the Internal Revenue Code. These provisions are similar, but not identical, to the partnership provisions of Subchapter K. The popularity of S status is attributable primarily to three factors: (1) accumulated earnings increase the outside stock basis of the shareholders' stock; (2) an S corporation is free of any threat of a double tax on shareholder distributions or sale and liquidation proceeds; and (3) S status can facilitate income shifting and passive income generation. As described below, when compared to a C corporation or partnership, there are a variety of other tax perks and traps as well. The S corporation is particularly attractive to golfers who own part of a corporate entity that makes regular earnings distributions and to a C corporation that wants to convert to a structure that offers pass-through tax benefits.

There are certain limitations and restrictions with an S corporation that can pose serious problems in the planning process. Not every corporation is eligible to elect S status. If a corporation has a shareholder that is a corporation, a partnership, a non-resident alien or an ineligible trust, S status is not available.[18] Banks and insurance companies cannot elect S status.[19] Also, the election cannot be made if the corporation has more than 100 shareholders or has more than one class of stock.[20] For purposes of the 100-shareholder limitation, a husband and wife are counted as one shareholder and all the members of a family (six generations deep) may elect to be treated as one shareholder.[21] The one class of stock requirement is not violated if the corporation has both voting and nonvoting common stock and the only difference is voting rights.[22] Also, there is an important straight debt safe harbor provision that easily can be satisfied to protect against the threat of an S election being jeopardized by a debt obligation being characterized as a second class of stock.[23]

In defining S status eligibility, trusts have received serious Congressional attention in recent years. There has been a constant expansion of the trust eligibility rules. Trusts that are now eligible to qualify as S corporation shareholders include: (1) voting trusts; (2) grantor trusts; (3) testamentary trusts that receive S corporation stock via a will (but only for a two year period following the transfer); (4) testamentary trusts that receive S corporation stock via a former grantor trust (but only for a two year period following the transfer);

18. I.R.C. § 1361(b).
19. I.R.C. § 1361(b)(2).
20. I.R.C. § 1361(b)(1)(A) & (D).
21. I.R.C. § 1361(c)(1).
22. I.R.C. § 1361(c)(4).
23. I.R.C. § 1361(c)(5). To fit within the safe harbor, there must be a written unconditional promise to pay on demand or on a specified date a sum certain and (1) the interest rate and payment dates cannot be contingent on profits, the borrower's discretion, or similar factors; (2) there can be no stock convertibility feature; and (3) the creditor must be an individual, an estate, a trust eligible to be a shareholder, or a person regularly and actively engaged in the business of lending money. For planning purposes, it is an easy fit in most situations.

(5) "qualified subchapter S" trusts (QSSTs), which generally are trusts with only one current income beneficiary who is a U.S. resident or citizen to whom all income is distributed annually and that elect to be treated as the owner of the S corporation stock for tax purposes; and (6) "electing small business" trusts (ESBTs), which are trusts whose beneficiaries are qualifying S corporation shareholders who acquired their interests in the trust by gift or inheritance, not purchase.[24] An ESBT must elect to be treated as an S corporation shareholder, in which case each current beneficiary of the trust is counted as one shareholder for purposes of the maximum 100 shareholder limitation and the S corporation income is taxed to the trust at the highest individual marginal rate under the provisions of the Internal Revenue Code [25]

Electing in and out of S status can present some planning challenges. An election to S status requires the consent of all shareholders.[26] A single dissenter can hold up the show. For this reason, often it is advisable to include in an organizational agreement among all the owners (typically a shareholder agreement) a provision that requires all owners to consent to an S election if a designated number of the owners at any time approve the making of the election. The election, once made, is effective for the current tax year if made during the preceding year or within the first two and one-half months of the current year.[27] If made during the first two and one-half months of the year, all shareholders who have owned stock at any time during the year, even those who no longer own stock at the time of the election, must consent in order for the election to be valid for the current year.[28] Exiting out of S status is easier than electing into it; a revocation is valid if approved by shareholders holding more than half of the outstanding voting and nonvoting shares.[29] For the organization that wants to require something more than a simple majority to trigger such a revocation, the answer is a separate agreement among the shareholders that provides that no shareholder will consent to a revocation absent the approval of a designated supermajority. The revocation may designate a future effective date. Absent such a designation, the election is effective on the first day of the following year, unless it is made on or before the fifteenth day of the third month of the current year, in which case it is retroactively effective for the current year.[30]

4. PARTNERSHIP OPTIONS

Partnership structures often are used for ventures that hold appreciating assets, such as real estate and oil and gas interests. Historically, they have been used as effective family planning tools to shift income to family members, freeze estate values, and facilitate gifting of minority interests at heavily discounted values. Often they are used in conjunction with one or more other business entities. Their use with operating businesses has diminished in recent years as the limited liability company has taken center stage.

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24. I.R.C. §§ 1361(c)(2), 1361(d), 1361(e).
25. I.R.C. §§ 1361 (e)(1)(A), 1361(c)(2)(b)(v).
26. I.R.C. § 1362(a). See generally Reg. § 1.1362-6.
27. I.R.C. § 1362(b)(1).
28. I.R.C. § 1362(b)(2). For potential relief on a late election where there is reasonable cause for the tardiness, see I.R.C. § 1362(b)(5) and Rev. Proc. 2004-48, 2004-2 C.B. 172.
29. I.R.C. § 1362(d)(1).
30. I.R.C. § 1362(d)(1)(C) & (D).

Generally, there are four types of partnerships: general partnerships, limited liability partnerships, limited partnerships, and limited liability limited partnerships. In a general partnership, each partner is personally liable for the debts of the entity and has a say in the management of the business.

A limited liability partnership ("LLP") is a partnership that, pursuant to applicable state law, has filed a statement of qualification (sometimes called an "application") with the state's secretary of state to eliminate the personal liability exposure of the partners. The name of an LLP must end with the words "Registered Limited Liability Partnership," "limited liability partnership," or the abbreviation "R.L.L.P," "RLLP," "L.L.P.," or LLP."

A limited partnership is an entity that has one or more general partners ("GP") and one or more limited partners ("LP") and is formed under a state's limited partnership act. GPs have the authority to manage and conduct the business of the partnership and are personally liable for the debts and obligations of the partnership. LPs typically are investors who have limited or minimal control over daily business decisions and operations of the partnership and have no personal liability for the obligations of the partnership beyond their capital contributions to the partnership.

The limited liability limited partnership ("LLLP") is to a limited partnership what an LLP is to a general partnership. Its role is to eliminate the personal liability exposure that general partners have for the obligations of a limited partnership. It's a relatively new entity form that has been adopted in roughly half the states. An LLLP must elect LLLP status in the limited partnership's filed certificate and use a name that includes the phrase "limited liability limited partnership," "LLLP," or "L.L.L.P." With LLLP status, a general partner is not personally liable for an obligation of the limited partnership incurred while the partnership is an LLLP, whether arising in contract, tort, or otherwise. This limited liability exists even if the partnership agreement contained inconsistent provisions before making the election to become an LLLP.

Substantive details regarding the different types of partnerships and the related planning challenge are discussed in Chapter 5.

Although partnerships file separate returns, they are not taxpaying entities. The profits and losses of the partnership are passed through and taxed to the partners under the provisions of Subchapter K of the Internal Revenue Code.

5. The Limited Liability Company

The limited liability company ("LLC") is a relatively new candidate. All states now have statutes authorizing LLCs, most of which were adopted during the 1980s. Many claim that the LLC is the ultimate entity, arguing that it offers the best advantages of both corporations and partnerships and few of the disadvantages. It's an overstatement, but not by much in some situations. There is no question that the arrival of the LLC has made the choice of entity challenge easier in many cases. Like a corporation, the LLC is an entity organized under state law. And as with a corporation, it offers liability protection to all owners, making it possible for its owners to fully participate in the management of the

business without subjecting themselves to personal exposure for the liabilities of the business. LLCs are classified as either "member-managed" (managed by all members) or "manager-managed" (managed by designated managers).

Although similar to a corporation for state law purposes, a limited liability company is taxed as a partnership for federal income tax purposes unless it elects otherwise. As such, it offers better pass-through benefits than an S corporation and completely avoids all the S corporation eligibility and election hassles. It can have more than 100 owners, and partnerships, corporations, nonresident aliens, and any kind of trust can be included as owners. For these reasons, many wrongfully conclude that the LLC eliminates the need to consider S corporations and partnerships as viable pass-through entity candidates. As we will see, there are still many situations where an S corporation or a partnership will be the entity of choice.

The professional limited liability company ("PLLC") is a state-chartered entity that allows licensed professionals (i.e., doctors and lawyers) to enjoy the benefits of a limited liability company. A PLLC does nothing to reduce a professional's personal liability for his or her own mistakes, but does eliminate a professional's liability for the errors, omissions, negligence, incompetence or malfeasance of other professionals who are not under his or her supervision and control. It also eliminates personal exposure for contract liabilities that the professional has not personally guaranteed. States often require that a PLLC register with the applicable state licensing board before filing its organizational documents with the state.

D. TAX PERKS AND TRAPS

The choice of entity analysis requires a careful assessment of all relevant income tax considerations. Each entity option offers certain tax benefits – perks – and traps that may pose problems down the road. The smart planner will review the perks and traps by carefully pondering their potential relevance under various scenarios that may be applicable to the client's situation. In most cases, it is advisable to review the tax consequences with the client, even those consequences that at first blush are not likely to impact the ultimate choice of entity decision. Such a review usually triggers a detailed dialogue that significantly improves the quality of the analysis and enhances the client's appreciation of the issues. Plus, it can go a long way in protecting against the potential for a "no one told me" complaint when a tax trap, deemed unimportant upfront, kicks in because circumstances change. The planner who quickly jumps to an ultimate conclusion and then becomes a dogmatic advocate for that conclusion usually shortchanges the analytical process and forfeits a valuable opportunity to educate the business owner about the relevant factors and trade-offs and the value of sound judgment and wisdom. It is a mistake to assume that business owners, like so many other clients, want to be spared the details. While a few may wave off discussion of the fine points, most business owners yearn for understanding that promotes confidence in major decisions.

Also, clients should be reminded that taxes are a moving target. The rules

often change. What works today may make no sense tomorrow. Those who watched the eleventh-hour theatrics of the Congress and the White House during the closing days of 2010 and 2012 to prevent threatened tax chaos saw that it is all about politics and inherent uncertainty. We can make predictions and try hard to access the political winds, but uncertainty is a given that makes choice of entity planning more challenging and exciting.

Our starting point is a brief review of some of the primary tax perks and traps of an entity being taxed as a C corporation, a partnership, or an S corporation. This foundational review is followed by a discussion of the 16 factors that should be considered in the choice of entity analysis.

1. C CORPORATION PERKS

a. Favorable Low-End Rates. The first $50,000 of a C corporation's taxable income each year is subject to a favorable 15 percent tax rate. The rate jumps to 25 percent on the next $25,000 of taxable income. Thus, the overall rate on the first $75,000 of taxable income is an attractive 18.33 percent, far less than the personal marginal rate applicable to most successful business owners. Beyond $75,000, the rate advantage disappears as the marginal rate jumps to 34 percent. Plus, if the corporation's income exceeds $100,000, the rate "bubbles" an additional five percent on taxable income over $100,000 until any rate savings on the first $75,000 is lost. The impact of this five percent "bubble" is that any C corporation with a taxable income of $335,000 or more will pay a rate of at least 34 percent from dollar one. Earnings of a C corporation in excess of $10 million are taxed at 35 percent, and a three percent "bubble" applies to C corporation earnings in excess of $15 million until the 35 percent rate has been applicable to all income.[31] And remember, there are no rate breaks for a professional service organization that is taxed as a C corporation; it is subject to a flat 35 percent rate from dollar one.[32]

b. Shareholder Employee Benefits. A shareholder of a C corporation who is also an employee can participate in all employee benefit plans and receive the associated tax benefits. Such plans typically include group term life insurance,[33] medical and dental reimbursement plans,[34] section 125 cafeteria plans, dependent care assistance programs,[35] and qualified transportation reimbursement plans.[36] Partners and most S corporation shareholder/employees (those who own more than 2 percent of the outstanding stock) are not eligible for the tax benefits associated with such plans.[37] This factor alone makes the C corporation an attractive option for many toiler and professional service organizations.

c. Tax-Free Reorganization Potential. A C corporation may participate

31. I.R.C. § 11(b)(1).
32. I.R.C. § 11(b)(2).
33. I.R.C. § 79.
34. I.R.C. § 106.
35. I.R.C. § 129.
36. I.R.C. § 132(a)(5).
37. The benefits are available only to "employees," a status that partners can never obtain. Although S corporation shareholders may clearly qualify as "employees," Section 1372 provides that, for fringe benefit purposes, the S corporation will be treated as a partnership and any shareholder owning more than 2 percent of the stock will be treated as a partner.

in tax-free reorganizations with other corporate entities. It's possible for corporations to combine through mergers, stock-for-stock transactions, and assets-for-stock transactions on terms that eliminate all corporate and shareholder-level taxes.[38] This perk often is the key to the ultimate payday for those private business owners who cash in by "selling" their business to a public corporation. Cast as a reorganization, the transaction allows the acquiring entity to fund the acquisition with its own stock (little or no cash required) and enables the selling owners to walk with highly liquid, publicly traded securities and no tax bills until the securities are sold.

d. Reduced Dividend Rates. The economic stimulus package of 2003 resulted in a compromise that reduced the maximum tax rate on "qualifying corporate dividends" paid to non-corporate shareholders to 15 percent (5 percent for low-income shareholders otherwise subject to maximum marginal rates of 15 percent or less).[1] These reduced rates applied to all dividends received from January 1, 2003 to December 31, 2012. The American Taxpayer Relief Act of 2012 (the "Fiscal Cliff" legislation signed into law during the final days of 2012)[2] increased this low dividend rate to 20 percent starting in 2013 for couples with taxable incomes in excess of $450,000 and individuals with taxable incomes in excess of $400,000. Plus, in 2013, the 3.8 percent Medicare tax kicked in on interest, dividends, capital gains, and other "net investment income" to the extent that this income, when added to the taxpayer's other modified adjusted gross income, exceeds $200,000 in the case of unmarried individuals, $250,000 in the case of married individuals filing jointly, and $125,000 in the case of married individuals filing separately. The net result is that a couple with an adjusted income of less than $250,000 or a single person with an adjusted gross income of less than $200,000 will continue to pay the pre-2013 dividend rates (a maximum of 15 percent).[3] Couples or individuals with higher incomes will pay a combined income and Medicare dividend rate of either 18.8 percent or 23.8 percent, depending on whether the new $450,000 or $400,000 thresholds are exceeded.

e. Tax Year Flexibility. Unlike a partnership and an S corporation, a C corporation may adopt any fiscal year to ease its accounting and administrative burdens and to maximize tax deferral planning.[42] No special showing is required, and there are no special deferral limitations. The only exception is for personal service organizations that are taxed as C corporations.[43]

f. Rollover Deferral. Section 1045 permits non-corporate shareholders to defer the recognition of gain on the disposition of qualified small business stock held for more than six months by investing the proceeds into the stock of another qualified small business within 60 days of the sale.[44] This perk can excite the

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38. I.R.C. §§ 368, 354, 361. See Chapter 7.
39. I.R.C. § 1(h)11(b).
40. Section 102 of the American Taxpayer Relief Act of 2012.
41. I.R.C. § 1411.
42. See generally I.R.C. § 441.
43. I.R.C. § 441(i).
44. Section 1045 incorporates the Section 1202(c) definition of "small business stock," which generally requires that the stock have been issued to the original issuee after the effective date of the Revenue Reconciliation Act of 1993 by a C corporation that actively conducts a trade or business and that has gross assets of $50 million or less at the time the stock is issued. I.R.C. § 1202(c), (d) & (e).

entrepreneur who is in the business of moving money from one deal to the next or the shareholder who has a falling out with his or her co-shareholders and wants to exit for another opportunity.

g. Section 1202 Gain Exclusion. Section 1202 allows a non-corporate shareholder to exclude 50 percent of the gain recognized on the sale or exchange of qualifying small business stock held for more than five years.[45] To qualify, the stock must have been issued after August 10, 1993, the shareholder must be the original issuee of the stock, and the company must be a C corporation whose aggregate gross assets did not exceed $50 million at the time the stock was issued. The maximum amount of eligible section 1202 gain with respect to the stock of a single corporation is the greater of $10 million or 10 times the taxpayer's basis in the stock of the issuing corporation. The perk has always sounded better than it really is because the taxable portion of the gain is subject to a high 28 percent capital gains rate and the tax break can trigger or enhance an alternative minimum tax. So often section 1202 has been ignored in the planning process. The Small Business Jobs Act of 2010 gave this perk a huge shot in the arm by increasing the exclusion to 100 percent and eliminating the alternative minimum tax risk for stock bought between September 27, 2010 and January 1, 2011. Congress then extended these benefits for stock bought during 2011 under section 760 of the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act passed during the final days of 2010 and then further extended the benefits through 2013 under section 324 of The American Taxpayer Relief Act of 2012. For many companies formed during 2013, this mammoth change in section 1202 may be a big factor in any choice of entity analysis; it eliminates all the negatives of old section 1202 and provides a potential tax free exit for those shareholders who hold their stock for five years. This factor, coupled with the different pressures on C corporation rates and individual rates (discussed below), could make the C corporation the darling choice for many in 2013. And if by chance Congress down the road chooses to make this temporary 1202 perk a permanent fix, section 1202 will become an important threshold consideration in all choice of entity planning.

h. Ordinary Loss Treatment. Section 1244 grants individuals and partnerships ordinary loss treatment (as opposed to the less favorable capital loss treatment) on losses recognized on the sale or exchange of common or preferred stock of a "small business corporation" (generally defined as a corporation whose aggregate contributions to capital and paid-in surplus do not exceed $1 million). In order to qualify, the shareholder must be the original issuee of the stock and the stock must have been issued for money or property (services do not count).[46] There is no longer a requirement that the corporation adopt a formal 1244 plan, although many legal advisors routinely include a directors' resolution in the organizational documents that makes specific reference to 1244 in authorizing the issuance of stock. Again, this perk often sounds better than it is. The problem is that the ordinary loss in any single year (usually the year of sale) is limited to $50,000 ($100,000 for married couples).[47] This serious dollar

45. See I.R.C. §§ 1202, 57(a)(7), 1(h)(3), 1(h)(7).
46. I.R.C. § 1244.
47. I.R.C. § 1244(b).

limitation, together with the fact that bailout loss treatment is not an exciting topic during the start-up planning of any business, usually results in this perk having no impact on the choice of entity analysis.

i. Consolidated Return Option. Often it is advantageous to use multiple corporations to conduct the operations of an expanding business. Multiple entities can reduce liability exposures, regulatory hassles, and employee challenges as the operations diversify and expand into multiple states and foreign countries. While there may be compelling business reasons for the use of multiple entities, business owners often prefer that all the entities be treated as a single entity for tax purposes in order to simplify tax compliance, eliminate tax issues on transactions between the entities, and facilitate the netting of profits and losses for tax purposes. All this is possible with multiple C corporations under the consolidated return provisions of the Code.[48] The key, of course, is that the entities constitute an "affiliated group," which generally means that their common ownership must extend to 80 percent of the total voting power and 80 percent of the total stock value of each entity included in the group.[49]

j. Long-Term Capital Gain on Stock Sale. The stock of a C corporation is a capital asset that qualifies for long-term capital gain treatment if sold after being held for more than a year.[50] Unlike an interest in a partnership-taxed entity, the disposition of which will generally trigger ordinary income treatment to the extent that the entity would recognize ordinary income on the disposition of its assets, the character of the gain on the disposition of C corporation stock is not impacted by the asset mix of the entity. Today, this perk shines because the maximum capital gains rate (15 percent to 23.8 percent, depending on income level)[451] is substantially less than the maximum 43.4 percent rate on ordinary income. The difference is significant in some cases and can provide a compelling incentive. The problem for planning purposes is that it is usually difficult, if not impossible, to accurately predict when the stock may be sold and even more difficult to predict what the state of the long-term capital gains break will be at that time. Too often, planners and clients mistakenly assume that the status quo will remain the status quo. History, even very recent history, confirms the fallacy of this assumption with respect to the capital gains tax. Just over the past two decades, we have seen the gap between ordinary and capital gains rates completely eliminated, narrowed to levels that were not compelling for planning purposes, and (as now) widened to levels that get everyone excited. The report

48. See generally I.R.C. §§ 1501-1504.
49. I.R.C. § 1504(a).
50. I.R.C. §§ 1221(a), 1222(3).
51. I.R.C. § 1(h). The American Taxpayer Relief Act of 2012 (the “fiscal cliff” legislation signed into law during the final days of 2012)4 increased the capital gains rate to 20 percent starting in 2013 for couples with taxable incomes in excess of $450,000 and individuals with taxable incomes in excess of $400,000. Plus, in 2013, the 3.8 percent Medicare tax kicked in on interest, dividends, capital gains, and other "net investment income" to the extent that this income, when added to the taxpayer's other modified adjusted gross income, exceeds $200,000 in the case of unmarried individuals, $250,000 in the case of married individuals filing jointly, and $125,000 in the case of married individuals filing separately. The net result is that a couple with an adjusted income of less than $250,000 or a single person with an adjusted gross income of less than $200,000 will continue to pay the pre-2013 capital gains rates (a maximum of 15 percent).4 Couples or individuals with higher incomes will pay a combined income and Medicare dividend rate of either 18.8 percent or 23.8 percent, depending on whether the new $450,000 or $400,000 thresholds are exceeded.

entitled "The Moment of Truth" issued by The National Commission on Fiscal Responsibility and Reform in December 2010 once again proposed a revised tax structure that would tax capital gains the same as ordinary income. The capital gains tax has always been a political football, and we have no reason to believe that this reality will ever change. Many powerful forces view it as nothing more than a sop to big business and the rich, while others passionately label it an essential element of a strong and vibrant economy.

k. Corporate Dividend Exclusion. Section 243 provides an attractive income deduction for dividends paid by one C corporation to another C corporation. The purpose of the deduction is to eliminate the potential of a triple tax on corporate earnings – one at the operating C corporation level, a second at the corporate shareholder level, and a third at the individual shareholder level. The deduction is at least 70 percent, and increases to 80 percent for corporate shareholders who own 20 percent of the operating entity's stock and 100 percent for members of an affiliated group.[52] There are special anti-abuse provisions designed to eliminate or water down the benefit of the deduction if the corporate-owned stock has been held for a very short period[53] or has been debt-financed,[54] or if extraordinary dividends are paid on stock held for less than two years.[55] Plus, use of the deduction to reduce the overall tax hit in a bootstrap corporate acquisition structured to include a corporate dividend bailout that has no bona fide business purpose is likely to trigger an attack from the Service.[56] This perk affects the choice of entity analysis only in those situations where all or a significant portion of the business enterprise is going to be funded and owned by one or more C corporations.

l. True Separateness. Often one of the most compelling benefits of a C corporation is that for tax purposes it truly is separate from its shareholders. Absent the payment of a dividend or the sale of stock (both uncommon events for closely held corporations), nothing the corporation does will affect the personal income tax returns of its shareholders. The absence of any pass-through impacts to the shareholders' personal returns is attractive to many. Some are fearful of anything that complicates their personal return or increases the risk that their personal return may be affected by a tax audit of an entity in which they have invested. This perk is often a compelling factor for many emerging public companies and those golfers who are looking for big capital gains on a relatively quick exit.

2. C CORP TRAPS

a. Double Tax Structure. The biggest negative of the C corporation is the double tax structure: a corporate level tax and a shareholder level tax. It surfaces

52. I.R.C. § 243(a) & (c).
53. I.R.C. § 246(c).
54. I.R.C. § 246A.
55. I.R.C. § 1059. Section 1059 requires that a corporate shareholder receiving an "extraordinary dividend" (generally defined as a dividend exceeding 5 percent of the basis of preferred stock and 10 percent of the basis of other stock) reduce its basis in the underlying stock by the deductible portion of the dividend if the corporation held the stock for two years or less before the dividend announcement date.
56. See, e.g., TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980) and Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970).

whenever a dividend is paid or is deemed to have been paid, although the lower rates on dividends reduce the pain. Still, even with the lower dividend rates, 43.9 percent to 49.7 percent [57] of every dollar earned and distributed by a C corporation subject to a marginal 34 percent rate will be consumed in corporate and shareholder federal income taxes. Added to these numbers are the state income tax hits, which also are pumped up by the double tax structure. But the grief of the double tax structure is not limited to dividends; it kicks in whenever the assets of the business are sold and the proceeds distributed. The bottom line impact is that when it comes time to bail out of a C corporation, the selling shareholders often face an ugly dilemma: sell assets and pay corporate and personal income taxes that collectively may equal 43 to 50 percent of the gain recognized (depending on the capital gains rate at the time of sale), or sell stock and take a hit on the price because the buyer gets no basis step-up on the assets of the business. It's all a result of the inherent double tax structure of a C corporation.

b. Trapped Losses. Losses sustained by a C corporation are trapped inside the corporation. They may be carried backward or forward, but they will never be passed through to the shareholders.

c. Locked-In Basis. The basis of a shareholder's stock in a C corporation is not affected by the entity's income or losses. This can have a profound impact in a situation where a profitable C corporation has accumulated substantial earnings. Assume, for example, that XYZ Inc. has always had a single shareholder, Linda, who purchased her stock for $100,000, and that the company has accumulated $2 million of earnings over the last ten years. Linda's stock basis at the end of year ten is still $100,000. In contrast, if XYZ Inc. had been taxed as an S corporation or a partnership from day one, Linda's basis at the end of year ten would have grown to $2.1 million. [58] On a sale, the difference would be a capital gains hit on $2 million. This basis step-up potential may not be viewed as a big deal for the shareholder who plans on holding his or her stock until death and is confident that Section 1014 (the basis step-up rule at death) will still be around. But for all other business owners who anticipate substantial earnings accumulations, it can be a compelling factor in the choice of entity analysis.

d. No Entity Capital Gains Break. There is no rate break for any capital gain recognized by a C corporation. All income is subject to normal corporate rates. [59]

e. Redemption Traps. In contrast to the partnership provisions of the Code, Subchapter C is structured to maximize the recognition of income at the entity and owner levels whenever cash or property passes from the entity to the owners. A good example is a C corporation's redemption of a shareholder's stock. The double tax structure surfaces in a couple of ways. First, unless the

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57. This number is obtained by first reducing the dollar by the 34 percent corporate tax rate and then applying the 15 percent dividend rate to the remaining 66 percent. The sum of the two taxes is 43.9 percent. The result increases to 49.7 percent if the 23.8 percent dividend rate is applicable.

58. I.R.C. § 1367(a). Partners experience the same basis adjustment for accumulated earnings under I.R.C. § 705(a).

59. I.R.C. § 1201(a).

transaction is structured to fit within one of the exceptions of Section 302(b), the full amount distributed in redemption of the stock is taxed as a dividend to the shareholder to the extent of the corporation's earnings and profits. [60] So long as the maximum dividend and capital gains rates remain the same, this 302 issue is affected only by the stock basis. If a 302 exception applies, the stock basis is recovered before any income is recognized. If no exception fits, the full amount distributed is taxable. Second, if the corporation distributes property in redemption of the stock, any built-in gain on the distributed property also is taxed to the corporation. Built-in losses are not recognized. [61] So if appreciated property is distributed to a shareholder in redemption of stock and a Section 302 exception does not apply, the corporation will pay taxes on the built-in gain at ordinary corporate rates and the full fair market value of the distributed property will be taxed to the shareholder as a dividend.

f. Disguised Dividend Trap. Any payment from a C corporation to a shareholder may be scrutinized by the Service to see if the payment constitutes a disguised dividend. What's at stake is a deduction at the corporate level. Common examples of disguised dividends include excessive compensation payments to shareholder/employees or family members,[62] personal shareholder expenses that are paid and deducted as business expenses by the corporation, [63] interest payments on excessive shareholder debt that is reclassified as equity, [64] excess rental payments on shareholder property rented or leased to the corporation, [65] personal use of corporate assets, and bargain sales of corporate property to a shareholder.[66] The lower rates on corporate dividends soften the shareholder tax hit on any such payments being reclassified as a dividend, but the combined impact of the loss of the corporate deduction usually produces a significant net tax cost.

g. The Accumulated Earnings Trap. The C corporation double-tax structure produces more revenue for the government when larger dividends are paid and less income is accumulated in the corporation. For this reason, Section 531 imposes a penalty tax on excess income accumulations in a C corporation. Some mistakenly assume that the 531 penalty only applied in years past when individual marginal rates exceeded corporate rates. Not so. Although the penalty may be applied whenever there are excessive income accumulations, there is some good news. First, the current penalty rate, which is applied at the corporate level to the corporation's "accumulated taxable income" (taxable income for the current year, adjusted for certain items including dividends paid and deemed

60. The four exceptions of Section 302(b) that will qualify for exchange treatment are (1) redemptions that are not essentially equivalent to a dividend; (2) substantially disproportionate redemptions; (3) complete redemptions of a shareholder's stock; and (4) partial liquidations. The attribution rules of Section 318 are applicable, although in select situations the family attribution rules do not apply to complete redemptions of a shareholder's stock.

61. I.R.C. § 311(b).

62. See, e.g., Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999); Elliotts Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983); and Charles McCandless Tire Service v. United States, 422 F.2d 1336 (Ct. Cl. 1970).

63. See, e.g., Hood v. Commissioner, 115 T.C. 172 (2000).

64. See the discussion accompany footnotes 99-111 in Chapter 4. Also, see generally Hariton, "Essay: Distinguishing Between Equity and Debt in the New Financial Environment," 49 Tax L. Rev. 449 (1994).

65. See, e.g., International Artists, Ltd. v. Commissioner, 55 T.C. 94 (1970).

66. See, e.g., Honigman v. Commissioner, 466 F.2d 69 (6th Cir. 1972).

paid) is 20 percent.[67] Second, the tax doesn't kick in until the aggregate accumulated earnings exceed $250,000 ($150,000 in the case of certain professional service organizations).[68] And finally, the penalty tax can be avoided completely if the corporation can demonstrate that it accumulated the earnings in order to meet the reasonable business needs of the corporation.[69] Most companies need to retain earnings to finance operations and growth, and the best evidence is on the asset side of the balance sheet – there is little or no excess cash. If earnings above the statutory thresholds ($250,000 or $150,000, as the case may be) are being accumulated, what is required is an annual resolution of the corporate directors, ideally supported by a numbers analysis, that spells out why the income accumulations are necessary to meet the reasonable business needs of the company. There is a great deal of latitude in defining the reasonable business needs. For this reason, the accumulated earnings penalty usually is a trap for the uninformed who never saw it coming. Apart from being another nuisance that has to be watched as good things start to happen with a C corporation, it seldom is a factor in the choice of entity analysis.

h. Personal Holding Company Trap. The personal holding company trap is a close cousin to the accumulated earnings trap. Its purpose is to prohibit C corporations from accumulating excess amounts of investment income, compensation payments (the incorporated movie star or other talent), and shareholder rental income (the corporate yacht scenario). Unlike the accumulated earnings tax, the personal holding company penalty cannot be avoided by documenting reasonable business needs. Generally, the penalty is applicable if the company is closely held (defined as five or fewer individuals owning more than 50 percent of the outstanding stock value, with broad attribution rules[70]) and at least 60 percent of the corporation's "adjusted ordinary gross income" is "personal holding company income."[71] Personal holding company income is defined to include dividends, interest, annuities, most royalties, most rents, and personal service income.[72] The penalty rate of 20 percent is applied at the corporate level to the undistributed personal holding company income.[73] If the penalty becomes a threat, remedial actions include increasing compensation payments to shareholder/employees and paying dividends. Like the accumulated earnings penalty, it's just a nuisance that has to be monitored in select situations.

i. The AMT Trap. Large C corporations are subject to an alternative minimum tax. There are blanket exceptions for a company's first year of operation, for any company with average annual gross receipts of not more than $5 million during its first three years, and for any company with average annual

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67. I.R.C. § 531.
68. I.R.C. § 535(c).
69. I.R.C. § 532 provides that the tax is applicable to any corporation that is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders..." Section 533(a) then provides that, unless the corporation can prove by a preponderance of evidence to the contrary, any accumulation of earnings and profits "beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax..."
70. I.R.C. § 542(a)(2).
71. I.R.C. § 542(a)(1).
72. I.R.C. § 543.
73. I.R.C. § 541.

gross receipts of not more than $7.5 million during any three-year period thereafter.[74] The tax applies only to the extent it exceeds the corporation's regular income tax liability. The tax is calculated by applying a 20 percent rate to the excess of the corporation's alternative minimum taxable income (AMTI) over a $40,000 exemption.[75] AMTI is defined to include the corporation's taxable income, increased by a host of tax preference items and adjustments designed to reduce certain timing benefits (i.e., accelerated cost recovery deductions) of the regular corporate tax. [76] The greatest impact in recent years has been the expansion of AMTI to include an amount which, roughly speaking, is designed to equal 75 percent of the excess of the corporation's true book earnings over its taxable income.[77] This expansion was Congress' answer to those public companies that, through the maintenance of separate books, would report big earnings to their investors and miniscule tax liabilities. But as we will see in later chapters, the sweep of the expansion is broad enough to trigger problems for closely held C corporations in dealing with corporate-owned life insurance policies and other select planning issues.

j. The Controlled Group Trap. This trap is the flip side of the consolidated group perk described above. It is aimed primarily at the business owner who would like to use multiple C corporations to maximize low C corporation tax rates, the $250,000 accumulated earnings trap threshold, or the $40,000 alternative minimum tax exemption. For example, absent this trap, $500,000 of annual corporate earnings could be spread among ten C corporations ($50,000 each) at a 15 percent tax rate. If multiple corporations are deemed to be part of a controlled group, they are treated as a single entity for purposes of these tax perks, and the multiple-entity benefits are gone.[78]

There are three types of controlled groups. The first, known as a parent-subsidiary controlled group, exists when a chain of corporations is connected by common stock ownership such that at least 80 percent of the total voting power or total stock value of each corporation (other than the parent corporation) is owned by other corporations in the group, and a parent corporation owns at least 80 percent of the total voting power or total stock value of at least one of the other corporations.[79] For example, if corporation A (the parent) owns 80 percent of the stock of B and C, and B and C collectively own 80 percent of the stock of D, then A, B, C and D would constitute a parent-subsidiary controlled group.

The second type of controlled group is the brother-sister controlled group. Its reach was significantly expanded by the American Jobs Creation Act of 2004.[80] It exists when five or fewer individuals, estates or trusts own (i) more than 50 percent of the total combined voting power of all voting stock of two or more corporations, *or* (ii) more than 50 percent of the value of all classes of stock

74.[74] I.R.C. § 55(e).
75. I.R.C. §§ 55(b)(1)(B), 55(d)(2).
76. See generally I.R.C. § 56.
77. I.R.C. § 56(g).
78. I.R.C. § 1561.
79. I.R.C. § 1563(a)(1); Reg. § 1.1563-1(a)(2).
80. Prior to the American Jobs Creation Act of 2004, two or more corporations had to satisfy both an 80 percent test and a 50 percent minimum common ownership test to be treated as a brother-sister controlled group.

of each corporation, taking into account only each shareholder's identical stock ownership in each corporation.[81] For example, assume that A corporation and B corporation each have 1,000 shares of voting common stock outstanding. Assume further that Jim owns 80 percent of the voting common stock of A corporation and 20 percent of the voting stock of B corporation, and that Linda owns 20 percent of the voting stock of A corporation and 80 percent of the voting stock of B corporation. Under such facts, A and B would not be considered a brother-sister controlled group because the value of each of Jim and Linda's identical common ownership in the two corporations is only 20 percent. Thus, their combined identical stock ownership is only 40 percent. Under these facts, A and B would not satisfy the requisite 50 percent test.

The third type of controlled group, known as the combined controlled group, exists when three or more corporations are each part of a parent-subsidiary controlled group or a brother-sister controlled group, and at least one of the corporations is both a common parent of the parent-subsidiary controlled group and a member of the brother-sister controlled group.[82] For example, assume that Jim and Linda each own 50 percent of the stock of A and B corporation, that A owns 80 percent of the stock of C corporation, and that B owns 80 percent of the stock of D corporation. Under these facts, A, B, C and D would be considered a controlled group. Special attribution and other rules apply in unique situations.[83] The existence of this trap requires, as part of the choice of entity analysis, a disclosure of other C corporation interests owned by those who are going to own an interest in the new entity that is considering C corporation status.

k. The 482 Trap. Section 482 is that ominous provision that gives the Internal Revenue Service authority to "distribute, apportion, or allocate gross income, deductions, credits or allowances between and among" commonly controlled business interests "whenever necessary to prevent evasion of taxes or clearly to reflect the income" of any such businesses. Although 482, by its terms, applies to any type of business organization, its application to related C corporations who do business with each other can trigger brutal double tax consequences. The following short Revenue Ruling says it all.

Rev. Rul. 69-630, 1969-2 C.B. 112

Advice has been requested as to the treatment of a 'bargain sale' between two corporate entities controlled by the same shareholder(s).

A, an individual, owns all of the stock of X corporation and all of the stock of Y corporation. In 1967, A caused X to sell certain of its property to Y for less than an arm's length price. It has been determined that such sale had as one of its principal purposes the avoidance of Federal income tax and resulted in a significant understatement of X's taxable income.

Section 482 of the Internal Revenue Code of 1954 provides authority to distribute, apportion, or allocate gross income, deductions, and credits among

81. I.R.C. § 1563(a)(2).
82. I.R.C. § 1563(a)(3).
83. I.R.C. § 1563(d) & (e).

related organizations, trades, or businesses if it is necessary in order to clearly reflect the income of such entities or to prevent the evasion of taxes. Section 482 of the Code applies to bargain sale transactions between brother-sister corporations that result in significant shifting of income. Where an allocation is made under section 482 of the Code as a result of a bargain sale between brother-sister corporations, the amount of the allocation will be treated as a distribution to the controlling shareholder(s) with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder(s) to the other entity involved in the transaction giving rise to the section 482 allocation.

Accordingly, in the instant case, the income of X for 1967 will be increased under section 482 of the Code to reflect the arm's length price of the property sold to Y. The basis of the property in the hands of Y will also be increased to reflect the arm's length price. See section 1.482-1(d) of the Income Tax Regulations. Furthermore, the amount of such increase will be treated as a distribution to A, the controlling shareholder, with respect to his stock of X and as a capital contribution by A to Y.

3. PARTNERSHIP PERKS

a. Income Pass Through. The income of a partnership is passed through and taxed to its partners. The entity itself reports the income, but pays no taxes. The advantage, of course, is that there is no threat of a double tax. There is only one tax at the owner level. Unlike a C corporation, a distribution of cash or other assets generally does not trigger a tax at either the partnership or owner level. Since there is no double-tax structure, all the C corporation traps tied to that menacing structure, including the redemption trap, the disguised dividend trap, the accumulated earnings tax trap, the personal holding company trap, and the consolidated group trap have no application to entities taxed as partnerships. Even the 482 trap is less threatening because there is no threat of a double tax flowing from any allocation the IRS might make.

b. Loss Pass Through. The losses of a partnership also pass through to its owners. Unlike a C corporation, the losses are not trapped inside the entity. Does this mean the partners can use the losses to reduce the tax bite on their other income? Maybe. There are three hurdles that first must be overcome, and they can be very difficult in many situations. The first and easiest hurdle is the basis hurdle – the losses passed through to a partner cannot exceed that partner's basis in his or her partnership interest.[84] This hurdle seldom presents a problem in a partnership, because each partner's share of the partnership's liabilities, even its nonrecourse liabilities, is treated as a contribution of money by the partner for basis purposes.[85] The second hurdle, known as the at-risk hurdle, generally limits a partner's losses to only the amount that the partner actually has at risk.[86] A partner's at-risk amount typically includes property contributed to the partnership by the partner and the partner's share of the partnership's recourse liabilities

84. I.R.C. § 704(d).
85. I.R.C. § 752(a).
86. I.R.C. § 465(a).

(those liabilities that create personal exposure for the partners).[87] Nonrecourse liabilities (those liabilities for which no partner has any personal exposure) generally do not count for purposes of the at-risk hurdle, but there is an important exception for qualified nonrecourse financing that makes it easy for many real estate transactions to satisfy the at-risk limitations.[88] The third hurdle (and usually the toughest) is the passive loss rule,[89] a 1980s creation that is designed to prevent a taxpayer from using losses from a passive business venture to offset active business income or portfolio income (i.e., interest, dividends, gains from stocks and bonds, etc.). It was created to stop doctors and others from using losses from real estate and other tax shelters to reduce or eliminate the tax on their professional and business incomes. Losses passed through from a passive venture can only be offset against passive income from another source. If there is not sufficient passive income to cover the passive losses, the excess passive losses are carried forward until sufficient passive income is generated or the partner disposes of his or her interest in the passive activity that produced the unused losses.[90] Whether a particular business activity is deemed passive or active with respect to a particular partner is based on the partner's level of participation in the activity – that is, whether the partner is a "material participant" in the activity. A limited partner is presumed not to be a material participant and, therefore, all losses allocated to a limited partner generally are deemed passive.[91] To meet the "material participation" standard and avoid the hurdle, a partner must show "regular, continuous, and substantial" involvement in the activity.[92] Given these three hurdles, in a choice of entity planning analysis, it is never safe to assume that use of a partnership-taxed entity will convert start-up losses into slam-dunk tax benefits for the owners.

c. Passive Income Potential. Generally, taxable income is classified as portfolio income (dividends, interest, royalties, gains from stocks and bonds, and assets that produce such income), active income (income from activities in which the taxpayer materially participates), or passive income (income from passive business ventures). Passive income is the only type of income that can be sheltered by either an active loss or a passive loss. So the passive loss rule, by limiting the use of passive losses, exalts the value of passive income. An activity that generates passive income can breathe tax life into passive losses from other

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87. I.R.C. § 465(b).

88. I.R.C. § 465(b)(6). To qualify as "qualified nonrecourse financing," the debt must be incurred in connection with the activity of holding real estate, must not impose any personal liability on any person, must not be convertible debt, and must have been obtained from a "qualified person" (generally defined to include a person who is in the business of lending money, who is not related to the borrower, and who is not the seller or related to the seller).

89. See generally I.R.C. § 469.

90. I.R.C. §§ 469(a), 469(b), 469(d)(1).

91. I.R.C. § 469(h)(2).

92. I.R.C. § 469(h)(1). Under the temporary regulations, a taxpayer meets the material participation standard for a year by (1) participating in the activity for more than 500 hours in the year; (2) being the sole participant in the activity; (3) participating more than 100 hours in the activity and not less than any other person; (4) participating more than 100 hours in the activity and participating in the aggregate more than 500 hours in significant participation activities; (5) having been a material participant in the activity for any five of the last ten years; (6) having materially participated in the activity in any three previous years if the activity is a personal service activity; or (7) proving regular, continuous and substantial participation based on all facts and circumstances. Temp. Reg. § 1.469-5T(a)(1)-(7).

activities. A C corporation has no capacity to produce passive income; it pays dividends or interest (both classified as portfolio income) or compensation income (active income). In contrast, a profitable entity taxed as a partnership can pass through valued passive income to those partners who are not material participants.

d. Outside Basis Adjustment. A partner's basis in his or her partnership interest is adjusted upward by capital contributions and income allocations and downward by distributions and loss allocations.[93] Unlike stock in a C corporation, there is no locked-in basis. This can be a valuable perk to the owner of a thriving business that is retaining income to finance growth and expansion. In the case of Linda above (C Corporation Trap c.), the $2 million of retained earnings in an entity taxed as a partnership would have increased the outside basis in her partnership interest from $100,000 to $2.1 million.

e. Special Allocations Perk. An entity taxed as a partnership has the flexibility to structure special allocations of income and loss items among its various partners. For example, one partner may be allocated 60 percent of all income and 30 percent of all losses. Although a C corporation has some limited capacity to create allocation differences among owners through the use of different classes of stock and debt instruments, that capacity pales in comparison to the flexibility available to a partnership. A partnership allocation will be respected for tax purposes only if it has "substantial economic effect," three words that make section 704(b) and its regulations one of the most complex subjects in the world of tax.[94] Generally speaking (and I do mean generally), an allocation that does not produce a deficit capital account for a partner will have "economic effect" if capital accounts are maintained for all partners and, upon liquidation of the partnership, liquidating distributions are made in accordance with positive capital account balances.[95] In order for an allocation that produces a deficit capital account balance to have "economic effect," the partner also must be unconditionally obligated to restore the deficit (i.e., pay cash to cover the shortfall) upon liquidation of the partnership,[96] or the partnership must have sufficient nonrecourse debt to assure that the partner's share of any minimum gain recognized on the discharge of the debt will eliminate the deficit.[97] An "economic effect," if present, will not be deemed "substantial" if it produces an after-tax benefit for one or more partners with no diminished after-tax consequences to other partners.[98] The most common examples of economic effects that are not deemed "substantial" are shifting allocations (allocations of different types of income and deductions among partners within a given year to reduce individual taxes without changing the partners' relative economic interests in the partnership) and transitory allocations (allocations in one year that are offset by allocations in later years).[99]

93. I.R.C. § 705(a).
94. I.R.C. § 704(b).
95. Reg. §§ 1.704-1(b)(2)(ii) (b)(1), 1.704-(b)(2)(ii) (B)(2).
96. Reg. § 1.704-1(b)(2)(ii) (b)(3).
97. Reg. §§ 1.704-(2)(c), 1.704-(2)(f)(1), 1.704-(g)(1), 1.704-2(b)(1) & (e).
98. Reg. § 1.704-1(b)(2)(iii).
99. Reg. § 1.704-1(b)(2)(iii) (b) & (c).

f. Easy Bailouts. It's easy to get money or property out of an entity that is taxed as a partnership. Both in the case of ordinary and liquidating distributions, the Code is structured to eliminate all taxes at the partnership and owner level. Built-in gains generally are deferred through basis adjustments.[100] There are a few exceptions. One is where a distribution of money to a partner exceeds the partner's basis in his or her partnership interest; the excess is taxable.[101] Another is where the partnership has unrealized accounts receivable or substantially appreciated inventory items; in these cases, ordinary income may need to be recognized to reflect any change in a partner's interest in such assets.[102] These easy bail-out provisions are a far cry from the harsh dividend, redemption, and liquidation provisions of C corporations, all of which are designed to maximize the tax bite at both the entity and owner levels on any money or property flowing from the corporation to its owners.

g. Inside Basis Adjustments. A partnership's basis in its assets may be adjusted whenever an interest in the partnership changes hands as a result of a sale or exchange of a partnership interest or the death of a partner.[103] The basis of that portion of the partnership assets attributable to the transferred interest is adjusted to reflect the current value of the assets. The result can be higher depreciation deductions and less taxable gain down the road. The adjustment requires that an election be made under Section 754. Nothing comparable exists for C or S corporations.

h. Tax-Free Profits Interests. Often a business entity desires to transfer an equity interest in future profits to one who works for the business. An entity taxed as a partnership can do this without triggering any current tax hit for the recipient.[104] A corporation generally cannot transfer an equity interest in return for services without creating a taxable event. Note: this perk only applies to an equity interest in future profits, not an interest in existing capital.

i. Transfer for Value Exception. Transfers of interests in life insurance policies among partners are exempt from the reaches of the transfer-for-value rule, that harsh provision that converts tax-free life insurance proceeds into taxable income.[105] No such similar exemption exists for transfers among co-shareholders of a corporation. As we will see in later chapters, this exemption makes insurance planning easier in a partnership-taxed entity.

4. PARTNERSHIP TRAPS

a. Ordinary Income Asset Traps. Section 751 is a complex provision designed to require a partner to recognize ordinary income whenever a change occurs in the partner's interest in ordinary income assets owned by the partnership. The change may be a result of a distribution, the partnership's purchase of the partner's interest, or a sale of a partnership interest to a third party. The result is that any gain represented by these assets is taxed to the

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100. See generally I.R.C. §§ 731.
101. I.R.C. § 731(a).
102. I.R.C. § 751; Reg. §§ 1.751-1(b)(2)(ii), 1.751-1(b)(3)(ii), 1.751-1(g).
103. See generally I.R.C. §§ 743, 754.
104. See Rev. Proc. 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43, 2001-2 C.B. 191.
105. I.R.C. § 101(2)(b).

partner as ordinary income, not capital gain. In contrast, the capital gain realized on the sale of corporate stock is not affected by the corporation's asset mix.

b. Family Partnership Trap. Family partnerships are subject to a special trap that is designed to prevent the use of a partnership to aggressively shift income among family members. If any person gifts a partnership interest to another, the donor must be adequately compensated for any services rendered to the partnership, and the income allocated to the donee, calculated as a yield on capital, cannot be proportionately greater than the yield to the donor.[106] In effect, special allocations to favor donees are out, as are attempts to shift service income. Any purchase among family members is considered a "gift" for purposes of this trap.[107]

c. Conversion Trap. As discussed in Chapter 6, usually it is prohibitive from a tax standpoint to convert from a C corporation to an entity taxed as a partnership. Such a change will produce a double tax triggered by a liquidation of the C corporation. The far better option in most cases is to convert to S corporation status if pass-through tax benefits are desired.

5. S CORPORATION PERKS

a. Comparable C Corporation Perks. Although taxed as a pass-through entity, an S corporation offers a few of the same tax perks as a C corporation that are not available to a partnership. An S corporation may enjoy all the benefits of the tax-free reorganization provisions of the Code, and, except for collectibles, the capital gains benefit realized from the sale or exchange of S corporation stock is not watered down by ordinary income assets owned by the S corporation. An S corporation may even have a multi-entity structure that offers benefits comparable to the C corporation consolidated return perk. An S corporation may own 100 percent of the stock of multiple domestic corporations, each referred to as a "qualified subchapter S subsidiary" (QSSS). Each QSSS is disregarded for tax purposes, and the parent S corporation is deemed the owner of its assets, liabilities, income, deductions and tax credits.[108]

b. Pass-Through Income. The income of an S corporation is passed through and taxed to its owners, much the same as a partnership. The entity itself pays no tax on the income, and the shareholders' recognition of the income is not affected by the corporation's retention or distribution of the income. This eliminates the double tax threat and the need for the C corporation traps that are designed to maximize the double tax impact. Also, like a partnership, the income passing through an S corporation may qualify as passive income for those shareholders who are not deemed "material participants." There are a few situations, all arising from an S corporation's prior history as a C corporation, where the pass-through benefits are lost and the S corporation itself is required to pay a tax or a distribution to a shareholder is taxed as a dividend. These are discussed in Chapter 6.

c. Pass-Through Losses. An S corporation's losses also are passed through

106. I.R.C. § 704(e).
107. I.R.C. § 704(e)(3).
108. I.R.C. § 1361(b)(3).

to its owners, subject to the same three loss hurdles applicable to partnerships. The big difference is that the first hurdle – the basis hurdle – is much tougher in the context of an S corporation. The reason is that the basis calculation considers only amounts that an S corporation shareholder actually pays out-of-pocket (for stock purchases and loans to the entity).[109] There is nothing comparable to the generous liability basis allocation provisions applicable to partnerships.

d. Stock Basis Perk. An S corporation shareholder's stock basis is adjusted up and down for allocable income and losses and cash distributions, much as with a partnership.[110] There is no locked-in basis, as there is with a C corporation. However, as regards the entity's basis in its assets, there is nothing comparable to the 754 election available to an entity taxed as a partnership.

e. Bail-Out Potential. The tax consequences of distributing money or property from an S corporation generally are much less severe than for a C corporation, but not nearly as painless as for a partnership. Distributions of allocated S corporation income are tax-free to the shareholders. Distributions of prior C corporation earnings are taxable,[111] as are liquidating distributions and redemptions that qualify for sale or exchange treatment. Also, unlike a partnership, an S corporation that distributes appreciated property gets no break; the appreciation is taxable income to the S corporation that is passed through to the shareholders.[112]

6. S CORPORATION TRAPS

a. Eligibility Limitations. The eligibility requirements for an S corporation (qualifying shareholders, number of shareholders, one class of stock, etc.) are traps that can limit flexibility for an S corporation or result in the loss of S corporation treatment.

b. Tax Year Trap. An S corporation generally is subject to the same limitations as a partnership in selecting a tax year.[113] As compared to a C corporation, there is much less flexibility.

c. No Special Allocations. Unlike a partnership, an S corporation has no capacity to structure special allocations among its owners. Income and losses are allocated according to stock ownership percentages. As discussed in later chapters, employment agreements and shareholder loan arrangements may provide some planning flexibility in select situations.

d. Conversion Traps. A C corporation's conversion to an S corporation is far easier from a tax perspective than a conversion to a partnership-tax entity, which often triggers prohibitive taxes. But there are traps even in an S

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109. I.R.C. § 1366(d). A shareholder's guarantee of an S corporation's loan will not result in a basis increase. See, e.g., Harris v. United States, 902 F.2d 439 (5th Cir. 1990); Brown v. Commissioner, 706 F.2d 755 (6th Cir. 1983); Uri v. Commissioner, 949 F.2d 371 (10th Cir. 1991); and Sleiman v. Commissioner, 187 F.3d 1352 (11th Cir. 1999). Contrary is Selfe v. United States, 778 F.2d 769 (11th Cir. 1985).

110. I.R.C. § 1367(a).

111. I.R.C. § 1368(c).

112. I.R.C. § 1371(a) provides that the provisions of Subchapter C will be applicable to S corporations except as otherwise provided in Subchapter S or inconsistent with Subchapter S. As a result, the C corporation provisions dealing with redemptions, liquidations, appreciated property distributions, reorganizations and similar issues are directly applicable to S corporations.

113. I.R.C. § 1378(b).

conversion (all discussed in Chapter 7) for built-in asset gains, accumulated earnings, LIFO inventory reserves, and excessive S corporation passive income. These traps can usually be managed or completely avoided with some basic planning.

E. THOSE OTHER TAXES

The choice of entity analysis may be impacted by self-employment, payroll, and new healthcare taxes in many situations. The self-employment/payroll tax is a regressive tax that's easy to ignore, but the consequences of neglect can be painful. The tax is levied at a flat rate of 15.3 percent on a base level of self-employment earnings ($113,700 for 2013) and 2.9 percent above the base. Starting in 2013, the rate jumps to 3.8 percent on a married couple's earnings in excess of $250,000 and an unmarried individual's earnings in excess of $200,000, and the new 3.8 percent healthcare tax applies to any interest, dividends, capital gains, and "net investment income" received by such taxpayers.[114] A self-employed person is entitled to an income tax deduction of one-half of self-employment taxes paid at the 15.3 percent and 2.9 percent rates.[115]

How does the payroll tax impact employees? An employee has one-half of the tax (7.65 percent) come directly from his or her paycheck in the form of payroll taxes. The other half is paid by the employer who, in order to stay in business, must consider this tax burden in setting the employee's pay level.

For high-income taxpayers, including many business owners, the personal impact of the self-employment tax often is not significant because they are able to structure their affairs to reduce or eliminate its impact, or the base amount subject to the tax is considered small in relation to their overall earnings. The tax, by design, is structured to punish middle- and low-income workers. For 80 percent of American workers, the self-employment and payroll taxes paid on their earnings exceed the income tax bite, often by many times.[116]

Are these an important factor to consider in choosing the best form of business entity? The answer is "yes" in many, but not all, situations. The form of business entity that is selected can affect the self-employment tax burden for the owners of the business.

Compensation payments from a C corporation to owner/employees are subject to payroll taxes. Corporate dividends are now subject to the 3.8 percent tax to the extent a married couple's income exceeds $250,000 and an unmarried individual's income exceeds $200,000.[117] For other taxpayers, dividends are not subject to the tax. In a C corporation context, the negative trade-off is that the dividends are subject to the double income tax structure.

The C corporation double-tax trade-off disappears for an S corporation

114. I.R.C. § 1411.
115. I.R.C. § 164(f).
116. Report of the Congressional Budget Office, Economic Stimulus: Evaluating Proposed Changes in Tax Policy – Approaches to Cutting Personal Taxes (January 2002), footnote 7.
117. I.R.C. §§ 1402(a)(2), 1411.

whose earnings are taxed directly through to its shareholders. Compensation payments to an S corporation shareholder are subject to payroll taxes. But a shareholder who works for an S corporation avoids all self-employment taxes on dividends, including the 3.8 percent Medicare tax.[118] An S corporation investor who does not materially participate in the venture will also avoid any self-employment tax on dividends unless the applicable $250,000/$200,000 threshold is exceeded, in which case the 3.8 percent tax will kick in.

Can a shareholder who works for an S corporation eliminate all self-employment and payroll taxes by paying only dividends? If a shareholder renders significant services to the S corporation and receives no compensation payments, the Service likely will claim that a portion of the dividends are compensation payments subject to payroll taxes.[119] The key is to be reasonable in taking advantage of the tax loophole for S corporation dividends paid to a shareholder/employee. Set a defensible compensation level and pay payroll taxes at that level. Then distribute the balance as dividends that are not subject to any self-employment or payroll tax burden.

As for a partnership, section 1402(a) of the Code specifically provides that a partner's distributive share of income from a partnership constitutes earnings from self-employment tax purposes.[120] There is a limited statutory exception for retired partners[121] and a broader exception for limited partners, but the new 3.8 percent Medicare tax will still be applicable to the extent the triggering income thresholds ($250,000 or $200,000) are exceeded.[122] Thus, the key to minimizing the tax in a partnership structure is to fit within this limited partnership exception.

What are the self-employment tax impacts with a limited liability company? It may be more difficult to avoid the tax for a member of a limited liability company that has no limited partners. The Service's first attempt to provide some guidance on the issue came in 1994 when it published its first Proposed Regulations. After public comment, new Proposed Regulations were issued in 1997, defining the scope of the limited partnership exception for all entities taxed as a partnership, without regard to state law characterizations.[123] Under the 1997 Proposed Regulations, an individual would be treated as a limited partner for purposes of the self-employment tax unless the individual was personally liable for the debts of the entity by being a partner, had authority to contract on behalf of the entity under applicable law, or participated for more than 500 hours in the business during the taxable year. The 1997 Proposed Regulations also drew criticism because LLC members who had authority to contract on behalf of the entity could never fit within the limited partner exception. The result was a statutory moratorium in 1997 on the issuance of any temporary or proposed

118. If an S corporation shareholder materially participates in the venture, dividends paid to that shareholder do not fall within the definition of "net investment income" in IRC § 1411. See IRS Guidance in Reg.130507-11 (November 30, 2012).

119. See, for example, Joseph Radtke, S.C. v. United States, 712 F.Supp. 143 (E.D. Wis. 1989), affirmed 895 F.2d 1196 (7th Cir. 1990); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); and Dunn & Clark, P.A. v. Commissioner, 57 F.3d 1076 (9th Cir. 1995).

120. I.R.C. § 1402(a).

121. I.R.C. § 1402(a)(10).

122. I.R.C. §§ 1402(a)(13), 1411.

123. Proposed Reg. § 1.1402 (a)-2.

regulations dealing with the limited partnership exception.[124]

For planning purposes, where does this history leave us now with respect to entities taxed as partnerships? Any general partner under state law is exposed to the tax. Any limited partner under applicable state law is probably safe. As for LLC members, any member who can fit within the 1997 Proposed Regulations' definition is justified in relying on the statutory limited partner exception. Beyond that definition, it becomes more difficult and uncertain to evaluate the facts and circumstances of each situation. The risk escalates in direct proportion to the individual's authority to act on behalf of the entity and the scope of any services rendered. Note, however, that any member will now be subject to the new 3.8 percent Medicare tax to the extent the applicable triggering income thresholds ($250,000 or $200,000) is exceeded.

Is it smart to design a plan that reduces or eliminates self-employment tax burdens for the owners of a business? Most think it is. Of course, the payment of self-employment taxes may result in higher Social Security benefits down the road. The Social Security program, as presently structured, will become unsustainable in the future. Current benefit levels can be maintained long term only if tax rates or government borrowing levels are increased to unprecedented levels. There is a strong likelihood that, at some point in the not-too-distant future, forced structural reform of the program will reduce future government-funded benefits for all except those who are close to retirement or at the lowest income levels.[125]

PROBLEM 3-A

Marsha is ready to start a business that will generate about $150,000 of earnings each year. Marsha will work full time for the business. Her plan is to withdraw $100,000 of earnings from the business each year. She will leave the remaining earnings in the business to retire debt and fund future needs of the business. Marsha wants to minimize the overall tax bite on these earnings.

What will be the total entity and personal tax cost under each of the following scenarios, assuming Marsha's ordinary income tax rate is 25 percent, her dividend rate is 15 percent, and the applicable self-employment/payroll tax rate is 15.3 percent? Ignore all potential state income tax consequences.

1. Marsha's business is a C corporation that distributes Marsha a $100,000 dividend each year.

2. Marsha's business is a C corporation that pays Marsha a salary of $100,000 each year for services she renders to the corporation?

3. Marsha's business is an S corporation that pays Marsha a $40,000 salary each year and distributes a $60,000 dividend to her each year.

4. Marsha's business is a limited liability company that is taxed as a partnership. Marsha owns 90 percent of the business, and Joe, an investor who

124. Tax Relief Act of 1997 § 935.

125. See generally The Interim and Final Reports of the President's Commission to Strengthen Social Security (August 2001 & December 2001).

does not work in the business, owns the remaining 10 percent. The LLC distributes $90,000 to Marsha each year and $10,000 to Joe. Assume Joe's marginal tax rate is also 25 percent.

F. KEY FACTORS – FIVE CASE STUDIES

The choice of entity analysis requires a careful assessment of all relevant factors. This sections reviews 16 of the key factors, illustrated through five case studies. Each entity option offers certain benefits and traps that may pose problems down the road. The analysis should review the benefits and traps by carefully pondering their potential relevance under various scenarios that may be applicable to the specific situation.

Although each factor may be important, they never have equal weight in any given situation. It is not a game of adding up the factors to see which entity scores the most points. In many cases, one or two factors may be so compelling for the particular situation that they alone dictate the ultimate solution. But even in that situation, the other factors cannot be ignored because they help identify the collateral consequences of the decision that is about to be made.

The issue of limited liability protection for the owners of the business, once considered to be the most critical factor in the choice of entity analysis, is no longer included in the list of key factors. It's not that insulating the owners of a business from personal liability for the business' liabilities is no longer important; it's as important today as ever. Its absence from the critical factor list is due to the fact that, if desired, it can be accomplished in any given situation. Thus, it is a neutral consideration that no longer needs to affect the decision-making process. With the new check-the-box regime, there is no longer a fear that providing limited liability protection may result in an unincorporated business being inadvertently taxed as a corporation. Even a general partner can be protected by parking the ownership interest in a limited liability company or an S corporation.

EXAMPLE CASE ONE: JASON

Jason, a seasoned entrepreneur, plans to start a new business that will offer specialized heavy equipment moving services in the western United States. Jason will own 60 percent of the new enterprise, and the remaining 40 percent will be owned equally by two investors, buddies of Jason. Jason will oversee the business, as he does with the other businesses that he has organized. He will not be a fulltime employee of the business.

The business will initially have about 30 employees. Jason anticipates that the business will be profitable by year two, and he has advised the investors that regular distributions will be made starting in year two. Plus, if things play out as planned, there might be a potential to sell to a larger strategic player down the road. Jason wants an entity that will minimize all tax bites, always leave him in complete control, and avoid, to the fullest extent possible, any potential hassles with the minority owners.

The best option for Jason's new company would be an S corporation. This

case illustrates six key factors.

Factor 1: Earnings Bailout

In Jason's situation, an important factor in the choice of entity decision analysis is the tax cost of getting earnings out of the enterprise and into the hands of Jason and the other owners. Bailing out earnings in S corporations, LLCs, partnerships and sole proprietorships usually is no big deal. Profits generated by the business are passed through and taxed directly to the owners, so the distribution of those profits in the form of dividends or partnership distributions carries no tax consequences. In contrast, bailing out the fruits of a C corporation may trigger substantial income tax consequences, because a C corporation is not a pass-through entity.

When a C corporation bails out its earnings by distributing them to its shareholders in the form of dividends, the dividend distribution is not deductible to the corporation. The corporation pays a tax on the earnings, and the distribution of those earnings to the shareholders in the form of dividends is taxed a second time at the shareholder level. This double tax is one of the negatives of a C corporation.

For some businesses, this double tax risk is more academic than real. There are often ways to avoid it. The most common is for the shareholders to be employed by the corporation and to receive earnings in the form of taxable compensation. The payment of the compensation to the shareholders is deductible by the corporation, so that income is only taxed once, at the shareholder level. But the compensation must be reasonable for the services actually rendered. If it isn't, it may be re-characterized as a dividend. In service corporations where the services are rendered by the shareholders, stripping out all of the earnings of the business through the use of compensation payments usually can be easily justified. Since Jason does not plan on working for his new business, the compensation bailout structure isn't an option.

If earnings are piled up in a C corporation, keep an eye on the accumulated earnings tax. As previously described, this penalty tax is imposed on accumulated earnings exceeding the greater of the reasonable needs of the business or $250,000 ($150,000 for personal service corporations). The key is to have the board of directors document through resolutions the reasonable business needs that justify the retention of substantial earnings in the business.

Factor 2: Self-Employment Taxes

Self-employment taxes can be an important choice of entity factor in some situations. In Jason's situation, use of an S corporation may create the opportunity to save self-employment taxes by just paying dividends that escape double income tax treatment by virtue of the S election.

If the plan is to bail out earnings as compensation payments to owners of a C corporation, the compensation payments will be subject to payroll taxes. Of course, except to the extent the new 3.8 percent Medicare tax is applicable to those with incomes above the triggering thresholds ($250,000 or $200,000), there is no self-employment tax imposed on dividends from a C corporation, but such

dividends are subject to a double income tax structure.

In Jason's situation, the goal is for the owners to avoid the double income tax structure and self-employment taxes. S corporation dividends will do the job (subject to the 3.8 percent Medicare tax, where applicable), but distributions by a partnership-taxed entity, including a limited liability company, will not escape self-employment taxes unless the owners are limited partners. If the owners are limited partners of a limited partnership, there is a statutory exception that will protect them from self-employment taxes. The same exception should work in the context of a limited liability company where the owners have no management rights in the enterprise and are not personally responsible for the liabilities of the entity. The tough situation comes when a key owner, such a Jason, wants to exercise management rights. In Jason's case, reliance on the limited partnership exception in the LLC context may create an intolerable risk, given the uncertainty of current law. For self-employment tax purposes, a much smarter option would be an S corporation. Given the size of the self-employment tax, this factor may be the deciding issue in some cases.

Factor 3: Tax-Free Reorganization Potential

If the business succeeds and a sellout opportunity surfaces, a corporate entity will be able to participate in a tax-free reorganization with a corporate buyer. Corporations may combine through mergers, stock-for-stock transactions, and assets-for-stock transactions on terms that eliminate all corporate and shareholder-level taxes. This benefit often is the key to the ultimate payday for those business owners who cash in by "selling" to a public corporation. Cast as a reorganization, the transaction allows the acquiring entity to fund the acquisition with its own stock (little or no cash required) and enables the selling owners to walk with highly liquid, publicly traded securities and no tax bills until the securities are sold.

A partnership-taxed entity, such as a limited liability company, can't enjoy the tax-free benefits of a corporate reorganization.

Factor 4: Control Rights

Jason wants complete control over all business decisions with as little discussion and fanfare as possible. A corporation, either C or S, or a limited partnership automatically offers this type of ultimate control in favor of the majority, absent a special agreement to the contrary. Minority corporate shareholders often have no control rights; the majority elects the board of directors, and the board has the authority to manage the affairs of the corporation. Limited partner status and the benefits associated with that status (i.e., liability protection and freedom from self-employment taxes) mandate little or no control. For the majority player who wants control of all the reins, the idea of easily getting it all "the normal way" can be appealing.

Limited liability companies and general partnerships are different only in that the control rights need to be spelled out in an operating agreement among the owners. In some cases, the fear is that the need for a single operating agreement may result in more dialogue, more negotiation, and more compromise. Minority

owners may see that there is no "standard" or "normal" way of locking in voting requirements and that the agreement can be crafted to address the control concerns of all parties. Once minority expectations are elevated, the majority players' options become more difficult. One option, of course, is to throw down the gauntlet and demand ultimate majority control. Beyond the personal discomfort of having to overtly make such demands, the demands themselves may fuel suspicions, undermine loyalties, or, worst case, trigger the departure of a valuable minority player. The alternative option is to build into the operating agreement "mutually acceptable" minority rights.

The lawyer's role in this scenario depends entirely on which side of the fence the lawyer sits on. The lawyer who solely represents the interest of the big fish or the dominant golfer group may push for, even mandate, a corporate structure that automatically grants all control rights to the majority. The lawyer who represents solely the interests of the minority players may appropriately push for key minority control rights in all situations, even in the corporate format. As discussed in Chapter 4, state laws permit the use of shareholder agreements in closely held corporate situations to provide for voting restrictions and control limitations that are binding on all shareholders and the board of directors. The dangerous scenario is where the lawyer sits on the fence by representing the entity and allows complete majority control to be automatically and quietly put in place through a corporate entity. More on this in Chapter 4. For choice of entity planning purposes, suffice it to say that specific control interests of the client and the dynamics between the parties (or lack thereof) may favor the use of a corporate entity or limited partnership in some cases.

Factor 5: Sellout Tax Hit

Many who start a new business are not focused on selling out down the road. But this factor can be extremely important in selecting the right form of business organization. If this factor is neglected, a business owner may find that, when it comes time to cash in, there is an added tax burden that could have been avoided. If Jason's business flourishes and its assets are ultimately sold within a pass-through entity, such as an S corporation, partnership or LLC, the gains realized on the sale of the assets are taxed to the owners in proportion to their interests in the business. After those taxes are paid, the owners are free to pocket the net proceeds. Bailing out of a C corporation may carry a significant additional tax cost. A simple example illustrates the impact.

Assume Jason started a C corporation with a $250,000 investment, that the assets in the company have a present basis of $750,000, and that the company is worth $3 million. It's now time to cash in. The buyer does not want to buy the stock, but is willing to pay $3 million for the assets in the business.

The C corporation would sell the assets for $3 million to the buyer, and the corporation would recognize a $2.25 million gain – the difference between the $3 million purchase price and the corporation's $750,000 tax basis in the assets. After the corporation pays a corporate income tax on the gain, the balance of the proceeds would be distributed to the shareholders, who would pay a capital gains tax on the difference between the amount received and their low basis in the

stock. The threat of this double tax at the time of sale is a major disadvantage for many C corporations.

Beyond this double tax impact, other important elements of this sellout factor should be considered. First, if a C corporation accumulates earnings within the corporation over an extended period of time, those accumulations do nothing to increase the shareholders' tax basis in their stock. If the shareholder sells stock down the road, the shareholder recognizes capital gains based upon the shareholder's original cost basis in the stock. In contrast, if the business organization is operated in a pass-through entity, such as an LLC, an S corporation, or a partnership, the earnings accumulated in the business will boost, dollar for dollar, the owner's tax basis in his or her stock or partnership interest. So if the owner down the road sells the stock or partnership interest, the earnings accumulated within the enterprise reduce the tax bite to the owner. This is a significant consequence, and it should not be ignored if the business plans to accumulate earnings in anticipation of a sale at a future date.

A second consideration is that, if a C corporation already has substantial value, it is not easy to convert to a pass-through entity and eliminate the threat of double tax. The business cannot make the conversion just before the sale and expect to get off tax free. Usually, it takes a significant period of time to wind out of the double-tax threat.

When all these factors are thrown into the mix, the S corporation looks attractive to Jason with respect to this sellout factor. As a pass-through entity, it eliminates the double tax hit and provides the basis booster. Plus, as a corporate entity, it offers the potential of tax-free reorganization benefits and eliminates the potential ordinary income asset mix complications of an entity taxed as a partnership.

Factor 6: Passive Income Potential

If Jason uses a pass-through entity, such as an S corporation or an LLC, the income allocated to the owners who are not material participants in the business (a given in this situation) will be passive income that can be offset by tax losses, including passive losses. Even if the income is not distributed to the owners and is retained in the business to finance growth, the owners' losses from other activities can be used to reduce the tax bite on the business income. This capacity to use real estate and other passive losses of the owners to reduce current taxes on income from profitable activities often enhances the reinvestment of earnings in a profitable business to finance growth.

By comparison, if the business is operated as a C corporation, there is no way that the income of the business, whether retained in the business or distributed to the owners, can be sheltered by passive losses that the owners generate from other activities. The bottom line is that, for many income-producing enterprises, those owners who are not employed by the business (and perhaps the business itself) will be much better off with a pass-through entity.

EXAMPLE CASE TWO: SUE AND JOYCE

Sue and Joyce are planning to form a new business that will offer specialized catering services. They will be the sole owners (in equal shares), and they will both work full time for the business. They will start out with eight other employees, but anticipate that the employee base could grow to 50 or more as they expand into neighboring markets.

They project that the business will need to reinvest $50,000 to $100,000 of earnings each year to finance growth and expansion. They will bailout the rest of the earnings as compensation income for the long hours they both will put into the business. They can't imagine ever selling the business and doubt anyone would be willing to pay much for it. The business is a means for them to each pursue a passion and earn a nice living along the way. It will be their careers. They want to maximize any fringe benefits for themselves.

The best option for the new company that is being organized by Sue and Joyce is a C corporation. This case illustrates three additional key choice-of-entity factors.

Factor 7: Owner Fringe Benefits

Sue and Joyce's desire for employee fringe benefits may be a compelling factor in selecting a business form. There are a number of fringe benefits that are available to shareholder/employees of a C corporation that generally are not available to owner/employees of pass-through entities, such as a partnerships, LLCs, or S corporations. The significance of these fringe benefits depends on their importance to the particular owners. Investor owners could care less; employee owners, like Sue and Joyce, often view them as big deals. Each owner needs to assess whether the tax advantages of the fringe benefits are attractive enough to impact the choice-of-entity decision. The most significant fringe benefits available to shareholder-employees of C corporations include group-term life insurance plans under Section 79, medical-dental reimbursement plans under Section 106, Section 125 cafeteria plans,[126] and dependent care assistance programs under Section 129. Note that health insurance premiums are usually a neutral factor because they can be deducted in full by a self-employed person, a partner or an S corporation shareholder.

Factor 8: The Bracket Racket

Only the C corporation offers the potential that the tax rate applied to the net income of the business may differ from the income tax rate applied to the owners of the business. All other entities (S corporations, LLCs, partnerships and sole proprietorships) are not separate taxpaying entities. Income earned by these entities is simply passed through and reported by the owners in proportion to their interests in the business. The C corporation may create an income splitting opportunity – to

126. A section 125 cafeteria plan may be adopted by a partnership, LLC, or S corporation, but S corporation shareholders holding two percent or more of the corporation's stock, partners of the partnership, and members of the LLC cannot participate in the plan. C corporation shareholders may participate so long as no more than 25 percent of the nontaxable benefits selected within the cafeteria plan go to key employees. Subject to the 25 percent limitation, C corporation shareholders can take full advantage of the tax benefits of the plan.

have the income retained in the business taxed at a rate lower than the rates paid by the owners. In Sue and Joyce's situation, the different rate structure can be used to their advantage. It's the bracket racquet.

C corporations have a tiered graduated rate structure. This structure imposes a low 15 percent tax on taxable income up to $50,000 and 25 percent on taxable income between $50,000 and $75,000. So if Sue and Linda can keep the corporation's taxable income to less than $100,000 each year, these low corporate rates will produce a significant bottom line tax savings. If this reinvested income were passed through to them, it is likely that the income tax rate would be at least 28 percent and perhaps more, and payroll taxes would be on top of the income tax hit. This bracket differential can be a big deal when the numbers are in these ranges.

Note that the potential negative consequences of a C corporation are no big deal in Sue and Linda's situation. They will avoid all double tax fears by bailing out all available earnings as deductible compensation. The C corporation accumulated earnings tax, personal holding company tax, and alternative minimum tax pose no threats. The locked-in stock basis and other sellout costs are not a factor because Sue and Joyce have no plans to sell.

Note that this potential bracket rate advantage does not apply to personal service C corporations because they are subject to a single-tiered tax bracket of 35 percent. For this reason, clients who are personal service C corporations will be better off stripping the income out as compensation on a tax-deductible basis. A personal service corporation is defined as any corporation that meets two tests: a function test and an ownership test. The function test requires that the corporation perform substantially all of its services in the fields of health, law, engineering, architecture, accounting, actuarial science, the performing arts or consulting. The ownership test requires that substantially all of the stock be held directly or indirectly by employees who perform services in one of those fields. For example, the typical medical professional corporation will be a personal service corporation. Clients who fall within the personal service corporation definition should be advised to keep the taxable income of the corporation at or close to zero. This can be accomplished by stripping out the earnings in the form of salaries, bonuses, rent, or other forms of deductible payments to the owners. Generally, there are no advantages to accumulating earnings in the corporation.

In view of this tax bracket discrimination against personal service corporations, should a personal service C corporation convert to a partnership, an LLC, an S corporation, or a sole proprietorship? The answer is "no" for most clients. First, the conversion itself might trigger an immediate tax cost. Second, the owners can enjoy the single-tax benefits of a pass-through entity by stripping all the corporate earnings through compensation and other deductible payments. And third, as discussed above, the owners may participate in tax-favored employee benefit programs by sticking with the C corporation.

Factor 9: Tax Year Flexibility

Most C corporations may select any fiscal year for tax reporting purposes. Thus, use of a C corporation will give Sue and Joyce an opportunity to select a tax

years that simplifies and accommodates their accounting and that may provide a tax deferral potential. Partnerships, LLCs, S corporations and sole proprietorships generally are required to use a calendar year unless they can prove a business purpose for using a fiscal year (a tough burden in most cases) or make a tax deposit under Section 7519 that is designed to eliminate any deferral advantage. C corporations that are personal service corporations may adopt a fiscal year with a deferral period of no more than three months, but the minimum distribution rules applicable to such personal service corporations under Section 280H substantially reduce any tax deferral potential.[127]

The income tax deferral potential of a C corporation that is not a personal service corporation is a fairly simple concept. Consider a toiler-owned manufacturing corporation that uses a calendar year for tax reporting. Its projected taxable income for 2013, its first year of operation, will be $240,000, and it will earn that income proportionately in each month during the year. For 2013, the choice for the owners of the corporation is to either report the income in the corporation or pay all or a portion of it to themselves as deductible compensation payments. With either approach, all of the $240,000 of taxable income will be reported in the 2013 tax returns of the owners or the corporation.

If the same corporation elects to use a fiscal year ending March 31, a one-year deferral can be achieved on $180,000 of the $240,000 of taxable income. This is accomplished by having the corporation file a short-year return ending March 31, 2013, reporting $60,000 of taxable income. The remaining $180,000 earned during the last nine months of 2013 is reportable in the fiscal year ending March 31, 2014. But during the first three months of 2014, the owners pay themselves bonuses totaling $180,000 plus any income earned by the corporation during those three months, thus zeroing out the corporation's tax liability for the fiscal year ending March 31, 2014. These bonuses are deducted from the corporation's income for the fiscal year ending March 31, 2014, but are not reported by the calendar year shareholders until they file their 2014 returns on April 15, 2015. The ability to use this technique is limited by the normal compensation reasonableness standards. Plus, the deferral impact is often watered down by withholding and estimated tax payment requirements. But the technique is fairly common and is a legitimate means of deferring taxes.

EXAMPLE CASE THREE: CHARLES

Charles plans on buying and operating a large apartment complex. Charles will put up 10 percent of the equity capital, and the other 90 percent of the equity will come from four outside investors. The business will obtain debt financing equal to nearly four times the total equity capital, and is expected to generate substantial taxable losses during the first five years of operation, fueled in large part by big depreciation deductions.

Charles wants an entity that will allocate 99 percent of the losses to the investors, award him with 50 percent of the profits after the investors have recouped their investment, and, to the maximum extent possible, free him from minority owner hassles and contractual negotiations and dealings with minority

127. I.R.C. §§ 444(b)(2), 280(H).

owners. He wants total control. Plus, he would like to protect the investors from any self employment taxes.

Charles is going to need a partnership-taxed entity, either a limited liability company where he is the sole manager or a limited partnership where his investors are limited partners and his wholly-owned LLC or S corporation is the general partner. Of these two, the limited partnership option may make it easier for Charles to nail down his absolute control rights and reduce any self-employment tax risks for the investors. But either approach will work with some quality planning.

This case illustrates three additional choice-of-entity factors.

Factor 10: Different Ownership Interests

As Charles' deal illustrates, often owners want to structure different types of ownership interests in the entity. Income rights, loss rights, cash flow rights, or liquidation rights may need to be structured differently for select owners to reflect varying contributions to the enterprise. With a C corporation, different types of common and preferred stock may be issued to reflect the varying preferences.

An S corporation is extremely limited in its ability to create different types of equity ownership interests. It is limited to voting and non-voting common stock, all of which must have the same income, loss, cash flow and liquidation rights.

Partnerships and limited liability companies offer the most flexibility in structuring different equity ownership interests. These partnership-taxed pass-through entities can customize and define the different interests in the entity's operating agreement. Although the design possibilities are almost unlimited, all allocations of profits, losses and credits will be respected for tax purposes only if the allocations are structured to have "substantial economic effect" within the meaning of section 704(b).

In Charles' situation, there's a clear need to use one of these flexible pass-through entities to create different types of ownership interests. This is particularly true in situations where one group of owners is providing capital and another group of owners is providing management, services and expertise. Often, an LLC is the answer; it offers the centralized management and limited liability benefits of a corporation, and the structuring and tax flexibility of a partnership.

Factor 11: Loss Utilization

Like many organizers of businesses that are projected to generate losses in the early years, Charles wants to insure that such losses are funneled to the tax returns that will trigger the highest tax savings. The threshold issue is whether the losses should be retained in the entity or passed through to the owners.

Losses generated by a C corporation are retained in the C corporation and are carried backward or forward to be deducted against income earned in previous or future years. Losses sustained by S corporations, LLCs, partnerships and sole proprietorships are passed through to the business owners. When losses

are anticipated in the initial years of a business, using a pass-through entity may generate a tax advantage if the owners have other taxable income against which those losses can be offset, within certain limitations. The advantage is that the losses may produce immediate tax benefits.

In planning to pass through losses to the owners, never lose sight of the fact that the losses, even if passed through, may produce no benefit if one or more of the three loss hurdles mentioned get in the way. The at-risk and passive loss hurdles usually are not affected by the type of pass-through entity selected. The basis hurdle is different in this regard. The general rule is that losses generated by a pass-through entity are not available to an owner of the entity to the extent that the cumulative net losses exceed the owner's basis in the entity. For example, if an investor puts $50,000 into an S corporation, that owner's basis in the S corporation stock is $50,000. If the S corporation generates a loss of $150,000 in the first year and finances the loss through corporate indebtedness, the S corporation shareholder may only use $50,000 of the loss against his or her other income. The other $100,000 is suspended because it exceeds the owner's stock basis. It is carried forward to be used in future years if and when the basis is increased. In contrast, if the indebtedness is incurred in an entity taxed as a partnership, such as a limited liability company or a limited partnership, the indebtedness will increase the partners' basis in their partnership interests under the provisions of Section 752, and the basis limitation will no longer be a factor in assessing the current tax value of the losses.

This loss pass-through factor, perhaps more than any other factor, underscores the value of quality projections of the business operations for the first few years and an evaluation of the individual tax positions of the business owners.

Factor 12: Real Estate

The choice of entity analysis is always affected by the presence of real estate. The fact that most real estate tends to appreciate over time has some powerful consequences for planning purposes. First, it permits the owners to take advantage of the biggest fiction in the Internal Revenue Code – depreciation cost recovery deductions that are based on the premise that real estate improvements lose their value over time. Second, it facilitates the use of nonrecourse debt because lenders are willing to make loans that are secured only by the value of the real estate. The nonrecourse debt eliminates the loss basis hurdle for any entity taxed as a partnership and escapes the at-risk hurdle by virtue of the "qualified nonrecourse debt financing" exception that is applicable only to real estate.[128] And third, it is never prudent to subject the appreciation of the real estate to the double tax structure of a C corporation. As a general proposition, appreciating real estate should be kept out of C corporations. Plus, income from real estate activities that is passed through to the owners generally is not subject to the self-employment tax.[129]

128. I.R.C. §§ 752(a), 465(b)(6).

129. I.R.C. § 1402(a)(1). The tax will apply to anyone who receives rental income in the course of a trade or business as a real estate dealer.

Given these consequences, real estate usually warrants its own entity, and in nearly all situations that entity should be a partnership-taxed entity.

EXAMPLE CASE FOUR: JURDEN INC.

Jurden Inc. is a successful C corporation that is poised to explode. It has five shareholders, all successful business investors. The plan for the next five to10 years is to aggressively reinvest earnings to create a global presence and then sell out to a strategic buyer at the right time. The shareholders want to shed the C status now. They want the future tax benefits of a pass-though entity, including the stock basis booster for all reinvested earnings and the elimination or serious reduction of double tax bites at time of sale.

Jurden Inc's only option, as a practical matter, is to covert to an S corporation. This case illustrates a controlling choice-of-entity factor for many.

Factor 13: C Corporation Conversion Flexibility

As a C corporation, Jurden Inc. has only one option that makes any sense. If it converted to a partnership structure or an LLC, a gain on the liquidation of the corporation would be triggered at both the corporate and shareholder level at time of conversion – a disastrous scenario. The corporation would recognize a gain on all its assets, and the shareholders would recognize a gain on the liquidation of their stock. The tax costs of getting into a partnership or LLC pass-through entity usually are too great to even think about.

The only practical answer for Jurden Inc. is an S corporation. At the present time, a C corporation may convert to an S corporation without automatically triggering the type of gain that would be triggered on a deemed liquidation of a C corporation.

The S corporate conversion, while clearly the preferred choice in most situations, is not a perfect solution and may trigger some additional tax costs at the time of the conversion and later down the road. If, for example, the corporation values its inventories under the LIFO method, the corporation must recognize as income the LIFO reserve as a result of the S election conversion. Also, the conversion will not eliminate all threats of double taxation. If a C corporation converts to an S corporation and liquidates or sells out within 10 years after the election, the portion of the resulting gain that is attributable to the period prior to the election will be taxed at the corporate level as if the corporation had remained a C corporation. If the C corporation had accumulated earnings and profits before the conversion, the shareholders may end up with taxable dividends after the conversion. A completely clean break from C status often is not possible. But in most situations, these tax consequences of conversion can be managed and do not provide a basis for rejecting the conversion to S status.

EXAMPLE CASE FIVE: PETER

Peter has developed a business plan for creating and exploiting a series of new Internet games that promise the potential of a huge success. He has attracted the attention of various investors, none of whom want their personal tax returns

exposed to any venture and all of whom would love to see Peter's unique talents showcased and exploited through a public company at the right time. The plan is to reinvest all business earnings so that Peter can build the business as fast as possible.

Peter is going to want a C corporation. This case illustrates three additional choice-of-entity factors, two of which usually are controlling when they are applicable to the situation.

Factor 14: Going Public Prospects

When a company is funded with outside capital and the plan is to go public at the first solid opportunity, the C corporation often is the mandated choice. The interests of the outside investors and the potential of going public trump all other considerations. Usually the audited track record of the company leading up to the offering is best reflected in the same form of entity that will ultimately go public, which is a C corporation in nearly all cases.

Factor 15: The "Not My Return" Factor

This factor is one of those considerations that sometimes preempts everything else when it is present. It is the owner who has no interest in anything that will implicate or complicate his or her personal tax return. Some just cannot buy into the concept of having to personally recognize and pay taxes on income from a pass-through entity that has never been (and may never be) received in the form of hard cash. Others are spooked by the accounting and audit risks. The thought that their personal tax return and their personal tax liability could be affected by the audit of a company managed by others is too much to bear. Still others are just adamant about keeping all personal matters as simple and as understandable as possible. A stack of K–1 forms flapping on the back of their return is not their concept of simple. When this factor is present and cannot be eliminated, the only option is a C corporation that offers the benefit of complete "separateness."

Factor 16: Reinvestment Growth

Like many companies, Peter hopes to grow his company by reinvesting all earnings. In recent years, the tax rate differential between individual taxpayers and a C corporation has not been a big deal. Both have topped out at a maximum rate of 35 percent. So the choice-of-entity analysis has not turned on the potential to reinvest after tax earnings and grow the business.

But that has changed in 2013. The American Taxpayer Relief Act of 2012 (the "Fiscal Cliff" legislation signed into law during the final days of 2012)[130] increased individual ordinary income tax rates to 39.6 percent starting in 2013 for couples with taxable incomes in excess of $450,000 and individuals with taxable incomes in excess of $400,000. Plus, in 2013, the 3.8 percent Medicare tax kicks in for couples with a modified adjusted gross income in excess of $250,000 ($200,000 for individuals). The net result is that a successful business owner who is allocated profits through a pass-through S corporation or LLC could end up

130. Section 101 of the American Taxpayer Relief Act of 2012.

paying federal taxes at a combined income and Medicare rate of 43.4 percent. In contrast, political leaders on both sides of the aisle and the Obama administration have agreed that top corporate tax rates should be reduced to the 25 to 28 percent range to remain competitive with other countries. The result is that we could end up with a condition that we haven't had for decades – a mammoth gap between top individual rates and top corporate rates.

For a company looking to grow with reinvested earnings, such a huge rate differential between individual and corporate rates may compel use of a C corporation. The difference between reinvesting 56 cents on every earned dollar and reinvesting 75 cents, when compounded over five or 10 years and adjusted for leveraging differences, may impact a business' capacity to finance growth by as much as 50 percent or more. As the push for such rate differentials intensifies, this may emerge as the newest and most dominant choice-of-entity factor for businesses that need to grow. The old C Corporation could emerge as the ultimate comeback kid.

Factor Summary and Conclusion

A review of these 16 factors in a given situation will help the lawyer assist a client in choosing the best form of business entity and understanding the primary and collateral consequences. One conclusion is fairly obvious: The C corporation is a very different creature from the other forms, all of which are pass-through entities. Therefore, the starting point for many clients will be to take a hard look at the C corporation as an alternative. If it fails to pass muster (and it will in many situations), the alternative pass-through entity forms will need to be evaluated.

Having reviewed the tax perks and traps of each entity form and the 16 key choice-of-entity factors, you should be teed up to analyze the following 11 fact situations.

PROBLEMS 3-B THRU 3-L

3-B. Lucy owns and manages two businesses. She now intends to start a third. Her new business will offer high-end catering services. Lucy will be the sole owner, but will spend very little time in the business. The inspiration and driving force behind the business will be Jane. In addition to Jane, the business will have ten employees and regularly have three trucks on the road. Lucy anticipates that the business will be profitable from the get-go. She anticipates withdrawing profits on a regular basis. She wants to have a separate entity for business purposes. What form of entity do you recommend? What additional facts would you like to have?

3-C. Sam, Larry and Joe are going into the business of offering management consulting and computer training services. The business will generate fees for professional services. Sam, Larry and Joe anticipate that they will always be the sole owners (in equal shares), and they will all work full-time for the business. They will start out with two staff employees, but will add other professional and staff employees as the business grows. The three owners intend to bail out the earnings of the business as compensation income, and they want to maximize their fringe benefits. What form of business entity do you

recommend?

3-D. Roger plans on opening a specialized machine shop. He will put up 55 percent of the capital, receive 55 percent of the equity interests in the business, work full-time as CEO of the business, and draw a salary and a bonus based on his performance. Three other individuals have committed to fund the balance of the needed capital in equal shares, and they will each receive 15 percent of the equity of the business. The business will have minimal debt and is expected to be profitable by year two. Roger wants a structure that ensures, to the maximum extent possible, freedom from minority owner hassles and contractual negotiations and dealings with minority owners. He wants total control. He wants to ensure that his investors do not have to pay self-employment taxes on any income they receive from the business. You represent Roger. What form of business entity do you recommend?

3-E. Same as 3–C, except (1) Roger puts up only 10 percent of the equity capital; (2) the other owners put up 90 percent of the equity capital; (3) the business will incur debt financing equal to nearly four times the total equity capital; (4) the business will generate substantial start-up losses during the first three years; and (5) a primary incentive for the investors is big tax write-offs in the early years. What form of business entity do you recommend?

3-F. Ronda has developed a business plan for creating and exploiting a new flash-type Internet application that, if successful, will make streaming media obsolete. She has already attracted the attention of one venture fund. She anticipates the company will need up to three levels of venture financing before it is in a position to go public. When asked about the opportunity, she lights up and says, "It will either be out of the park or a complete bust." What form of business entity do you recommend?

3-G. The outstanding common stock of corporations X, Y and Z, all C corporations, are owned by Jim, Linda and Sam, unrelated parties, in the following percentages:

	X Corp	Y Corp	Z Corp
Jim	10%	40%	30%
Linda	80%	5%	25%
Sam	10%	55%	45%

Jim, Linda and Sam plan to accumulate and reinvest $75,000 of income in each of the three corporations at the lowest corporate tax rates each year, and they assume that each of the corporations has an accumulated earnings tax threshold of $250,000. Will their plan work?

3-H. ABC Inc. and Smith Enterprises Inc. are friendly competitors in the medical supply industry. They are both C corporations owned and operated as successful family businesses. They now desire to form a joint venture to market their respective products in Europe. The venture will be a separate U.S. entity owned by ABC Inc. and Smith Enterprises and will have its own employees and

facilities. Both parties want flexibility in transferring funds into and out of the new entity and a clear written understanding of how decisions will be made and control exercised. What form of business entity would you recommend?

3-I. Jones Industries ("JI") is a successful C corporation that provides brand promotion products to multi-national companies. It buys many of its products and components offshore. To strengthen its offshore operations, it wants to create a new entity that will only develop and source products in other countries and then import and sell the products to JI. The new company will be owned by JI's three shareholders and will have its own employees. The pricing between the new company and JI will be structured to enable the new company to cover its costs and expenses and make a nominal profit. What form of business entity would you recommend for the new company?

3-J. Jerry has plans to form a new company that will build large trawler yachts (measuring 55 to 65 feet) in China. At his own expense, he has completed the initial plans for the first four yachts, all of which will be built from the same mold. He has secured equity financing from five wealthy yacht enthusiasts, who collectively have agreed to put up $6 million for the first four yachts. The "deal" is that (1) Jerry will get a salary of $90,000 a year; (2) the investors will get their investment money back first; (3) Jerry will then be paid the $150,000 he has invested in the initial plans; and (4) profits then will be distributed 30 percent to Jerry and 70 percent to the investors. Any losses will be allocated 99 percent to the investors and one percent to Jerry. Jerry wants to ensure that he always is in complete control of all business decisions. You represent Jerry. What business form would you recommend?

3-K. Five individuals are going to form a new manufacturing company that should quickly become profitable (starting at $150,000 and growing to $800,000 a year within five years). None of the shareholders will work for the company. Their shareholders' plan is to reinvest the profits to quickly grow the company and then to sell to a strategic buyer as soon as possible. Ideally, the sale of the business might be structured as a tax-free reorganization that would provide the shareholders with stock in a publicly-traded company. The shareholders want a structure that will minimize taxes, limit liability exposure, and ensure that they all have equal control in future decisions. What business form would you recommend?

3-L. Wharton Enterprises Inc. ("WI") is a successful S corporation owned by three individuals, all of whom work full-time for the business. WI has now decided to expand into many other states. In order to limit its liability exposure and simplify regulatory requirements, WI believes it must form a separate business entity for each state. WI will own all the state business entities. The shareholders want to ensure that profits and losses from the various entities can be consolidated for tax purposes. What business form would you recommend for WI and the state entities?