CHAPTER 5

ENTITY TAXATION AND CHOICE-OF-ENTITY PLANNING

A. ENTITY TAXATION CONCEPTS

Business owners need to be smart with taxes. The objective is to minimize the government's bite, consistent with other objectives, and to avoid look-back planning blunders – those situations where an owner, faced with an ugly tax bill that could have been avoided with some advance planning, exclaims in disgust, "I sure wish someone had told me that five years ago."

Smart tax planning requires more than just strategizing against a static set of rules. Changes in the rules must be anticipated and factored into the mix. Tax planning has always favored those who can wisely anticipate a moving target. And there is little question that today, perhaps more than ever, the target is moving faster and is harder to predict.

1. CORPORATION TAX BASICS – Q&As

5.1 What is a C corporation?

A C corporation is a regular corporation that pays its own taxes. It is a creature of state law, is recognized as a separate taxable entity, and is governed by the provisions of subchapter C of the Internal Revenue Code. Any corporation that does not properly elect to be taxed as an S corporation will be taxed as a C corporation.

5.2 What tax rates do C corporations pay?

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 rate applicable to all income is 35 percent.[1]

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.[2]

5.3 What is the C corporations double tax structure?

The biggest negative of a C corporation is the double tax structure – a corporate level tax and a shareholder level tax. It surfaces whenever a dividend is paid or is deemed to have been paid. 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. It's all a result of the inherent double tax structure of a C corporation.

5.4 What are the federal tax rates that shareholders must pay on dividends received from a C corporation?

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).[3] 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)[4] 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 kicks 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).[5] 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.

5.5 How are C corporation dividends paid to C corporation shareholders taxed?

There is an attractive income tax 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

1. I.R.C. § 11(b)(1).
2. I.R.C. § 11(b)(2).
3. I.R.C. § 1(h)11(b).
4. Section 102 of the American Taxpayer Relief Act of 2012.
5. I.R.C. § 1411.

entity's stock and 100 percent for members of an affiliated group.[6]

5.6 How are tax losses of a C corporation treated?

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.

5.7 How much flexibility does a C corporation have in selecting a tax year?

A great deal. A C corporation may adopt any fiscal year to ease its accounting and administrative burdens and to maximize tax deferral planning.[7]

5.8 Can a C corporation combine with other corporations on a tax-free basis?

Yes. A C corporation may participate in a tax-free reorganization 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.[8] This opportunity 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.

5.9 How is the gain recognized on the sale of C corporation stock taxed?

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.[9] The problem for planning purposes is that it is usually difficult, if not impossible, to accurately predict when stock may be sold and even more difficult to speculate on what the state of the long-term capital gains break will be at that time. Too often, planning is based on the assumption 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.

5.10 What is the Section 1045 small business stock rollover deferral option?

Section 1045 of the Internal Revenue Code permits a non-corporate shareholder 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.[10] This perk

6. I.R.C. § 243(a) & (c).
7. See generally I.R.C. § 441.
8. I.R.C. §§ 368, 354, 361.
9. I.R.C. §§ 1221(a), 1222(3).
10. 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

can excite the 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.

5.11 How is a loss recognized on the sale of C corporation stock treated for tax purposes?

Generally, any such loss is subject to all the limitations of capital losses. Thus, the loss usually is limited to offsetting capital gains or being recognized over time at a maximum pace of $3,000 a year.

There is a limited exception under Section 1244 of the Code. This exception 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).[11] This benefit often sounds better than it really is because the ordinary loss in any single year (usually the year of sale) is limited to $50,000 ($100,000 for married couples). This serious dollar 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 in the planning process.

5.12 May C corporation shareholders who are also employees participate in a company's employee benefit programs?

Yes. A shareholder of a C corporation who is also an employee may participate in all employee benefit plans and receive the associated tax benefits. Such plans typically include group term life insurance, medical and dental reimbursement plans, section 125 cafeteria plans, dependent care assistance programs, and qualified transportation reimbursement plans. 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.[12]

5.13 May multiple C corporations that are commonly controlled file as a single entity for federal income tax purposes?

Yes. 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

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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).

11. I.R.C. § 1244.

12. 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.

order to simplify tax compliance, eliminate tax issues on transactions between the entities, and facilitate the netting of profits and losses for tax purposes. This is permitted under the consolidated return provisions of the Code.[13] The key 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.[14]

5.14 Is the tax basis of the stock owned by a C corporation shareholder impacted by the corporation's retention and reinvestment of its earnings?

No. 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 10 years. Linda's stock basis at the end of year 10 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 10 would have grown to $2.1 million.[15] On a sale, the difference would be a capital gains hit on $2 million. This basis step-up may be a compelling planning consideration in many situations.

5.15 Are C corporations subject to an alternative minimum tax?

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 gross receipts of not more than $7.5 million during any three-year period thereafter.[16] The alternative minimum 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.[17] 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.[18] 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.[19]

5.16 What are the disguised dividend traps of a C corporation?

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

13. See generally I.R.C. §§ 1501-1504.
14. I.R.C. § 1504(a).
15. I.R.C. § 1367(a). Partners experience the same basis adjustment for accumulated earnings under I.R.C. § 705(a).
16. I.R.C. § 55(e).
17. I.R.C. §§ 55(b)(1)(B), 55(d)(2).
18. See generally I.R.C. § 56.
19. I.R.C. § 56(g).

stake are a deduction at the corporate level and an imputed taxable dividend at the shareholder level. Common examples of disguised dividends include excessive compensation payments to shareholder/employees or family members,[20] personal shareholder expenses that are paid and deducted as business expenses by the corporation,[21] interest payments on excessive shareholder debt that is reclassified as equity,[22] excess rental payments on shareholder property rented or leased to the corporation,[23] personal use of corporate assets, and bargain sales of corporate property to a shareholder.[24]

5.17 What is the C corporation 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, the tax code imposes a penalty tax on C corporations that accumulate excessive amounts of income accumulations by not paying sufficient dividends. The tax doesn't kick in until the aggregate accumulated earnings exceed $250,000 ($150,000 in the case of certain professional service organizations).[25] And 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.[26] 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.

5.18 What is the C corporation 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. 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 a nuisance that has to be monitored in select situations.

5.19 What is the C corporation controlled group trap?

This trap is aimed primarily at the business owner who would like to use multiple C corporations to take multiple advantage of the low C corporation tax rates, the $250,000 accumulated earnings trap threshold, or the $40,000

20. 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).

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

22. See the related discussion Chapter 4. Also, see generally Hariton, "Essay: Distinguishing Between Equity and Debt in the New Financial Environment," 49 Tax L. Rev. 449 (1994).

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

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

25. I.R.C. § 535(c).

26. 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..."

alternative minimum tax exemption. 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.[27] Section 1563 of the Internal Revenue Code defines three types of controlled groups: parent-subsidiary controlled group, brother-sister controlled groups, and combined controlled group.[28] The existence of this trap requires, as part of any business planning 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.

5.20 What is the section 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. All business dealings between commonly controlled entities must be carefully monitored to avoid Section 482 exposure.

5.21 What is an S corporation?

An S corporation is a hybrid whose popularity has grown in recent years. It is organized as a corporation under state law and offers 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.

5.22 Can any corporation elect to be taxed as an S corporation?

No. 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.[29] Banks and insurance companies cannot elect S status.[30] Also, the election cannot be made if the corporation has more than 100 shareholders or has more than one class of stock.[31] 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.[32] The one class of

27. I.R.C. § 1561
28. I.R.C. § 1563(a)(3).
29. I.R.C. § 1361(b).
30. I.R.C. § 1361(b)(2).
31. I.R.C. § 1361(b)(1)(A) & (D).
32. I.R.C. § 1361(c)(1).

stock requirement is not violated if the corporation has both voting and nonvoting common stock and the only difference is voting rights.[33] Also, there is a huge 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.[34]

5.23 What trusts are eligible to own stock of an S corporation?

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); (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 who 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.[35] 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 Internal Revenue Code.[36]

5.24 How does a corporation elect in and out of S status?

An election to S status requires a timely filing of a Form 2553 and the consent of all shareholders.[37] 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 percentage 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.[38] 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.[39] 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

33. I.R.C. § 1361(c)(4).

34. 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.

35. I.R.C. §§ 1361(c)(2), 1361(d), 1361(e).

36. I.R.C. §§ 1361 (e)(1)(A), 1361(c)(2)(b)(v).

37. I.R.C. § 1362(a). See generally Reg. § 1.1362-6.

38. I.R.C. § 1362(b)(1).

39. 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.

shares.[40] 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 15th day of the third month of the current year, in which case it is retroactively effective for the current year.[41]

5.25 How is the income of an S corporation taxed?

The income of an S corporation is passed through and taxed to its shareholders. The entity itself pays no tax on the income,[42] 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 (e.g., accumulated earnings tax, and personal holding company tax) that are designed to maximize the double tax impact. Also, the income passing through an S corporation may qualify as passive income for those shareholders who are not deemed "material participants."

5.26 How are losses of an S corporation taxed?

An S corporation's losses also are passed through to its shareholders. , subject to the same three loss hurdles applicable to partnerships that are discussed in question 5.33 below.

5.27 Is the tax basis of the stock owned by an S corporation shareholder impacted by the corporation's allocation of income and losses and distributions?

Yes. 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.[43] There is no locked-in basis, as there is with a C corporation.

5.28 As compared to a C corporation, is it easier from a tax standpoint for an S corporation to make distributions to its shareholders?

Yes. The tax consequences of distributing money or property from an S corporation generally are much less severe than for a C corporation. Distributions of allocated S corporation income are tax-free to the shareholders.

5.29 How much flexibility does a S corporation have in selecting a tax year?

S corporations have very little flexibility, particularly as compared to the flexibility of C corporations. 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

40. I.R.C. § 1362(d)(1).
41. I.R.C. § 1362(d)(1)(C) & (D).
42. I.R.C. § 1363(a).
43. I.R.C. § 1367(a).

advantage.

5.30 Is it costly from a tax standpoint to convert from a C corporation to an S corporation?

A C corporation's conversion to an S corporation is far easier from a tax perspective than a conversion to a partnership. But there are traps even in an S conversion for built-in asset gains, accumulated earnings, LIFO inventory reserves, and excessive S corporation passive income. Usually these traps can be avoided or managed with smart planning.

2. LLC AND PARTNERSHIP TAX CONCEPTS – Q&As

5.31 Are limited liability companies and partnerships taxed the same?

Generally, yes. They are both treated as partnership-taxed entities under subchapter K of the Internal Revenue Code. However, as explained below, any limited liability company or partnership that has more than one owner may elect to be taxed as either a C corporation or an S corporation.

5.32 How is the income of a limited liability company or partnership taxed?

The income of the entity is passed through and taxed to its owners. 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 entity 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.

5.33 How are losses of a limited liability company or partnership taxed?

The losses of a partnership-taxed entity also pass through to its owners. Unlike a C corporation, the losses are not trapped inside the entity.

Does this mean the owners 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 an owner cannot exceed that owner's basis in his or her interest in the entity.[44] This hurdle seldom presents a problem in a partnership-taxed entity, because each owner's share of the entity's liabilities, even its nonrecourse liabilities, is treated as a contribution of money by the owner for basis purposes.[45] The second hurdle, known as the at-risk hurdle, generally limits an owner's losses to only the amount that the owner actually has at risk.[46] An owner's at-risk amount typically includes property contributed to the entity by the owner and the owner's share of the entity's recourse liabilities

44. I.R.C. § 704(d).
45. I.R.C. § 752(a).
46. I.R.C. § 465(a).

(those liabilities that create personal exposure for the owners).[47] Nonrecourse liabilities (those liabilities for which no owner 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.[48] The third hurdle (and usually the toughest) is the passive loss rule,[49] 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 owner disposes of his or her interest in the passive activity that produced the unused losses.[50] Whether a particular business activity is deemed passive or active with respect to a particular partner is based on the owner's level of participation in the activity – that is, whether the owner 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.[51] To meet the "material participation" standard and avoid the hurdle, an owner must show "regular, continuous, and substantial" involvement in the activity.[52] 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.

5.34 Are there potential passive income benefits with a limited liability company or partnership?

Yes. 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

47. I.R.C. § 465(b).

48. 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).

49. See generally I.R.C. § 469.

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

51. I.R.C. § 469(h)(2).

52. 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).

passive income can breathe tax life into passive losses from other 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 owners who are not material participants.

5.35 Is the tax basis of the interest owned by the owner of a partnership-taxed entity impacted by the corporation's allocation of income and losses and distributions?

Yes. The owner's basis in his or her partnership interest is adjusted upward by capital contributions and income allocations and downward by distributions and loss allocations.[53] 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 (Question 5.14), 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.

5.36 How much flexibility does a partnership-taxed entity have in designing special allocations among its owners?

It has tremendous flexibility. An entity taxed as a partnership may structure special allocations of income and loss items among its various owners. For example, one owner 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-taxed entity. A partnership-taxed entity allocation will be respected for tax purposes only if it has "substantial economic effect,"[54] three words that make section 704(b) and its regulations one of the most complex subjects in the world of tax. 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.[55] 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,[56] 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.[57] 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.[58] The most common examples of economic effects that are not deemed "substantial" are shifting allocations (allocations of

53. I.R.C. § 705(a).
54. I.R.C. § 704(b).
55. Reg. §§ 1.704-1(b)(2)(ii) (b)(1), 1.704-(b)(2)(ii) (B)(2).
56. Reg. § 1.704-1(b)(2)(ii) (b)(3).
57. Reg. §§ 1.704-(2)(c), 1.704-(2)(f)(1), 1.704-(g)(1), 1.704-2(b)(1) & (e).
58. Reg. § 1.704-1(b)(2)(iii).

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).[59]

5.37 How easy is it from a tax standpoint to get money out of a limited liability company or a partnership?

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 entity and owner level. There are a few exceptions. One is where a distribution of money to an owner exceeds the owner's basis in his or her entity interest; the excess is taxable.[60] Another is where the entity has unrealized accounts receivable or substantially appreciated inventory items; in these cases, ordinary income may need to be recognized to reflect any change in an owner's interest in such assets.[61] 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.

5.38 What is the tax-free profits interest benefit available to a limited liability company or a partnership?

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.[62] A corporation generally cannot transfer an equity interest in return for services without creating a taxable event. Note that this benefit only applies to an equity interest in future profits, not an interest in existing capital.

5.39 What is the family partnership tax trap applicable to a limited liability company or a partnership?

Entities that are considered family partnerships for tax purposes are subject to a special trap that is designed to prevent the use of the entity to aggressively shift income among family members. If any person gifts an entity 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.[63] In effect, special allocations to favor donees are prohibited, as are attempts to shift service income. Any purchase among family members is considered a "gift" for purposes of this trap.[64]

5.40 Is it possible to convert a C corporation to a limited liability company or a partnership?

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59. Reg. § 1.704-1(b)(2)(iii) (b) & (c).
60. I.R.C. § 731(a).
61. I.R.C. § 751; Reg. §§ 1.751-1(b)(2)(ii), 1.751-1(b)(3)(ii), 1.751-1(g).
62. See Rev. Proc. 93-27, 1993-2 C.B. 343 and Rev. Proc. 2001-43, 2001-2 C.B. 191.
63. I.R.C. § 704(e).
64. I.R.C. § 704(e)(3).

Technically it may be possible, but 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.

3. SELF-EMPLOYMENT AND PAYROLL TAX BASICS

5.41 What impact does the self-employment and payroll tax have on the business planning process?

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 rate applies to any interest, dividends, capital gains, and "net investment income" received by such taxpayers.[65] 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.[66]

5.42 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 the tax burden in setting the employee's pay level.

5.43 How does the self-employment tax impact high-income taxpayers?

For high-income owners, 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.[67]

5.44 Is the self-employment tax a factor to consider in choosing the best form of business entity to use in a given situation?

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.

5.45 What are the self-employment and payroll tax impacts with a C corporation?

65. I.R.C. § 1411.
66. I.R.C. § 164(f).
67. Report of the Congressional Budget Office, Economic Stimulus: Evaluating Proposed Changes in Tax Policy – Approaches to Cutting Personal Taxes (January 2002), footnote 7.

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.[68] 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.

5.46 What are the self-employment tax impacts with an S corporation?

The C corporation double-tax trade-off disappears for an S corporation 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 an S corporation avoids all self-employment taxes on dividends, including the 3.8 percent Medicare tax.[69] 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.[70] 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.

5.47 What are the self-employment tax impacts with 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.[71] There is a limited statutory exception for retired partners[72] 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.[73] Thus, the key to minimizing the tax in a partnership structure is to fit within this limited partnership exception.

5.48 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.

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68. I.R.C. §§ 1402(a)(2), 1411.

69. 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).

70. 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).

71. I.R.C. § 1402(a).

72. I.R.C. § 1402(a)(10).

73. I.R.C. §§ 1402(a)(13), 1411.

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.[74] 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 regulations dealing with the limited partnership exception.[75]

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.

5.49 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.[76]

CASE PROBLEM 5-1

Marsha is ready to start a new 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 to fund her personal needs. 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

74. Proposed Reg. § 1.1402 (a)-2.

75. Tax Relief Act of 1997 § 935.

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

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 Marsha 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 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.

B. SELECTING THE BEST ENTITY FORM

1. THE CHALLENGE

A primary planning challenge for all businesses is to select the best form of business organization. Too many business owners and executives mistakenly assume that this challenge is limited to new ventures. Many mature businesses have a need, albeit often unrecognized, to reevaluate 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.

The analytical process usually requires the business owner or executive 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. The best answer is an easy call in some cases and a tough challenge in many others. 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 entity candidates include the C corporation, the S corporation, the limited liability company, the general partnership, and the limited partnership.

There are a few additional business entity forms that should be considered in

select situations. The first is the professional limited liability company ("PLLC"), a state-chartered entity that many states now authorize in order to limit the liability exposure of professionals (i.e., doctors and lawyers) who render professional services. The entity 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. Some states require that a PLLC register with the applicable state licensing board before filing its organizational documents with the state. A close cousin to the PLLC is the registered limited liability partnership ("LLP"), a partnership that some state statutes allow to be registered for the sole purpose of providing liability protections to the partners of a partnership. Finally, there is the limited liability limited partnership ("LLLP"), a form of entity that some states authorize to permit a general partner of a limited partnership to eliminate his or her personal exposure for the entity's debts.

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 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.

2. "CHECK-THE-BOX" RULES

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 a business owner 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. It was 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

system provides certainty and, unlike the prior system, contains default provisions that greatly reduce the likelihood of the uninformed being punished.

The "check-the-box" regulations apply to any business entity that is separate from its owner and that is not a trust.[77] Following is a brief description of the key provisions of the "check-the-box" system:

- **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.[78] Thus, any corporation formed under state law is taxed as a corporation, either as a C corporation under Subchapter C or as an S corporation under Subchapter S of the Internal Revenue Code.

- **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.[79] Any such election may be effective up to 75 days before and 12 months after the election is filed.[80] 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.[81]

- **Single Owner Entity.** An unincorporated single-owner entity, such as a single-member limited liability company, is treated as a disregarded entity - a nullity - 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.[82]

- **Pre-1997 Entities.** With one exception, pre-1997 entities retain the 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.[83]

- **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.[84] 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).[85]

- **Election Tax Consequences.** If an entity that is taxed as a partnership

77. Reg. §§ 301.7701-1(a), 301.7701-2(a).
78. Reg. § 301.7701-2(b)(1).
79. Reg. §§ 301.7701-2(c)(1), 301.7701-3(a), 301.7701-3(b)(1).
80. Reg. § 301.7701-3(c)(1)(iii).
81. Reg. § 301.7701-3(c)(2).
82. Reg. §§ 301.7701-2(a), 301.7701–2(c)(2), 301.7701–3(a), 301.7701–3(b)(1).
83. Reg. § 301.7701-3(b)(3).
84. Reg. § 301.7701-3(c)(1).
85. Reg. § 301.7701-3(f).

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.[86] 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.[87] Similar rules apply to a single-owner entity that elects corporate status or that, having elected and maintained corporate status for at least 60 months, elects sole proprietorship status.[88]

3. KEY FACTORS – FIVE EXAMPLE CASES

The choice of entity analysis requires a careful assessment of all relevant factors. This sections reviews 15 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.

In most cases, it is advisable to review all tax consequences, even those consequences that, at first blush, are not likely to impact the ultimate choice of entity decision. Such a review usually results in a deeper analysis and often triggers a detailed dialogue that significantly improves the quality of the analysis and enhances an 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 individual who quickly jumps to an ultimate conclusion and then becomes a dogmatic advocate for that conclusion usually shortchanges the analytical process.

Everyone involved in the process should be ever mindful of the fact that taxes are a moving target; the rules often change. What works today may make no sense tomorrow. Advisors 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.

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;

86. Reg. § 301.7701-3(g)(1)(i).
87. Reg. § 301.7701-3(g)(1)(ii).
88. Reg. § 301.7701-3(g)(1)(iii) & (iv).

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 owns and manages three businesses. He now intends to start a fourth. His new business 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, but will spend little time in the business.

The inspiration and driving force behind the business will be Joe, who has extensive experience in the industry. Joe will be given strong economic incentives as the CEO, but will not be an owner. In addition to Joe, the business will initially have about 30 employees. Jason anticipates that the business will be profitable from the get-go, and he plans on withdrawing profits on a regular basis. 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 One: 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.

Factor Two: 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 Three: Tax-Free Reorganization Potential

If Jason's 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 Four: 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.

For choice-of-entity planning purposes, suffice it to say that specific control interests of a dominant owner, such as Jason, and the dynamics between the various players (or lack thereof) may favor the use of a corporate entity or limited partnership in some cases.

Factor Five: Sellout Tax Hit

Most who start a new business or operate a seasoned business are not focused on selling out down the road. But the truth is that 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.

Other important elements of this sellout factor should be kept in mind. 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 a year 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 pretty 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 Six: 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 2: 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 Seven: 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,[89] 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

89. 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.

partner or an S corporation shareholder.

Factor Eight: 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 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.

Factor Nine: 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.[90] When the plan is to bailout most of the corporate earning as deductible compensation to the shareholders, often a C corporation may offer an opportunity to defer the payment of income taxes by using a corporate fiscal year that is different than the shareholders' calendar tax year.

The ability to use this deferral technique is limited by the normal

90. I.R.C. §§ 444(b)(2), 280(H).

compensation reasonableness standards. Plus, the deferral impacts often are watered down by withholding and estimated tax payment requirements. But the technique is fairly common and is a legitimate means of deferring taxes if properly executed.

Example Case 3: Charles

Charles plans on opening a chain of indoor snow skiing facilities. Charles will put up 10 percent of the equity capital. The other 90 percent 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 and amortization 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 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 two additional choice-of-entity factors.

Factor Ten: 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 Eleven: 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.

Example Case 4: Jurden Inc.

Jurden Inc. is a successful C corporation that is poised to explode. It has five shareholders, all successful business investors. Then 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 Twelve: 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 5: 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 now is to reinvest all business earnings to 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 Thirteen: 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 Fourteen: 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 Fifteen: 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)[91] 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 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

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

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.

CASE STUDY 5-2

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 that 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?

CASE STUDY 5-3

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. Plus, he wants to minimize income and self-employment taxes and have no personal liability for the entity's obligations.

You represent Roger. What form of business entity do you recommend?

CASE STUDY 5-4

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?