



Choice of Entity

Formation and Other Considerations

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Jon R. Stefanik



Outline

- State Law Considerations
 - Structure
 - Formalities
 - Liability
 - Management rights
- Tax Considerations
 - Income tax
 - Self-employment
 - Net investment income
- Miscellaneous Considerations

● ● ● | Formation and Formalities

○ Corporations

- Formation – Articles of Incorporation
- Must maintain corporate formalities
 - E.g., directors and officers, meetings, meeting minutes, share certificates, stock records, etc.
 - Some formalities may be dispensed with via a Close Corporation Agreement
 - ORC § 1701.591.

● ● ● | Formation and Formalities

- Sole Proprietorship
 - No formalities
 - Sole proprietor has unlimited liability
- Partnerships
 - Limited formalities
 - Partners have unlimited liability
- Hybrid Entities (LLC, LLP, LP)
 - Limited partners and LLC members (but not general partners) have limited liability
 - Limited formalities

● ● ● | Liability for Venture Obligations

- Are owners personally liable for venture obligations?
 - Sole Proprietorship → proprietor is fully liable for venture obligations
 - GP → general partners are jointly and severally liable for venture obligations
 - LP → general partner = yes; limited partner = no
 - LLP → no, except to the extent attributable to the partner's own wrongful acts
 - LLC → no
 - Corporations → no



● ● ● | Management Rights

- GP/LLP → Statutory right to participate in management
- LP → General partners have statutory right to participate in management; limited partners jeopardize their limited liability if they participate in management
- LLC → Members or managers may participate in management
- Corporation → Shareholders participate by electing directors, who in turn appoint officers



- ● ● | Transfers of Shares/Interests

- LLC/LP/LLP/GP → Transferee generally acquires only an “assignee” interest
 - Economic interest only; no management rights
 - Can be varied by Partnership/Operating Agreement
- Corporation → No consequence

- ● ● | Continuity

- GP/LLP/LP/LLC

- Death of a partner/member may under certain circumstances result in a dissolution of the entity

- Corporation

- Death of a shareholder is of no consequence to the corporation's continuity



● ● ● | Creditors' Rights

○ LLC/GP/LLP/LLC

- Creditor of a partner/member may obtain a “charging order”
- Status as assignee (not a full member)
- No right to force a dissolution

○ Corporation

- Creditor may foreclose upon and sell off of a shareholder's rights in the corporation



● ● ● | General Tax Considerations

- Sole Proprietorship
- “C” corporations
 - Income taxed at entity-level
 - Cash and property distributions taxed to shareholders
 - So-called “double taxation”
 - Distributions of appreciated property also trigger corporate-level income tax on built-in appreciation
 - Incorporation is generally tax-free



● ● ● | General Tax Considerations

○ Pass-through entities (“PTEs”)

- Entities that have elected “subchapter S” status, and
 - Partnerships, LLCs, LLPs, LPs, and any other entity characterized as a partnership for federal income tax purposes
- PTEs generally are not subject to income tax at the entity level. IRC §§ 701, 1363(a)
 - Tax elections made at entity level. IRC §§ 703(b), 1363(c)(1)



● ● ● | PTE Tax Treatment

- Taxable income of a PTE is determined in the same manner as an individual. IRC §§ 703(a), 1363(b)
- Exceptions to treatment of entity as an individual
 - Certain deductions disallowed (IRC §§ 703(a)(2), 1366(b)(2))
 - E.g., personal exemption, NOLs, itemized deductions
 - Certain items must be separately stated (IRC §§ 702(a)(1), 1366(b)(1))
 - Capital gains and losses
 - Section 1231 gains and losses
 - Charitable contributions
 - Dividends
 - Foreign taxes

● ● ● | PTE Cash Distributions

- Cash distributions from a PTE are generally tax-free to the extent of “basis”
 - Basis generally determined at year-end
 - Income applied first to increase basis
 - Then, distributions followed by non-deductible expenses and then operating losses
 - Maximizes amount that can be received tax-free
 - Slightly different rules for S corps that are former C corps





Example

A contributes \$10,000 to ABC Corp. (an S corporation) in exchange for stock. In Year 1, ABC earns \$5,000 and distributes \$8,000 to A on December 31

Initial Stock Basis	\$10,000
Income	5,000
Distribution	<u>(8,000)</u>
Year End Stock Basis	\$ 7,000

● ● ● | PTE Property Distributions

- S Corp → Under IRC § 311(b), treated as if property was sold by corporation and gain, but not loss, is recognized
 - Same as with C corporation
- Partnership → Generally no gain or loss

- ● ● | S Corporations - Eligibility

- “Small Business Corporation” § 1361(b)
 - No more than 100 shareholders
 - No shareholders other than individuals, certain trusts and estates
 - No non-resident alien shareholders
 - Only one class of stock
- Must affirmatively elect + SH consent



S Corp Entity-Level Taxes

- Excess net passive income (“NPI”). Tax is imposed at highest corporate rate on excess NPI if NPI exceeds 25% of gross receipts. Only applies if corp. has E&P.
 - Passive income (“PI”). PI means royalties, dividends, interest, and rents unless lessor provides substantial services in connection with rental.
 - Loss of S election. S election is lost if corporation receives excess NPI for three years.
- Purpose. The purpose is to ensure that an S corporation that was formerly a C corporation liquidates and incurs double tax after an asset sale unless it continues a substantial operating business.



● ● ● | S Corp Entity-Level Taxes

- Built in Gains (“BIG”) tax. Tax is imposed at the highest corporate rate on net BIG recognized within the five-year period after making of S election. IRC § 1374
- Definition of BIG. BIG is the excess of the value of the corporation’s assets over their bases as of the effective date of the S election.
- Built-in losses. BIG may be offset by built-in losses recognized in the same year as the BIG.





BIG Continued

- Taxable income. BIG may only be taxed to extent of taxable income. Excess BIG will be carried forward and taxed in a future year in the five-year recognition period when corporation has taxable income.
- Loss carry forwards. C corporate NOL and capital loss carry forwards may offset BIG.
- Purpose. Purpose of BIG is to prevent avoidance of C corporate double tax by making S election shortly before asset sale.

● ● ● | Pass Through of Losses

- Advantage of PTEs over C corporations
- Use venture losses to shelter income from other sources
- Subject to several limitations

● ● ● | Loss Limitations

- Basis – IRC §§ 704(d), 1366(d)
 - Share of losses cannot exceed outside basis
- At-Risk Amount – IRC § 465
 - Share of losses cannot exceed “amount at risk”
- Passive Loss Rules – IRC § 469
 - Losses from a “passive activity” cannot be used to offset income from active sources
 - Passive activity is one in which the taxpayer does not “materially participate”



● ● ● | Self-Employment Taxes

- Partners cannot be W-2 employees, even as to IRC § 707(c) guaranteed payments
 - All income reported on K-1
 - Thus, no payroll taxes
- Self-employment tax fills gap

● ● ● | Net Earnings from Self Employment (“NESE”)

- A partner’s distributive share of partnership income is NESE subject to SE tax
- Exception → income allocated to LP in his or her capacity as an LP (excluding guaranteed payments). IRC § 1402(a)(13)
- Issue → when is an LLC member an LP for this purpose?

● ● ● | NESE – LLC Members

- Under proposed regulations, an LLC member would be treated as an LP unless he or she:
 - has authority to bind LLC;
 - is liable for LLC's debts; or
 - participates > 500 hours in LLC's business.
 - Prop. Reg. Sec. 1.1402(a)-2(h)

● ● ● | Prop. Regs. - Cont'd

- The Proposed Regs establish possibility for multiple classes of LLC interests
 - Same person could hold “LP” interest and “GP” interest under certain circumstances
- Congress issued moratorium on guidance (TRA 1997, Sec. 935 – since expired)
- IRS informally indicates that taxpayers may rely on the Proposed Regs

● ● ● | NESE – S Corporations

- Income allocated to S Corp shareholders is not subject to SE tax
- But, service providers must be paid reasonable compensation (which is treated as wages subject to payroll taxes)
- Nevertheless, uncertainty re LLCs has resulted in abundant use of S Corps for the purpose of limiting SE tax exposure
- Frequent target of congressional scrutiny

● ● ● | Tax on Net Investment Income

- For individuals, the tax is imposed at the rate of 3.8% upon the lesser of:
 - net investment income (“NII”); or
 - the amount by which modified adjusted gross income exceeds the applicable threshold amount.
- Threshold amount: \$125,000 (married filing separately), \$200,000 (single) or \$250,000 (married filing jointly).





What is NII?

- NII can come from three different “buckets”:
 - Gross income from interest, dividends, annuities, royalties and rents (unless derived in a trade or business).
 - Gross income from a passive activity (as defined in IRC §469) or the trade or business of trading in financial instruments or commodities.
 - Net gain from the disposition of property, other than property held in a trade or business.
- Importantly, the 3.8% tax on NII applies to a taxpayer’s distributive share of passive income and to a taxpayer’s disposition of an interest in a passive activity.



● ● ● | Equity Compensation

- Corporations (including S corps)
 - Phantom stock
 - Stock Appreciation Rights
 - Restricted Stock
 - Options
- Partnerships
 - All of the foregoing, plus “profits” interests



Rev. Proc. 93-27

- Grant of profits interest not taxable
 - Interest must be issued in exchange for services performed or to be performed
- Exceptions:
 - Substantially certain/predictable stream
 - Disposition w/in 2 years
 - LP interest in PTP

● ● ● | Rev. Proc. 93-27 - Definitions

- Capital Interest

- An interest that would entitle the holder thereof to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership.

- Profits Interest → interest that is not a capital interest



Rev. Proc. 93-27 - Issues

- What if the interest is not vested as of the date of grant?
 - Does Rev. Proc. 93-27 apply?
 - Is service provider subject to tax upon vesting?
 - Should SP be treated as a partner prior to vesting?

● ● ● | Rev. Proc. 2001-43

○ Clarifies Rev. Proc. 93-27

- Determination of whether an interest is a capital or profits interest is made at time of grant
 - Even if substantially non-vested at that time

○ Conditions:

- Requirements of Rev. Proc. 93-27 satisfied
- P and SP treat SP as owner of the interest
- No deduction for P or other partners at grant or vesting



IRC § 754 Election

- Matching of “inside” basis and “outside” basis
 - Benefit to a purchaser of an interest or a person who inherits an interest
- Available to partnerships, but not S corporations

● ● ● | COD Income

- IRC § 61(a)(12)
 - Gross income includes income from cancellation of indebtedness
- IRC § 108 includes a number of exemptions
- Insolvency exemption: IRC § 108(a)(1)(B)
 - S corp → insolvency determined at entity level
 - Partnership → insolvency determined at partner level

- ● ● | Tax Summary:
S Corp. vs. C Corp.

- Fundamental difference between “S” and “C”
 - Pass-through taxation
- Similarities
 - S corporation treated as C corporation except as otherwise provided
 - E.g., Sections 351 / 368 are available
 - Gain on distribution of appreciated property

● ● ● Tax Summary: Partnerships v. S Corps

○ Similarities

- Pass-through taxation

○ Differences

- Tax-free property distributions (subject to exceptions)
- Flexibility re profit allocation mechanisms
- Flexibility re types of shareholders
- For partnerships, liabilities included in basis
- Ability to make 754 election in partnership context
- Insolvency exception to “COD” income
- Equity Sales



● ● ● | CTB Regulations – Core Terms

○ “Entity”

- Organization separate from its owners
 - Matter of federal tax law; not dependent on state law
 - Cost sharing alone does not create entity
- Entity may have one or many owners

○ “Business entity”

- Any entity not classified as a trust and not subject to special treatment (e.g., REITs)

● ● ● | Eligible Entities

- Eligible → entities not meeting definition of a “corporation”
- Two or more members
 - Default classification → partnership
 - Can elect to be taxed as association
- One member
 - Default classification → disregarded entity
 - Can elect to be taxed as an association

● ● ● | Corporation Defined

- Corporation under state law
- Association
- Insurance company or bank
- Joint stock company
- Entity wholly-owned by a state
- PTPs, TMPs, etc.
- Certain specified foreign organizations

● ● ● | Disregarded Entities

- Provide state law limited liability
- No additional taxpayers created
 - Avoid complicated consolidated return rules
- Generally uses EIN of sole member
 - Exception for payroll/excise taxes

● ● ● | Method of Making Election

- Form 8832
- Must specify name, address and TIN of the entity and the chosen classification
- Effective when filed unless an earlier date is specified (no earlier than 75 days prior)
- May be signed by all members or any authorized member

● ● ● | Effect of Election

- Only one election per 60-month period
- Exceptions:
 - Initial elections/classifications
 - IRC § 708(b)(1)(B) terminations
 - Acquisitions

● ● ● | LLC as S Corporation?

- State law LLC
- CTB election to be “association”
- S election for association
- S election made on Form 2553
- No need for CTB election for LLC if S election is made
- Why?

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Changes in Classification

Partnership → Association

- “Assets over” approach

- Partnership contributes all of its assets and liabilities to the association in exchange for stock in the association (IRC § 351)
- Partnership then liquidates by distributing the stock of the association to its partners
- Compare Rev. Rul. 84-111

- ● ● |

Changes in Classification

Association → Partnership

- “Assets up” approach
 - Association distributes all of its assets and liabilities to its shareholders in liquidation of the association
 - Taxable under IRC § 336 unless corp. parent
 - Shareholders contribute all of the distributed assets and liabilities to a newly-formed partnership
 - Generally non-taxable under IRC § 721



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Changes in Classification

To or From Disregarded Entity

- Association → DE: Liquidation

- The association distributes all of its assets and liabilities to its single owner in liquidation

- DE → Association: Incorporation

- The owner of the DE contributes all of the assets and liabilities thereof to the association in exchange for stock of the association (IRC § 351)



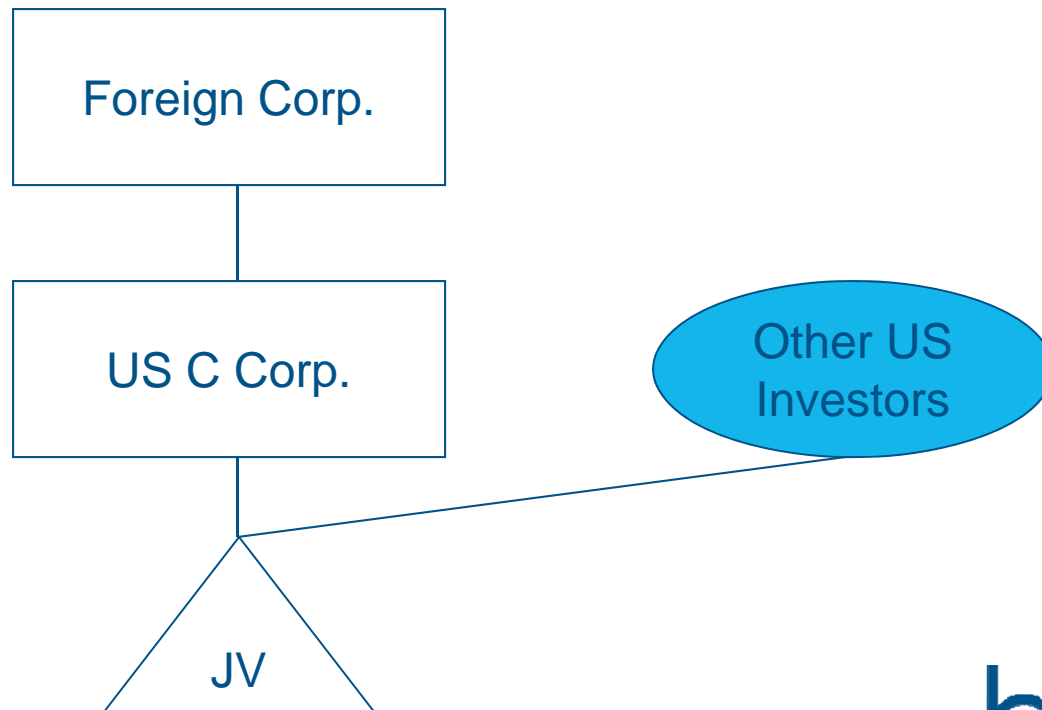
● ● ● | Financing Considerations

- Delaware “C” corporation likely preferred by:
 - Angel Investors
 - Venture Capital
 - Private Equity
- Tax reasons → avoid flow-through income
- State law reasons → Delaware business laws

● ● ● | International Considerations

- US Operations generally conducted directly or indirectly through domestic “C” corporation
 - Domestic corporation may conduct operations directly, or
 - Domestic corporation may serve as a “blocker” corporation

● ● ● | Blocker Corporations





Series LLCs

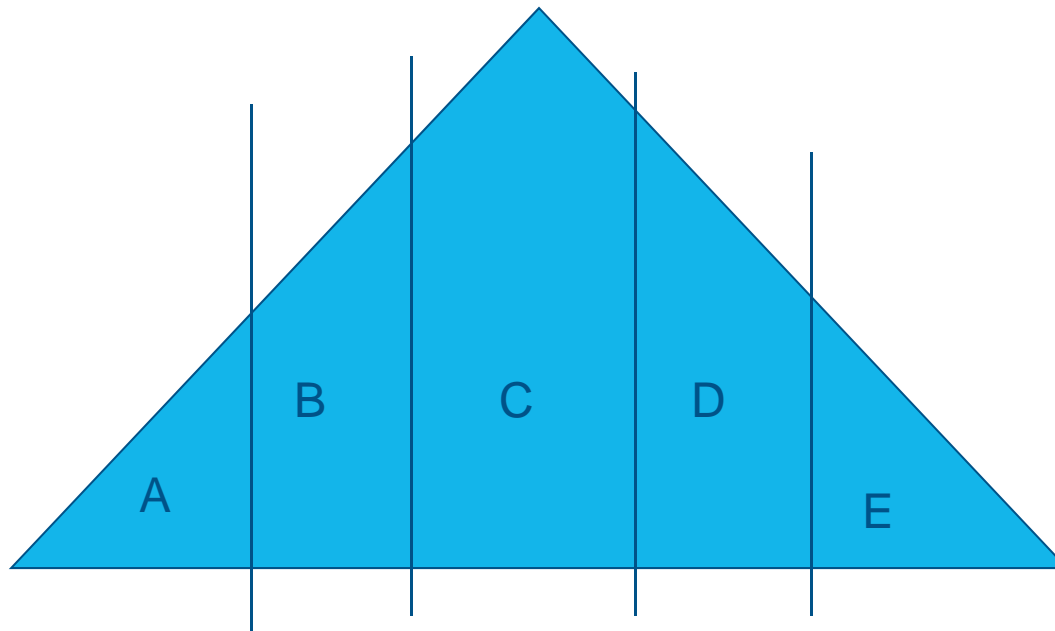
- o Authorized in:

- D.C., Delaware, Illinois, Iowa, Kansas, Minnesota, Montana, Nevada, North Dakota, Oklahoma, Tennessee, Texas, Utah, Wisconsin

● ● ● | Series LLCs

- One single LLC
 - Assets and liabilities separated into separate series
 - Assets of any one series shielded from liabilities of another series
 - Ownership may vary by series

- ● ● | Series LLCs - Structure



● ● ● | Series LLCs – Why?

○ Purported Benefits

- Ease of administration
 - Only one entity, one filing, one minute book, etc.
 - Reduce legal / accounting fees
 - Yet benefit from liability isolation
- Use in insurance planning
 - Captive “cell” companies
 - Risk shifting / Risk distribution

- ● ● | Series LLCs - Detriments

- Complicated Operating Agreement
- Uncertainty regarding:
 - true asset protection
 - state taxation
 - federal Taxation
- A solution looking for a problem?

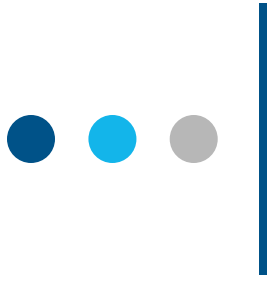
● ● ● | Proposed Regulations

- Prop. Reg. 301.7701-1(a)(5)
 - Treat each series as a separate “entity”
 - Look to CTB Regulations
 - Impact on state “entity-level” taxes
 - Such as CAT



Summary

- Why LLC/Partnership?
 - Loss pass-through, flexibility, Section 754 elections
- Why S corporation?
 - Loss pass-through, NEST, Section 108 COD exclusions
- Why C corporation?
 - Long view, no need for losses, financing or international considerations



Thank you