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The answers point to the LLC: Twenty questions on selections of a legal entity

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Abstract:

A comprehensive guide to choosing a legal entity for business operations is provided. The question-and-answer format highlights the pros and cons of each type of entity, from the traditional professional corporation through to the new limited liability company. No one entity is perfect for every business venture: there are a number of different factors that would favor the selection of one entity over another. Special attention is paid to the LLC and how it measures up to the limited partnership and the C corporation. The tax benefits of pass-through entities in general as compared to corporations are discussed; so are the effects of self-employment taxes and income taxes on S corporations. The **business entity's** purpose will have a large effect on the decision process. When all factors are considered, however, it is believed that the LLC is the best all-around entity choice, especially if liability protection is paramount.

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[Headnote]

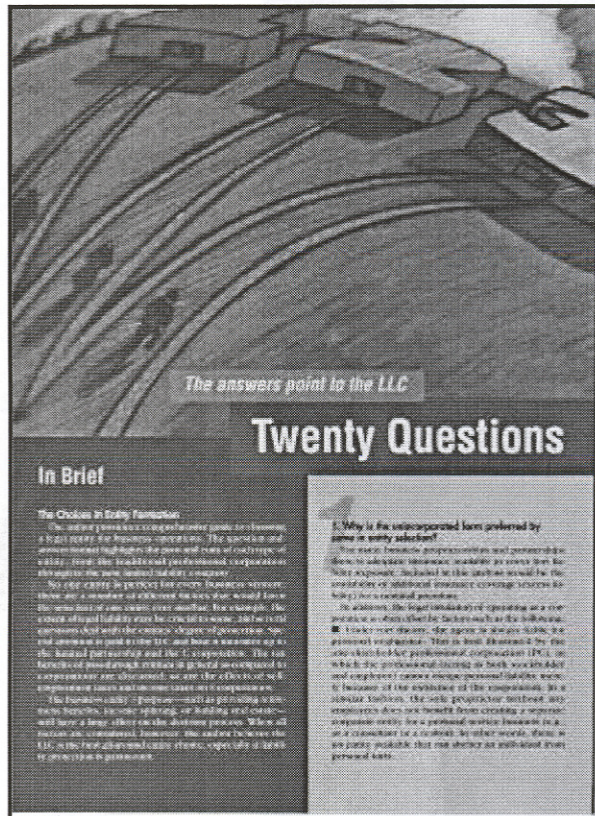
In Brief

The Choices in Entity Formation

[Headnote]

The author provides a comprehensive guide to choosing a legal entity for business operations. The question-and-answer format highlights the pros and cons of each type of entity, from the traditional professional corporation through to the new limited liability company.

No one entity is perfect for every business venture; there are a number of different factors that would favor the selection of one entity over another. For example, the extent of legal liability may be crucial to some, and several questions deal with the entities' degree of protection. Special attention is paid to the LLC and how it measures up to the limited partnership and the C corporation. The tax benefits of pass-through entities in general as compared to corporations are discussed; so are the effects of selfemployment taxes and income taxes on S corporations. The business entity's purpose—such as providing retirement benefits, income splitting, or holding real estate—will have a large effect on the decision process. When all factors are considered, however, the author believes the LLC is the best all-around entity choice, especially if liability protection is paramount.



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Enlarge 400%

1. Why is the unincorporated form preferred by some in entity selection?

For many business proprietorships and partnerships there is adequate insurance available to cover tort liability exposure. Included in this analysis would be the availability of additional insurance coverage (excess liability) for a nominal premium.

In addition, the legal insulation of operating as a corporation is often offset by factors such as the following:

Under tort theory, the agent is always liable for personal negligence. This is best illustrated by the one-shareholder professional corporation (PC), in which the professional (acting as both stockholder and employee) cannot escape personal liability merely because of the existence of the corporation. In a similar fashion, the sole proprietor without any employees does not benefit from creating a separate corporate entity for a personal service business (e.g., as a consultant or a realtor). In other words, there is no entity available that can shelter an individual from personal torts.

With respect to contracts, the owner may be required to personally guarantee the transaction (e.g., a bank loan).

The IRS can always "pierce the corporate veil" of a corporation and personally hold liable any shareholder involved in a decision-making capacity as a responsible party with respect to any unpaid "trust taxes" (such as employee income tax and FICA withholdings).

2. Besides unlimited legal liability, are there other disadvantages to the sole proprietorship as a form of conducting business?

Two other inherent disadvantages of the sole proprietorship are

the inability to split income among family members with respect to the business unearned income (for the benefit of children age 14 or over) as discussed in Question 3. However, a child employed by a parent's proprietorship does generate FICA and Ft TA savings if under age 18.

the unavailability of certain estate planning techniques such as valuation freezing (as a result of transfers of a portion of the ownership) because of indivisibility of the ownership of a proprietorship.

3. What are the tax benefits in using "pass-through" entities?

Pass-through entities such as S corp<r rations and partnerships provide the following planning opportunities:

Family income splitting of the business' earnings for income tax purposes can be accomplished provided that the entity's income is derived mainly from the fruits of capital as opposed to labor (e.g. a personal service enterprise).

Estate splitting of the business' value among family members.

Distribution of the losses that many start-up businesses incur (though the deduction at the individual owner's level is subject to such restrictions as the passive activity rules).

4. What is a limited liability company LLC)?

An I C is another type of pass-through entity that is separate from its owners (known as members), which are afforded corporate-like liability protection. The advantages of this entity are numerous, and this form of organization could very likely become the entity of choice when liability insulation is needed.

5. How many owners can an LLC have?

There is no limit on the number of owners, with additional states following New York and Texas in permitting an LLC to have only one owner.

6. How have the IRS "check in the box" regulations affected LLCs?

Pursuant to Treasury Regulations section 301.7700-1, an LLC with two or more members can choose to be treated as either a partnership or a corporation for Federal income tax purposes; partnership treatment will be automatic (and the usual choice) in the absence of any election to the contrary using IRS Form 8892.

An LLC containing a single member may elect to be taxed as a corporation; more commonly, the single-member LLC would want to have the entity's tax results reported on Form 1040 (i.e., a single level of taxation on a Schedule C if a business or Schedule E if rental realty).

7. What advantages does an LLC have over a limited partnership?

First, in an LLC there is no restriction on the owners' involvement in management. In contrast, a limited partner loses liability protection by undertaking an active role.

Second, limited partners are precluded from claiming the \$25,000 rental real estate loss allowance under IRC section 469. A member of an LLC owning realty would not be automatically prohibited from obtaining this benefit provided that the active participation standard is met.

Third, there is no need in an LLC to have any owners with unlimited liability, such as is required of the general partner in a limited partnership.

The limited partnership is still being utilized, most commonly in the family limited partnership (FLP) version, for economic reasons such as asset protection (useful, for example, in the subsequent divorce of one of the partners). This arrangement involves the elder generation of a family contributing the property (i.e., an operating business or realty) to the FLP while designating the parents as general partner(s) and the children as limited partners. A transfer tax benefit is also achieved because the sum of the FLP interests after the contribution may be less than the asset's

value outside of the FLP as a result of applicable discounts (such as those for marketability and minority interest).

Those considering the FLP should also review the benefits of the LLC's companion version, the family limited liability company (FLLC). An FLLC, like an FLP, is not a specific statutory entity; it merely uses the term "family" because of who the member-owners are. However, when the objective is control of the entity by a minority owner, the FLP will be preferred.

8. What are the benefits of an LLC over a C corporation?

With the passage of time, the C corporation becomes less and less attractive from a tax perspective for the following reasons:

✓ Unlike in a corporation, there is no need for LLC members that transfer property to the entity to have at least 80% initial control in the LLC.

✓ Double taxation in a C corporation exists not merely at the time of dividend distributions but, more significantly, upon liquidation (if the corporation has accumulated or current earnings: ')

✓ Unique to the C corporation is the existence of such penalty taxes as the alternative minimum tax (when the \$5 million gross receipts test is not met), the personal holding company tax, and the accumulated earnings penalty tax (exposure to which can be reduced by documentation such as corporate minutes supporting the reasonable needs of the business to accumulate earnings in excess of \$250,000; \$150,000 in the case of a personal service corporation).

The mere distribution of appreciated property (i.e., asset retitling) from the C corporation is an "as if" (constructive) sale, resulting in taxation to the corporation and a possible dividend to the shareholder. It should be noted that the appreciated property distribution can itself create current earnings and profits even in situations where accumulated earnings and profits did not exist. This tax detriment is generally inapplicable in the case of the same property distribution from an LLC.

The best illustration of the excessive tax cost due to double taxation (found only with the C corporation) is IRC section 1374. It retains the imposition of subchapter C corporate taxation on the disposition of appreciated property for a period of 10 years following the conversion of a C corporation to S status.

9. What methods exist to mitigate t of potential double taxation distribution of appreciated property?

If the corporate form is chosen, the possibility of leasing property to the corporation should be considered (such as the realty needed by the corporate business). The lease could be structured in the "triple net" format, providing for all property expenses to be paid by the corporate lessee along with leasehold improvements, which are not taxable to the real property owner (who receives rent not subject to Social Security taxes). Similarly, the lending of capital is to be encouraged either initially (though the receipt of debt in exchange for appreciated property will result in gain recognition) or subsequently--as long as the debt-equity parameters are followed.

10. When can a C corporation be recommended?

✓ There is a need to reinvest pro its for reasons such as capital expansion. Limited income splitting can occur, resulting in the C corporation obtaining the benefit of the 15% and 25% tax brackets on the first \$75,000 of taxable income.

✓ In addition, there is the availability of excluding 70% of the dividend income of publicly-traded stocks as a result of the dividends received deduction. This is beneficial for nonappreciating securities being held for investment by the corporation (e.g., preferred stock).

✓ The full deductibility of the type of fringe benefits (principally health insurance including dental, optical, and longterm care or nursing home coverage) is not available to the owners of partnerships, S corporations, and LLCs having more than a two percent interest.

✓ A corporation formed in a state without a corporate income tax (e.g., Nevada) can be funded with money and assets in order to lend (in a secured manner) or lease to a corporation in a state where business operations are being conducted. This can reduce the corporate income taxes in the latter state by shifting income in the form of deductions such as interest and lease payments, or perhaps royalties and licensing fees, to the corporation in the state without taxation.

This strategy can be utilized provided a bona fide corporate office presence exists in the tax-free state (e.g. a Nevada corporate resident agent headquartered in Carson City). Though the implications of any applicable unitary tax must be considered, Federal law prohibits states from taxing interstate commerce when activity (such as from the corporation formed in the tax-free state) is limited in the high tax state to such activities as the solicitation of orders. This concept was expanded in 1992 by the U.S. Supreme Court case Wisconsin Department of Revenue vs. Wrigley, in which the Court ruled that "solicitation" includes ancillary activities such as recruiting, training, and evaluating an in-state sales force.

11. What favorable tax code provisions exist upon the sale of closely held corporate stock? 1045/1284

The tax code provides two separate provisions on the disposition of qualified small business stock (QBS): a rollover and a partial exclusion of the gain realized. To qualify as QBS, the following tests must be met:

The shares must be original issue stock from a C corporation whose certificates were issued after August 10, 1993.

The corporation must have gross assets of \$50 million or less in businesses other than

those involving the fields of health, engineering, architecture, accounting, actuarial science, the performing arts, consulting, athletics, or financial or brokerage services;

those where the principal asset is the reputation or skill of one or more employees;

any banking, insurance, financing, leasing, or investing business;

any farming business; or

any business operating a hotel, motel, restaurant, or similar business. The tax-free rollover provision applies to the capital gain stemming from the sale of QBS to the extent that these proceeds are reinvested within 60 days of the stock sale in other QBS.

The exclusion of one-half the gain from the sale or exchange of QBS applies to any QBS held for five years or more prior to disposition.

It should be noted that unlike section 1244, in which ordinary loss treatment is available on the sale of either C or S corporate stock (up to \$ 100,00 annually for joint filers), the QBS provisions are not available for S corporations.

12. From a retirement planning perspective, does a C corporation offer any advantages over other entities?

There is near parity between incorporated and unincorporated retirement plans in terms of deductions and benefits. However, the following two advantages exist with respect to the pension plan of a C corporation:

The taxpayer may borrow up to \$50,000 from a corporate pension plan provided that the loan is secured and its terms are similar to those required by a financial institution.

Generally, corporate pension plans subject to ERISA receive more court protection from creditors than unincorporated plans.

13. Of the various types of entities, which is allowed to freely choose its year end?

Only the C corporation can still provide limited income splitting through the use of salary and bonuses paid in the calendar year of the stockholder/ employee(s) following the corporation's first fiscal year.

14. From an income tax perspective, what are the benefits of an LLC over an S corporation?

When the LLC borrows money, the owners are treated as incurring a proportionate amount of debt to their individual membership interest under the "outside basis" concept. This is true even though there is generally no personal liability to the members of the LLC with any nonrecourse debt (unless personally guaranteed by the individual LLC members). If all of the LLC's debt is considered nonrecourse, the LLC operating agreement must comply with IRC section 704(b), which requires that such concepts as qualified income offset, allocation of nonrecourse deductions, and minimum gain chargeback be addressed.

In contrast, the liability incurred by the S corporation does not create outside basis at the shareholder level (even when the shareholder guarantees the loan; recent case law has attempted to liberalize this position). Given that most operations initially incur start-up losses, there is the desire to structure the entity for the maximum loss passthrough (i.e., the owners have enough outside basis to permit the deductibility of the allocated amount of the entity's losses).

Similar to partnerships, favorable tax allocations can be accomplished in the LLC's operating agreement, provided that they have substantial economic effect pursuant to IRC section 704. Thus, an LLC has flexibility in the allocation of income and losses among members. In contrast, an S corporation can only have one class of stock, with profit and loss being allocated based on a per share, per day basis.

The only occasion in which the S corporation is more flexible in allocating gain as compared to the LLC is as a result of the latter being subject to IRC section 704(c). Under this provision, a member of an LLC who contributes appreciated or depreciated property to the entity may have built-in gain/loss implications upon the LLC's subsequent transfer of the property. Since no comparable provision exists for S corporations, the built-in tax consequences may be shifted among the S shareholders.

A section 754 election is available for the LLC (as can be accomplished with a partnership but not with as chapter S corporation) to adjust the inside basis of assets held by the L upon the sale or exchange of an interest or upon the death of a member.

There are no restrictions as to who can be an LLC member, unlike the limitations on the type and number of owners applicable to S corporations. In addition, an LLC can have various classes of equity interests, discriminating within each class as to distributions (along with differences in voting rights).

In comparison, another corporation cannot be an owner of an S corporation, and only certain types of trusts are permitted as owners (qualified subchapter E grantor type trusts under IRC sections 671-677, qualified chapter S trusts, and if the stock is acquired by gift in bequest, an electing small business trust).

15. What differences in application of the self-employment tax exist between an S corporation and an LLC?

Since distributions from subchapter S corporations (i.e., dividends) are not subject to self-employment tax, wages can be reduced a corresponding amount in certain justifiable circumstances, with resulting FICA tax savings. The optimal situation for this is when a portion of the income can be attributed to a return of the capital invested. Consequently, dividends from an S corporation are much more favorable to its stockholders than similar distributions from a closely held C corporation.

Whether or not income from an LLC will be subject to the self-employment tax at the member level is dependent upon whether the member would otherwise qualify as a limited partner in a limited partnership. The general rule an individual is treated as a limited partner under IRC section 1402 (and is not subject to self-employment tax on the individual's distributive share income) unless the individual

has personal liability for the debts of or claims against the LLC by reason of being a member;

has authority to contract on behalf of the LLC; or

participates in the entity's trade or business for more than 500 hours during taxable year.

16. When contributing property having a liability in excess of basis, how can the resulting tax problem be controlled on the choice of entity?

Property with a liability in excess of basis contributed to a C corporation or S corporation always creates taxable gain to the extent of the differential. However, with an LLC this result is reduced and sometimes avoided since the member divesting the liability is also considered to be retaining a portion of the debt within the LLC (as is the partnership).

17. Are professional corporations (PCs) still a viable option for those needing liability insulation?

Professional corporations (also known as professional associations or PAs in some jurisdictions) are being utilized less and less. Their initial lure was the availability of more attractive retirement plans as compared to the unincorporated counterpart. This benefit was substantially reduced in 1982 with the passage of the Tax Equity and Fiscal Responsibility Act.

The second major benefit to this organization is liability protection in group practices where caseload is segregated among the professionals in such a way that malpractice by one will not be deemed as malpractice by another. Given the additional tax restrictions applicable to PCs (such as the elimination, for those being taxed under subchapter C, of the graduated rate structure with its 35% bracket) the PC may eventually be called the dinosaur entity, evolutionarily surpassed by the LLC (or its pro onal equivalent in many jurisdictions, the LLP).

18. What advantages does an LLC have an S corporation for holding real estate?

Though both entities offer passthrough taxation (flow-through of tax attributes reported at the individual level), the following advantages favor the LLC (or a partnership if liability insulation is not needed) when real estate holdings are involved:

The LLC does not have the potential for limiting losses that the S corporation has (i.e., not allowing for attribution of liabilities at the entity level to count toward the shareholder's outside basis).

The members of an LLC can retitle realty to and from the entity without adverse tax consequences (such as the potential in an S corporation for taxation on the appreciation and accumulated depreciation).

The flexibility of IRC section 704 special allocations and IRC section 754 basis elections are available to LLC members but not to S corporation stockholders.

It may be noted that there are two advantages to the holding of realty in any type of pass-through entity:

Realty previously owned in severalty (or as tenants in common or joint tenancy) transforms into intangible personal property when exchanged for an interest in an entity. This treatment can avoid an ancillary probate proceeding with respect to out-ofstate realty upon death. In addition, it should be determined whether the state of the location will subject a nonresident to income or estate taxation if the real property is held for nonbusiness purposes and is in an entity with the intangible ownership interest being held by the nonresident.

There is the benefit of legal protection (of the underlying realty held by the entity) from one of the personal creditors (including the IRS) of an individual owning an interest in a multiowner entity. The creditor cannot seize the underlying realty (titled in the name of the entity) to satisfy the judgment but must apply to the court for a "charging order" against the judgment debtor's ownership interest. This order limits the creditor to the distributions to which the debtor would have been entitled.

The use of an entity for the holding of investment or business realty is not advised if an IRC section 1031 exchange is contemplated in the near future when one owner wishes to "cash out" and another wants to reinvest in realty. The reason is that the membership interest in a realty LLC (like a real estate partnership) is considered intangible personal property and, if exchanged for a fee interest in real property, is not considered like kind under IRC section 1031. One solution to this dilemma is to establish an IRC section 761 co-tenancy arrangement with individual tenants or, if liability is a concern, with separate one-person LLCs as members. Alternatively, a partnership holding investment realty can elect out of subchapter K in order to report under IRC section 761.

19. What nontax hazards of the C corporation or S corporation are not found in the LLC?

Having the corporate entity completely disregarded by a judgment creditor or the IRS is always a possibility, particularly when the corporate formalities such as shareholder and board of director meetings are not held and formalized for the record. This can occur especially with solely or closely held corporations. This problem does not exist with the LLC, which can be quite flexible in terms of both entity formalities (particularly for the one-member LLC) and management operation (offering in a multimember LLC different classifications of membership with accompanying variety of voting rights).

Additionally, a membership interest in an LLC is not necessarily treated as a security (i.e., an investment contract under the SEC), which label could apply to the limited partnership interests or airt shares when issued, We 1 nonfamily members.

20. In summary, what three rebuttable presumptions exist in entity formation?

First, the unincorporated form is the preferred format.

Second, in the event adequate (and reasonably priced) insurance for tort liability protection cannot be obtained, presume the S corporation, particularly when the potential for FICA savings exist, as discussed in Question 15. The

exception to this would be the rarer situation where the answers to Questions 10-13 indicate a C corporation would be more beneficial.

Third, in situations where the S corporation is under consideration, the LLC should be reviewed. This organization has the most flexibility and the least amount of associated "tax baggage" (as discussed in Questions 8 and 14). Consequently, the initials LLC might one day stand for the "Lawyer's Likely Choice" when choosing a business form.

[Author note]

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