The Choice of Entity Maze

Selecting the right entity for your operations is an important issue for every new business. Whether a corporation or a limited liability company (LLC) is the better choice is not always obvious. The selection involves numerous legal, accounting, and tax issues and should involve as many outside professionals as possible who can intelligently add to this decision making process. One must consider all the facts and alternatives and, above all, understand the business owner's objectives. This article highlights key differences between types of corporations and LLCs that are treated as a partnership for tax purposes.

Fortunately, the choice-of-entity question does not have to be answered absolutely. The majority of closely held businesses engage in more than one business activity, and it's possible to use a different entity for each.

Owners of closely held businesses often ignore the structural barriers between entities (and sometimes between their business and personal activities). They tend to treat all the businesses as one entity. This can have significant negative repercussions, particularly for limited liability protection and income taxes.

The following chart list some of the issues to consider when choosing the form of an entity. This process can broadly be organized into four categories: capitalization, compensation, profit and loss allocation, and distributions.

Exhibit 1 Selected Issues Affecting Choice of Entity	
Tax Issues	**Non-tax issues**
Sale of business/liquidation	Limited liability protection
Tax rate exposure	Capital Structure
Use of losses	Stockholders and buy-sell agreements
Compensation package	Type of business/investment activity
Complexity	State law
State tax issues	

CAPITALIZATION

For a corporation, the contribution of property solely in exchange for at least 80% of the corporation’s stock generally is tax-free under Section 351 of the Internal Revenue Code of 1986, as amended (the “Code”). From the standpoint of capital structure, C corporations and LLCs offer more flexibility than S corporations, which are subject to statutory restrictions on their classes of stock and the number and type of stockholders. Depending on the business owner’s objectives and goals, these restrictions can have a critical effect on the choice-of-entity decision. For example, if the organizer of a new business plans to raise equity capital that provides a fixed rate of return and limited liquidation rights, an S corporation would not be appropriate. This is due to the limitation on the number of shareholders allowed in an S corporation, which is currently limited to 100. Moreover, an S corporation is only allowed one class of stock. Thus a business owners is unable to employ preferred stock and other more sophisticated financial vehicles to raise capital or reward employees.

The basis of property contributed to a corporation under Code Section 351 is equal to the contributor’s basis at the time, plus any gain recognized from excess liabilities or the receipt of property other than stock (such as a note). In certain situations, the corporation’s basis can be limited to the property’s fair market value. If the assets are encumbered by liabilities that exceed their basis, the contributor must recognize gain equivalent to that excess under Code Section 357. This gain recognition may be avoided if the contributing stockholders also contribute a bona fide note (with a fair market value equal to the difference) to the corporation. The important point is that the issue must be addressed when the initial capitalization takes place, and not sometime down the road.

Sometimes, to attract or retain a key person, a corporation may issue stock in exchange for services. The normally results in taxable income to the recipient equal to the stock's fair market value – unless the stock is subject to a substantial risk of forfeiture, as described by Code Section 83(a)(1). If Code Section 351 applies, it may be possible to avoid this result if the recipient exchanges some form of property for the stock, such as a customer list or other intangible asset. In general, Revenue Procedures 2001-43 and 93-27 state that an exchange for a profit-only interest in an LLC does not give rise to taxable income. However, in May 2005, the IRS issued proposed regulations that treat the exchange of a profit-only interest for services similarly to an exchange of corporate stock (see proposed Treasury Regulations 1.761-1). And for S corporations, the basis of the assets contributed becomes the basis of the contributor's stock for purpose of using losses that may pass through in the future.

In many situations, capital is contributed with a loan to the corporation. When aalyzing whether to receive stock or debt, one should consider:

- Will there be more than one stockholder?
- Will all the stockholders be equal?
- Will stockholders contribute property of equal value?
- Will the entity be an S corporation or a C corporation?
- Will stockholder distributions be made?

The answers to the first three questions revolve around the difference in rights between a stockholder and a creditor. For example, if three individuals intend to be equal stockholders but one of them contributes $100,000 more in cash than the others, that stockholder should receive a note for the excess, possibly secured by corporate assets. The decision to make an S corporation election does not change this conclusion.

Because of the S corporation basis rules under Code Section 1366, the debt-vs.-equity question carries important tax ramifications. S corporation stockholders can use debt basis for deducting losses, but subsequent repayment of the debt results in the recognition of taxable income, which in many cases comes as a surprise. On the other hand, C corporation stockholders are better served by holding debt, because generally they can receive non-taxable loan repayments, regardless of the corporation's profits or losses. In general barring any legal issues, S corporation stockholders should choose to receive stock in exchange for capital.

Dividend distributions to stockholders of a C corporation represent after-tax-corporate earnings and are subject to tax at the stockholder level (generally at a 15% rate). A C corporation may be the appropriate entity in situations involving a complex capital structure designed to provide investors with a specified rate of return. If preferred stock is issued, the rate of return will not include appreciation in the value of the company, unless it is convertible into common stock. In general, distributions to S corporation stockholders are not taxable. However, S corporation distributions must be made on a pro rata basis to all stockholders, including liquidating distributions (see "Distributions" below).

COMPENSATION

How compensation is structured can have both tax and non-tax effects on the choice of entity. Members of an LLC cannot be treated as employees. Therefore, to design a compensation plan other than one based solely on ownership, an LLC's operating agreement must provide for guaranteed payments, (other issues regarding LLC member's exposure to self-employment tax on their share of allocated earnings are still evolving and beyond the scope of this article). Corporate stockholders can be treated and compensated as employees and are subject to payroll tax withholding. In a corporate environment, many non-taxable fringe benefits (such as health insurance and retirement plans) can be offered only to employees; therefore, it is critical that stockholder/employees' compensation is properly reported on form W-2.

At the most fundamental level, the structure of compensation is affected by the number of stockholders and their involvement in the corporation's business. Typically, a sole-stockholder C corporation structures a compensation to reduce taxable income on the corporate level, thereby reducing the stockholder's future exposure to double taxation. This is true despite the fact that qualifying dividends are currently subject to a 15% federal tax rate.

But a sole stockholder of an S corporation may structure compensation to increase corporate taxable income that will pass through to him or her, thereby reducing exposure to Social Security taxes. Due in part to a Treasury Inspector General Report issued in 2002, the IRS has increased its focus on S corporation compensation vs. distribution to shareholders. Overall, a C or S corporation provides a familiar compensation structure.

In a multistockholder corporate environment, the following issues affect compensation vs. distribution:

- Do all stockholders own the same amount of stock?
- Are all stockholders performing services to the corporation?
- How are fringe benefit plans designed?

C corporations offer more flexibility, such as a deferred compensation benefit and stock option plans. In general, as a pass-through entity, an S corporation cannot offer deferred compensation; the fact that the salary is not currently deductible increases the amount of income that flows through to shareholders. S corporations can offer stock options, provided they do not create a second class of stock.

In both C and S corporations, one must also be concerned about the reasonableness of compensation. For C corporations, the question is whether the stockholder/employee's salary is too high in relation to any dividends paid. For S corporations, the question is whether the stockholder/employee's salary is too low in relation to distributions. Exhibit 2 lists relevant factors for each type of entity.

Exhibit 2 Factors in determining Reasonable Compensation	
C Corporations	**S Corporations**
Compensation pain in proportion to stock ownership	Services performed in relation to salary
Dividend history	Number of employees
Corporation's capital structure	Degree of control over corporation
Year-end increases in salary	Undocumented loans receivable
Existence of employment agreement	Existence of employment agreement
Statistical reasonableness of compensation based on the company's sales	Compensation lever of other employees
Industry guidelines	Industry guidelines
Loan covenants	Loans covenants

ALLOCATION OF PROFITS AND LOSSES

Another decision is whether to create a flow-through entity such as an S corporation or LLC. C corporations are subject to corporate tax rates on the first $75,000 of taxable income, which are lower than an individual would pay with a flow-through entity. Individuals considering organizing a C corporation, however, should be aware that:

- Personal service corporations, such as medical practices, are subject to a flat 35% tax rate.

- Multiple C corporations, commonly owned by up to five persons who own more than 50% of the corporations' voting stock and value, must allocate the C corporation tax brackets among the various C corporations.
- Except for personal service and farming businesses, C corporations with gross receipts exceeding $5 million cannot use the cash-basis method of accounting.

As an S Corporation's profit and loss is allocated to its stockholders on a per-share, per-day basis, based on stock ownership. In general, LLCs offer greater flexibility in allocating profits and losses among members, provided the allocation has substantial economic effect (as defined in Code Section 704). This is complex topic, but basically, profits and losses must be allocated in a manner that mirrors the true economic risk of each LLC member.

The ability to use losses generated by a pass-through entity often is critical consideration when choosing a structure. In general, S corporations do not offer as great an opportunity to use losses as LLCs.

Both S corporations and LLCs limit interestholders' ability to use losses that pass through to their basis in the entity. you must properly document the owner's basis in either form of entity. For example, if an individual has a stock basis of $50,000 and allocable losses of $75,000 in an S corporation or LLC, only $50,000 of losses can be used to offset other income, assuming the at-risk (Code Section 465) and passive activity loss (Code Section 469) rules do not apply.

The distinction between S corporations and LLCs turns on the definition of basis. In an S corporation, basis is defined as capital in the form of stock and direct stockholders loans. Third-party debt, personally guaranteed or not, do not create basis. But many forms of third-party debt do create basis for an LLC member. If, in the example in the preceding paragraph, the entity borrowed $25,000 form a personally guaranteed business line of credit, an S corporation stockholder could still deduct only $50,000 of losses. But an LLC member could deduct the entire $75,000 loss, because his or her basis would include the personally guaranteed debt.

DISTRIBUIONS

The entity's stockholder or operating agreement should specify the amount and timing of distributions of property or cash. This is particularly important to a holder of a minority interest. The tax treatment of a non-liquidating distribution is determined by the type of entity making the distribution, the type of entity receiving it, and the type of property being distributed. Property distributions from either C or S corporations trigger a recognized corporate-level gain to the extent the fair market value of the property distributed exceeds its basis.

The value of the property distributed from a C corporation is included in the gross income of the recipients (possibly subject to a 15% tax rate) if the 90-day holding period for individuals and the dividends-received deduction requirements for corporations are met. This inflexible structure is one of the principal reasons corporations generally are considered the wrong type of entity for owning appreciable property, such as real estate.

The income-tax treatment of S corporation distributions of cash or property (at fair market value) to shareholders, on the other hand, follows a specified order. First, distributions are not taxable to the extent of the corporation's undistributed earnings (its accumulated adjustment account); then they are considered a return of capital, to the extent of the recipient's basis in the S corporation stock; and finally, any excess is treated as capital gain.

At first glance, the ability to make non-taxable distributions appears attractive. However, an owner's exposure to taxation is based on their allocable share of profits. It is possible to have income allocated to a stockholder and reported on a schedule K-1 without a corresponding distribution of cash or other property. This problem can be eliminated (or at least mitigated) with a well-drafted stockholder agreement.

The distribution rules for LLCs, meanwhile, are deceptively simple. In general, cash and property distributions are tax-free to the extent of the member's basis in the LLC. However, there are numerous exceptions, as shown in Exhibit 3, depending on factors such as the type of property being distributed, when it was contributed to the LLC and by whom. In addition, subchapter K, which governs the tax treatment of LLCs, provides various rules for determining the basis of distributed property as well as the property retained by the LLC.

One significant advantage LLC/partnerships enjoy over corporations is the ability to adjust the entity's basis in assets retained if a gain of loss is recognized due to a distribution from the LLC (Code Section 734) or a sale of an LLC interest (Code Section 743). A partnership can make this election, which applies to all subsequent transactions and cannot be revoked without the IRS's consent. The election is provided by Code Section 754. However, the American Jobs Creation Act of 2004 requires a mandatory basis adjustment if the built-in loss amount exceeds $250,000.

Summary

- When advising on the choice of business entity, one should consider the advantages and disadvantages of each type. If more than one entity is involved, you also need to determine whether the business owner can deal with the complexity of the resulting structure.

- The many issues to consider can be organized into four categories: capitalization, compensation, allocation of profits and losses, and distributions.
- From the standpoint of capital structure, C corporations and LLCs offer more flexibility than S corporation, which are subject to statutory restrictions.
- Compensation within corporations is affected by the number of shareholders and their involvement in the corporation's business. Consider whether there are one or multiple shareholders, whether the shareholders each own the same amount of stock, whether they perform services and how fringe benefit plans are set up.
- For both C and S corporations**,** reasonableness of compensation is an issue. For C corporations, the question is whether a shareholder/employee's salary is too high relative to any dividends paid. For S corporations, the question is whether the salary is too low in relation to distributions.
- The ability to use losses is often critical in the choice of a business structure. In general, because third-party debt may create basis for members, LLCs provide better opportunities for passing through losses than do S corporations for their shareholders.
- The tax treatment of distributions may vary, depending on the type of entity making the distribution, the type of entity receiving it and the type of property being distributed. Property distributed from a C corporation is generally taxed to the recipients; distributions to S shareholders are subject to rules that follow

a specified order. For LLCs, cash and property distributions are generally tax-free (to the extent of basis), but there are many exceptions.

We have just scratched the surface of a very complex subject matter and there remain numerous unresolved issues surrounding LLCs, as well as Sub S corporations. Additionally, there are always new court cases coming out, new regulations, and just new wrinkles as to how to choice the form of entity in which to operate. Accordingly, it now becomes more important than ever to consult with professionals in order to not make any missteps.

Exhibit 3 LLC Distributions – Exceptions to the General Rule
Distributions of marketable securities-Code Section 731.
Disproportionate distribution of unrealized receivables or appreciated inventory-Code Section 751.
Distributions of property within two years of a contribution to the LLC-Treasury Regulations 1.707-3(1).
Noncash distributions to a member within seven years of contributions-Code Section 737.
Contributed property distributed to another member within seven years-Code Section 704