Choosing a Business Entity for the 21st Century

Samuel P. Starr

Thomas P. Rohman

L. Michael Gracik Jr.
William & Mary
48th Annual Tax Conference

Choosing a Business Entity for the 21st Century

Sam Starr
PricewaterhouseCoopers LLP

Tom Rohman
McGuireWoods

Michael Gracik
Keiter, Stephens, et al.

November 21, 2002
Choice of Entity of Business Entity

- Sole proprietorships
- General and limited partnerships
- Limited Liability Companies (LLCs)
- Regular corporations
- S corporations
- Single member LLCs
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- 1990s - popularity of LLCs grew and all 50 states adopt LLC statutes
Federal Check-the-box Rules

- Final Rules released 1997

- Eligible business entities can choose their tax form by filing check-the-box election (IRS Form 8832)

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- Can always elect to be an association taxable as corporation

- Different rules for foreign entities
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Top Ten Factors in Choosing A Business Entity

#10

Is the business exposed to potential service and/or product liabilities?

- Generally, all U.S. legal entities offer some degree of limited liability protection.
- General partnerships and limited partnerships require some general exposure to entity liabilities.
- Corporations and LLCs offer equivalent liability protection.
Top Ten Factors In Choosing A Business Entity

#9 Financing Needs

- Will the business need to raise money in a public offering?
  - Corporations are still the preferred vehicle for IPOs
- Will multiple classes of stock or equity-flavored debt instruments be important to attracting capital?
  - Using S corporations will be a problem
#8 Is a business merger or acquisition expected?

- Corporate entities can participate in tax-free mergers with other corporate entities.
- Similarly, partnerships can engage in tax-free mergers with other partnerships or partnership-type entities (e.g., LLCs).
- But corporations and partnerships cannot merge tax-free with each other.
#7 Is equity participation important in compensating employees?

- Corporations can provide tax-free fringe benefits
- These same fringe benefits are taxable in partnerships and S corporations (partial deductions for health insurance premiums)
- All entities allow for equity participation but with varying degrees of complexity
- Reasonable compensation
#6 Will employment taxes be a driver in choosing a business entity?

- 7.65% employer and 7.65% employee FICA tax versus 15.3% self-employment tax
- 2.9% Medicare tax
- $84,900 Wage base (unlimited for Medicare)
- Unreasonably low or no compensation?
#5 Will the owners contribute cash or property in exchange for an interest in the business? Are distributions of property expected?

- Contributions of property with built-in gain value

- Distributions of appreciated property generally not taxed in partnerships (unless "built-in gain" property), but corporate property distributions can trigger gain recognition
#4 Is the business generating or expected to generate either operating or capital losses?

- Pass-through entities allow for loss utilization at the owner level
- Tax rules impose various restrictions, e.g., basis limitations, at-risk, passive activity loss rules
#3 Do the owners want to allocate income gain, loss, deduction, and credits among themselves in proportions differing from their ownership interests?

- Special allocations of income/deduction items serve as incentives to reward service-providers
- Can also use special allocations to attract equity capital to business
- Special allocations vs. preferred stock
#2 Is the business plan facilitated with an entity that is flexible?

- Flexibility is important in admission of new owners (number and type)

- Flexible capital structure

- Differing compensation strategies

- Transactions between entity and owners
Top Ten Factors In Choosing A Business Entity

#1 SHOW ME THE MONEY

- What is the effective marginal income tax rate on earnings?

- What is the maximum federal tax rate on income?
  - Corporations: 35%
  - Individuals: 38.6%

- Are earnings/appreciation in assets subject to double tax?
  - Corporations: Effective 60% rate
  - Individuals: 38.6% rate
Advantages of Regular Corporations:

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- The LLC provides limited liability, flexibility, single-tax regime
S Corporation Election is the Only Exit Strategy for Closely-Held C Corporations.

- For closely-held C corporations, only practical exit from double tax is through subchapter S
- Role today is much the same as when enacted in 1958 except for startups
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What's in the Crystal Ball?

- LLCs will be become the dominate entity of choice

- There will be fewer corporate entities; less growth in subchapter S elections but continual conversions from subchapter C

- Simplification of Internal Revenue Code (Rep. Houghton, HR 5505)
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### Statistical Overview

Where are We?

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Comparison by Percentage of Number of Pass Through Entities

0% 10% 20% 30% 40% 50% 60% 70% 80% 90% 100%


- Partnerships, excl. LLCs
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- C(corps

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