Family Businesses: Using LLCs and S Corporations

By
Samuel P. Starr
Jay M. L. Payne

I. Current Developments

A. Current environment for choice of entity

1. Recent events necessitate that taxpayers reexamine their family business and choice of entity. S corporation legislation has made many desirable changes for that choice of entity. The proposed "Check-the-Box" regulations will provide certainty and a new concept of a "disregarded entity". The proposed liquidation tax on S corporation elections may effectively close the door for many family owned C corporations from moving into a single tax regime.

2. While the selection of a business form is one of the first questions an entrepreneur faces upon engaging in an enterprise, the question should be re-examined and considered from time to time. Business owners are faced with many imposing factors such as legislative changes, business climate, market competition, and personal concerns. Among these, changes in tax structure and rates can have immediate and long term financial consequences.

3. With the enactment of OBRA 1993, the maximum marginal tax rates for individuals and corporations were re-inverted.

   a. Tax rates for individuals are again greater than those for corporations. Due to this consideration, the decision to use either a corporate structure or a pass through structure is again more complex.

Mr. Starr is a partner in Coopers & Lybrand L.L.P.'s National Tax office where he specializes in the taxation of pass-through entities. Mr. Payne is a tax consultant in Coopers & Lybrand L.L.P.'s National Tax office.

Copyright Coopers & Lybrand, L.L.P.
b. C corporation distributions are generally subject to double taxation; but, individuals are generally subject to immediate taxation from enterprises in pass through entities at a higher tax rate.

c. Although the immediate incentive to do business as a pass through entity due to a lower individual tax rate is gone, the benefit of eliminating double taxation on C corporation distributions and business appreciation is still available.

4. The advent of the LLC is one of the most influential factors affecting business owners' choice of entity. LLCs, while simplistic on the surface, require sophisticated assessment as to their appropriateness in particular situations. With all states enacting some reasonably common form of LLC statute, the increasing question raised by business owners is whether they should do business as an LLC.

5. Check-the-Box Proposed Regulations

a. In May 1996, the IRS and Treasury issued landmark proposed entity classification regulations (commonly referred to as "check-the-box" regulations) that will allow certain unincorporated entities to choose whether they wish federal tax treatment as a partnership, corporation or entity disregarded as separate from its owner.

b. The creation of the disregarded entity classification—the single most important aspect of the proposed regulations—will give rise to a number of significant business restructuring opportunities.

c. The ability to elect a tax classification will eliminate the need for businesses seeking partnership tax treatment to guard against having corporate characteristics, thereby dramatically streamlining the entity classification process (and freeing partnerships to conduct themselves in a manner similar to corporations). The issue is frequently even more difficult for limited liability companies (LLCs), for which the traditional line between corporations and partnerships is blurred.

It is important to note that the current rules will remain in effect until the proposed regulations are finalized.

d. The proposed regulations first address whether a separate entity exists for federal tax purposes. Eight categories of entities are categorized automatically as per se corporations; one of those categories includes a list of foreign entities that automatically will receive corporate tax treatment.
e. Business entities that are not treated as per se corporations are considered "eligible entities" and may choose their desired tax classifications. Under a special default rule, a domestic eligible business entity automatically will be classified as a partnership, unless it elects to be treated as a corporation. Single-owner domestic eligible entities will be disregarded as entities separate from their owners. A foreign eligible entity will default to a classification based on its members' limited liability, but can still elect its preferred classification.

f. Most eligible entities in existence when the rules become final will retain their tax classifications unless they elect to change their tax classifications. Elections are effective on the date selected, but will not be considered effective more than 75 days before the filing date.

Caution: It is important to remember that general tax provisions apply to changes in classification by elections. For example, if a corporation elects partnership tax treatment, the event will be treated as a corporate liquidation followed by a partnership formation.

6. Proposed Liquidation Tax

a. In late 1995 and early in 1996, the current administration included in its balanced budget program a proposal that would impose a wholesale liquidation tax on a C corporation at the time of converting to S status for any corporation which has a fair market value of more than $5 million.

b. The proposed change would repeal IRC Sec. 1374 for any corporation with a value of more than $5 million at the time of conversion, immediately recognizing taxable gain as if the corporation liquidated and reformed. The $5 million threshold is based on the fair market value of the corporations outstanding stock on the date of conversion. The proposal would be effective for all elections taking effect after January 1, 1997.

c. The argument posed for the change is that C corporations converting to a single level tax regime should be treated as if converting to a partnership for tax purposes. In particular, any appreciation in the corporate assets that occurred during the time the corporation is a C corporation should be subject to the corporate-level tax immediately. Under the proposal, however, the shareholders will also recognize gain on the deemed liquidation.
d. Much concern has been voiced over the Administration's repeal of IRC Sec. 1374, which effectively imposes a liquidation tax on large C corporations electing S status. However, most vocal are the corporations that wish to make the S election under a grandfathering of the effective date.

THE REPEAL OF SECTION 1374 WILL AFFECT FUTURE GROWTH AND ACQUISITIONS BY CURRENT S CORPORATIONS!!!

e. Current S corporations shouldn't be concerned, right? Wrong!

Current growing and acquisition minded S corporations invariably bump up against IRC Sec. 1374(d)(8), which allows a tax free acquisition of a C corporation's assets, but requires that they are tainted under the built-in gain tax rules.

In other words, if an S corporation acquires or merges with a C corporation, and the bases of the assets in the hands of the surviving S corporation are determined with reference to the bases in the hands of the C corporation, then those assets are built-in gain assets as if the C corporation had made an S election.

f. Under the administration's proposal, similar acquisitions, where the fair market value of the target C corporation's stock is greater than $5 million, would result in a completely taxable transaction. In this case a tax free Type A merger between an S corporation and a C corporation, with the S corporation surviving, would not be possible.

Comment: Although this aspect of the administration's proposal has not been significantly underscored or highlighted, it is important to make existing S corporations aware of the consequences to them.

B. S corporations will continue to exist

1. Since the mid-1980s, increasing numbers of C corporations have made S elections. In addition to full corporate limited liability, shareholders are able to realize substantial tax benefits. Many taxpayers seeking these benefits have organized as, or converted to S corporation status.

a. The highest marginal individual tax rate during that time was lower than that of C corporations.
b. Flow through treatment afforded by electing S corporation generally eliminates double taxation for the owners.

c. In 1993 S corporations represented slightly more than 48% of all corporate returns filed with the IRS. This is nearly 1.9 million S corporations.

d. All of these existing S corporation taxpayers will continue to require compliance, consulting, and estate planning services from informed providers.

2. Many circumstances—both for existing and new corporations—still allow consideration of using the S corporation as a valuable business form and estate planning tool.

C. S Corporation Legislative Developments

On August 20, 1996, the President signed into law, H.R. 3448, the "Small Business Job Protection Act of 1996". The Act provides for a number of revisions applicable to S corporations.


NUMBER OF SHAREHOLDERS

The maximum number of shareholders will be increased from 35 to 75.

This provision would be effective for taxable years beginning after December 31, 1996.

PERMIT CERTAIN TRUST TO HOLD S CORPORATION STOCK

The Act expands the rules to include "electing small business trusts" as permissible S corporation shareholders that would tax the trust directly but would allow for accumulations and sprinkling of income. The beneficiaries of the trust must themselves be individuals, estates, or public charities. Each beneficiary of the trust is counted as a separate shareholder for purposes of the 75 shareholder limit. In addition, the trust may only acquire the stock through gift or bequest (no purchase of stock may be made by the trust).

This provision would be effective for taxable years beginning after December 31, 1996.
EXTEND HOLDING PERIOD FOR CERTAIN TRUSTS

The post death holding period for testamentary trusts will be expanded to two years.

This provision would be effective for taxable years beginning after December 31, 1996.

TAX EXEMPT ENTITIES AS SHAREHOLDERS

Those entities described in §401(a) and §501(c)(3) will be allowed to be shareholders in S corporations. For purposes of determining the shareholder limit, each qualified tax exempt entity will be counted as one shareholder. Items of income which flow through to the entities will be considered unrelated business taxable income (UBTI). In addition, gain or loss on the disposition of the S corporation stock will generate UBTI.

Certain special tax rules relating to ESOPs will not apply with respect to S corporation stock held by the ESOP. These rules include rules relating to certain contributions (§404(a)(9)), deductions for dividends paid on employer securities (§404(k)), and rollover of gain on the sale of stock to an ESOP (§1274).

This provision would be effective for taxable years beginning after December 31, 1997.

2. Corporate Eligibility Provisions

S AND C SUBSIDIARIES

S corporations will be allowed to hold C and S subsidiaries. C subsidiaries could elect to be included in a consolidated tax return of other affiliated C corporations. The S corporation parent would be required to file a separate return. Distributions out of E&P by the C corporation to the parent S corporation (to the extent related to an active trade or business) would not be considered passive income for purposes of §1375.

Subject to other S corporation simplification rule changes, S-subsidies must be "eligible" corporations (i.e. not an insurance company or a foreign corporation). The S-subsidiary must be owned 100% and the parent must elect to treat the subsidiary as a qualified subchapter S subsidiary. S subsidiaries will not be treated as separate corporations; rather, all the assets, liabilities and items of
income, loss, deduction and credit of the subsidiary are treated as belonging to the parent. When an S-subsidiary ceases to qualify as an S corporation or the election is revoked, another such election may not be made for the sub for five years (unless the IRS consents).

Any elections to treat existing Csubs as S subs will trigger the LIFO recapture tax under §1363(d) and subject the assets of the new S sub to built in gains tax under §1374.

This provision would be effective for taxable years beginning after December 31, 1996.

FINANCIAL INSTITUTIONS AS ELIGIBLE CORPORATIONS

Banks (as defined in §581) will be eligible small business corporations unless such institution uses a reserve method of accounting for bad debts. Thus large banks that meet all the subchapter S eligibility requirements and small banks using the specific chargeoff method (and also meeting S eligibility requirements) may elect to be treated as S corporations.

This provision would be effective for taxable years beginning after December 31, 1996.

3. Technical Changes

INADVERTENT TERMINATIONS AND INVALID ELECTIONS

The IRS will be allowed to waive the effect of invalid elections. Currently, the IRS can only waive inadvertent terminations. The Act also allows the IRS to treat late S elections as timely filed where it determines reasonable cause existed for the failure to timely file.

This provision would be effective for tax years after December 31, 1982. This presents an opportunity to go back and revisit invalid or late elections with clients.

TREATMENT OF DISTRIBUTIONS IN LOSS YEARS

Adjustments for distributions will be taken into account prior to applying losses for the year when adjusting AAA to determine the tax treatment of the distributions. In addition, in calculating AAA, net negative adjustments will be disregarded in determining the tax treatment of distributions for S corporations with accumulated E&P.
This provision removes a trap and conforms the S corporation distribution rules to the partnership rules.

This provision would be effective for taxable years beginning after December 31, 1996.

TREATMENT OF S CORPORATIONS AS SHAREHOLDERS IN C CORPORATIONS

S corporations will no longer be treated as individuals in their capacity as shareholders of another corporation. Thus, liquidations of C subsidiaries will be governed by the generally applicable subchapter C rules. These include §332 and §337 allowing tax free liquidations into a parent corporation, and §338 elections. S corporation shareholders would still be prohibited from receiving a dividend received deduction.

This provision would be effective for taxable years beginning after December 31, 1996.

FINANCIAL INSTITUTIONS SAFE-HARBOR DEBT

The definition of "straight debt" for purposes of meeting single class of stock requirements will be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

This provision would be effective for taxable years beginning after December 31, 1996.

INTERIM CLOSING OF BOOKS FOR AFFECTED SHAREHOLDERS

Regulations to be prescribed by Treasury will provide that the election under IRC Sec. 1377(a)(2), to close the books of the S corporation upon the termination of a shareholder's interest, would be made by, and apply to, all affected shareholders and the corporation, rather than by all shareholders.

This provision would be effective for taxable years beginning after December 31, 1996.
REAL ESTATE HELD BY AN S CORPORATION

Present law capital gains presumption, in the case of land held by an S corporation provided in §1237 will be allowed.

This provision would be effective for taxable years beginning after December 31, 1996.

ADJUSTMENT TO BASIS OF INHERITED S STOCK TO REFLECT IRD ITEMS

A person who acquired S corporation stock from a decedent would treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. The stepped up basis in the S corporation stock would be reduced to the extent to which the value of the stock is attributable to items consisting of IRD. This rule is comparable to current partnership rules.

This provision will be effective to decedents dying after the date of enactment.

EXPAND POST-TERMINATION PERIOD AND MISC. AUDIT PROCEDURES

The 120-day rule related to the post termination period would be expanded to include periods after which, under audit, a determination is made and adjusts a subchapter S item of the corporation during the S period. The definition of "determination" would be expanded to include a final disposition by the IRS of a claim for refund and, under regulations, certain agreements between the IRS and any person, relating to the tax liability of the person.

In addition, the bill would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

This provision would be effective for taxable years beginning after December 31, 1996.
ELIMINATION OF CERTAIN E&P OF S-CORPORATIONS

If a corporation is an S corporation for its first taxable year beginning after December 31, 1996, the accumulated earnings and profits of the corporation as of the beginning of the year would be reduced by the accumulated E&P (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing S corporation. With this reduction, a corporation's accumulated E&P would be solely attributable to years when the corporation was not an S corporation.

TREATMENT OF AT RISK LOSS CARRYFORWARDS

Losses of an S corporation that are suspended under §465 would be carried forward to the post termination period of the S corporation.

This provision would be effective for taxable years beginning after December 31, 1996.

4. Fresh Start Provision

TRANSITION RULE FOR ELECTIONS AFTER TERMINATION

Any termination in effect immediately before the date of enactment of this provision would not be taken into account for purposes of the 5 year rule. Any small business corporation waiting to re-elect S status may do so without the consent of the IRS. Thus, clients who have terminated S-status in the last 5 years can re-elect without waiting for the 5 year period to expire.

This provision will be effective for termination in taxable years beginning prior to January 1, 1997.

D. S Corporation Reforms Still on Hold

For several years there has been a legislative push to reform S corporation tax rules. Several of these provisions were enacted as described above. However, several have fallen by the way-side. The following are a few of the fallen provisions.

1. Opening up of the single class of stock rules for S corporations to include convertible preferred stock

2. Nonresident aliens as eligible shareholders
3. Family attribution for purposes of counting the number of shareholders in an S corporation

4. Parity with C corporations for an increased deduction for charitable contributions of inventory

II. Conversions to a Single Tax Regime

A. Incorporated businesses generally not converting to LLC's

1. Exiting corporate solution without incurring a tax consequence with respect to appreciated assets is not possible. Under IRC Sections 331 and 336, both the shareholders and the corporation are likely to be required to recognize taxable income on the distribution of the corporation's property to shareholders in liquidation. This double tax could be an enormous price to pay for converting to partnership or LLC status, and probably will make the conversion impractical in most instances.

2. For example: XYZ Company is an existing subchapter C corporation in the 40% bracket. Its shareholders have recently heard some benefits of operating as an LLC, especially from a single level of tax perspective. XYZ's assets have a fair market value of $1,100,000 and an adjusted basis of $100,000. To convert to LLC status and remove XYZ's assets from corporate solution, XYZ would need to be liquidated. XYZ would recognize $1,000,000 gain, paying tax of $400,000. XYZ shareholders would also recognize capital gain to the extent fair market value of the assets exceeds their stock basis. Upon formation of the LLC, the shareholders would receive tax free treatment under the partnership rules, with a stepped up basis in the remaining assets contributed and an equivalent outside basis in the LLC.

3. Creative planning around these limitations is possible, but not without increasing the complexity of the enterprise's structure. Multiple entities structures made up of a C corporation and either a limited partnership or LLC may provide a method for owners to shift some taxability of income and appreciation from an enterprise to shareholders.

B. As a practical matter, a C corporation's exit to single level of tax is the election of S corporation status.

1. Subchapter S election is a convenient approach to a single level of taxation for most eligible C corporations. Although future dispositions of assets carried into S solution would be subject to a built in gains tax under IRC Sec. 1374 on the pre-subchapter S appreciation, all post
election earnings and appreciation would be subject to tax only once at the shareholder level.

2. Business Life Cycle. The normal business life cycle strongly encourages the use of subchapter S rules. Business owners can avail themselves of these rules generally without causing severe adverse tax consequences.

   a. **Formation**: The company is incorporated and elects S status, so that operating losses can be passed through to its materially participating shareholder(s) and can offset ordinary income from other sources.

   b. **Growth**: When the company turns profitable but wishes to retain and reinvest most of its earnings after shareholder salaries and other expenses, S corporation status is terminated. The business is operated as a regular corporation, so that the owners will not be taxed on undistributed earnings.

   c. **Expansion**: The company or shareholders wish to launch a new product or venture that is expected to lose money for two or three years. This new venture is organized as a subsidiary, a partnership or an LLC.

   d. **Maturity**: The company matures, its rate of growth slows, its earnings exceed what is needed for reinvestment, and it begins to pay sizable dividends. It elects S status once again, avoiding double tax on distributions to shareholders and concerns associated with the accumulated earnings tax.

   e. **Exit/Public**: The shareholders decide to go public, merge or be acquired to improve liquidity for their personal estates. S status may once again be terminated or revoked.

3. There are many benefits to making an S election for existing C corporations.

   a. C corporations can move into a single level tax without incurring a liquidation tax as is the case in most instances when converting to a partnership or LLC.

   b. C corporations can exploit the natural life cycle of business enterprises by appropriately making S elections as discussed above.
c. S corporations are not subject to the stringent and complicated corporate minimum tax. See IRC Sec. 56(f)(4), 56(g)(6), 59A and 1363(a).

d. Large C corporations are restricted on their ability to use cash or hybrid method of accounting. Non tax shelter S corporations may use any method of accounting that clearly reflects their income without being subject to the statutory rules forcing C corporations to use the accrual method. See IRC Sec. 448.

e. Shareholders have the ability to use losses to offset income from other sources subject to passive activity loss rules and basis limitations. C corporation shareholders cannot utilize corporate losses.

4. Although the benefits generally outweigh the negative concerns owners must be aware of these considerations for C corporations making an S election.

a. As previously addressed, tax rates on income from pass through entities is taxed immediately at higher individual tax rates than the rates for corporations.

b. S corporations are limited to 75 "eligible" shareholders.

c. Currently, S corporations are still subject to limitations of capitalization, i.e., only one class of stock.

d. The passive activity loss limitation rules under IRC Sec. 469, reduce the attractiveness of S corporation status for inactive shareholders.

e. S corporations, like partnerships, must generally conform their tax years to their owner's tax years (usually a calendar year) unless they meet the business purpose test or make required payments under IRC Sec. 444.

f. Recognition of built-in gains result in immediate double tax for S corporations that were formerly C corporations. IRC Sec. 1374.

g. A LIFO recapture tax is imposed on all C corporations using LIFO inventory method that elect S corporation status. IRC Sec. 1363(d).

h. Shareholder/employees owning a more than two percent interest in an S corporation are treated as if they were a partner in a
partnership with respect to the taxability of fringe benefits. IRC Sec. 1372.

C. New operations are being formed as LLC's, but not without potential pitfalls

1. Background

From a tax perspective, the LLC offers all the flexibility of the partnership form, and, from a business perspective, the LLC generally offers limited liability for operations.

a. Limited liability companies ("LLCs") are hybrid entities that under state law are neither partnerships nor corporations. From a state law standpoint, they purport to offer the owners of a business a very desirable benefit, the protection from personal liability for the debts of the business.

b. From a federal tax standpoint, the Internal Revenue Service ("IRS") recognizes that an LLC can be classified as a partnership so long as the LLC lacks at least two of the four corporate characteristics that distinguish a partnership from an association taxable as a corporation, namely limited liability, centralized management, continuity of life, and free transferability of interests. If treated as a partnership for tax purposes, the LLC provides a combination of limited liability, flow-through of tax items, and the absence of S corporation restrictions on ownership and other attributes.

Comment: The check-the-box regulations will relieve taxpayers from the uncertainty of classification for federal tax purposes. It is anticipated that most states will conform, and those that do not will specify classification further removing uncertainty at the state level.

c. In general, for state law purposes, an LLC is treated as a separate legal entity. Organizers must file articles of organization with the designated state authority, at which time the LLC is generally issued a certificate of organization and its existence begins.

d. Although a uniform provision has been adopted by the National Conference of Commissioners on Uniform State Laws, at present only a few states have adopted the uniform LLC Act. Generally, statutes have developed through an evolutionary process as states have added various provisions to the basic concepts introduced by Wyoming and Florida. Due to the wave of acceptance, use of LLCs will no doubt continue to increase. Many specific tax issues are as yet unsettled in the LLC context.
e. By comparison, if the S corporation form is chosen, business decisions are hampered by eligibility rules imposed by Subchapter S. Although the C corporation would be more flexible than the S corporation, the C corporation leaves much to be desired from a federal income tax standpoint because such flexibility comes at the cost of double taxation.

2. Deemed liquidation of goodwill associated with the existing business

The rush by shareholders in corporations to begin contracting their current operations inside a new LLC may present problems associated with goodwill held in existing corporate solution. It may be argued that, but for the fact that the LLC is affiliated with and is attributed the existing corporation's goodwill, the customer would not have done business with the LLC.

If this is the case, the IRS could propose that the existing corporation realized and recognized a taxable distribution of goodwill, with a subsequent contribution by the shareholder to the newly formed LLC. It is conceivable that this deemed transaction could have significant tax consequence to the shareholders.

3. Employee vs. Employer issues

a. Self-employment income. This area has been addressed to a limited extent by the Service. They have proposed regulations under IRC Sec. 1402 providing that generally, LLC member allocations would be treated as an individual's earnings from self employment. The effective date for this regulation is prospective in that it will be the date the regulation is published as a final regulation in the federal register. (Prop. Reg. 1.1402-18)

Members excluded from this treatment would need to meet the following requirements.

i. The member is not a manager of the LLC, and

ii. The entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction, and the member could have qualified as a limited partner in the limited partnership under applicable law.

Definitions related to this proposed regulation are rather straightforward, however questions as to the "applicable law" and "jurisdiction" would obviously be addressed according the facts and circumstances.
b. LLC Member as an employee. In general, since LLCs are classified as a partnership for federal tax purposes, members receiving salary type payments will be treated as partners receiving guaranteed payments. These payments are not subject to employment tax withholding and are not reported on a Form W-2. Furthermore, LLC members will be taxed on most typical employee fringe benefits.

4. State and local issues. The trend in this area is that, generally state and local jurisdictions are arriving at a consensus. This being the case, the following concerns will continue to diminish.

a. Income and Franchise taxes. Several states will continue to disregard the federal treatment of LLC for tax purposes and assess an entity level tax although another form of business would receive pass through treatment.

b. Comparability of various statutes. The extent to which states will respect the LLCs of other states with differences in their statutes is not yet clear.

c. Tested scope of limited liability. By definition, members of an LLC would be afforded the protection of limited liability. However, the concept of "piercing the veil", is subject to the protections provided by state statutes or judicial decisions made with respect to corporations.

d. Single owner eligibility. Several state statutes, including New York state, allow a single owner LLC. The question arises as to whether the federal Partnership tax rules can be applied to a single owner LLC. It is likely it will not receive partnership treatment under subchapter K.

The proposed check-the-box regulations resolve this question by classifying such an ownership arrangement as a "disregarded entity".

III. Client service -- So what do we do now?

A. Tax planning is still important to the S corporation and its shareholders

1. Ventures in partnership or LLC. A variety of planning ideas are available to S corporations with respect to partnership and LLCs. These ideas increase the flexibility for an S corporation venture to
attract financing and avoid limitations on the number of S corporation shareholders.

a. Forming separate corporations to avoid the 75-shareholder (new law) limit is permitted. In Rev. Rul. 94-43, the IRS has reconsidered its long-standing position concerning S corporations partners and revoked Rev. Rul. 77-220. Previously, the IRS had ruled that since an S corporation could not have more than 35 shareholders under prior law, the use of a partnership consisting of partners merely to exceed the 35 shareholder limitation was prohibited.

Rev. Rul. 94-43 states that the purpose of the number of shareholders requirement is to restrict S corporation status to corporations with a limited number of shareholders so as to obtain administrative simplicity. The ruling states that the fact that S corporations are partners in a partnership does not increase the administrative complexity at the S corporation level. Therefore, it is permissible for multiple S corporations to conduct business through a partnership, even if there are collectively more than 75 shareholders (new law) in the S corporations.

b. Impact on venture capital financing. By using partnerships and LLCs some of the eligibility rules can be planned around to maximize structure flexibility. Reg. §1.701-2(d), Ex. 2.

For example, if an S corporation wishes to expand, but requires outside capital from an ineligible shareholder (such as a corporation or nonresident alien), they should be able to put the new business in a joint venture with the ineligible shareholder, thus retaining S status and allowing the ineligible shareholder to participate as an equity owner in the venture. Vehicles for joint ventures include partnerships and LLCs.

2. S corporation subsidiaries

a. As previously discussed, for tax years beginning after December 31, 1996, S corporations can own 80 percent or more of another corporation. Additionally, if a subsidiary is 100 percent owned and meets the other eligibility requirements, the subsidiary can make a Qualified S Subsidiary election, obtaining flow-through treatment.

b. This rule greatly enables an S corporation to structure multiple lines of business in a more favorable structure segregating liability of the enterprises.
3. Employee-shareholder compensation

a. Planning for reasonable compensation. S corporations must take care to pay reasonable compensation to its shareholder-employees. The IRS has been enforcing Rev. Rul. 74-44 which provides that compensation cannot be disguised as distributions in order to avoid FICA and FUTA taxes. In these situations, the service centers identified S corporation returns on which no salaries were paid to shareholder-employees. Identified corporations were then sent computer-generated letters recharacterizing distributions as salary to the extent of the social security wage base, assessing back payroll taxes plus substantial penalties and interest.

b. Medicaid surtax -- It is obvious that the removal of the cap on wages subject to the Medicaid surtax will prompt the IRS to further scrutinize S corporation compensation to shareholder-employees. The key here is to pay shareholder-employees a reasonable amount in the form of wages.

4. Basis in debt

Under IRC Sec. 1366(d), shareholders in an S corporation whose stock basis has been reduced to zero may take into account losses and deductions (but not distributions) to the extent of the shareholder’s direct indebtedness from the S corporation.

Structuring the holding of this debt is vitally important to the ability of a shareholder to utilize it as basis available to recognize losses of the enterprise. In Hitchins v. Comm. 103 T.C. 711, (1994), the Tax Court decided that debt held through a brother-sister corporate relationship did not provide the shareholder with basis in order to recognize losses realized in the other corporation. In so determining, the court stated that there are two principles guiding the treatment of shareholder basis in S corporation debt.

i. First, there must be economic outlay by the shareholder.

ii. Second, the indebtedness must run directly to the shareholder.

Planning for basis in debt

a. Shareholders, rather than the S corporation, should borrow from outside sources when funds are needed. The shareholders then could either contribute the borrowed funds to the corporation or lend them to the corporation in order to obtain additional basis. If the funds are loaned to the corporation, the note should show a
maturity date, and a reasonable rate of interest should be paid. The concept of borrowing from a bank and subsequently lending the proceeds to an S corporation is known as a back-to-back loan.

b. If a shareholder is already a guarantor on corporate debt, the shareholder should consider making arrangements with the lender to substitute his own debt. This can be done with the shareholder borrowing the funds, then lending these funds to the corporation on the same terms, and the corporation using the funds to pay off the original loan. See also PLR 8443002. If the lender insists on a lien against corporate assets, the corporation can give a lien to the shareholder-guarantor who, in turn, can assign it to the lender.

B. Exit strategies remain very flexible

1. Liquidation. S corporation liquidations are treated the same as C corporation liquidations under IRC Sec. 331. This is the first half of the transaction considered by many corporations in converting to partnership or LLC status. It clearly has, as a prohibitive factor, severe tax consequences when assets have appreciated in value. In addition, this transaction may require substantial liquid assets to pay the taxes imposed on the shareholders of an S corporation.

a. Under the rules of IRC Sec. 336, the liquidating corporation recognizes gain or loss on assets as if it has sold them to the shareholder for fair market value. In an S corporation, the gain or loss flows through to the shareholders increasing or decreasing their basis.

b. Assets with built-in loss may be subject to the special provisions of IRC Sec. 336(d). Distributions of property to a related party are not recognized by the corporation if the distribution is not pro rata or the property is "disqualified property. Disqualified property is property that was contributed under IRC Sec. 351 or was contributed as capital within the five year period immediately preceding the liquidating distribution.

c. Be aware if the S corporation liquidates depreciable property, recapture could be triggered at the corporate level. Also at the shareholder level, §1239 can convert capital gains to ordinary income where shareholders own more than 50% of the corporation.

d. Subsequently, the shareholders recognize gain or loss to the extent that the fair market value of the assets distributed differ from the adjusted basis in their stock. In this respect they are better off
than shareholders in a C corporation because their stock basis is increased, reducing any gain on liquidation.

2. Reorganizations

An S corporation is able to use an "A" reorganization (statutory merger), "C", acquisitive or divisive "D" or "F" reorganization under IRC Sec. 368(a). (GCM 39768.) An S corporation may also acquire assets in an IRC Sec. 351 transaction. However, in all these cases the general eligibility rules of S status must be observed.

Example: T is a calendar year C corporation that made its S election in 1996 to be effective January 1, 1997. In 1997, T merges into P, another calendar year S corporation in a reorganization described in IRC Sec. 368(a)(1)(A), with T's shareholders receiving solely P stock in the merger.

Nontaxable Transaction. In a subchapter C context, this transaction is a statutory merger and would be nontaxable to the parties involved. In GCM 39768, the IRS found that, in general, the subchapter C reorganization provisions apply to S corporations. Therefore, T's merger into P is a nontaxable transaction. However, T's assets are subject to corporate level tax if disposed of by P because the irc sec. 1374 taint on T's assets will carry over to P.

In a divisive "D" reorganization, the transferor corporation generally transfers part of its assets to a new transferee corporation in exchange for stock of such corporation. This stock is then distributed to one or more of the shareholders of the transferor. These shareholders must then be in control (defined as 80% of the value and voting power) of the transferee. IRC Sec. 368(a)(1)(D) and IRC Sec. 355.

Example: P is a calendar year S corporation. P wants to split-off one of its operating divisions to A, one of its two shareholders. On July 1, 1997, P transfers the assets and liabilities of one of its operating divisions to NewCo in exchange for NewCo stock. On the same day, P distributes the NewCo stock to A solely in exchange for all of A's stock in P. NewCo elects S corporation status for its short year ending December 31, 1997 effective July 1.

3. IRC Sec. 338(h)(10).

The IRS issued final regulations under IRC Sec. 338, that permit a IRC Sec. 338(h)(10) election to be made for S corporation targets. Prior to the issuance of the regulations, IRC Sec. 338(h)(10) elections were only permissible for targets that were members of a consolidated
group. Because any purchase of stock by another corporation will terminate a target corporation's S election, 80% or more of the target S corporation stock must be acquired in one purchase.

The result of an IRC Sec. 338(h)(10) election is that the sale of the S corporation stock to the acquirer is ignored. Instead, the transaction is treated as a sale of all the target S corporation's assets to the acquirer followed by a distribution of the proceeds of the sale to the S corporation shareholders in a taxable liquidation under IRC Sec. 331.

The benefit of a IRC Sec. 338(h)(10) election is that a step-up in asset basis can be achieved with only a single level of tax. The basis step-up yields increased tax deductions for the acquirer through amortization of the target's assets. The corporation recognizes any gain on the deemed sale of its assets to the acquirer. This gain passes through to the shareholders and increases their basis. The basis step-up will result in reducing or eliminating shareholder gain upon the subsequent deemed liquidation of the corporation.

In PLR 9630005, the IRS officially ruled that an newly formed S corporation could be the acquirer in a qualified stock purchase, making a IRC Sec. 338(h)(10) election. The acquirer immediately liquidated the subsidiary and did not terminate its S election. The new law taking effect for tax years beginning after December 31, 1996, remedies the uncertainty of such transactions for S corporations purposes. (Amendment to IRC Sec. 1371)

C. Estate planning opportunities abound

1. Gifting shares is an excellent method of transferring wealth. Shares generally provide freedom of transferability, proportionate allocation of value, and limited control based on quantity or ability to vote. For S corporations, special attention must be given to ensure that eligibility of shareholders is always considered. Other features associated with gifting of shares include voting rights, placing in trust, and discounting values.

   a. Voting rights. S corporations may not have two classes of stock. However, a single class of stock may consist of voting shares and non-voting shares (IRC Sec. 1361(c)(4)). S corporation shareholders may wish to gift shares of stock to children, but reserve right to control the business.

      For example, P is a 100% shareholder of S, an S corporation. P is planning for the future. P would like to transfer some value of accumulated wealth to P's children, and to maintain absolute
control of the S corporations business. S issues non voting stock to P of identical rights to distribution and liquidation proceeds as the voting shares. P transfers non voting stock as a gift to P's children. P's realizes all of the above estate planning objectives. In addition, P may take advantage of discounted values of the gifted shares as discussed below.

b. QSST Planning. QSSTs can be used to shift current income and the appreciating value in an S corporation's stock to more junior shareholders without vesting control in them. The use of the trust may be better for both business and personal reasons, than making an outright gift of the stock.

Structuring a QSST. The key point is establishing a trust to which the S corporation stock is transferred, with no conditions that would require the trust's assets to be included in the donor's estate, e.g., an irrevocable, nonreversionary trust for the benefit of a spouse or child.

Example: A, in his early 50's, owns 100% of an S corporation, which currently is appreciating substantially in value. A has two children. However, A is not sure either of them will ever take an active interest in the business. Keeping in mind that he does not want to vest control over the corporation in the children, A establishes an irrevocable, nonreversionary trust for each child with a local bank serving as trustee. Both children elect to treat their trusts as QSSTs. A's primary goal is to shift appreciating stock out of his estate and to shift income from his 39.6% marginal tax bracket to his children.

c. Electing Small Business Trusts. The recent law change includes a new type of trust that will be eligible to hold S corporation stock for tax years beginning after December 31, 1996. An electing small business trust can accumulate and sprinkle income. This type of trust will likely supplant QSSTs in many instances. The flexibility comes at the cost of the highest marginal individual income tax rate applied to the trust's share of S corporation income.

d. Discounts. Shareholders gifting minority interests in closely held S corporations would be able to take advantage of discounting provisions according to Rev. Rul. 93-12. A minority interest discount is generally available in connection with the transfer of a non controlling interest in closely held stock. As a practical matter, few outside buyers are willing to pay full value for a minority interest when faced with a corporation whose officers and directors are usually family members with a controlling interest. In addition
to the lack of control, consideration should also be given to lack of marketability.

2. Structuring expanded operations. New ventures or expansions of operations of an S corporation could be dropped into a limited partnership or LLC in the form of a family limited partnership.

Specifically, this type of structuring can afford the estate planner additional flexibility with respect to other issues presented in this outline. Advantages include limited liability, controlling and marketability discounts, access to venture capital, and freezing of value for estate tax purposes.


Among the issues that should be considered are:

a. Providing for an orderly transfer upon the death, retirement or disability of a shareholder

b. Establishing and affixing a fair market price

c. Reducing the risk of dissolution or loss of value by assuring the continuation of the business

d. Maintaining shareholder liquidity through life insurance or other funding arrangements

e. Providing a framework to prevent outsiders from acquiring the stock of the corporation.

IV. What about the future?

A. Analyze the LLC as an operating entity

1. Limited liability.

   a. Any new investor needs to consider not only the investment potential for economic rewards, but also the economic risk associated with making the investment. For clients considering any business form, the liability protection afforded any particular form of business is a crucial factor to making the investment. S corporations afford owners this liability protection. It is expected that LLCs would give individual members of the LLC virtually

Copyright Coopers & Lybrand, L.L.P. Starr 23
complete personal liability protection from any company debt or obligations.

b. Although states may not impose minimum capital requirements, one should query whether personal liability protection would be available if the LLC is thinly capitalized or the members somehow "pierce" the LLC's liability protection by using it for personal purposes? Under the LLC rules, it is not clear whether there is a comparable concept to "piercing the corporate veil" commonly known to corporate owners who use their corporation as an incorporated pocketbook.

2. Governing board

a. A fundamental principle to the governance of the corporate entity is management through a board of directors and corporate officers. From a business point of view, this management structure may well be attractive to investor shareholders. They do not need to partake in day-to-day decision-making and can rely on management's fiduciary responsibilities to investors to carry out management duties in a reasonable way.

b. By comparison, the LLC may or may not have a separate board-like group that manages the entity's business. Designated managers will have the power to bind the LLC to outside creditors. The LLC can have employee-managers and still be managed by its members for federal and state law purposes.

3. Perpetual life

Many LLCs are structured to lack continuity of life for tax classification purposes. Because local law may require unanimous consent to continue the LLC, any dissenting member at the time of dissolution could withhold consent to extract concessions from any remaining members. This could present a practical problem for those entities where continuing the business enterprise is important. However, in most cases, the fact that the LLC must lack continuity of life will serve more as an inconvenience to members than anything else. Generally, a dissolution of the LLC will not require an actual liquidation of the LLC for tax purposes. An accounting of varying ownership interests for the year may be all that is required so that income and loss items can be appropriately allocated among the members.

4. Restrictions on transferability

Under current law, to be classified as a partnership for federal tax purposes, the LLC generally will lack the corporate characteristic of
free transferability of interest. For many closely held business entities, whether partnerships or corporations, real restrictions (principally in the form of buy-sell agreements) are imposed on an owner's ability to transfer ownership interests. Thus, for all practical purposes, even though the LLC will probably lack free transferability of interests, this feature will not necessarily make it any less attractive than the closely held corporate form of doing business.

5. Professional liability

a. Many states have long recognized professional service corporations as an appropriate form of doing business for professionals within their states. The professional service corporation does not protect owner-professionals from liability exposure due to their negligent professional conduct, or any individual under the owner-professional's supervision or control. On the other hand, the corporate form does offer the professional liability protection from vicarious liability and general claims against the corporation.

b. Forty-five states and the District of Columbia presently recognize the limited liability partnership (LLP) in their states and LLP statutes are either pending in the legislature or awaiting their effective date in the remaining states. The LLP, a modified general partnership, is designed specifically for the professional to operate as a partnership with liability protection at the owner level from vicarious liability, but not for general claims of the LLP or for breaches of personal professional responsibility or supervisory liability. The LLP is extremely attractive because of the flexibility of the partnership form and it compares favorably to the personal service corporation in the liability protection afforded to its members. Because it is a general partnership, the LLP does not present some of the tax difficulties faced by LLCs.

6. Familiarity and recognition among taxing jurisdictions

Now that all states recognize LLCs, perhaps the biggest drawback to using the LLC is the fact that to date many state law issues relating to formation and governance remain unclear and will need to be resolved in years to come. Until a body of law develops around the LLC, it will not be as "comfortable" an entity as the time-challenged corporate form. Third parties such as banks, creditors, and joint ventures may be reluctant to transact business with an entity with which they are not familiar.
B. Checklist of Choice of Entity Issues

1. General Business Considerations

   a. What is the cost of formation?

   b. What will the reporting requirements be and are there related complexities?

   c. How will the entity be managed and what amount of flexibility is desired?

   d. Is a limitation of owner's personal liability for the entity's obligations a necessity?

   e. Is the transferability of the investment in the entity and liquidity of the owners important?

   f. Is the continuous existence of the entity and prevention of unintended termination important?

2. Tax Considerations

   a. What effect to the economics of the entity do differences in income tax rates have on the choice of entities?

   b. Is a single-tier tax important for the economics of the entity and owners.

   c. How important is the certainty of tax classification of the entity?

   d. What are the anticipated methods of formation and capitalization?

   e. Do any of the contributed assets have a tax basis and different from fair market value?

   f. Will there be entity level debt?

   g. How will the passive activity loss rules apply to the owners?

   h. Are special allocations of operating profits and losses desirable?

   i. Do owner eligibility requirements present unnecessary limitations on choice of entity?

   j. Does the entity desire to use the cash method of accounting?
k. What tax year would be most appropriate for the entity?

l. Has the treatment of employee fringe benefits to employee-owners been considered?

m. How will the choice of entity treat income for purposes of self-employment tax?

n. What are future business structuring and acquisition plans of the entity?

o. Have exit strategies been considered for the type of entity?

C. Profiles of Businesses Using Either the LLC or S corporation

Enterprises bring to bear many varying issues and concerns that should be considered when making the decision of what form of business to use. The following are suggestions based on sample characteristics.

1. Profitable C corporations, with generous cash flow

   a. The classic entity for electing S corporation status is the very profitable, cash rich closely held corporation. If this entity's activities can be conformed to an S corporation structure, then the single-level of tax-imposed on the S corporation can maximize tax savings and allow for the tax-free distribution of earnings.

   b. With an S corporation election, this entity need not be concerned with personal holding company tax or accumulated earnings tax. Presumably any mechanical problems encountered with operating as an S corporation are overshadowed by the tax savings that will flow to shareholders by virtue of the single level of tax.

   c. C corporations cannot convert to LLC status without undergoing a complete liquidation subjecting shareholders to a double tax on the appreciation of corporate assets.

2. Banking Institutions

   a. The IRS has long protected what it has considered long-standing intent by Congress: Any entity engaged in banking activities will be taxed as a corporation. Period!

   b. Recent evidence of this practice of preventing pass-through tax treatment to banking businesses includes, for example:
i. In PLR 9551032, the IRS determined that the new statutory entity called a Texas Limited Banking Association would not be treated as a partnership, even under the corporate characteristic tests, because it was engaged in banking activities.

ii. Under the "check-the-box" regulations, any federally insured entity carrying on the business of banking is a corporation by default. (Prop. Reg. Sec. 301.7701-2(b)(5)) In other words, an LLC Bank will always be a corporation for federal tax purposes.

c. The Act, however, includes a monumental change in the tax law aimed at closely held banks. In general, banks (as defined in IRC Sec. 581) will be eligible to be considered as small business corporations (assuming the other tests are met) and can elect S corporation status, resulting in pass-through treatment of taxable income.

d. This new opportunity exists even under the check-the-box regulations, which require the classification of all federally insured banking organization as corporations. Only an entity classified as a corporation can make an S election. In effect, the legislation "takes the ball out of the IRS's hands" with respect to a single tax regime for closely held banks.

e. Effective Date: This new law change is effective for tax years beginning after December 31, 1996.

3. Interstate enterprises

Over the past few years, uncertainty regarding an LLC's limited liability for doing business in states not recognizing LLCs has gradually been resolved by the fact that virtually all states and the District of Columbia now recognize LLCs.

a. It is now presumed that nearly all states will recognize the limited liability of foreign LLCs operating within their state boundaries. Thus, business operations in LLC form are no longer as compelled to confine their activity to their home state. Companies engaging in interstate activity can adopt the LLC format, and be reasonably comfortable that their members will enjoy limited liability in the LLC's interstate activity.

b. However, if there is any concern as to limited liability for interstate operations, the S corporation form could be adopted. The
corporate entity is universally recognized throughout the fifty states for limited liability offered to owners.

c. State taxation of LLCs and S corporations will continue to be varied and taxpayers should consider the treatment on a state by state basis.

4. Manufacturing operations

a. Because manufacturing businesses generally are high product liability operations, the S corporation may be preferable to the LLC. Where many outside investors are necessary to provide the capital for operations, the regular corporation is the most flexible and preferred entity. However, the S corporation may indeed be an ideal entity for a closely held situation because it will provide the same protection against liability claims as afforded to a regular corporation.

b. Taxation and reporting of compensation to employee-owners of manufacturing enterprises may be most surprising and imposing in an LLC structure. As discussed earlier, such treatment is identical to a partner in a partnership.

5. Natural resources

The LLC is particularly appropriate for the natural resources industry. By placing interests in natural resources in an LLC classified as a partnership, the members will enjoy the tremendous flexibility of the LLC's partnership features for tax purposes while protecting themselves from general liabilities.

6. Real estate

LLCs have been used frequently in the real estate industry as a substitute for limited partnerships.

a. The LLC should be a highly attractive entity for holding real estate because, unlike a corporation, the real property can be liquidated out of the LLC without triggering an entity level tax. In addition, the owners of the real estate can shield themselves from liability compared to a limited partnership, and the LLC members can participate in day-to-day activities without losing their liability protection. And, the LLC is not required to have a "general partner" as one of its members subject to unlimited liability.

b. Because of stock basis, limits on special allocations and gain on liquidation, the S corporation has not served well for holding real
estate. However, an S corporation acting as the general partner of a limited partnership may provide the necessary protection to the general partner from liability claims while providing flow-through treatment.

c. Two additional factors in favor of using an LLC in a real estate venture are: special allocations and increased outside basis due to allocation of nonrecourse debt. Members of an LLC are able to take non recourse deductions similar to the limited partnership.

7. Startups

a. New operations can easily be placed into the LLC form. In these situations, if operations are limited to one state recognizing the LLC form, the flow-through of losses to its members may well be an attraction to using the LLC. If operations later expand and involve several states, incorporating can be accomplished easily if deemed necessary for third party purposes, e.g., dealing with outside creditors or buyers.

b. In addition, high-tech companies engaged in risky research might find the LLC to be attractive while at the same time offering a flexible entity for tax planning purposes. The LLC would give the high-tech company the ability and flexibility to flow initial losses up to its owner-members, to structure preferred equity interests, to compensate employees with special ownership interests, and to joint venture with other high-tech companies.

c. The S corporation also would allow for the creation of §1244 stock so that if the stock needs to be sold or exchanged for a loss, the loss will be treated as an ordinary loss. By electing S corporation status for a brand new entity, a built-in gains tax and passive income tax can be avoided.

d. S corporation eligibility restrictions have as a general purpose the simplification of ownership operations, which may be attractive to start-up businesses.

8. Venture Capital

a. The LLC can readily be used by venture capitalists as an investment vehicle while at the same time allowing the LLC members to actively engage in the investment activities. As long as the LLC is classified as a partnership, the venture capital fund can make special allocations of earnings generated from their investments to its members. The LLC could invest in a number of corporations and partnerships and its ownership can be structured
to give different ownership interests to lenders, underwriters, employees, and other investors.

b. Equity compensation issues have often discouraged use of an LLC in circumstances where talented or key employees were to participate in ownership.

9. Professional service organizations

As an alternative to forming professional organizations as general partnerships, the LLC presents an attractive option whereby partnership tax treatment can be obtained while at the same time the liability of the individual professionals providing services is limited to their own personal misdeeds. A number of the LLC statutes specifically allow professionals in their states to use the LLC as a form for doing business. As an alternative, some states permit or require professionals such as attorneys and accountants to conduct operations through a Limited Liability Partnership.

10. Corporate joint ventures

A joint venture between two or more corporations could be conducted through an LLC. In general, the corporate members would consist of single purpose subsidiaries which would hold the LLC interest. This constitutes a layered defense against liabilities of the business.

Consideration could also be given to using the LLC as a leveraged-buyout vehicle. In this case, the target corporation could drop its assets into an LLC and the investors (e.g., senior management) could take direct LLC interests along with any third-party banks and underwriters. The LLC as an LBO vehicle has the practical limitation of being unable to freely transfer interests, and therefore generally cannot be used in a publicly traded context.

11. International

Businesses seeking international capital investments could structure operations in LLCs both domestically and abroad. Many countries acknowledge the entity characteristics of the LLC. Flexibility of structure is a major incentive for this form of international business.

12. Substitute for a trust, or family limited partnership

Another possible use of the LLC is as a substitute to an irrevocable life insurance trust, or other gift trusts used in an estate planning context. The distribution and investment limitations generally used in a trust
instrument can be used in the LLC as well. The LLC has a clear advantage over trusts because its members are subject to the 39.6% tax rate much less quickly than are trusts (39.6% applies at $7,500 of income or more in 1994).

V. Conclusion

Since 1982, much has happened to the choice-of-entity decision process. Certainly, the foremost development has been the advent of the LLC as a choice-of-entity for both domestic and international situations. It must be noted that S corporations are generally more attractive now than they have been, and they could get better, but the S corporation will still not enjoy all the flexibility of the LLC.

With the LLC's flexibility, comes complex subchapter K (partnership) tax rules. Some taxpayers may not be ready to deal with these complexities. They may need an expert to assist them and forestall any traps in which they might fall.

Selecting the appropriate form of business operation -- whether to use a regular corporation, a partnership, an S corporation, or an LLC -- is a decision complicated by both business and tax considerations.

Each situation will need to be evaluated on the facts, and the merits of each form of business addressed from time to time as internal and external factors require.