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CHOICE OF ENTITY - GENERAL CONSIDERATIONS
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A. LIMITED LIABILITY

1. C Corporations, S corporations, and LLC's generally provide limited liability for owners. Exception - individual's own professional errors.
2. Partnerships. General partners have no liability protection. Limited partners have liability protection as long as they are not actively involved in the trade or business of the partnership.
3. Limited Liability Partnerships. Partners are not liable for acts, errors, omissions, malpractice or negligence of others unless they supervised or were involved. In most LLP states, partners are liable for contractual obligations.

B. FLEXIBLE OWNERSHIP AND CAPITAL STRUCTURE

1. S corporations are limited to 35 shareholders and one class of stock; types of shareholders are limited; cannot own 80% or more of another corporation.
2. Partnerships and LLC's generally need at least 2 partners or members.

C. LOSSES AND PASSTHROUGHS TO OWNERS

1. S corporations, partnerships, LLC's, LLP's, allow for passthrough of losses to the owners.
2. If the losses are to be financed from borrowed funds, a partnership, LLC, or LLP would be the preferable entity because the funds borrowed by the entity can be used as basis against which to deduct the loss.

D. LOWER TAX RATES

1. C corporations allow the business to, initially, retain income at a lower current tax cost. The maximum effective federal tax rates on ordinary income are lower for a C corporation than for individuals (35% vs. 43%).
2. Offsetting this tax advantage is the continuation of the double level of tax on C corporation liquidations. The combined double tax rate to the owners of a C corporation is approximately 53.2% vs. the highest individual rate of 43%.
3. New IRC § 1202 allows a 50% exclusion for capital gain on the sale or exchange of stock in a C corporation engaged in a manufacturing, wholesale, or retail business, if the stock was issued after August 10, 1993 and was held for five years.

- a. The exclusion decreases the combined double tax rate (using a corporate rate of 34%) to approximately 44.1% if the seller is not subject to the alternative minimum tax, and approximately 48.7% if the seller is subject to the alternative minimum tax at the highest rate (28%). One-half of the amount excluded from income is included in alternative minimum taxable income.

E. FRINGE BENEFITS

1. A C corporation can provide fringe benefits such as health insurance, group term life insurance, etc. to its shareholder employees on a tax-free basis.
2. Partners, members of an LLC and more than 2% shareholders of an S corporation are not entitled to these tax-free fringe benefits.

F. PASSIVE LOSS RULES

1. Passive loss rules do not apply to C corporations unless the corporation is a personal service corporation (PSC) or closely held.
2. For S corporations, LLC's, and partnerships the passive loss rules apply at the owner level. It is more difficult for limited partners to satisfy the material participation rules, and they cannot satisfy the active participation rules. A membership interest in a LLC will fall within the definition of a limited partnership interest (PLR 9452024).

G. USE OF FAVORABLE CAPITAL GAIN RATES

1. Regular, ordinary income tax rates apply to capital gains recognized by a C corporation.
2. Long-term capital gains recognized by partnerships, LLC's, and S corporations are passed through to the owner and taxed at the favorable long-term capital rates applicable to individuals.
3. See discussion of IRC Section 1202, above.

H. QUALIFIED PLAN LOANS

1. Loans against qualified plan accounts are allowable to C corporation owners.
2. Qualified plan loans are prohibited transactions for loans to more than 5% owners of S corporations and owners of more than 10% of the capital or profits interests of a partnership or LLC.

I. PAYROLL TAXES OF OWNER EMPLOYEES

1. Generally, income that is passed through and taxed to the owner of an S corporation is not subject to payroll taxes as long as the S corporation shareholder receives a reasonable salary for his efforts on behalf of the corporation.
2. Under IRC Section 1402(a)(13), a limited partner's distributive share of partnership income is exempt from self-employment tax except for guaranteed payments made to the limited partner for services rendered to, or on behalf of the partnership.
3. Proposed Reg. Section 1.1402(a)-18 states that a member of an LLC will not be subject to the self employment tax if:
 - the member is not a manager of the LLC, *and*
 - the LLC could have been formed as a limited partnership in the same jurisdiction and the member could have qualified as a limited partner.

J. TREATMENT IF INTEREST EXPENSE INCURRED TO ACQUIRE INTEREST

1. Rev. Rul. 93-68 states that interest incurred to purchase stock in a C corporation is treated as investment interest.
2. According to Notice 89-35, 1989-1 CB 675, debt is allocated to the purchase of an interest in a pass through entity in accordance with §1.163-8T, and the associated interest expense shall be allocated among the assets of the entity using any reasonable method. Accordingly, the interest expense could be classified as trade or business interest, investment interest, etc.

K. ABILITY TO USE CASH METHOD OF ACCOUNTING

1. C corporations are not allowed to use the cash method of accounting unless the corporation is a PSC or meets the small corporation definition (\$5 million gross receipts tests of IRC Section 448(c)).
2. S corporations, partnerships, and LLC's are not limited in the use of the cash method of accounting unless the entity is a "tax shelter".
3. Cash method is not available to a partnership that has a C corporation as a partner unless that corporation is a PSC.

L. SPECIAL C CORPORATION ISSUES

Generally, S corporations, partnerships, and LLC's are not subject to the following rules unique to C corporations.

1. Personal holding company tax.
2. Accumulated earnings tax.

3. Unreasonable owner compensation issues.
4. Corporate level AMT.

M. PARTNERSHIP TAX ISSUES

Because of the favorable tax rules applicable to partnerships in the areas of contributions and distributions, a partnership or LLC would be the favored form of entity in the following situations.

- Contribution of appreciating assets by the owner at formation or in the future.
- Potential for distributions of appreciated property to owners.
- Where the owners want cash flow to be shared in varying percentages, or in varying amounts based upon cumulative returns.
- Entity holds appreciating assets and the potential exists for the entity to borrow against these assets to make distributions to owners rather than to sell the assets.
- The availability of the IRC Section 754 election in the case of the death of an owner and the sale of an interest in the entity by an owner.

N. ESTATE PLANNING

1. Where an entity will be used to hold appreciating assets and interests in the entity will be given away for estate planning purposes, a limited partnership should be used.
 - a. Older family members can retain control as general partners, in contrast to an LLC. Most LLC acts give all members rights concerning the transfer of interests in the company and the continuity of the company.
 - b. Appraisers may give a lower value to an otherwise equivalent interest in a limited partnership because an LLC is more likely to experience an event of withdrawal causing a dissolution.
 - c. The case law related to limited partnerships is much more certain and appraisers are aware of it. Appraisers generally do not know the rules applicable to LLC's.