Choosing a Business Entity for the 21st Century

Samuel P. Starr
Thomas P. Rohman
L. Michael Gracik Jr.

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Choosing a Business Entity for the 21st Century

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
Choice of Entity of Business Entity

- Sole proprietorships
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- Regular corporations
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- Single member LLCs
• 1978 - Wyoming Limited Liability Company Act


• 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)

- Domestic Default rules:
  - Only one member = disregarded entity
  - More than one member = partnership

- Can always elect to be an association taxable as corporation

- Different rules for foreign entities
## Statistical Overview: Where are We?

<table>
<thead>
<tr>
<th>Type</th>
<th>Number of Returns</th>
<th>Income Reported</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1999 Tax Data</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• C Corporations</td>
<td>2.2 million</td>
<td>$791.64 billion</td>
</tr>
<tr>
<td></td>
<td>32%</td>
<td>65%</td>
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</table>
Comparison by Percentage of Number of Pass Through Entities

[Graph showing percentage of pass-through entities from 1991 to 1999, with categories for Partnerships, excl. LLCs, LLCs, and S corps.]

William & Mary Tax Conference
Comparison of Pass-Through Net Income by Entity


- Partnerships, excl. LLCs, LLCs, S corps.

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#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
#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
Top Ten Factors In Choosing A Business Entity

#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

William & Mary Tax Conference
Top Ten Factors In Choosing A Business Entity

#6

Will employment taxes be a driver in choosing a business entity?

- 7.65% employer and 7.65% employee FICA tax versus 15.3%
- 2.9% Medicare tax
- $84,900 Wage base (unlimited for Medicare)
- Unreasonably low or no compensation?
Top Ten Factors In Choosing A Business Entity

#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
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#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
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#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
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#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
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# Advantages of LLCs

- Can operate as a disregarded entity with limited liability: **X**
- No double tax on distributed income: **X**
- Limited liability: **X**
- Unlimited number & type of owners: **X**
- Special allocations of income & loss: **X**
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The preferred entity of choice is now the LLC.

- For startups, is there any reason why not to use the LLC?

- The LLC provides limited liability, flexibility, single-tax regime


- 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
- 10-year built-in gains tax. After 10 years, there is only one-level of tax on liquidation
• Tax Rate Reduction
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  – 150 shareholders
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• LLCs will be become the dominate entity of choice

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• Simplification of Internal Revenue Code (Rep. Houghton, HR 5505)
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William & Mary Tax Conference
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**William & Mary Tax Conference**
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