***THE BUSINESS OWNER’S CHECKLIST FOR SELECTING***

***THE RIGHT BUSINESS ENTITY FORM***

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**By: Keith A. Wood, Attorney, CPA**

**Craig A. Taylor, Attorney**

**Carruthers & Roth, P.A.**

*235 N. Edgeworth Street*

*Greensboro, NC 27401*

*Telephone: (336) 379-8651*

*Fax: (336) 273-7885*

*kaw@crlaw.com*

*cat@crlaw.com*

**INTRODUCTION**

 Without a doubt, one of the most important decisions facing a new business owner (and his or her advisor) involves the selection of the appropriate organizational form in which to conduct the activities of the business enterprise. The selection of an organizational form will have dramatic and profound consequences upon:

(i) the relative **complexity and expense** of complying with state law formalities;

(ii) whether the business owner will risk **personal liability** for debts and obligations of the business; and

(iii) how business income will be **taxed** in the future.

 In general, a business venture will be classified, for business and tax law purposes, as either:

 - a sole proprietorship;

 - a partnership (general, RLLP or limited);

 - a corporation (S or C corporation); or

 - a limited liability company.

 New Businesses

 Since each of these organizational forms presents unique tax and non-tax issues, the business owner (and his or her advisor) should take care in selecting an organizational form for the new business that is most advantageous for both tax and business law purposes.

 Existing Businesses

 In addition, it is incumbent upon the business advisor to periodically review the choice of entity decision to determine whether changes in circumstances warrant a change in the choice of entity decision.

 This paper will provide an in-depth analysis of the choice of entity selection process. We will begin by reviewing the various types of entity forms and will then compare and contrast the relative tax and non-tax advantages and disadvantages of each entity form.

 To illustrate the choice of entity selection process, we will review specific examples to illustrate this decision-making process. Finally, we will illustrate some of the advantages and disadvantages of converting an existing business into a new entity form, and how this conversion process may be achieved with the least tax-cost to the client.

**I.** ***The Ongoing Role of Professional Advisors in the Entity Selection Process.***

 Because of the significant ramifications the choice of entity decision will have upon the future success, profitability and viability of the business enterprise, the client's professional advisor team (attorneys, CPAs, accountants, return preparers, and others) must play an **active** **and ongoing** role in advising the client on the choice of entity selection process.

 From the advisor's perspective, advising a *new* business owner on selecting a business entity form requires the advisor to "look into the crystal ball." In advising his or her clients, the advisor must recognize and anticipate the impact that future changes may have on the choice of entity decision.

**A.** **Tax Law Changes.**

Because the choice of entity decision often is made based upon tax considerations, the advisor must always be mindful of the impact of future tax law changes on the choice of entity decision. This is especially true when Congress acts to change personal and corporate income tax rates.

 **B.** **Changes in the Nature of the Client's Business.**

The choice of entity decision may also be affected by changes in the client's business. In the initial choice of entity decision-making process, clients may be focused on income tax issues. But as their businesses grow and mature, employment tax and estate tax considerations may arise.

 **C.** **Changes in Business Operations**.

In the early stages of business formation, clients may be focused on how the choice of entity will affect their businesses on a day-to-day ongoing basis. However, as new business issues arise (such as the issuance of stock to new investors, the possible sale of the business, or the buy-out of a business partner), the business advisor must periodically re-evaluate the choice of entity decision.

 **D.** **The Client Who Fails to Keep the Advisor Informed.**

In many cases, changes in the business may arise by the unilateral act of the business owner without the advice and consultation of the advisory team. For example, clients may fail to consult their advisors prior to making a critical business decision, such as:

*1.* Acquiring real estate;

*2.* Purchasing the assets of another business; and

*3.* Acquiring corporate-owned life insurance.

**E.** **Summary.**

In light of all these issues, professional advisors must always be mindful that the choice of entity decision is not merely a question that arises in the business formation phase. In any of the situations described above, where there has been a substantial change in the tax laws or the specific activities of the business enterprise, the advisor must re-evaluate whether yesterday's choice of entity decision is still appropriate for today or tomorrow.

Indeed, the choice of entity question must be constantly re-evaluated and readdressed on an ongoing basis. In some cases, the business owner must even consider converting the business to a new entity form or perhaps restructuring the business arrangement.

**II.** **An Overview of the Four Types of Organizational Forms.**

 For business law and tax law purposes, there are four organizational forms in which a business enterprise may be classified:

**A. Sole Proprietorships.** Business ventures that are owned and operated by a single individual.

**B.** **Partnerships (General, RLLPs and Limited).** Joint business ventures among two or more persons to carry on a business as co-owners for a profit.

**C.** **Corporations.**  Separate legal entities formed by one or more individuals by complying with specific statutory provisions through a grant of authority from the North Carolina Secretary of State. Corporations may be taxed under Subchapter C or Subchapter S of the Internal Revenue Code, with substantially different results.

**D. Limited Liability Companies (LLCs).** Like corporations, LLCs are formed by complying with specific North Carolina statutes. LLCs are generally taxed as partnerships, but can elect to be taxed as S or C corporations.

**III.** **Three Factors to Consider in Making the Choice of Entity Selection.**

 In advising a business owner on the selection of an appropriate organizational form, the advisor should focus on three primary issues:

**A.** **Organizational Complexity and Expense.** How do the four organizational forms differ with respect to their relative organizational complexity and expense?

**B.** **Liability Concerns:** How would the selection of an organizational form impact and affect the business owner's personal liability for debts and obligations of the business enterprise – and how might the choice of an organizational form place the business assets at risk for the "outside" liabilities of the business owner?

**C.** **Tax Considerations.** What are the relative tax advantages and disadvantages that arise under these four different organizational forms?

**IV. Organizational Complexity and Expense.**

 **A. Sole Proprietorships.**

 ***1****.* ***Formation****.*

Sole Proprietorships are the least complex types of business entities to form and operate. A sole proprietorship arises simply where a business owner engages in a business for profit.

 - No filings with the Secretary of State are required and no annual filing fees are required.

 - Since the sole proprietor already owns his or her business assets, there is no need for a formal transfer of business assets.

***2****.* ***Tax Compliance****.*

Tax compliance cost is kept at a minimum since there is no separate income tax reporting requirements. The sole proprietor simply reports all business income on Schedule C of his Form 1040. The sole proprietor may not even be required to obtain a separate taxpayer identification number.

 **B. Partnerships**

Like sole proprietorships, partnerships are very easy and inexpensive to form and operate.

 ***1****.* ***Formation****.*

A general partnership arises simply where two or more persons engage in a business for profit as co-owners. A limited partnership is formed by filing a Certificate of Limited Partnership with the North Carolina Secretary of State along with a $50 filing fee.

 ***2****.* ***Management and Operational Issues****.*

Although partnerships are relatively easy to form, the parties must keep in mind that state law will govern the relative rights and obligations of the partners unless there is a contrary agreement among partners.

 **(a) Profits and Losses Shared Equally**--Unless there is a contrary agreement of the partners, profits and losses of a partnership are shared equally regardless of the partners' respective contributions of property to the partnership.

 **(b) Equal Voice in Management Decisions**--Absent an agreement to the contrary, all partners have equal rights in the management of the partnership regardless of how profits and losses are shared and regardless of the partners' respective contributions of partnership property.

**Example**: Steve and Terry form a partnership. Steve contributes $75,000 and Terry contributes $25,000 in cash to form the partnership. Although Steve contributes 75% of the partnership property, unless they agree otherwise, Steve and Terry are each entitled to one-half (½) of partnership profits and Steve and Terry both have an equal voice in the management decisions of the partnership. This would probably be a great surprise to Steve!

 **(c) Rights of Partners in Partnership Property**

**i.** During the term of the partnership, all partners have equal rights in partnership property, regardless of who contributed the partnership property.

**ii.** At dissolution, each partner receives back an amount of property equal to his original contribution of property, but the excess is split evenly between the partners.

**Example**: Alice and Bob form a real estate partnership. Alice contributes real property worth $50,000 and Bob contributes $50,000 in cash. After the value of the real estate appreciates to $150,000, Alice decides that the partnership should sell the real estate. However, since Bob has equal rights in the partnership property, Alice can't force the partnership to sell the real estate without Bob's consent.

Therefore, Alice decides to terminate and dissolve the partnership. At dissolution, however, Alice is only entitled to receive property worth $50,000 (the value of her contribution to the partnership) plus one-half (½) of the appreciation in partnership property. Thus, although the value of Alice's property has tripled in value, she is only entitled to receive $75,000 worth of property, or one-half (½) of the existing partnership property.

 ***3.******Income Tax Treatment****.*

Partnerships are not subject to entity level taxation on partnership income. Instead, the partners report partnership income on their personal returns.

However, in order to avoid having the partnership classified as a corporation, the agreement among the partners (whether written or unwritten) must comply with certain requirements under I.R.C. Section 7701.

 **C. Corporations (S and C).**

In contrast to sole proprietorships and partnerships, North Carolina corporations are substantially more complicated and expensive to form and operate than are sole proprietorships.

 ***1.******Formation****.*

In order to avail themselves of the limited liability protection of the corporate form, owners of corporations must file Articles of Incorporation with the North Carolina Secretary of State. A $125 filing fee must accompany the filing of Articles of Incorporation. In order to capitalize a corporation, cash and legal title to corporate assets must be transferred to the business enterprise.

 ***2.******Preserving Limited Shareholder Liability****.*

Strict corporate formalities must be observed in order to avoid the piercing of the corporate veil.

- Separate books and accounts must be kept to segregate activities of the business from the personal affairs of the business owners.

- In addition, corporate formalities, such as annual minutes of shareholder and board of directors meetings, must be documented.

 ***3.******Annual Reports****.*

In addition, each year the corporation must file an annual report with the North Carolina Secretary of State or risk facing administrative dissolution by the Secretary of State. A $25.00 filing fee must accompany the annual report.

***4.******Income Tax Reporting****.*

Regardless of whether the corporation is an S corporation or a C corporation, all business income must be reported on a separate tax return for income tax reporting purposes. A separate taxpayer identification number must be secured.

 ***5. North Carolina Franchise Tax.***

In addition to the annual report fee and any state or federal income tax liability, all North Carolina corporations are subject to the North Carolina franchise tax. The franchise tax rate is one dollar and fifty cents ($1.50) per one thousand dollars ($1,000) and is applied to the largest of the three tax bases determined as set forth in the law. The minimum franchise tax is thirty-five dollars ($35).

The taxable franchise tax base is the largest of these tax bases:

- Capital stock, surplus and undivided profits

- Fifty-five percent (55%) of appraised ad valorem tax value of all real and tangible property in N. C.

- Actual investment in real and tangible property in North Carolina (generally, book value of the asset less debt incurred to acquire or create the asset).

For most small businesses, franchise taxes do not create a large liability. However, substantially appreciated real property or valuable equipment can give rise to substantial franchise taxes.

 **D. North Carolina Limited Liability Companies.**

A limited liability company ("LLC") is a much more complicated business arrangement than is a sole proprietorship or partnership. LLCs can be more or less expensive and complicated than corporations, depending on the business objectives of the owners.

A North Carolina LLC is a business organizational form that offers limited liability protection to its owners. Generally speaking, an LLC will be treated as a partnership for tax purposes **(although it is possible, under the IRS "check-the-box" regulations, for an LLC to elect to be taxed as a C or S corporation).** Therefore, the primary benefit of an LLC is that it combines the limited liability protection of corporations with the tax advantages of partnerships.

 ***1. Formation****.*

An LLC is formed by filing Articles of Organization with the North Carolina Secretary of State along with a $125 filing fee.

 ***2. Annual Reports****.*

In addition, in each year in which the LLC operates, it must file an annual report with the North Carolina Secretary of State along with a **$200 filing fee**. However, LLCs are not subject to franchise tax.

 ***3.******Preserving Limited Liability****.*

In order to guarantee limited liability protection to its owners, the LLC must be validly formed and operated as a separate legal entity. Thus, as with corporations, certain corporate law type formalities must be observed. Thus, in order to prevent the piercing of the corporate LLC veil, the LLC must be treated as a distinct separate legal entity separate and apart from the business affairs of the owners. Therefore, separate books and records must be kept to track business affairs of the LLC.

 ***4.******Operational Issues: Ownership and Management of an* *LLC****.*

The owners of an LLC are called "members" rather than partners or shareholders. A person becomes a member by being named as such in the Articles of Organization, acquiring an interest in the LLC or by unanimous consent of the other members. Unless otherwise agreed, the LLC will be "member managed" which means that the members of an LLC manage the LLC by majority rule with one vote each. This is the same "one partner, one vote" rule found in a partnership.

In a member-managed LLC, it is possible to give managers voting power tied with their ownership interests. This is a convenient way to provide for rule by majority in interest rather than a per capita majority.

As an option, an LLC can be "manager managed". This means that the members are not necessarily managers but that a person or group of persons is designated to "run" the LLC. The members must specify this arrangement in the Articles of Organization and appoint managers in the LLC Operating Agreement.

The concept of "managers" is similar to the concept of a Board of Directors of a corporation. Managers function like a combination of Board of Directors and Officers. As such, management decisions are made by the majority of the managers (like a Board of Directors), but managers also, acting alone, have the power to bind the LLC and take actions on its behalf (much like officers).

 ***5. Income Tax Treatment****.*

If properly structured, an LLC will be treated as a partnership for tax purposes. However, in order to establish the rights, obligations and responsibilities of the members and managers, the parties to an LLC will almost always want to enter into a formal operating agreement setting out the members' specific rights, obligations and duties. Although the North Carolina LLC law provides a "default" set of rules outlining the rights of managers and members, the business owners will almost always wish to vary this by agreement. However, when the parties set out to vary the default provisions of North Carolina law, they must take care to insure that they do not inadvertently violate the association and partnership tax rules under the Internal Revenue Code.

 ***6. LLCs Are Relatively New Entity Forms****.*

The LLC arrangement is now familiar to many third parties, including lenders and potential investors. However, because they have been available for less than twenty years (as opposed to well over a hundred years for corporations), the courts have not had an opportunity to hear and decide many cases relating to LLCs. Therefore, the body of law governing LLCs is more limited than for corporations, and the parties must look to the statute and the express terms of the operating agreement for guidance.

**V. Limited Liability Issues.**

 **A. Introduction.**

In selecting among the several choices of entity options, a critical issue often is whether the individual business owners will have personal liability for debts and obligations of the business enterprise.

 **B. Several Common Types of Liabilities for Which Businesses and Their Owners May be Liable.**

*1. Vicarious Liability For Acts of Employees;*

 *2. Vicarious Liability For Acts of Partners/Co-Owners;*

 *3. Accidents on the Premises --"Slip and Fall" Cases;*

 *4. Workmen's Compensation Claims;*

*5. Breach of Contract Actions (Lease Agreements, Employment Agreements);*

 *6. Commercial/Financial Obligations (Debt Obligations); and*

*7. Product Liability and Environmental Contamination Cases.*

 **C. Sole Proprietorships**.

The sole proprietorship business form arrangement provides **no** limited liability protection to its owners. Instead, the owner of a sole proprietorship will be personally liable for **all** debts and obligations of business enterprise.

 **D. Partnerships**

With general partnerships, the general partners will be **jointly and severally** liable for **all** business obligations of the general partnership. North Carolina General Statutes Section 59-45(a). These liabilities can arise vicariously from acts of employees of the general partnership or by acts of other general partners.

In contrast to general partners of a general partnership, limited partners of a limited partnership do not have personal liability for debts and obligations of the limited partnership merely by virtue of their status as limited partners. Instead, as long as limited partners do not participate in control of the general partnership, the limited partners will not be liable for limited partnership obligations. North Carolina General Statutes Section 59-303(a). If a limited partner takes an active role in the business of the limited partnership, it may be possible for a creditor to argue that the limited partner held herself out to be a general partner, thus causing the limited partner to lose her liability protection.

Nevertheless, with all limited partnerships, there must be at least one general partner. This general partner by virtue of its status as a general partner, will have full unlimited liability for all debts and obligations of the general partnership.

Often, a general partner of a limited partnership will be a corporation. This will insulate the corporate general partner shareholders' personal assets from liabilities of the limited partnership. The problem with this arrangement is that it creates an additional level of complexity since an additional corporate entity must be involved.

**E. Corporations and Limited Liability Companies.**

Although all of the assets of "limited liability entities" are subject to claims of third parties, owners of these "limited liability entities" generally are not individually liable for the debts and obligations of the business since these forms of businesses are separate and distinct legal entities.

Thus, generally, as a shareholder or member of a corporation or limited liability company, personally owned assets (such as the owner's home) won't be subject to claims of third parties.

 **Exceptions to Non-Liability Rule**:

 ***1. "Piercing the Corporate Veil"****.* The separateness of the corporate legal entity will be disregarded in those extreme circumstances where owners have treated the business as an extension of themselves or have structured the corporate form to defraud creditors or other third parties such that a basic injustice would be served by recognizing the corporate form.

***2. Business owners are always liable for their own individual debts and obligations****.*

**(i)** Tortious or negligent conduct of the business owner; and

**(ii)** personal guaranty of debt of the entity (loan) or performance of a business obligation (lease or employment agreement).

**VI. Registered Limited Liability Partnerships ("RLLPs"), Limited Liability Partnerships and Limited Liability Limited Partnerships).**

 Traditionally, many professional organizations (such as accountants, lawyers and physicians) have operated in general partnerships. As discussed in Section V(D) above, the principal disadvantage of the general partnership arrangement is that all general partners in a partnership are jointly and severally liable for debts and obligations of the partnership. These liabilities can arise as a result of:

 *1. Vicarious liability for negligence and acts of employees;*

 *2. Negligence of other partners;*

 *3. Direct commercial liabilities (such as loans) to the general partnership; and*

 *4. Commercial obligations to other trade creditors.*

 As a result of recent changes to North Carolina law, general partners of a North Carolina partnership now can insulate themselves from liabilities of the business by forming a registered limited liability partnership ("RLLP").

 Under North Carolina General Statutes Section 59-45(b), general partners of an RLLP will not be individually liable for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence or malfeasance committed by another partner or representative of the partnership not working under the supervision or direction of the first partner.

 Therefore, by becoming an RLLP, general partners of professional partnerships now may be insulated from personal liability arising from the acts of other partners or employees of the partnership as long as that partner does not have direct supervision over the other employee or partner and as long as that partner was not directly involved in the specific business activity in which the errors or negligence was committed.

 It is also important to note that general partners in an RLLP also will not be personally liable for other debts and obligations of the partnership, such as:

 *1. Trade obligations; and*

 *2. Other commercial obligations, such as loans to the general partnership.*

North Carolina General Statutes Section 59-45(c).

 Moreover, under N.C.G.S. 57C-2-01(c) a member or manger of a professional LLC is not liable for the professional malpractice of another member, manager or employee not working under the first member's supervision or direction at the time the professional negligence occurred. This obviously significantly eases the liability rules for professionals practicing in these entities.

 A general partnership may become an RLLP by filing an application with the North Carolina Secretary of State (at a cost of $100) and renewing this registration each year (at the same cost). In addition, the general partnership's name must contain the words "registered limited liability partnership" or "L.L.P."

**Registered Limited Liability Partnership (RLLP’s or LLP’s)**

 A partnership (other than a limited partnership) may become an RLLP (also called an LLP) by filing an application with the Secretary of State. See N.C.G.S. § 59-84.2.

 Like partnerships, RLLP’s do not have general and limited partners; instead, in RLLP’s, there is no distinction between general partners and limited partners. Basically, a partner is not individually liable for the debts and obligations of the partnership while the partnership is an RLLP solely by reason of being a partner and does not become liable by participating, in whatever capacity, in the management or control of the business of the partnership. See N.C.G.S. § 59-45(a1). Moreover, a partner in an RLLP is not individually liable, directly or indirectly, for debts, obligations or liabilities of the RLLP that arise from errors, omissions or otherwise by another partner or agent of the partnership. The partners will be liable, however, for their own individual torts. See N.C.G.S. § 59-45(b).

**Limited Partnerships (LP’s)**

 In contrast to RLLP’s, LP’s have both general and limited partners. Basically, general partners have the same liabilities as a partner would in a regular partnership, i.e., a general partner is liable for the acts and obligations of the partnership. See N.C.G.S. §§ 59-403(a) and (b).

 Limited partners in an LP are not liable for the LP’s obligations by reason of being limited partners, and they do not become liable for an LP’s obligations by participating in management or control of the LP.

 To form an LP, a certificate of limited partnership must be filed with the Secretary of State. See N.C.G.S. § 59-201.

**Limited Liability Limited Partnership (LLLP’s)**

 An LP may become an LLLP by filing an application with the Secretary of State. See N.C.G.S. § 59-210.

 Like LP’s, LLLP’s also have general and limited partners. However, the North Carolina statutes addressing liability of general partners in an LLLP refer back to the rules applicable to partners in an RLLP.

 Specifically, a general partner in an LLLP has the same liability as a partner in an RLLLP to persons other than the partnership and other partners with respect to debts and obligations of the LLLP incurred while the entity is an LLLP. See N.C.G.S. § 59-403(b).

 So, in effect, the general partner of an LLLP is not individually liable for debts and obligations of the partnership, though the general partner remains liable for his or her own individual torts.

Limited partners in an LLLP are not liable for the LLLP’s obligations by reason of being limited partners, and they do not become liable for an LLLP’s obligations by participating in management or control of the LLLP.

**VII. Tax Consequences of the Choice of Entity Decision.**

 The selection of an organizational form will have dramatic tax consequences to the business owner. These tax consequences will impact virtually every category or type of taxes:

 *1. Income Taxes*

 *2. Employment Taxes*

 *3. Estate and Gift Taxes*

 *4. State Franchise and Intangibles Taxes*

 *5. New Affordable Care Act Medicare Tax*

 Although we will review these tax issues in more detail later, a brief review of some of these tax issues will be beneficial.

 **A. Pass-through vs. Entity Level Income Taxation.**

Depending upon how the business entity is structured, business income will be taxed either at the entity level or at the individual level. Where personal tax rates and corporate tax rates differ, this distinction will be extremely important.

 **B. C Corporation Double Tax.**

In the case of C corporations, income earned by the C corporation may be subject to two levels of income tax. First, as business income is earned, it will be taxed to the C corporation at the C corporation tax rates. And second, as C corporation earnings are distributed to the shareholders, either as dividends or upon liquidation of the business when business assets are sold, any gain on the sale will be subject to a second level of tax at the individual level.

 **C. Deductibility of Business Losses.**

Depending upon the choice of entity selected, the individual business owners may be entitled to take personal income tax deductions for losses incurred by the business enterprise.

**D. Operational Structure.**

Unlike the case with other business enterprises, S corporations are limited under federal tax law in the way the business entity may be structured. First of all, S corporations are prohibited from having certain types of shareholders. Second, S corporations are restricted from offering more than one class of stock. This means that the S corporation may not offer different types of equity interests which confer varying rights to liquidating and distribution proceeds.

 **E. FICA Tax Issues.**

In selecting an appropriate organizational form, business owners and their advisors often fail to address employment tax issues. Under the federal tax laws, Federal Insurance Contributions Act (FICA) taxes are assessed on both the employer and the employee at the rate of 7.65% of wages paid to the employee during the year (15.3% total).

The FICA tax consists of Old Age, Survivor, and Disability Insurance Tax (or "Social Security tax") at the rate of 12.4% on the first $113,700 of wages paid during the 2013 year (6.2% on both the employer and employee). Also, the Medicare Hospital Insurance tax (or "Medicare tax") is assessed at the rate of 2.9% on all wages paid to the employee during the year (1.45% on both the employer and employee). There is no wage base cap on the Medicare portion of the FICA tax. Therefore, all wages paid to the employee will be subject to the 2.9% Medicare tax.

Furthermore, the 2010 PPACA increases the Medicare tax to 3.8% on wages over $200,000 ($250,000 for married filing jointly, $125,000 for married filing separately)

 ***1. Sole Proprietorships****.* All income earned by a sole proprietorship will be subject to FICA taxes.

 ***2. C Corporations****.* In contrast, where a C corporation is involved, FICA taxes are assessed only on amounts actually paid to the employee-owners as salary during the year.

***3. S Corporations****.* Likewise, with S corporations, the FICA taxes are assessed only on wages actually paid to the employee-owners during the year.

***4. Limited Liability Companies****.* Since LLCs are taxed as partnerships, generally all income earned by the LLC will be subject to the FICA employment taxes unless the LLC income is attributable to rental real estate activities. In addition, there are a few limited exceptions to the imposition of FICA taxes on LLC income attributable to members who would be treated as limited partners if the LLC were a limited partnership.

**F. Self-Employment Tax Issues.**

Under IRC Section 1401, the owners of a business may be subject to self-employment tax ("SE tax") instead of, or in addition to, FICA taxes. SE tax is levied on net earnings from self-employment ("NESE") at a rate of 13.3% on the first $110,100 of NESE (scheduled to increase back to the historical level of 15.3% in 2013). NESE over $110,100 are subject to a 2.9% Medicare tax (increasing to 3.8% in 2013).

NESE does not include wages paid to shareholder ⎯ employees of S or C corporations (these are subject to normal FICA and Medicare taxes). NESE does include an individual's distributive share (whether or not cash is actually distributed) of income or loss from a business carried on by the individual's sole proprietorship or a partnership (including LPs and LLCs taxed as partnerships) of which the individual is a partner.

NESE also excludes gain and loss from rental activities, dividends and interest (including S corp dividends), capital gain and loss from a sale or exchange, disposition of timber, coal, and iron ore, and most other dispositions of property.

 **G. Taxation on Distributions of Appreciated Property.**

In many cases, the business enterprise will utilize assets, such as real estate or patents, which are likely to appreciate in the future. In these cases, the business advisor should always consider the possibility that these appreciating assets may be distributed in-kind to the shareholders in the future, such as where the business dissolves or where appreciated assets are distributed in-kind to redeem an owner's interest in the business.

If appreciated assets are distributed from an S corporation or a C corporation, the distribution will be treated as a sale of the asset which will generate capital gains tax to the extent the fair market value of the asset at distribution exceeds the company's income tax basis in the asset. This taxable gain will be borne by all shareholders, including the shareholders who receive no distributions.

In the case of a C corporation (and maybe even with an S corporation), an additional level of tax will be recognized by the distributee-shareholder who receives the appreciated asset in liquidation.

With LLCs, however, no gain is realized either to the distributing LLC or to the distributee-member upon the distribution of appreciated assets in-kind (unless the distribution constitutes a "disguised sale" under Section 707).

 **H. New Medicare tax on Net Investment Income.**

One of the funding mechanisms for the 2010 Patient Protection and Affordable Care Act is a new 3.8% Medicare tax on the **lesser** of (a) "net investment income" ("NII") or (b) adjusted gross income over $200,000 ($250,000 for married filing jointly, $125,000 for married filing separately). See IRC Section 1411.

NII includes:

(i) Gross income from any passive activity;

(ii) Interest, dividends, annuities, royalties, and rents, including such items when passed through a partnership or S corporation;

(iii) Net gain from the disposition of any property, unless the property is held in a trade or business that is not a passive activity for the taxpayer; and

(iv) Income, gain or loss on investment of working capital, even in an active trade or business.

NII excludes:

(i) Interest, dividends, annuities, royalties, and rents generated in the ordinary course of a non-passive trade or business that does not involve trading in financial instruments or commodities);

(ii) Distributions from IRAs and qualified retirement plans; and

(iii) Items already subject to SE tax (to avoid double taxation).

**VIII. Characteristics of C Corporation Tax Treatment.**

 **A. Entity Level Taxation.**

The most significant aspect of C corporation taxation lies in the fact that C corporations are subject to a corporate level tax on all income earned by the C corporation. This is in direct contrast to the tax treatment of sole proprietorships, S corporations, LLCs and partnerships where business income is taxed at the individual, rather than entity, level.

***1. Review of Corporate and Individual Tax Rates****.*

 As the following discussion indicates, the imposition of federal taxation on business income will vary depending upon whether the business income is taxed at the individual level or at the entity level:

Corporate Tax Rates

 Marginal

Taxable Income Over Not Over Tax Rate

 $ 0 $ 50,000 15%

 50,000 75,000 25%

 75,000 100,000 34%

 100,000 335,000 39%

 335,000 10,000,000 34%

 10,000,000 15,000,000 35%

***2. Comparison of Maximum Ordinary Income Tax Rates****.* For C corporations, the maximum tax rate is 39%. For individuals, the maximum tax rate is 39.6%. Note that the 39% corporate marginal tax rate kicks in once income rises above $100,000, and does not lower to 34% until income reaches above $335,000. With individual taxpayers, however, the top 39.6% marginal tax rate only applies for taxable incomes above $450,000 (for married filing jointly).

***3. Maximum Long-term Capital Gains Tax Rate****.* For corporate taxpayers, any long-term capital gain will be taxed at the regular tax rates including the 39% phase-out rate for corporations with income between $100,000 and $335,000. This maximum long-term capital gain tax rate is in direct contrast with the 20% maximum capital gains tax rate for individual taxpayers. I.R.C. Section 1(h) and 1222(11).

***4. Personal Service Corporations ("PSCs")****.* Personal service corporations are not entitled to the benefit of the regular corporate graduated tax rates. Instead, all income of a personal service corporation is taxed at a flat 35% tax rate. I.R.C. Section 11(b)(2).

For these purposes, a personal service corporation (PSC) is defined as a corporation in which:

1. substantially all of the activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial services, performing arts or consulting; and

2. substantially all the stock is held directly or indirectly by employees performing such personal services for the corporation.

I.R.C. Section 448(d)(2).

 **B. The C Corporation "Double-Tax".**

The principal disadvantage with the C corporation arrangement lies in the fact that C corporate income may ultimately be subject to two levels of income tax. First of all, as corporate income is earned, it will be subject to corporate income tax at the C corporation level. Then, when the earnings of the business are distributed to the shareholders (either as dividends or upon liquidation of the business when the assets are sold), the C corporate income will be subject to a second level of tax at the individual level.

The result of the C corporation double tax is that the effective tax rates for income earned by a C corporation will be substantially higher than income taxed at the individual level.

 **C. In-Kind Distributions of Appreciated Assets.**

For a variety of reasons, C corporations may make distributions of appreciated property in kind to its shareholders. For example:

***1. In-Kind Distributions of Assets to Redeem Shareholder Stock****.* If a corporation does not have sufficient **liquid** assets to redeem the stock of a shareholder, the corporation may be forced to distribute **appreciated assets** in liquidation of a shareholder's stock.

***2. Corporate Dissolution****.* In other cases, the business owners may elect to part ways. If the division of the business will not qualify for a Section 355 tax-free spin-off, the distribution of appreciated assets in corporate dissolution will be fully taxable to the C corporation and to the distributee-shareholder.

***3. Distribution of Life Insurance Policies for Estate Planning Purposes****.* Where there is corporate-owned life insurance on the life of a key shareholder-employee, the corporation may wish to distribute corporate owned life insurance policies to the insured-shareholder (to prevent the proceeds of the policies from being includible in the insured-shareholder's taxable estate or to prevent the death benefit proceeds from being subject to the potential C corporation alternative minimum income tax).

 In any of these events, the distribution of appreciated property will be treated as a deemed sale of the asset that will cause the corporation to recognize capital gain to the extent the fair market value of the asset at distribution exceeds the corporation's adjusted tax basis. This creates a potential hardship to the corporation **since no cash will be generated to pay the income tax.**

 Also, once again, a second level of income tax will usually result at the shareholder level since this distribution will almost always be a taxable event to the shareholder-distributee.

**D. Potential Application of the Alternative Minimum Income Tax.**

In contrast to S corporations, partnerships, and LLCs, C corporations may be subject to the alternative minimum income tax. This is another disadvantage with the C corporation arrangement, especially where the C corporation owns life insurance on the lives of key employees.

 **E. Potential 50% Capital Gains Exclusion.**

Under I.R.C. §1202 which was added by Congress as part of the Revenue Reconciliation Act of 1993, individual taxpayers may now be able to exclude up to one-half (½) of their gain on sales of original issue qualified small business stock in a C corporation as long as this stock is held for at least five (5) years before the sale. This means that the effective maximum capital gains tax rate on sales of "qualified small business stock" may be as low as fourteen percent (14%).

As a result of a new §1202, investors in "qualified small business stock" (QSBS) may be able to dramatically increase their after-tax earnings on investments in small business companies.

In order for a stock sale to qualify for the fifty percent (50%) capital gains exclusion under §1202, the following requirements must be met:

*1. The QSBS must be "original issue" stock in a C corporation;*

*2. The QSBS must have been issued after August 10, 1993;*

*3. The QSBS must have been acquired by the taxpayer in exchange for money or other property or as compensation for services;*

*4. The QSBS must have be acquired from a "qualified small business" C corporation; and*

*5. The QSBS must be held for at least five (5) years prior to the sale.*

 **What is a Qualified Small Business?**

Under I.R.C. §1202, only sales of stock in a "qualified small business" will qualify for favorable treatment under I.R.C. §1202. First of all, the rules provide that only a C Corporation may qualify as a qualified small business. In addition, to qualify as a "qualified small business" the issuing corporation must meet both the "active business" test and the "gross assets test." Under the gross assets test, the issuing corporation must be a domestic C corporation with gross assets not exceeding $50,000,000.

The issuing corporation must also meet the "active business" test. Under the "active business" test, the issuing corporation must be involved in a trade or business other than the business of performing certain services, such as:

 *1. Traditional personal services;*

 *2. Financial or brokerage services;*

 *3. Banking, insurance, financing, leasing, investing or similar services;*

 *4. Farming businesses; and*

 *5. Hotel, motel and restaurant businesses.*

 **F. Choice of Accounting Method.**

With some exceptions, C corporations generally are not allowed to use the cash method of accounting, but instead must use the accrual method of accounting. I.R.C. Section 448(a)(1) and I.R.C. Section 448(b).

 **G. Employment Tax Issues.**

With C corporations, employment taxes are assessed on corporate income only to the extent the corporate income is paid to shareholder-employees as compensation for services. In contrast, members of a LLC may be required to pay employment taxes on all LLC income. This is one advantage of C corporations and S corporations over LLCs. Note, however, that C corporation dividends are subject to the new Medicare tax on NII.

 **H. Choice of Taxable Year.**

Most individual taxpayers report their income on a calendar year basis. I.R.C. Section 441(b)(1). In general, C corporations are free to adopt a fiscal year (unless they are a personal service corporation).

S corporations are entitled to adopt a fiscal year only in limited circumstances. Depending upon the nature of the C corporation's business, the adoption of a fiscal year may provide income tax deferral opportunities.

**I. Disposition of C Corp Stock.**

Sales of C Corporation stock are taxed at capital gains rates; however, the buyer and seller may have to "price in" the imputed double tax on appreciated assets. Also, sales of C Corporation stock are subject to the new 3.8% Medicare tax because disposition gain is NII.

**IX. Tax Characteristics of S Corporations.**

**A. Pass through income taxation.**

In contrast to the C corporation arrangement, S corporations generally are not subject to federal income taxation. Instead, items of S corporation income and losses are allocated to the shareholders on a per-share, per-day basis. I.R.C. Section 1377(a)(1).

Therefore, depending upon the level of business income, the income of an S corporation may be subject to higher income tax rates with S corporations as opposed to C corporations.

On the other hand, income by an S corporation will never be subject to double taxation.

 **B. No Double Tax on S Corporation Income.**

In contrast to C corporation income, S corporation income is not subject to a "double tax." With S corporations, all income earned by the S corporation will be taxed to the shareholders at their individual tax rate, regardless of whether the corporation income is actually distributed to them. In addition, once they pay tax on the S corporation earnings, the shareholders usually can then withdraw the S corporation profits free of additional income taxes.

Moreover, as S corporation income is earned, the shareholders may increase their income tax basis in their corporate stock by the amount of income earned by the S corporation. As a result, earnings by an S corporation will be subject to only one level of corporate income tax regardless of whether the earnings are attributable to operating income or capital gain earnings.

Therefore, since S corporation shareholders can avoid the C corporation double tax, the S corporation shareholders will almost always pay less tax on business income in the long run.

 **C. Deductibility of Corporation Losses.**

In general, S corporations shareholders may deduct S corporation losses to the extent of their income tax basis in the S corporation stock. I.R.C. Section 1366(d). For purposes of determining the deductibility of corporate losses, an S corporation shareholder is allowed to include in his adjusted basis any indebtedness of the S corporation to that shareholder. I.R.C. Section 1366(d)(1)(B).

However, the S corporation shareholders are not permitted to take other debts of the S corporation into consideration to determine the deductibility of corporate losses. Therefore, in order to establish tax basis to absorb loss deductions, the shareholder must actually make direct loans to the S corporation. Simply personally guaranteeing S corporation indebtedness to outside third parties will not be sufficient to establish additional tax basis.

As is discussed further in Section X(C) below, members of an LLC are entitled to take their pro rata share of LLC debts into consideration in determining the deductibility of LLC losses.

 **D. Employment and Medicare Tax Issues.**

S corporation earnings are generally not subject to payroll or self-employment tax. **Also, distributions from S corps are not NII with regard to the owners who materially participate in the business, and so are not subject to the new 3.8% Medicare tax until the owner's AGI exceeds the applicable threshold.** S corporation shareholder-employees must receive reasonable compensation for their services or risk recharacterization of distributions by IRS on audit. Wages paid to S corp owners are subject to FICA tax. This feature allows for significant planning opportunities in avoiding payroll taxes on high earning S corporation shareholders. That is, employment taxes may be avoided by having the S corporation earnings distributed as dividends rather than as salary to avoid federal employment taxes. It will be necessary, however, to justify the compensation amount actually paid to owner-employees.

**E. Limitations on S Corporation Qualification.**

Only certain types of business entities may qualify for S corporation treatment:

 **(i)** S corporations are limited to **100** shareholders, I.R.C. Section 1361(b)(1)(A);

**(ii)** LLCs, partnerships and other corporations are prohibited from being S corporation shareholders, I.R.C. Section 1361(b)(1)(B);

**(iii)** non-resident aliens are not permissible S corporation shareholders, I.R.C. Section ;

**(iv)** only certain types of qualifying trusts may be shareholders in an S corporation, I.R.C. Section 1361(c)(2);

**(v)** S corporations are prohibited from owning more than 80% of the stock of another corporation, I.R.C. Section 1361(b)(2)(A).

**F. One Class of Stock Rules.**

An S corporation is prohibited from having more than one class of stock. I.R.C. Section 1361(b)(1)(D). For purposes of these rules, differences in voting rights are ignored for purposes of determining whether the one class of stock rule is violated. I.R.C. Section 1361(c)(4).

This generally means that all stock of an S corporation must confer identical rights to liquidation and distribution proceeds. In other words, an S corporation may not have any class of preferred stock.

In certain venture capital arrangements, a "money" investor will desire to be repaid his investment before the other shareholders receive any return. Therefore, the venture capitalist will demand a "preferred return" or special allocation that would be payable (to the exclusion of the other shareholders) until the venture capitalist has recovered all or part of his investment in the entity. In other situations, a service provider may want a "carried interest".

Therefore, it would be very difficult to structure a venture capital arrangement where S corporations are involved.

 **G. In Kind Distributions of Appreciated Assets.**

As with C corporations, the distribution of appreciated assets in kind to S corporation shareholders will be treated as a deemed sale by the S corporation. This will generate a capital gain which will be passed through to all S corporation shareholders based upon their proportionate stock ownership. This requires that all S corporation shareholders recognize taxable gain where appreciated assets are distributed only to one shareholder.

**Example**. A and B each own 50% of the stock of an S corporation. The S corporation owns a valuable operating business and a piece of appreciated real estate, both of approximately equal value. A and B no longer get along and would like to split up the assets of the business. They have been told that the situation does not qualify for Section 355 spin-off. In this case, there is possibly no way to remove the operating business or the real estate from the corporation without incurring taxes. It would probably be possible, however, to dissolve an LLC and distribute the assets tax free.

Therefore, if business assets are likely to appreciate in the future, the S corporation form may cause potential problems down the road.

 **H. Estate Planning Considerations.**

Often times, clients will wish to make gifts with S corporation stock for estate planning purposes. Occasionally, the taxpayer will wish to make gifts of S corporation stock in trust for the benefit of donees who are young or who have demonstrated an inability to manage their financial affairs.

In these cases, there is often the desire to significantly limit the participation of these donees from participation and management of the business or from receiving distributions from the entity. However, under the S corporation one class of stock rules, all distributions from an S corporation must be made proportionally to all shareholders. Therefore, if corporate stock is transferred to these types of donees, the shareholder-client must always be wary of the fact that these donees must receive proportionate distributions whenever distributions are made from the S corporation.

Traditionally, one option for transfers of the S corporation stock to certain family members is through gifts to trusts. The problem here, however, is that any trust holding stock in an S corporation must be a qualified subchapter S trust under Section 1361(d)(3). One of the requirements of a QSST trust is that all income must be distributed to the beneficiary currently. Thus, because of the one class of stock rules for S corporations, if the shareholder-client desires to distribute S corporation income to certain shareholders, then proportionate distributions of income must be made to the other shareholders, including the QSST.

Moreover, since the QSST must then distribute this income to the trust beneficiary, this will cause the distribution of cash income to the persons the client-shareholder actually wishes to keep the income away from.

In contrast, with limited partnerships and LLCs, distributions can be made only to certain classes of partners and members. Furthermore, if limited partnership or LLC interests are held in trust for the benefit of one or more donees, the partnership or LLC can still make distributions of cash to its partners and members without concern that the trust beneficiaries will be able to get their hands on the cash. This is because a trust which holds the limited partnership or LLC interest does not have to be any type of "qualifying trust". Thus, the terms of the trust may restrict the trustee's authority to make distributions from the trust to trust beneficiaries, and this will not prevent the trust from being able to serve as limited partner or member of the LLC.

 **I. Choice of Tax Year.**

S corporations are generally required to report income or losses on a calendar year basis. However, an S corporation is allowed to use a fiscal year if it establishes a business purpose for doing so. I.R.C. Section 1378(b). However, an S corporation is limited in selecting a year other than a calendar year. I.R.C. Section 444(a). Moreover, even if the S corporation is permitted to use a fiscal year, the S corporation must make a payment to offset the benefit of this deferral. I.R.C. Section 444(c)(1) and I.R.C. Section 7519.

**X. Taxation Characteristics of Limited Liability Companies**

 As discussed above, if properly structured, an LLC will be treated as a partnership for tax purposes. As a result, the application of the partnership income tax rules generally will apply to LLCs.

 **A. Pass Through Income Taxation.**

As with S corporations, LLCs are not subject to a separate level tax on LLC income. Instead, items of income and loss of the LLC are passed through to the members and taxed at their individual tax rates. I.R.C. Section 702(a). Therefore, as with S corporations, income from the LLC will be subject to income tax at the members' individual tax rates which may exceed the C corporation tax rates.

 **B. No Double Taxation on LLC Income.**

Under I.R.C. Section 731(a)(1), LLC distributions will cause gain recognition to the distributee-member only to the extent that the actual amount of **cash** distributed exceeds that member's adjusted basis in his membership interest. As with S corporations, as LLC income is earned and is taxed to the members at their individual rates, the members' adjusted basis in their LLC interests will be increased by each member's distributive share of LLC income. I.R.C. Section 705(a)(1). Therefore, once the members pay tax on their LLC income, the members generally can then withdraw these earnings out of the LLC free of additional income taxes.

 **C. Deductibility of Operating Losses.**

As with S corporations (but unlike C corporations), members of an LLC are allowed to deduct losses of the LLC on their personal returns. I.R.C. Section 702(a)(7). However, as with S corporations, LLC members may not deduct LLC losses in excess of the member's adjusted tax basis in his LLC interest. I.R.C. Section 704(d).

However, in contrast to S corporations, with LLCs, each member is entitled to take his or her pro rata share of LLC debts into account in determining that member's deductibility of LLC losses. I.R.C. Section 752(a). This is true even where the LLC indebtedness is attributable to loans from outside third parties.

 **D. In-Kind Distribution of Appreciated Property.**

The most unique tax characteristic of LLCs results from the fact that, in general, no gain or loss is recognized on the distribution of appreciated property from an LLC to one or more LLC members. Under I.R.C. Section 731(a)(1), a distribution to an LLC member will cause gain recognition only to the extent that actual cash received exceeds that member's adjusted basis in his or her LLC interest.

For this reason, whenever it is anticipated that the business entity will hold potentially appreciating assets, it is usually advisable to structure the business entity as an LLC in light of the possibility that the members may wish to distribute this property in-kind to one or more of the members.

 **E. No Limitations on Capital Structure.**

Unlike the case with S corporations, there are no limitations on the business structure of an LLC. Thus, unlike S corporations, LLCs may:

 *1. be a member of an affiliated group (i.e. an LLC may own more than 80% of another corporation);*

 *2. have an unlimited number of owners;*

 *3. have nonresident aliens as members;*

 *4. have individuals, partnerships, corporations, other LLCs, estates or any types of trusts as LLC members.*

 **F. No One Class of Stock Rules.**

As indicated in Section IX(F) above, under I.R.C. Section 1361(b)(1)(D), an S corporation may only issue one class of stock. This generally means that equity interests in an S corporation may not confer unequal rights to distribution and liquidation proceeds.

With LLCs, however, the LLC members are free to allocate items of income and gains in any manner agreed to by the members. I.R.C. Section 704. This generally means that LLC members are free to create various classes of LLC membership interests which confer varying rights to LLC distributions.

 **G. Intangibles Tax and Franchise Tax.**

LLCs do not pay franchise tax (instead the LLC must pay a $200 filing fee with its annual payment). Also, LLC members are not required to pay intangibles tax on LLC membership interests.

 **H. Fringe Benefit Issues for Members of an LLC.**

Since an LLC is taxed as a partnership, LLC members generally are not permitted to exclude from their gross income the value of fringe benefits paid on their behalf by the LLC. This essentially results in a "double tax" on the fringe benefits provided by the LLC, since the income earned to pay these LLC fringe benefits will have already been taxed once to the LLC members on their individual schedule K-1's as part of their proportionate share of the LLC earnings. As with S corporations, this is another significant limitation of the LLC arrangement when compared to C corporations.

However, where fringe benefits are paid to a member as part of a compensation package for services rendered to the LLC, these fringe benefits should be excluded from the member's income. I.R.C. Section 707(c) and Rev. Rul. 91-26.

 **I. Employment Taxes on LLC Income.**

In general, since an LLC is a partnership for tax purposes, all income earned by the LLC will be subject to employment taxes, even for members who do not participate in the business at all. Income from the LLC will also be subject to the new Medicare tax if it is NII, unless an exception is met. Note if a member materially participates in a business so as to remove the LLC income from NII, that will generally make all income subject to FICA or SE tax. There are some exclusions to this rule.

 ***1. Exclusion For Rental Real Estate Activities****.*

For example, where the LLC income is derived from rental real estate, the LLC income will be exempt from employment taxes. However, rental income is expressly included in NII for purposes of new Medicare tax, except for the LLC members who are active in the LLC's business. I.R.C. Section 1402(a)(1).

 ***2. LLC Members Who Are Like Limited Partners****.*

Also, members who are equivalent to "limited partners" will not be subject to self-employment tax on their share of LLC income. I.R.C. Section 1402(a)(13). As noted below, it will often be difficult to distinguish the members who are "general partners" from members who are "limited partners." However, for protection from the self-employment tax, it may be appropriate to recite some self-serving language in the LLC Operating Agreement where it is clear that certain members will be providing no services and will not participate in management decisions.

The Internal Revenue Service recently issued some clarification on this issue, proposed Treas. Reg. § 1.1402(a)-18. This proposed regulation provides that members will be treated as limited partners for purposes of Section 1402(a)(13) if (a) the member is not a manager of the LLC and (b) the LLC could have been formed as a limited partnership and the member would have qualified as a limited partner. The significance of classification as a limited partner is that the member's share of the LLC's earnings will not be subject to self employment tax.

Under these rules, any person who is formally designated as a manager of the LLC will be subject to self employment tax, unless there is some other exception (such as rental real estate). However, even if a member is not officially a manger (a non-manager member), the income will still be subject to self employment tax if the member performs functions which would disqualify the member from treatment as a limited partner; for instance where he or she participates so extensively in the management of the business that the non-manager member would be deemed to be a general partner of a North Carolina limited partnership.

Members engaged in the typical operating business will be affected by this rule. For members who are below the Social Security wage base (2012 = $110,100), this represents an enormous additional tax of 15.3%. Even for those above this base, there will be an additional 2.9% tax for the recently uncapped Medicare portion, and potentially an additional 3.8% tax on NII (although note that the same income cannot be "double counted" for SE tax and Medicare tax).

**Example 1**. A and B each own 50% of a successful business that is operated by both A and B. The business generates $200,000 in income to each of A and B. A and B are advised that they can justify paying themselves a salary of $90,000 each. In an S corporation, A and B can avoid Medicare tax on the non-wage portion ($110,000). If the business were operated as an LLC, this amount would be subject to Medicare tax, resulting in an additional tax of $3,190.

**Example 2**. A is a 100% owner of a "manager-managed" LLC. The LLC is an operating business that generates $300,000 in income per year. For estate planning purposes, A gives 5% interests in the LLC to each of his four children. The children are not managers and do not participate in the business. Under the proposed regulations, the children's share of LLC income will not be subject to employment taxes.

**XI. Choosing the Right Organization Form for Specific Businesses.**

 Next, we will try to synthesize all of the issues previously addressed to make some general observations concerning the selection of the right organizational form depending upon the specifics of the business arrangement.

**A. Professional Organizations: C Corporation Status May Be the Right Answer.**

***1. Liability Risks and Tax Disadvantages of Sole Proprietorships****.*

 **(a) Liability Risks.**

Amazingly, many professional organizations (such as physicians, accountants and lawyers) are operated as sole proprietorships. From my experience, many sole practicing professionals have elected to operate as sole proprietorships in order to avoid the administrative complexity and expense associated with corporations and LLCs.

These professionals often are under the misimpression that there will be few, if any, advantages to operating as an LLC or corporation.

Since these professionals will always have individual liability for their own negligence, on the surface it may appear that the corporate or LLC arrangement would provide little additional liability protection. These professionals often fail to recognize their potential liability exposure that may result from vicarious liability for negligent acts or omissions on the part of their employees.

However, the reality is that these sole practicing professionals may be able to avoid vicarious liability for acts or omissions of their employees by operating as an LLC or corporation, as long as the professional exercises due care in hiring and supervising these employees.

**(b) Tax Disadvantages of Sole Proprietorships.**

There are also several tax disadvantages with operating professional practices as sole proprietorships.

**(i) Employment Taxes.** All income earned by the sole proprietorship will be subject to the self-employment tax, even where the business income is reinvested in purchasing business assets (office and medical equipment, computers, etc.)

**(ii) Fringe Benefits.** As discussed in Section VII(F) above, amounts paid by the sole proprietorship for fringe benefits on behalf of the sole proprietor may be subject to income tax of the sole proprietor.

 ***2. RLLPs****.* As discussed above, general partners in a professional general partnership may avoid joint and several liability for professional malpractice on behalf of other partners by registering the general partnership as a registered limited liability partnership. Also, as discussed in Section VI above, these general partners further will be insulated from personal liability for trade and commercial obligations of the professional general partnership.

However, the RLLP will be subject to the employment tax and fringe benefit tax disadvantages of the sole proprietorship.

 ***3. LLCs****.* Although LLCs provide limited vicarious liability for acts and omissions of employees, the same tax disadvantages associated with sole proprietorships and partnerships (employment tax issues and fringe benefits) will also apply to professional organizations operated as LLCs.

 ***4. Are S Corporations the Answer?*** Occasionally, professional organizations will elect to operate as S corporations in order to avoid:

 - double taxation on professional corporation income; and

 - application of the maximum 35% tax rate on professional service corporation income.

However, in most circumstances, the double tax and the 35% PSC corporation tax rate will not be a concern for a professional corporation. Professional corps rarely have any appreciating assets (especially if goodwill is considered an asset of the owners held outside the corporation). It is rare for professional corporations to be sold at a premium in any case. Moreover, since all profits are paid as compensation, there will be no NII to be subject to new 3.8% Medicare tax.

This is especially true where the professional corporation employ two or more professionals, since professional corporations usually will distribute all of their annual earnings to the professionals as salary each year any way.

**(a) No appreciated asset issues.**

Moreover, with most professional corporations, there will never be concerns about the imposition of the C corporation double tax on gains recognized on the sale of the business. Since most assets owned by professional corporations will be rapidly depreciating (such as medical equipment, computers and office equipment and furniture), these assets will rarely ever be sold at a gain.

 **(b) Double Taxation on Sale of Goodwill and Patient Lists.**

Conceivably, when a professional practice is sold, a buyer may pay a premium to acquire the goodwill, patient lists and clients of the professional corporation. Unless the business is an S corporation, the sale of these assets may be subject to the C corporation double tax.

 Often times, however, the C corporation double tax may be avoided by having this purchase price premium paid to the professional owner-employees in the form of consulting or non-compensation fees.

Therefore, in most cases there will be very little if any taxable income retained in the business enterprise that could ever be subject to the 35% PSC corporate tax rate or the C corporation double tax.

In other words, the traditional tax benefits of S corporation status usually will not apply to professional corporations.

Therefore, many professional corporations choose to operate as C corporations to take advantage of tax-free fringe benefits that may be provided by C corporations.

 ***5. C Corporations: The Choice of Entity for Professional Corporations****.*

Since owners of a professional corporation will rarely ever be forced to incur the 35% PSC corporate tax rate or the C corporation double tax on professional corporation income, most professional corporations are much better off operating as C corporations.

This is primarily because of the C corporation treatment of fringe benefits provided to owner-employees.

Unlike members of an LLC or 2% shareholders of an S corporation, professional C corporation shareholders may be entitled to receive fringe benefits completely tax free. For this reason, the C corporation business form is most often the choice of entity for professional corporations.

 ***6. Personal Service Corporation Issues****.*

A professional service C corporation must be carefully operated to prevent the application of the PSC rules. Most importantly, the owners must track their income and deductions throughout the year and be able to accurately establish the amount of corporate profit remaining at the end of the year so it can be paid to the owners as bonuses for their professional services.

Professional service C corporation owners must also resist the temptation to be aggressive with their deductions. This is because accurate accounts of deductions are required to correctly calculate profit, as described above. If a later audit disallows deductions (such as for meals and entertainment or other items frequently challenged on audit), the calculation of profit will be off for that year. Therefore, the assessment will require the corporation to pay the 35% PSC tax on those undistributed profits.

If a PSC has trouble accurately tracking its profit, or if some or all of the owners have a tendency to cause the corporation to take aggressive or poorly documented deductions, the business may be better off choosing to operate as an S corporation or LLC.

Of course, if for some reason the owners have a need or desire to build up retained earnings within the corporation, clearly a C corporation is not the best choice because of the 35% PSC tax. However, this will rarely be the case in a professional services business.

Note that the US Tax Court recently agreed with the IRS that a C corporation providing tax return preparation and bookkeeping services was a "personal service corporation" and subjected its retained earnings to the 35% PSC corporate tax rate. Rainbow Tax Service v. C.I.R., 128 T.C. 42, March 8, 2007. The Tax Court found that these services fall within the traditional definition of "accounting" for purposes of the PSC rules, and rejected the taxpayer's contention that the PSC rules were inapplicable because no employees of the corporation were licensed CPAs.

**B. Real Estate Business Entities: LLCs are the Entity of Choice.**

Owners of real estate business ventures may face potential liability exposure for certain types of liabilities such as:

 - commercial and trade obligations;

 - "slip and fall" liability; and

 - environmental tort liability.

Therefore, owners of real estate business ventures usually should attempt to avail themselves of the limited liability protection offered by limited partnerships, corporations and LLCs.

 ***1. Limited Partnerships****.*

Before the introduction of LLCs, most real estate business ventures were structured as limited partnerships. The problem with a limited partnership arrangement is that all limited partnerships must have at least one general partner. As an added measure of protection, a corporation can be designated as the general partner of a limited partnership. This will insulate the corporate shareholders from individual liability for debts and obligations of the limited partnership.

The problem with the limited partnership arrangement is that having a corporate general partner adds an additional layer of tax compliance and administrative complexity.

 ***2. Corporations****.*

However, the corporate form is rarely appropriate for real estate business ventures. If the real estate business venture is structured as a C corporation, the business owners may be subject to the C corporation double tax in the event of the sale of appreciated real estate or in the event of in-kind distributions of appreciated real estate to the C corporation shareholders.

In addition, even though S corporation shareholders will only recognize one level of income tax on the sale of appreciated real estate, S corporation shareholders also will recognize taxable gain upon the in-kind distribution of appreciated real estate to one or more individual shareholders.

Finally, valuable real estate held in a corporation will cause the corporation to pay substantial franchise tax that would be completely avoided in an LLC.

***3. LLCs****.*

LLCs are virtually always the choice of entity option for real estate business ventures:

 - LLCs are never subject to more than 1 level of tax on operating income or capital gains;

 - Appreciated assets always may be distributed in-kind from an LLC without the recognition of any taxable gain;

 - LLC members may take LLC debts into account in determining the deductibility of operating losses;

 - LLC income from real estate activities will always be exempt from self-employment taxes;

 - Real Estate LLC's virtually never offer fringe benefits to members; and

- - LLCs are not subject to franchise taxes.

- Note that income from RE LLCs will be subject to the new 3.8% Medicare tax on NII.

**C. "Operating" Businesses: Manufacturing, Service and Retail Businesses: A "Toss-Up" Between S Corporations and LLCs.**

Selecting an appropriate organizational form is most complicated when operating business entities are involved. Depending upon the specific nature of the operating business, the most appropriate organizational form may be either the C corporation, S corporation or LLC.

Nevertheless, the business advisor usually can rely on a few basic principals.

***1. The C corporation arrangement is rarely ever the answer****.*

Where operating business are involved, the C corporation arrangement may provide limited tax advantages:

**(a) Individual vs. Entity Level Taxation.** Where individual tax rates exceed corporate tax rates, the C corporation arrangement may provide income tax advantages in the short run.

However, in most situations, the limited benefit of lower graduated C corporation rates will be greatly outweighed by the other disadvantages of C corporation taxation, principally the C corporation double tax. As discussed in Section VIII(B) above, the imposition of the C corporation double tax will greatly increase the effective tax rates attributable to C corporation income, notwithstanding the fact that the C corporation arrangement may produce lower taxes in the short run.

**(b) Fringe Benefits are Usually Not an Issue.** If the operating entity employs many individuals, the fringe benefit tax advantages of C corporations may not even be applicable since the business owners may not be willing to offer fringe benefits to all employees.

**(c) The C Corporation Double Tax on "Appreciating" Assets.** Because of the nature of the C corporation double tax, the C corporation arrangement is rarely appropriate where the business owns appreciating assets (such as real estate, patents, tradenames or goodwill), which may be sold in the future.

***2. Narrowing the Choice Down to Two: S Corporations and LLCs****.*

For most operating, non-professional service businesses, the business advisor should consider operating the business either as an S corporation or LLC.

**(a) No Double Tax.** With both LLCs and S corporations, operating income will never be subject to more than one level of income tax.

Moreover, there will never be more than one level of capital gains tax assessed on any sale of appreciated assets.

**(b) Pass-Through Tax Losses.** With both LLCs and S corporations, the members and shareholders may be entitled to take personal income tax deductions for losses incurred by the business enterprise.

***3. When Do LLC's Make Sense****?*

**(a) Venture Capital Arrangements.** Whenever the business arrangement necessitates that some investors will be given a preferred return on their investment, the S corporation arrangement may not be possible as a result of the "one class of stock" restriction placed upon S corporations. Therefore, the LLC may be the only possible option. However, it should be noted that some Venture Capital investors still prefer to invest in C corps. Fortunately, an LLC can generally be converted to C corporation status if necessary.

**(b) Foreign Investors.** If nonresident aliens will be equity owners in the business enterprise, the business arrangement cannot be structured as an S corporation. Instead, the LLC arrangement must be selected.

**(c) Appreciated Property Issues.** If the business venture will invest in assets that are likely to appreciate in the future (such as patents or real estate), the LLC arrangement may be preferable since LLCs (but not S corporations) may distribute appreciated property in-kind to the owners without causing capital gain recognition, and also are not subject to franchise tax.

**(d) Estate Planning Considerations.** If the business owners contemplate that ownership interests in the business will be transferred in trust for the benefit of inactive, passive owners for estate planning purposes, the LLC arrangement should be chosen, since there are no restrictions on the types of trusts which may hold interests in an LLC.

 ***4. When are S Corporations the Answer****?*

**(a) Organizational Simplicity.** In all other cases (where venture capital arrangements are not contemplated, where all investors will be US residents, where the entity will not hold rapidly appreciating assets where estate planning considerations are not an issue), the business owner should seriously consider structuring the business as an S corporation to avoid the additional complexity associated with LLCs.

**(b) Annual Filing Fees.** LLCs and S corporations both are required to file annual reports with the North Carolina Secretary of State each year. S corporations must submit a $25 annual fee with each annual report. LLCs, however, must submit a $200 annual report fee each year.

**(c) Employment Tax Issues.** As discussed above, all income earned by an LLC usually will be subject to self-employment taxes except for those members that would qualify as limited partners if the LLCs were structured as a limited partnership. This generally means that managers of a manager-managed LLC and members of a member-managed LLC usually must pay self-employment tax on **all** LLC income. Furthermore, some LLC income may be subject to the 3.8% Medicare tax on NII.

In contrast, with S corporations, self-employment taxes will only be assessed on salary compensation actually paid to the S corporation shareholder-employees.

**CONCLUSION.**

 Because of the significant ramifications the choice of entity decision will have upon the future success, profitability and viability of the business enterprise, the client's professional advisor team must play an active and ongoing role in advising the client on the choice of entity selection process.

 Furthermore, advisors must always be mindful that the choice of entity decision is not merely a question that arises in the business formation phase.

 Indeed, the choice of entity question must be constantly re-evaluated and readdressed on an ongoing basis. As business clients mature and evolve, or as tax laws or the specific activities of the business enterprise change, the CPA must re-evaluate whether yesterday's choice of entity decision is still appropriate for today and tomorrow.

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