Factors to consider when making a choice-of-entity decision

While numerous entities are available from which to choose, the focus of this **Practice Alert** is on the advantages and disadvantages of the following three business entities: (1) C corporation. (2) S corporation. (3) limited liability company (LLC). These are the most prevalent forms of business entities used today.

The driving legal reason to use one of these entities is to obtain limited liability for owners. No owner wants to be personally liable for the debts of the business entity. In some circumstances, however, owners will likely have to provide a personal guarantee.

For example, virtually all commercial lenders, most landlords, and many suppliers require personal guaranties from the shareholders of a corporation or members of an LLC in order to enter into a loan transaction, lease, or supply arrangement. The law also permits creditors to "pierce the shield" of personal liability provided by a corporation or LLC if the entity is undercapitalized, underinsured, or otherwise not functioning as a commercially reasonable separate legal entity apart from its owners. All three entities provide limited liability; however, their characteristics and optimal use vary significantly.

Advantages of C corporation. The advantages of the C corporation are as follows:

- Limited liability of shareholders. The C corporation is a separate legal entity, and if it is adequately capitalized and proper corporate formalities are followed, the shareholders should generally have liability protection from the debts and obligations of the entity.
- Easier to raise capital through public offering of stock.
- Shareholders of publicly traded corporations can come and go with ease.
- No shareholder-level tax on undistributed income.
- Given the duration that the C corporation entity form has been in existence, a well-established body of law is available with respect to both the tax and nontax legal treatment of C corporations.
- No ownership restrictions apply (in contrast with the ones to which the S corporation is subject).
- Multiple classes of stock permitted (unlike for S corporation).
- Code Sec. 1202 reduced rate of capital gains taxation on the sale of qualified small business stock.

- Code Sec. 1244 ordinary loss deduction for a failed small business corporation.
- The ability to file consolidated returns with controlled subsidiaries.

Disadvantages of C corporation. The C corporation has these disadvantages:

- Double taxation. Income is taxed twice, first at the corporate level and second when earnings are distributed to shareholders in the form of dividends.
- No capital gains rate differential; all income is taxed on the same rate schedule.
- Distributions of appreciated property usually triggers gain at the corporate level.
- Formalities and regulations must be followed very closely in conjunction with the laws regarding incorporating in a specific state; failure to do so can create a situation where shareholders may be held liable.
- Costlier to start than other business entities.
- More time and effort to maintain.
- Potential tax traps, such as the accumulated earnings tax (Code Sec. 531) and personal holding company tax (Code Sec. 541).
- Shareholders do not benefit from corporate losses.
- C corporations generally are required to use the accrual method of accounting, which can result in owing taxes on income that has not yet been received.

Planning tips. The single largest reason to use the C corporation is for access to capital via a public offering. However, the likelihood of a start-up business ultimately going public is quite remote. Further, one can always start as an S corporation and change to a C corporation if a public offering becomes realistic.

The C corporation also may be beneficial when its shareholders are in high individual income tax brackets. This works if the C corporation pays tax at the lower C corporation rates and then declares and pays dividends to its shareholders. Those dividends, at least for now, are taxed at only 15% to the individual shareholders. Another benefit of the C corporation is the Code Sec. 1244 ordinary loss deduction for small business stock; however, the S corporation also enjoys the potential benefit of this section.

The significant deterrents to using the C corporation are (1) potential double tax on operating income, asset sales, and liquidations and (2) corporate losses do not flow through to the shareholders. The second disadvantage is critical given the state of the economy. Right now, new business entities are even more likely than in the past to generate start-up losses. If the start-up is a C corporation, those losses will be suspended

and carried over to subsequent years and be used only when taxable income is generated. Both S corporations and LLCs allow for the flow through of losses.

While some practitioners may disagree, there are few scenarios where the use of the C corporation is recommended. This is particularly true in troubled economic times when shareholders and partners may benefit from the flow through of losses.

Advantages of S corporation. S corporations offer these advantages:

- Shareholder limited liability. The S corporation is a separate legal entity, and if it is adequately capitalized and proper corporate formalities are followed, the shareholders should generally have liability protection from the debts and obligations of the entity.

- An S corporation can easily convert to a C corporation if a public stock offering becomes desirable.

- Corporate losses flow through, which shareholders may be able to use to offset other income.

- An S corporation usually has the option of using the cash or accrual method of accounting.

- S corporation earnings are not subject to self-employment taxes; however, IRS has its sights aimed at requiring S corporations to pay reasonable salaries to shareholder-employees.

- Sale by a shareholder is not subject to the “hot assets” concern, as can occur with LLCs taxed as partnerships.

- Code Sec. 1244 ordinary loss deduction for a failed small business corporation.

Disadvantages of S corporation. S corporations have these disadvantages:

- Cannot have more than 100 shareholders.

- Cannot have as a shareholder a person who is not an individual other than an estate, trust, or certain tax-exempt organizations.

- Cannot have a nonresident alien as a shareholder.

- Cannot have more than one class of stock.

- Do not allow for special allocations as do LLCs taxed as partnerships.

- Obtain basis for only direct loans to the S corporation.

- Code Sec. 1374 built-in-gains tax on sale of assets within ten years after conversion from C to S.

- Code Sec. 1375 passive investment income tax. Shareholders of an S corporation will owe tax on the S corporation's income regardless of whether the S corporation makes a distribution to the shareholder.

Planning tips. The S corporation is a good entity choice principally because it avoids the double taxation problem inherent in the C corporation. Should a public offering of stock become desirable, the S corporation can be easily converted to a C corporation.

There are three major disadvantages to the S corporation: (1) Shareholders do not get tax basis for S-corporation-level loans with third-party lenders. (2) Numerous restrictions are placed on the ownership of an S corporation. (3) Generating passive investment income can subject the S corporation to an entity-level tax as well as a potential termination of the S corporation.

One benefit of the S corporation is that losses flow through to the shareholders and can be used to offset certain other income of the shareholders subject to Code Sec. 465 and Code Sec. 469. Given the state of the economy, it would not be unexpected for a start-up to generate losses for several years. Being able to use these losses at the shareholder level is a significant benefit. These losses, however, can be used to the extent of only the shareholder's tax basis.

Serious consideration should be given to the structure of the debt of the S corporation. If the shareholder lends money to the S corporation, the shareholder gets tax basis for the loan that will allow for the flow through of losses. If, on the other hand, the S corporation itself borrows from a third-party lender, the shareholder gets no tax basis for the loan. As long as the S corporation does not run afoul of the passive investment income rules and any S corporation debt is owed to the shareholders as opposed to third-party lenders, the S corporation is an excellent choice.

Additionally, the S corporation enjoys the benefit of the Code Sec. 1244 ordinary loss deduction for a failed small business corporation, whereas the LLC does not. The benefits of the S corporation are further supported by the fact that S corporation shareholders are not subject to the Code Sec. 751 “hot asset” rule that applies to members of an LLC taxed as a partnership.

Advantages of LLC. For purposes of this **Practice Alert**, a multi-member LLC is presumed to be taxed as a partnership. An election can be made, however, to tax the LLC as a C or S corporation. Advantages of the LLC are as follows:

- Provides limited liability for its members.

- No limitations on the number of members, as is the case for the S corporation.

- Allows for varying classes of membership.
- An LLC is permitted to specially allocate income and losses among its members.
- Losses of an LLC flow through to the members; however, the members can use the losses only to the extent of their tax basis in the LLC.
- Members, subject to certain exceptions, are allowed tax basis for the LLC's debt, which enhances the ability to use losses that flow through.
- Tax-free distributions of appreciated property.
- Ability to elect to step up members' interests in the LLC.

Disadvantages of LLC. The LLC has these disadvantages:

- Given the relatively young age of the LLC as an entity form, the body of law is less established, and therefore, less certain.
- Code Sec. 1244 does not apply to LLCs.
- Limitations imposed on contributions and distributions pursuant to Code Sec. 704(c).
- Transfer of 50% or more of the membership interests terminates the LLC.
- Disposition of an LLC interest can result in taxation at ordinary income rates.
- Members of an LLC will owe tax on the LLC's income regardless of whether the LLC makes a distribution to the member.

Planning tips. The LLC avoids the double taxation inherent in the C corporation. The significant difference between the LLC and the S corporation is that the S corporation must allocate all items of income, loss, deduction, or credit in accordance with the ownership percentages. The LLC has the ability to specially allocate those items so long as the allocations have substantial economic effect. A significant negative of the LLC is the potential for ordinary income treatment on the transfer of an LLC interest pursuant to Code Sec. 751.

Another major benefit of the LLC is the ability for additional capital contributions via Code Sec. 721 to be made without tax consequences as the “control” requirement of Code Sec. 351 is not included in Code Sec. 721 . The LLC has a significant advantage over the S corporation if a debt is involved and that debt is in the name of the LLC and obtained from a third-party lender. In that situation, the members will have tax basis to the extent of their proportionate ownership in the LLC.

In today's economy, generating losses is a distinct possibility. Shareholders of an S corporation or members of an LLC can deduct losses only to the extent of their tax basis. In the end, if debt must be held at the entity level and with a third-party lender, the LLC would be a better selection as the members will get tax basis and will enjoy the flow through and potential use of losses. The LLC is also the better choice if special allocations are desirable, as this is the only entity for which that can be accomplished.

Conclusion. The choice of which business entity to use can be difficult and costly if the wrong selection is made. The best approach is to gather as much information as possible about the intended life cycle of the business. Knowing what the owners plan or hope to do years later is helpful in the selection process.

However, this **Practice Alert** has been written primarily to help advisors recommend an entity that will take into consideration the possible economic hardships as a result of the overall financial condition of the U.S. and the world. The ability for owners to deduct losses is critical and only provided for in the S corporation and the LLC.

In the S corporation and LLC, losses can be deducted to the extent of only the shareholder or member's tax basis. These two entities have a significant difference in the determination of tax basis. Determining the ultimate debt structure is critical in the determination of which entity will provide the owners with tax basis. In the end, each scenario is different and requires a thorough factual analysis as there are many traps for the unwary in the choice-of-entity process.