# *Business Entity Selection & Structuring Transactions*

UNDERSTANDING THE OPTIONS AND HOW TO BEST USE THEM IN PLANNING



*Business Entity Selection & Structuring Transactions*

INTRODUCTION

## *Business Entity Selection & Structuring Transactions*

### INTRODUCTION

- **Front-end decisions can have significant effect on future operations of business and/or transaction implications**
- **Very important to choose proper legal and tax form for the business entity – primary drivers of decision:**
  - ***Liability protection***
  - ***Taxation issues (at entity and owner level)***
  - ***Overall complexity of operations and record-keeping***



## *Business Entity Selection & Structuring Transactions*

### INTRODUCTION

- **Entity-structure selection decisions extend over disciplines of law, accounting and taxation**
  - ***Accounting: reporting and record-keeping requirements***
  - ***Tax: application of federal income tax; ability to use tax breaks and incentives; compensation planning; taxation at the ultimate disposition of the business; state income and franchise tax implications***

## *Business Entity Selection & Structuring Transactions*

### TOPICS TO BE DISCUSSED

- **Corporations**
- **Partnerships**
- **Limited Liability Companies & Limited Liability Partnerships**
- **Disregarded Business Entities**
- **Alternative Entity Structures**
- **Comparing LLCs to S Corporations**
- **State Tax Considerations**
- **Transaction Implications**



# *Business Entity Selection & Structuring Transactions*

## CORPORATIONS

## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Autonomous legal entity, existing separate and apart from shareholders, officers, directors and management**
- **Usually carries same economic and legal powers as an individual**

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## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Core Attributes/Characteristics**
  - ***Continuity of existence***
  - ***Limited liability of the investors***
  - ***Transferability of ownership***
  - ***Centralized management***

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### CORPORATIONS

- **Continuity of existence**
  - *Indefinite life (as long as shareholders desire)*
  - *Transactions involving shareholders have no effect on the corporation's ongoing existence*
  - *Formal action must be taken to cease operations*

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### CORPORATIONS

- **Limited liability of the investors**
  - *Arguably most important benefit of using a corporation*
  - *Under state statutes, owners/shareholders are not personally liable for the debts of the corporation*
  - *Shareholder/owner exposure or loss limited to amount originally contributed plus any amount paid to purchase shares of stock of the corporation*

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### CORPORATIONS

- **Transferability of ownership**
  - ***Capital stock shares can be exchanged freely without approval of other shareholders***
  - ***Such transactions create no disturbance to the corporation's operations and existence***



## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Centralized management**
  - ***Responsibility for daily operations mandated by state law to rest with officers of the corporation that are appointed by the Board of Directors (who are elected by shareholders)***
  - ***Ultimate responsibility lies with Board of Directors***
  - ***Shareholder acting as manager or officer/director must meet fiduciary obligation to act in good faith and in best interests of the corporation***

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### CORPORATIONS

- **Taxation**
  - *Corporations are taxable entities (highest tax rate = 35%)*
  - *Possible "second layer" of tax may be imposed on the dividends distributed to shareholders*
  - *"Double taxation" effectively created with repeal of the General Utilities doctrine in Tax Reform Act of 1986*

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### CORPORATIONS

- **Distributions/Investment Returns**
  - *Shareholder can receive funds from corporation through:*
    - Salary and other earned compensation for services rendered, including rent
    - Debt strategy allowing shareholder to "borrow" funds from the corporation
    - Distribution of corporate earnings (dividends)

## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Distributions/Investment Returns**
  - *Salary and other earned compensation*
    - Generally deductible, but must be "reasonable" or will be re-characterized by IRS as dividends
    - Taxable as earned income, subject to ordinary income tax rates



## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Distributions/Investment Returns**
  - *Loans from corporation*
    - Generally not deductible
    - Not considered to be income (non-taxable)

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## Business Entity Selection & Structuring Transactions

### CORPORATIONS

- **Distributions/Investment Returns**
  - ***Dividends***
    - Generally not deductible
    - Taxed at dividend rates (currently 15%)

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### CORPORATIONS

- **Formation Process**
  - ***Choose business name in compliance with state rules***
  - ***Appoint initial directors***
  - ***Prepare Articles of Incorporation***
  - ***File formal paperwork***
  - ***Create "Bylaws" of the corporation***
  - ***Hold initial Board of Directors meeting***
  - ***Issue stock certificates in exchange for capital contributions***
  - ***Obtain any necessary licenses/permits to operate the business***

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## *Business Entity Selection & Structuring Transactions*

### CORPORATIONS

- **Formation/Maintenance**
  - ***Proper administration of the organization process can be somewhat costly***
  - ***Generally more expensive to maintain a corporation***
    - Complex income and franchise tax filing requirements
    - Other corporate registrations and state tax filings

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### CORPORATIONS

- **Reasons for Decline in Popularity**
  - ***"Double taxation" issue***
  - ***Differential between individual and corporate tax rates***
    - Corporate rates significantly higher than individual rates

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### S CORPORATIONS

- **Option created in 1958 under IRC Subchapter S**
  - ***Entity subject to single layer of tax with limited liability***
  - ***Limitations in exchange for favorable tax treatment:***
    - Must be U.S. company
    - Limited number of shareholders
    - Qualifications for eligible shareholders
    - Single class of Stock

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### S CORPORATIONS

- **Taxed as a "pass-through" entity**
  - ***No tax paid on corporation's earnings at corporate level***
  - ***Income, deductions, gains, losses and credits are passed through directly to the shareholder in proportion to stock ownership in corporation (Schedule K on form 1120S)***

## *Business Entity Selection & Structuring Transactions*

### S CORPORATIONS

- **Taxed as a "pass-through" entity**
  - ***Distribution of cash/property at discretion of shareholders***
  - ***Provision in shareholders agreement can provide for minimum distribution requirements to meet shareholders' tax obligations***



## *Business Entity Selection & Structuring Transactions*

### S CORPORATIONS

- **Not a state-authorized entity**
  - ***Merely tax mechanism built from the general corporation structure enabled under state incorporation statutes***
- **To qualify as an S corporation:**
  - ***Entity must be set up and organized as a corporation***
  - ***Election to be taxed as an S corporation must be filed with the Federal government (Form 2553 or Form 8832)***

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## *Business Entity Selection & Structuring Transactions*

### S CORPORATIONS

- **Shareholder basis**
  - ***Ongoing accounting must be performed to determine taxability of amounts distributed to shareholders***
  - ***Important to the ability of shareholders to use NOLs to offset income and preserve cash flow***
  - ***Generally considered to be the amount of cash or carrying value of property paid for stock or contributed to capital in exchange for stock***

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## *Business Entity Selection & Structuring Transactions*

### S CORPORATIONS

- **Shareholder basis**
  - ***Increased for additional shareholder contributions to capital as well as share of positive pass-through items (business income and gains)***
  - ***Decreased by negative pass-through items (deductions for operating losses and other loses) as well as distributions***

## *Business Entity Selection & Structuring Transactions*

### S CORPORATIONS

- **Shareholder basis**
  - *Net basis increase for shareholders owning capital stock in enterprise that does not distribute 100% of income*
  - *No similar benefit for C corporation shareholders*

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### S CORPORATIONS

- **Single class of stock**
  - *Adjustment/recharacterization may be required if the company does not make all distributions proportionate to ownership (excess compensation = distribution)*
  - *Resulting distributions can "create" second class of stock*

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### S CORPORATIONS

- **Mechanics/Example**
  - *Corporation earns $1,000,000 pre-tax income*
  - *No corporate tax (savings of $392,000)*
  - *$1,000,000 earnings passed-through to shareholders and taxed at 37% ($370,000)*
  - *No further tax due on distributions*
  - *Total tax = $370,000 ($495,360 for C corporation)*

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### S CORPORATIONS

- **JCT Paper (since 1986)**
  - *Drop in C corporations (from 2.6 to 1.73 million)*
  - *Rise in S corporations (7.26 million from 2.53 million)*

## *Business Entity Selection & Structuring Transactions*

### C CORPORATIONS VS S CORPORATIONS

- **Conclusion**
  - ***Generally C corporations desirable only for largest businesses***
    - Easy and effective access to capital markets
    - Ease of transferability of stock and access to capital sources that would not qualify under S corp status
    - Allows larger number of equity owners



# *Business Entity Selection & Structuring Transactions*

PARTNERSHIPS

## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Association of at least two parties who agree to contribute money, labor and/or skill to an enterprise, with an intent to make a profit**
- **Offer pass-through taxation benefits**
- **Less-rigid qualification and operating requirements than S corporations (governed by IRC Subchapter K)**
  - ***No limitation who can become a partner nor on how many***

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **General Partnership**
  - ***All partners agree to be "general partners," and as such, are jointly- and severally-liable for the debts and liabilities of the partnership***
    - Personal assets may be exposed to business creditors
  - ***Any single partner can contractually bind the partnership***
  - ***All partners can participate in daily management***

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **General Partnership**
  - *Entity structure and liability risks generally sufficient to convince businesses to form as another type of entity*
  - *Can be formed informally, but unwise*
  - *Partnership exists as a legal entity separate and apart from its partners or equity owners*

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Limited Partnership**
  - *"Limited" partners afforded greater liability protection*
    - Liable only to the extent of contributed capital
    - Personal assets not exposed to partnership obligations
  - *At least one partner must maintain "general" partner status and will remain exposed to all debts and liabilities*
  - *Limited partners cannot participate in day-to-day operations*

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### PARTNERSHIPS

- **Limited Partnership**
  - ***Often formed to accomplish specific goals and objectives***
    - Raising substantial capital from (passive) investors
    - Developing federal estate-planning strategies (FLPs)

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### PARTNERSHIPS

- **Taxation**
  - ***Taxed as a pass-through entity***
    - Partnership is not a tax-paying entity
    - All income, deductions, gain, loss and credits passed through to partners in proportion to their interest
  - ***Corporations, other partnerships and individuals can become partners in a partnership and pay tax on their partnership income according to applicable tax rules***

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Partner basis**
  - ***Ongoing accounting must be performed to determine taxability of amounts distributed to partners***
  - ***Important to the ability of partners to use partnership losses to offset other income and preserve cash flow***
  - ***Generally considered to be the amount of cash or carrying value of property paid for interest or contributed to capital in exchange for the capital interest***

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Partner basis**
  - ***Increased for additional partner contributions to capital as well as share of positive pass-through items (business income and gains)***
  - ***Decreased by negative pass-through items (deductions for operating losses and other loses) as well as distributions***

## *Business Entity Selection & Structuring Transactions*

PARTNERSHIPS

- **Partner basis**
  - *Partnership-level borrowings treated as contribution of cash in proportion to the partner's capital ownership*
  - *Payments of the borrowings treated as distributions of cash in proportion to the partner's capital ownership*

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PARTNERSHIPS

- **Partner basis**
  - *As in an S corporation, a net basis increase is afforded for shareholders owning capital stock in enterprise that does not distribute 100% of income*
  - *No similar benefit for C corporation shareholders*

## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Partner Distributive Shares**
  - *Distributive share of income, gain, loss, deduction or credit generally determined by partnership agreement*
  - *Can differ from economic allocations*
    - Substantial economic effect

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Partner Distributive Shares**
  - *Two sets of allocations:*
    - Economic (book) – controlled by partnership agreement
    - Tax – independent of economic allocations; can be disproportionate

## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Dispositions of Partner Interest**
  - ***IRC Section 754***
    - Allows adjustments to the basis of partnership property in the event of sale, exchange or death of partner
    - Basis in partnership assets is increased by the excess of the transferee's basis over his/her share of the partnership's adjusted basis in its property
  - ***Basis adjustment specific to transferee partner only***

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## *Business Entity Selection & Structuring Transactions*

### PARTNERSHIPS

- **Self-Employment Taxes**
  - ***All income of a general partnership subject to self-employment tax***
    - 15.3% of general partner's total income
    - One-half of this tax is deductible in computing AGI

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## *Business Entity Selection & Structuring Transactions*

PARTNERSHIPS

- **Complexity**
  - *Complicated IRC provisions, especially Subchapter K, apply to the taxation of partnerships*
    - Can create unanticipated, unwelcome situations

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## *Business Entity Selection & Structuring Transactions*

LIMITED LIABILITY COMPANIES
AND LIMITED LIABILITY PARTNERSHIPS

## *Business Entity Selection & Structuring Transactions*

### LLCs AND LLPs

- **Existed for several decades, but no long statutory history**
- **Have become the most widely-used entity for newly-formed businesses over the last ten years**
  - ***Limited liability protection for owners***
  - ***Increased flexibility with respect to business decisions***
  - ***Increased flexibility with respect to tax-related matters***

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## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **Business entity created under state law**
- **Has characteristics of corporations and partnerships**
- **Owners can determine how entity will be taxed – most commonly selected are:**
  - ***As a partnership (multiple-member LLC)***
  - ***As a disregarded entity (single-member LLC)***

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## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **Limited liability for investors**
  - ***No single member personally liable for debts of business***
- **Flexibility to choose tax treatment**
  - ***Easily accomplished through "check-the-box" election***
  - ***If no election is made, multi-member LLCs taxed as partnerships, single-member LLCs considered to be disregarded entities for Federal tax purposes***

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## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **Additional reasons for popularity**
  - ***Not subject to shareholder and stock restrictions like S corporations***
  - ***Members can allocate income/loss in a manner other than ownership percentage***

## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **When to use an LLC**
  - ***Should be considered for any business not planning an IPO***
    - Entrepreneurial enterprises with few active participants
    - Family and closely-held businesses
    - Real estate investments
    - Joint ventures
    - Investment partnerships
  - ***No tax consequences for later converting to corporation***



## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **LLC management**
  - ***Tremendous flexibility***
  - ***Can be centralized or decentralized***
  - ***"Manager" does not need to be a member***
  - ***Few formal rules regarding administrative procedures***

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### LIMITED LIABILITY COMPANIES (LLCs)

- **Federal taxation**
  - ***Federal tax consequences depend upon number of members***
    - Single-member LLC treated as disregarded entity; taxes flow up to the member holding the LLC interests
    - Multi-member LLC taxed as a partnership (unless other election is made); tax treatment is same as partnership
    - Specific elections can be made for other structures

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### LIMITED LIABILITY COMPANIES (LLCs)

- **Self-employment tax**
  - ***Not conclusive***
    - Limited partners generally excluded from self-employment tax, as they are more like passive investors
    - IRS has proposed regulations attempting to define “limited partner” to determine applicability of self-employment tax
    - Exceptions for service partners in certain professional service partnerships

## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **Advantages over other pass-through entities**
  - ***Better liability protection and freedom for members to participate than offered by a partnership***
  - ***Fewer membership restrictions (on number and types of members) than allowed in an S corporation***
  - ***Special allocations of income, gain and loss are permitted (only pro rata allocations are allowed in S corporations)***
  - ***Basis adjustments are permitted through election; they are not permitted in S corporations***

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## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **LLC vs. Corporation**
  - ***Typically LLC is a better choice for many reasons***
  - ***Limited circumstances favoring corporations:***
    - When company plans broad-based IPO
    - If corporation would result in lower self-employment tax
    - Fringe benefits available may outweigh tax disadvantages

## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **LLC vs. Limited Partnership**
  - ***Tax considerations usually not determinant for choice***
  - ***Two important tax differences can affect decision:***
    - No distinction between members (general vs. limited) – in LLC, no member is liable for obligations of entity
    - All members of LLC can take active role in management

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## *Business Entity Selection & Structuring Transactions*

### LIMITED LIABILITY COMPANIES (LLCs)

- **State statute issues**
  - ***In most situations, pass-through treatment is allowed***
  - ***Some states impose additional taxes on LLCs***
    - Capital stock tax filing required for businesses in PA
  - ***Most states follow "flexible statutes"***
    - Allow perpetual life for LLC and decisions can be made with less-than-unanimous consent of members

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### LIMITED LIABILITY PARTNERSHIPS (LLPs)

- **Important difference from general partnership**
  - ***Provides personal liability protection for each individual partner***
    - Limit of protection determined by state law
    - LLP must register with state and fulfill various requirements
    - Filing fee and use of "LLP" in name required

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### LIMITED LIABILITY PARTNERSHIPS (LLPs)

- **Exceptions to limited liability protection**
  - ***Personal negligence of member***
  - ***Vicarious liability for acts of professional misconduct (torts) can extend personal liability to actions of others under member's direct supervision and control***
    - LLPs generally offer liability protection in these cases

# *Business Entity Selection & Structuring Transactions*

## DISREGARDED BUSINESS ENTITIES

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### *Business Entity Selection & Structuring Transactions*

#### DISREGARDED BUSINESS ENTITIES

- **For Federal income tax purposes, "disregarded entity" is:**
  - *Entity not recognized as separate from its owner*
  - *Activity flows up to single owner and tax paid by owner*
  - *Exists for state regulatory purposes but is not recognized for Federal income tax purposes*

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## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **Generally one of two types of entity:**
  - ***SMLLC***
    - Can be wholly-owned by any type of taxpayer
    - By default, considered as a disregarded entity
  - ***QSub***
    - Must be wholly-owned by an S corporation
    - Election must be made to be a disregarded entity

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## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **SMLLCs**
  - ***Not required to file tax return separate from owner***
  - ***Can elect to be taxed as a corporation***
  - ***Entity of choice for sole proprietorships and solely-owned businesses due to personal liability and asset protection***

## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **SMLLCs – Personal Liability and Asset Protection**
  - ***Maintain separation between SMLLC and sole member***
    - Maintain formalities for operating business as LLC
    - Contracts entered through LLC not personally
    - Third parties must recognize sole member as agent/owner of the LLC
    - LLC must be adequately capitalized



## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **SMLLCs – Federal Tax Consequences**
  - ***SMLLCs very popular for liability protection and favorable tax consequences***
  - ***SMLLC does not file separate tax return***
  - ***Income and loss of SMLLC reported on return filed by the single member***
    - Individual uses Federal 1040
    - Corporation uses Form 1120 or Form 1120S

## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **SMLLCs – Other Tax Consequences**
  - ***Classification may be change if another owner is admitted (or bought-out) and may result in change in taxation***

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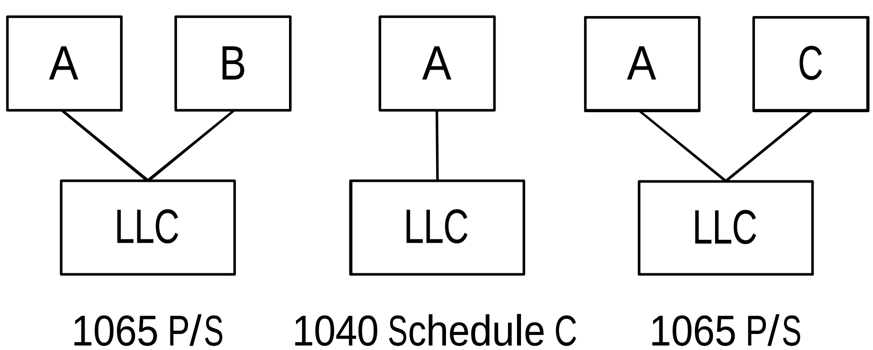
### DISREGARDED BUSINESS ENTITIES



## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **QSubs**
  - *Domestic corporation that:*
    - Would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of the parent S corporation
    - 100% of the stock of the subsidiary is held by its S corporation parent
    - Parent elects to treat it as qualified Subchapter S subsidiary

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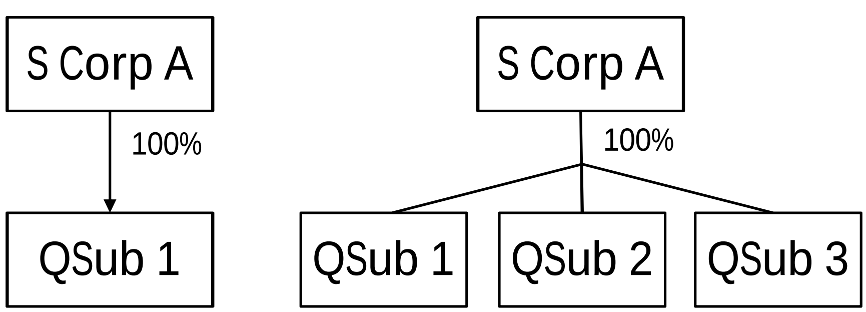
### DISREGARDED BUSINESS ENTITIES



## *Business Entity Selection & Structuring Transactions*

### DISREGARDED BUSINESS ENTITIES

- **QSubs**
  - *Certain states (including PA) require some type of filing, which may involve a franchise tax of filing fee*
  - *Used to protect parent from liability of a more-risky line of business and allow losses to be used to reduce parent's taxable income*



# *Business Entity Selection & Structuring Transactions*

## SPECIAL-PURPOSE ENTITIES

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Created to accomplish specific taxpayer and business goals**
  - ***REIT***
  - ***RIC***
  - ***REMIC***
  - ***Publicly-Traded Partnership***
  - ***ESOT***
  - ***FLP***
  - ***Homeowner Association***
  - ***Estate-Planning Trusts***

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Real Estate Investment Trust (REIT)**
  - ***Corporation (or trust/association taxable as a corporation) that invests in real estate, mortgages and similar assets***
  - ***Must elect to be treated as a REIT***
    - Results in undistributed income and capital gains being taxed at corporate rates (eliminates double taxation)
    - Limited liability depends on state statute, entity structure

## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Real Estate Investment Trust (REIT)**
  - ***Cannot elect REIT status unless:***
    - It qualified as a REIT for all tax years beginning after 2/28/86
    - As of the close of the tax year, the entity has no earnings and profits accumulated from any non-REIT year



## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Real Estate Investment Trust (REIT)**
  - ***Sources of income allowed***
    - Rents from real property that do not depend on the lessee's profits or are not from related parties
    - Interest, including mortgage interest
    - Qualified temporary investment income
    - Commitment fees
    - Foreclosure property and shared appreciation mortgages

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Real Estate Investment Trust (REIT)**
  - ***Other considerations***
    - A REIT cannot derive income from an independent contractor managing property
    - If gross receipts exceed $5MM, a REIT must use accrual method of accounting
    - Calendar year required as annual accounting period



## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Regulated Investment Company (RIC)**
  - ***Domestic corporation that qualifies as a regulated investment company and satisfies distribution requirements***
    - Must be registered with the SEC
    - Must derive at least 90% of income, dividends, interest and gains from sale of stocks, securities, foreign currencies
    - Must satisfy diversification requirements

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Regulated Investment Company (RIC)**
  - *Must elect to be treated as a RIC*
    - Taxed only on amount of undistributed net income and undistributed capital gains
    - If distribution requirements are met, taxed as a pass-through entity and can deduct dividends paid to share-holders when computing taxable and capital gain income

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Regulated Investment Company (RIC)**
  - *Distribution requirements*
    - Must distribute at least 90% of its investment company taxable income for the tax year (computed without taking into consideration the deduction for dividends paid)
    - Specified capital gains and distributions can be disregarded for this purpose

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Regulated Investment Company (RIC)**
  - ***Distribution requirements***
    - Must distribute amount equal to at least 98% of ordinary and capital gain net income or pay excise tax of 4%
    - Must distribute all earnings and profits for any non-RIC years to qualify for pass-through tax treatment

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Real Estate Mortgage Investment Conduit (REMIC)**
  - ***Created by Tax Reform Act of 1986***
  - ***Also called “Collateralized Mortgage Obligations”***
  - ***Investment vehicles that hold commercial and residential mortgages in trust***
  - ***Eliminates double taxation***

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Publicly-Traded Partnerships**
  - ***Partnerships whose interests are traded on an established securities market, secondary securities market or the substantial equivalent of a secondary market***
    - Substance, rather than form, dictates whether the partnership is publicly-traded
    - Rules regarding requirements are extensive and complex

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Publicly-Traded Partnerships**
  - ***An interest in a partnership is any interest in the capital or profits of the partnership***
    - It is also a financial instrument or contract
    - Does not include non-convertible debt or an interest in a partnership or a corporation that holds an interest in a lower-tier partnership

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Publicly-Traded Partnerships**
  - ***Treated as corporations unless 90% or more of their income is from passive sources***
    - Test must be met for each tax year and all previous tax years during which the partnership or its predecessor was in existence
    - Passive-type income specifically-defined these purposes



## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Employee Stock Ownership Trust (ESOT)**
  - ***The vehicle that holds the assets is an ESOP (stock-bonus plan or combination stock-bonus and money-purchase plan)***
  - ***ESOPs can be structured to garner favorable tax treatment designed to make it easier to acquire employer securities***
  - ***Prohibited-transaction rules are relaxed with respect to qualifying ESOPs***

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Employee Stock Ownership Trust (ESOT)**
  - ***Benefits of using an ESOP/ESOT***
    - Selling Subchapter C shareholder can sell shares to ESOP and defer Federal taxes due by investing qualifying U.S. securities
    - Debt borrowed to fund purchase of shares is funded by annual contributions to the plan by sponsoring company
    - Sponsoring company, in effect, receives a tax deduction for both the principal and interest on the debt



## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Employee Stock Ownership Trust (ESOT)**
  - ***Other benefits of ESOPs:***
    - Cost-efficient way to transition senior shareholders out of the corporation
    - Many positive attributes of employee ownership

## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Family Limited Partnership (FLP)**
  - *Limited partnership that allows tax advantages and the ability to protect family assets in a single entity*
  - *Effective for use in estate planning in order to leverage gift tax and lifetime giving exclusions*
  - *Must understand discounts to maximize advantages*
  - *Careful planning required to withstand IRS challenge*

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## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Family Limited Partnership (FLP)**
  - *Key considerations:*
    - Type of assets to be transferred (best to use those that are expected to appreciate over time)
    - Value of assets to be transferred must be determined
    - Provisions in partnership agreement will affect discounts

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Family Limited Partnership (FLP)**
  - ***Mechanics***
    - Form partnership, create partnership agreement and register limited partnership
    - A new liability-limiting organization is often created to hold general-partner ownership interests

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Family Limited Partnership (FLP)**
  - ***Mechanics***
    - Initial contribution to limited partnership accomplished by providing capital to general-partner entity in exchange for capital ownership interests and through contribution of assets for all of the limited-partner ownership interests
    - General-partner entity contributes capital to limited partnership in exchange for general-partner interests

## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Family Limited Partnership (FLP)**
  - ***Mechanics***
    - Limited-partner interests must have a valuation
    - Gift and transfer tax returns must be prepared

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## Business Entity Selection & Structuring Transactions

### SPECIAL-PURPOSE ENTITIES

- **Homeowner Association**
  - ***Corporation formed by a real estate developer for the purpose of marketing, managing and selling homes and lots in a residential subdivision***
    - Grants the developer privileged voting rights in governing the association, while allowing the developer to exit financial and legal responsibility of the organization
    - Allows a civil municipality to increase its tax base without providing equal services to all of its citizens

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Homeowner Association**
  - ***Membership by a residential buyer is typically a condition of purchase***
    - A buyer is not given an option to reject it
  - ***Some homeowner associations hire and retain property management companies***
    - Board of directors responsible for retaining the companies



## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Homeowner Association**
  - ***Most homeowners associations are incorporated, and are subject to state statutes that govern non-profit corporations and homeowner associations***
  - ***State oversight of homeowner associations is minimal, and mainly takes the form of laws which are inconsistent from state to state***

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Estate-Planning Trusts**
  - ***Formed for many purposes***
    - Supply one or more qualifications for dealing with the trust's assets, qualifications which the beneficiaries of the trust may lack, or that the person creating the trust thinks they may lack
    - Tax advantages afforded certain trust structures are sought to minimize or eliminate income and estate taxes

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## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Estate-Planning Trusts**
  - ***Irrevocable Living Trust***
  - ***Revocable Living Trust***
  - ***GRAT/GRUT/GRIT***
  - ***QPRT***
  - ***QTIP***

## *Business Entity Selection & Structuring Transactions*

### SPECIAL-PURPOSE ENTITIES

- **Estate-Planning Trusts**
  - ***ILIT***
  - ***CRUT/CRAT***
  - ***Crumney Trust***
  - ***Credit Shelter Trust***
  - ***IDGT***



# *Business Entity Selection & Structuring Transactions*

## COMPARING LLCs TO S CORPORATIONS

## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Relevant factors in determining which to choose**
  - ***Which provides best protection for legal-related issues?***
  - ***Which provides the best tax advantages?***

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## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Similarities**
  - ***Limited liability protection***
  - ***Separate entities***
  - ***Pass-through taxation***
  - ***Ongoing state requirements***

## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Differences – Ownership**
  - *LLCs have no restrictions on number of members*
  - *LLCs allow non-U.S. citizens to be members*
  - *LLCs can be owned by various types of entities*
  - *LLCs can have subsidiaries without restriction*

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## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Differences – Ongoing Formalities**
  - *S corporations required to follow internal formalities*
    - Adopt bylaws, issue stock, hold director/shareholder meetings, keep minutes with corporate records
  - *LLCs recommended to follow some formalities*
    - Adopt operating agreement, issue membership shares, hold and document member meetings, document all major company decisions

## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Differences – Management**
  - ***LLCs can have members (owners) or managers to manage***
  - ***S Corporations have directors and officers***

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## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Differences – Other Differences**
  - ***Allocation of income***
  - ***Tax basis differences***
    - LLC can include entity-level liabilities in basis
    - LLC can make basis-adjustment election when LLC interest is sold or exchanged

## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Differences – Benefits of Basis Differences**
  - ***Tax losses may be claimed in excess of LLC member's capital investment***
  - ***Greater amount of money and property may be distributed tax-free to the LLC member***
  - ***Adjustment of basis is permitted***



## *Business Entity Selection & Structuring Transactions*

### COMPARING LLCs TO S CORPORATIONS

- **Other Considerations**
  - ***Generally LLCs offer more benefits***
  - ***All facts and circumstances of specific situation must be considered when making the decision***

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# *Business Entity Selection & Structuring Transactions*

STATE TAX CONSIDERATIONS

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## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Increased scrutiny on state taxing matters with special attention paid to income, franchise and sales and use tax**
- **Limitations on state's authority to tax a business entity**
- **States must establish "nexus" and provide fair apportionment**

## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **C corporations**
  - *Definition of "corporation" and applicable rules vary from state to state*
- **Pass-through entities**
  - *Same flow-through treatment allowed as on Federal level*
  - *May be subject to other "non-income" taxes*



## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Unitary reporting**
  - *Unitary business principle (part of Due Process Clause) limits what activities a state may consider*
  - *Taxing authority may treat a business that is conducted within and outside the state as one unit in determining the taxable values attributable to the state (regardless of entity structure)*
  - *Controls what income is subject to apportionment*

## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Overview of Nexus**
  - ***Nexus is the term used to describe the types of contacts necessary to establish a state's right to impose a tax***
  - ***Public Law 86-272***
  - ***While taxpayers clearly have nexus in each state in which they own property or have employees, a more difficult issue is determining in which, if any, other states the taxpayer has nexus***



## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Affiliate or agent nexus**
  - ***Affiliate nexus***
    - Common ownership between entity with physical presence in a taxing state and an out-of-state entity that has no physical presence can create nexus when intercompany transactions or shared services exist
  - ***Agency nexus***
    - Use of independent agents by businesses can be considered a nexus-creating activity

## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Economic nexus**
  - *Based on the amount of income or sales derived from sources within a state*
  - *Some states have also adopted "bright-line tests" for determining economic nexus*



## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Common methods used to divide tax base**
  - *Separate accounting*
  - *State-specific allocations*
  - *Formulary apportionment*

## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Formulary apportionment**
  - *Historically, the most common factors utilized by states that incorporate an average apportionment factor are sales, payroll and property*
  - *Over the past decade, sales factor weighted more, as states attempt to move more of the state tax burden off in-state taxpayers to out-of-state businesses*



## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Other apportionment matters**
  - *Nonbusiness income is generally still allocated to the single state from which it is was derived.*
  - *Throwback sales pursuant to UDITPA exception specifies that if the taxpayer is not taxable in the state of the purchaser, the sale is attributed to the state from which the property is shipped*

## *Business Entity Selection & Structuring Transactions*

### STATE TAX CONSIDERATIONS

- **Other "non-income" taxes to consider**
  - ***Franchise/net worth tax***
    - Generally based on assets or capital that a taxpayer employs within a state
  - ***Gross receipts tax***
    - Based on level of sales within state in the reporting period
  - ***Hybrid tax***
    - Alteration of net worth or gross receipts concept



## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Many questions regarding ultimate disposition of the entity should be considered when determining entity type**
  - *Asset sale vs. sale of ownership interests*
  - *Different considerations for buyers and sellers*
    - Buyers generally favor asset sales
    - Sellers benefit more from sale of ownership interests



## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Buyer's Perspective:**
  - *Factors favoring asset purchase*
    - Protects buyer from unknown or contingent liabilities of the acquired business
    - Allows the buyer to purchase only the assets desired
    - Allows the buyer to allocate the purchase price to the assets acquired for tax basis purposes ("step up" basis)

## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Buyer's Perspective:**
  - *Factors favoring asset purchase*
    - May allow the buyer to terminate existing unfavorable employee collective bargaining (can be difficult)
    - No requirement for buyer to assume legal responsibility for underfunded employee benefit plans
    - Allows buyer to avoid minority shareholder problems that could arise with an entity acquisition



## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Buyer's Perspective:**
  - *Factors favoring purchase of ownership interests*
    - Fewer legal and transaction costs and difficulties
    - Valuable contractual rights (leases, franchises, etc.) are usually unaffected by acquisition
    - Gives buyer the right to use the seller's name, which is important if entity is well-known in the industry

## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Seller's Perspective:**
  – ***Factors favoring sale of assets***
    - Seller is an entity with unused NOL or capital loss carryforwards that can offset any entity-level gain on the sale of its assets
    - Assets to be sold have a high basis (no entity-level gain)



## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Seller's Perspective:**
  – ***Factors favoring ownership interest sales***
    - Target corporation avoids recognizing any gain
    - Seller will generally recognize capital gain
    - Avoids contract and asset transfer issues
    - Avoids unrecorded or underreported liability issues for the seller

## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Entity Formation Decisions Related to Future Transactions**
  - ***Entities taxed as C corporations***
    - For the most part, being a C corporation reduces the potential positive outcomes of a transaction event due to double-taxation effect

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## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Entity Formation Decisions Related to Future Transactions**
  - ***Entities taxed as S corporations and partnerships***
    - Tax consequences upon disposition of interests in these entities are similar
    - No double taxation in most cases
    - Similar tax treatment results with asset or ownership interest sale, which gives seller more negotiating options

## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Entity Formation Decisions Related to Future Transactions**
  - ***Disregarded entities***
    - Since a disregarded entity is not a tax-paying entity for income tax purposes, transactions will generally be treated as asset sales for both buyer and seller
    - Buyer benefits due to stepped-up tax basis for the assets
    - Seller's gain from the asset sale will be reported on the owner's income tax return (single level of tax)



## *Business Entity Selection & Structuring Transactions*

### TRANSACTION IMPLICATIONS

- **Entity Formation Decisions Related to Future Transactions**
  - ***Sole Proprietorships***
    - Treated as asset sales for both buyer and seller
    - Generally favorable to buyer, but non-tax matters must also be considered
    - Mixed results for seller can result due to differences between ordinary and long-term capital gains tax rates, as well as complications with non-tax matters

# *Business Entity Selection & Structuring Transactions*

CONCLUSION AND
PRACTICAL CONSIDERATIONS

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## *Business Entity Selection & Structuring Transactions*

### CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Important to select proper entity structure at inception of a business enterprise**
  - ***Consider business lifecyle to incorporate exit planning***
  - ***Centralized management and continuity of life important***
  - ***Personal asset protection and liability considerations***
  - ***Financing objectives and self-employment taxes should also be addressed***

# *Business Entity Selection & Structuring Transactions*

THANK YOU!