# *THE CPA'S CHECKLIST FOR SELECTING THE RIGHT BUSINESS ENTITY FORM*

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## INTRODUCTION

Without a doubt, one of the most important decisions facing a new business owner (and his or her CPA) 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 CPA) should take care in selecting an organizational form for the new business which 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 CPA's Ongoing Role 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 CPA must play an **active and ongoing** role in advising the client on the choice of entity selection process.

From the CPA's perspective, advising a *new* business owner on selecting a business entity form requires the CPA to "look into the crystal ball." In advising his or her clients, the CPA 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 CPA 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 CPA 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 CPA. For example, clients may fail to consult their CPA 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, the CPA 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 CPA 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 Three Types of Organizational Forms.

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

**A. Sole Proprietorships. Business ventures which 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.** **Limited Liability Entities: Corporations and Limited Liability Companies (LLCs).** 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.

## *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 CPA should focus on **three** primary issues:

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

**B.** **Limited 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?

**C.** **Tax Considerations.** What are the relative tax advantages and disadvantages that arise under these three 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. Of course, all sole proprietorship profits are subject to income tax, as well as the 15.3% self-employment taxes.

## 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 and Self-Employment Tax Treatment***.

Partnerships are not subject to entity level taxation on partnership income. Instead, the partnership files a Form 1065, Partnership Tax Return, and all of the partners report partnership income on their personal returns via Schedules K-1. If the partnership is engaged in active business operations (as opposed to rental activities), the pass-through income from the partnership also will be subject to self-employment taxes.

### 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 $20.00 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.

## D. North Carolina Limited Liability Companies.

An LLC is a much more complicated business arrangement than is a sole proprietorship or partnership. In addition, LLCs may also be more expensive and complicated than corporations.

A North Carolina Limited Liability Company is a business organizational form which offers limited liability protection to its owners. If properly structured, an LLC will be treated as a partnership for tax purposes. 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.

### *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 specifically agree to this arrangement either by designating managers in the Articles of Organization or 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 Unfamiliar Entity Forms.*

Unfortunately, although LLCs have been around since 1993, the legal aspects of the LLC arrangement are still relatively unfamiliar to some third parties, including lenders and potential investors.

## *V. Limited Liability Issues.*

### A. Introduction.

In selecting among the several choice 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).

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 times, 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.

## F. **Exceptions to Non-Liability Rule For Shareholders and LLC Members**:

***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").*

Traditionally, many professional organizations (such as accountants, lawyers and physicians) have operated as 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 changes to North Carolina law, general partners of a North Carolina partnership now can insulate themselves from liabilities arising from the acts of other partners if the general partnership becomes 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 important to note that general partners in an RLLP will **still remain jointly and severally liable** for debts and obligations of the general partnership attributable to:

1. *Trade obligations; and*

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

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

Therefore, in order to insulate professionals from these trade and commercial obligations, the general partnership should consider converting to an LLC. As discussed in Section V(E) above, members of an LLC will not have personal liability for commercial obligations of the

LLC as long as the LLC members do not assume or guarantee these trade and commercial obligations.

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."

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

As we will discuss in much detail throughout the remainder of our discussion today, 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. *State Franchise Taxes*

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. 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.

### C. 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.

## D. Operational Structure.

Unlike the case with other business enterprises, S corporations are limited 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. Employment 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 Social Security and Medicare (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 Social Security tax at the rate of 12.4% on the first $106,800 of wages paid during the 2009 tax year (6.2% on both the employer and employee). Also, the hospital insurance (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.

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

***2. C Corporations***. In contrast, where a C corporation is involved, self-employment 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 self-employment 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. **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 owners 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 usually is realized either to the distributing LLC or to the distributee-member upon the distribution of appreciated assets in-kind.

## *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

| 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%. In contrast, for individuals, the maximum tax rate for 2009 is 35%. However, 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 35% marginal tax rate only applies for taxable incomes above $372,950.

***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 15% 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. <u>The C Corporation "Double-Tax"</u>.

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, currently at a 15% federal tax rate.

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. <u>In-Kind Distributions of Appreciated Assets</u>.

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

> ***1.*** ***<u>In-Kind Distributions of Assets to Redeem Shareholder Stock</u>***. 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.*** ***<u>Corporate Dissolution</u>***. 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.*** ***<u>Distribution of Life Insurance Policies for Estate Planning Purposes</u>***. 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 which 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 a low as seven and one-half percent (7.5%).

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* <u>*after*</u> *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.

## 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.

## *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 of an S corporation will never be subject to double taxation, unless you have an S corporation that used to be a C Corporation.

### 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. <u>Employment Tax Issues</u>.**

S corporation earnings are generally not subject to payroll or self employment tax, assuming that the S corporation shareholder-employees are also receiving reasonable compensation for their services. This feature will allow 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. <u>Limitations on S Corporation Qualification</u>.**

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

> **(i)** S corporations are limited to 75 shareholders, I.R.C. Section 1361(b)(1)(A);
>
> **(ii)** LLCs, partnerships and some 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 less than 100% of the stock of another S corporation, I.R.C. Section 1361(b)(2)(A).

**F. <u>One Class of Stock Rules</u>.**

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 which 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.

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 weary 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. <u>No Limitations on Capital Structure</u>.**

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

1. *have an unlimited number of owners;*

2. *have nonresident aliens as members; and*

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

**F. <u>No One Class of Stock Rules</u>.**

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. <u>Franchise Tax Issues</u>.**

Currently, LLCs do not pay North Carolina franchise tax (instead the LLC must pay a $200 filing fee with its annual payment).

**H. <u>Employment Taxes on LLC Income</u>.**

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. 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. 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 previously 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 (2009 - $106,800), 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.

> **Example 1**. A and B each own 50% of a successful business which 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 which 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 which 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) Employment Tax Disadvantages of Sole Proprietorships.** 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.)

***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. However, as discussed in Section VI above, these general partners will still be jointly and severally liable for trade and commercial obligations of the professional general partnership.

In addition, 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.

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

**(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-competition fees.

Therefore, in most cases there will be very little if any taxable income retained in the business enterprise which 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 which may be provided by C corporations.

### *5. **C Corporations: May Be 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, many professional corporations will be 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.

## 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.

***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; and

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

**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 principles.

***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.

**(i) Potential C Corporation Double Tax.** First, whenever operating entities are structured as C corporations, the potential for the C corporation double tax must be considered. 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 manufacturing 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.

**(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 which 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.

**(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.

As discussed in Section IV(D)(6) above, the application of the LLC laws are relatively unknown and unfamiliar for many third parties.

**(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 $20 filing fees with each annual report. LLCs, however, must submit a $200 filing 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 manger-managed LLC and members of a member-managed LLC usually must pay self-employment tax on **all** LLC income.

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 CPA must play an active and ongoing role in advising the client on the choice of entity selection process.

Furthermore, the CPA 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.