

CHOOSING BUSINESS ENTITY: TAX CONSIDERATIONS

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FOUR DIFFERENT TAX ENTITIES

This outline discusses many of the various tax consequences of several different business entities. Every form of entity has its own advantages and disadvantages with respect to the tax consequences. This outline will address many of the different tax consequences in general terms. However, it is not intended to discuss all of the possible tax consequences.

This outline discusses the following four different tax entities: Sole Proprietorship/Disregarded Entity LLC, Partnership/Partnership LLC, S Corporation, C Corporation. After the issuance of the “check the box” regulations, a limited liability company may be treated as either one of these four types of entities for tax purposes. Because of this flexibility of a limited liability company, it is generally the preferred business entity.

1. Sole Proprietorship/Disregarded Entity LLC

For tax purposes, a sole proprietorship is a “non-entity.” If an individual operates a business as a sole proprietorship, no separate taxable entity is formed. The operations of the entity are reported by the individual on his or her individual tax return.

Under the “check the box” regulations, a single member LLC is treated as a “disregarded entity” for tax purposes if an election is not made to treat the LLC as a corporation.

2. Partnership/Partnership LLC

A partnership for tax purposes can consist of various legal entities such as a general partnership, a limited partnership, a registered limited liability partnership and a limited liability company with two or more members which does not elect to be taxed as a corporation.

3. S Corporation

An S Corporation is generally a corporation which elects to be taxed as an S Corporation under Section 1361 of the Internal Revenue Code (the “Code”). Under this section, an S Corporation must be a domestic corporation that meets four basic requirements: it must have 75 or fewer shareholders; all shareholders must be individuals or certain estates or trusts; no shareholder can be a nonresident alien; and it must have only one class of stock. Additionally, a limited liability company which elects to be treated as a corporation can subsequently make an S election to be treated as an S Corporation. See Private Letter Ruling 199942017.

4. C Corporation

A C Corporation is a regular corporation formed under a state’s corporate laws which does not make a Subchapter S Election. Additionally, a C Corporation may consist of a limited liability company which elects to be taxed as a corporation. The tax issues in this outline will address taxable C Corporations and not tax-exempt entities.

TAX ISSUES UPON FORMATION

1. Number of Owners

Sole Proprietorship - A sole proprietorship is an investment or business venture involving only one investor.

Partnership - A partnership requires two or more persons to carry on a business. Code Section 761(a) provides that a partnership includes “a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on.”

S Corporation - An S Corporation may have up to 75 shareholders. A husband and wife will count as one shareholder under Code Section 1361(c)(1).

C Corporation - There is no limitation on minimum or maximum number of shareholders for a C Corporation.

2. Election

Sole Proprietorship - No election is required to operate a business as a sole proprietorship. In a true sole proprietorship, an individual merely carries on a business in his or her individual capacity. With respect to a disregarded entity LLC, the default classification for a single member LLC is the disregarded entity.

Partnership - No election is required for the tax classification of a partnership. If the business is carried on by two or more individuals in an unincorporated form, then a partnership exists as defined in Code Section 761(a). With respect to an LLC, the default classification for a multi-member LLC is a partnership.

S Corporation - A corporation is required to make a Subchapter S election to be taxed as an S Corporation. Code Section 1362 requires that the corporation and all of its shareholders make the election on or before the 15th day of the third month of the taxable year for which the election is to be effective.

C Corporation - No election is required to be a C Corporation. Any corporation that does not make an S election is taxed as a regular C Corporation.

3. Types of Owners

Sole Proprietorship - By definition, a sole proprietorship must have an individual as the owner.

Partnership - There is no limitation on the types of owners for partnerships. Owners may consist of individuals or other legal entities.

S Corporation - As a general rule, all shareholders of S Corporations must be individuals. There are, however, exceptions for certain trusts, estates, and Qualified Subchapter S Subsidiaries. For example, a Qualified Subchapter S Trust is a common S Corporation shareholder but it must meet certain strict requirements to qualify as a shareholder.

C Corporation - There are no restrictions on the types of owners for C Corporations.

Owners may consist of individuals or other legal entities.

4. Contribution of Property

Sole Proprietorship - There is no tax event upon the contribution of property to a sole proprietorship because the proprietorship is operated by an individual in his or her name so there is no transfer of assets involved. This is also true for contributions to a disregarded entity LLC because for tax purposes the separate legal existence of the LLC is disregarded.

Partnership - Generally, a contribution by a partner to a partnership is not taxable under Code Section 721 and no gain or loss is recognized upon the contribution of property to the partnership. However, there are exceptions from this non-recognition rule for certain disguised sales under Code Sections 707 and 737. Additionally, if the partnership would be treated as an investment company within the meaning of Code Section 351, then gain might be realized under Code section 721(b). Also, Code Section 704(c) requires an allocation to the contributing partner of any pre-contribution built-in gain.

The partnership's basis in the assets contributed will be a carryover basis of the partner increased by any gain recognized under Code Section 721(b). Code Section 723.

S Corporation - A contribution by a shareholder to an S corporation in exchange for stock will be taxable unless the transferor or group of transferors transfer sufficient property to receive 80% control under the test established in Code Section 351. However, even if Section 351 applies, and it is possible that some gain could be recognized under Code Section 357(c) for debt relief.

Under Code Section 362, the corporation's basis in assets contributed to it will be a carryover basis increased by any gain recognized by the shareholder.

C Corporation - A contribution by a shareholder to a corporation in exchange for stock will be taxable unless the transferor or group of transferors transfer sufficient property to receive 80% control under the test established in Code Section 351. However, even if Section 351 applies, and it is possible that some gain could be recognized under Code Section 357(c) for debt relief.

Under Code Section 362, the corporation's basis in assets contributed to it will be a carryover basis increased by any gain recognized by the shareholder.

TAX ISSUES ARISING DURING OPERATIONS

1. Tax Year

Sole proprietorship - The tax year for a sole proprietorship is the calendar year since that is the year which must be used by an individual.

Partnership - Code Section 706(b) requires that a partnership adopt the same taxable year as a majority of its owners unless the partnership can establish to the satisfaction of the secretary a business purpose of a different taxable year.

S Corporation - Under Code Section 1378, an S Corporation must use a calendar year unless it can establish a business purpose for a different taxable year.

C Corporation - There is no limitation on the taxable year for a C Corporation (except for personal service corporations).

2. Who Pays Tax and Rates

Sole Proprietorship - The individual operating a sole proprietorship or a disregarded entity LLC reports all of the income and losses from the operations of the business on his or her individual tax return. The income will be taxed at the individual rates which currently range from 15% to 39.6%.

Partnership - A partnership is a pass-through entity and does not pay tax at the partnership level. The tax on the income from the partnership is paid by the partners at their respective tax rates.

S Corporation - Generally, an S Corporation does not pay tax at the corporate level. The tax on the S Corporation's income is paid by the shareholders at their respective rates. However, if an S Corporation had previously been a regular C Corporation, then it is possible that the S Corporation would have some built in gains tax liability at the corporate level. See Code Section 1374.

C Corporation - A C Corporation is a separate taxable entity which pays tax on all of its income at the corporate level. The tax rates for a C Corporation range from 15% to

35%. Additionally, any taxable distributions received by the shareholders will be taxed to them in some manner. Therefore, a C Corporation will generally result in double taxation.

3. Reporting Requirements

Sole Proprietorship - All of the operations of a sole proprietorship are reported by the individual on his or her individual income tax return, generally on Form 1040, Schedule C.

Partnership - A partnership files an information return, Form 1065, to report the income and deductions for the partnership as a whole. Each partner's respective share of the income and deductions are reported to the partners on Form K-1.

S Corporation - An S Corporation files an information return, Form 1120S, to report its income and deductions and possibly pay any built-in gains tax. Each S Corporation shareholder receives a K-1 with his or her respective share of the income.

C Corporation - A C Corporation files its own income tax return as a separate taxable entity on Form 1120.

4. Special Allocations of Income/Deductions

Sole Proprietorship - No special allocations are involved for a sole proprietorship because there is only one individual.

Partnership - Special allocations of income and deductions are allowed in a partnership to the extent they comply with the substantial economic effect rules of Code Section 704 and the regulations thereunder. In fact, some special allocations are required such as the Code Section 704(c) special allocation of a built-in gain to a contributing partner.

S Corporation - Special allocations are not allowed for an S Corporation because to do so might create more than one class of stock which would terminate the corporation's status as an S Corporation.

C Corporation - There are no special allocations of income and deductions in C Corporations because the corporation is a separate taxable entity that pays tax on its own

income and deductions. However, C Corporations may have different classes of stock with different dividend and other rights.

5. Net Operating Losses

Sole Proprietorship - Losses of a sole proprietorship are taken by the individual and there is generally no limitation on the deductibility of the losses.

Partnership - The losses of a partnership flow through to the partners and each partner may deduct his or her allocable share of the losses to the extent of his or her tax basis. For purposes of computing a partner's tax basis, the basis will generally include a partner's allocable share of the partnership's debt.

S Corporation - The losses of an S Corporation flow through to the shareholders. A shareholder may deduct the losses to the extent of his or her adjusted basis in the stock plus the adjusted basis of any indebtedness of the corporation to the shareholder. See Code Section 1366(d). However, unlike the partnership, an owner's adjusted basis in the stock does not include his or her share of the corporation's debt.

C Corporation - Owners are not entitled to deduct any of the entity's losses. All of the losses must stay within the C Corporation since it is a separate taxable entity.

6. Distributions to Owner

a. Cash

Sole Proprietorship - Because a sole proprietorship is not a separate taxable entity, an individual may receive distributions of cash from the "business" without any tax consequences.

Partnership - A distribution of cash from a partnership is generally non-taxable to the extent of the partner's basis. Any distribution in excess of a partner's basis is treated as a sale of the partner's interest in the partnership. For the purposes of the distribution rules, marketable securities are considered cash. See Code Section 731.

S Corporation - Generally, distributions from an S Corporation are non-taxable to the extent of the shareholder's tax basis and then any excess distributions are treated as a sale of the shareholder's interest. However, if the corporation had a history as a C Corporation, then a greater portion of the distribution could be taxable. See Code Section 1368.

C Corporation - Distributions of cash to shareholders are taxable as dividends to the extent of the corporation's earnings and profits, then non-taxable to the extent of the shareholder's basis in the stock and finally, treated as the sale of the shareholder's interest. See Code Section 301.

b. Property

Sole Proprietorship - There is no tax consequence if a sole proprietor received property from his "business" because the sole proprietor is the owner and there is no separate taxable entity.

Partnership - A distribution of property to a partner is generally non-taxable and the partner will take a carryover basis from the partnership in any property distributed to the extent the partner has sufficient basis of his or her own. Additionally, a distribution of property is generally non-taxable for the partnership under Code Section 731.

S Corporation - A distribution of property to an S Corporation shareholder is generally non-taxable to the extent of the owner's basis and any remaining amount is treated as a capital gain from the sale of the interest. The corporation will have to recognize any gain on a distribution of appreciated property and that gain would be taxed to the shareholder. As with the cash distribution, special rules may apply if the corporation has E&P from prior C Corporation years.

C Corporation - A distribution of property by a corporation is taxed the same as a distribution of cash and will be treated as a dividend to the extent of earnings and profits based upon the fair market value of the property, then as a reduction in basis, and finally as a taxable gain on the sale of the interest. The corporation must recognize gain (but not loss) on the distribution of any property to a shareholder. See Code Section 311(b).

7. Louisiana Tax Issues

Sole Proprietorship - A sole proprietorship is taxed for state law purposes in the

same manner as a sole proprietorship for federal law purposes. This includes the disregarded entity LLC because La. R.S. 12:1368 currently provides that for state income tax purposes, a limited liability company shall be treated and taxed in the same manner that it is treated and taxed for federal income purposes.

Partnership - Louisiana does not tax partnerships under current law. The partners are taxed under their respective taxing regimes.

S Corporation - Louisiana recognizes S Corporations for state income tax purposes. However, a corporation in Louisiana is subject to a franchise tax. Under current law, a limited liability company is not subject to franchise tax. Therefore, a true S Corporation would be subject to franchise tax while an S LLC would not.

C Corporation - Louisiana taxes C Corporations as separate taxable entities for income tax purposes. Additionally, Louisiana imposes a franchise tax on C Corporations. However, as stated above, the franchise tax does not apply to LLC's.

COMPENSATION ISSUES AND FRINGE BENEFITS

1. Reasonable Compensation

Sole Proprietorship - Generally, reasonable compensation is not an issue for a sole proprietor in a sole proprietorship. However, if the owner hires a family member, then, of course reasonable compensation could be an issue if that family member is overpaid.

Partnership - In the partnership context, the IRS does not normally challenge the payment of compensation as being unreasonable. This is generally because if compensation is not deductible by the partnership, then the excess is still taxable to the partners due to the flow through nature of the partnership. However, unreasonable compensation to a non-owner family member or other individual could be an issue.

S Corporation - As with a partnership, unreasonable compensation is rarely an issue with an S Corporation. However, as is mentioned below, it is possible that compensation could be challenged as unreasonable (too low) for purposes of the self-employment tax issues discussed below. See Revenue Ruling 74-44.

C Corporation - Because a C Corporation is a separate taxable entity, this is generally the only area where unreasonable compensation will arise. It is common for C Corporation owners to attempt to avoid double taxation at the corporate and individual level by paying out as much of the profits from the business as possible in the form of compensation. To the extent the compensation is reasonable, it is deductible by the corporation which in effect eliminates the corporate level of tax on this income.

2. Accident and Health Plans

Sole Proprietorship - Code Section 105 provides that gross income does not include amounts paid to an employee to reimburse the person for expenses incurred for medical care. However, for purposes of the section, a self-employed individual is not considered to be an employee for purposes of this provision. See Section 105(g). Therefore, a sole proprietor would not be entitled to any deduction for payments on his or her own behalf to some type of health plan. Nevertheless, self-employed individuals are allowed a deduction for a percentage of the amount paid for medical insurance. Currently, self-employed individuals are allowed a deduction for 60 percent. Code Section 162(l). This percentage is being phased up to 100% by the year 2003.

Partnership - Partners, as self-employed individuals, are subject to the same limitations on the deduction of health insurance as the sole proprietor. Therefore, the deduction for partners is limited to the percentage limitation mentioned above. See Revenue Ruling 91-26 which discusses the Code Section 106 exclusion for health insurance premiums and holds that a partner is not eligible for this exclusion either.

S Corporation - A more than two percent shareholder in an S Corporation is treated as a partner for fringe benefit purposes under code Section 1372(a). Therefore, a more than two percent shareholder would be subject to the same limitations as sole proprietors and partners.

C Corporation - All of the employees, including owner-employees, of a C Corporation are treated as true employees for fringe benefit purposes. Therefore, owner-employees of a C Corporation could take advantage of a corporate health plan.

3. Cafeteria Plans

A cafeteria plan allows a participant to choose among different benefits offered under the terms of the plan. The cafeteria plan must be a written plan in which all of the participants are employees and in which the participants may choose among two or more benefits consisting of cash and certain qualified benefits. The key requirement is that all of the participants in the cafeteria plan must be “employees.”

Sole Proprietorship - A sole proprietor is not considered an employee for purposes of the cafeteria plan rules. Therefore, a sole proprietor cannot be a participant in a cafeteria plan created for that individual's employees.

Partnership - As with the sole proprietor, a partner in a partnership cannot be a participant since a partner is not considered an employee.

S Corporation - As mentioned above, a more than two percent shareholder in an S Corporation is treated as a partner for fringe benefit purposes and as such could not be a participant in a cafeteria plan.

C Corporation - As with the health plans discussed above, an owner-employee of a C Corporation is an employee for all purposes and therefore could be a participant in a cafeteria plan. However, the income exclusion from the cafeteria plan does not include any benefit received by a highly compensated participant if the plan discriminates in favor of highly compensated individuals. See Code Section 125(b)(1).

4. Employment Taxes

Sole Proprietorship - As with all employers, a sole proprietor is required to withhold the proper income tax withholding and employment taxes from each employee's paycheck. However, with respect to the owner, the owner is not considered an employee of himself. The owner, as a self-employed individual, must pay self-employment taxes for his or her earnings.

Partnership - As with the sole proprietor, most partners are considered self-employed individuals and are required to pay self-employment taxes on their share of the partnership income. However, limited partners are not treated as self-employed individuals and they do not owe self-employment taxes on their share of income unless the income is received as some type of guaranteed payment such as salary. With respect to members of an LLC in which there is no category such as general or limited partners, the IRS has issued

proposed regulations to determine when a member of an LLC will be considered a limited partner. Under the proposed regulations, a member of an LLC will be treated as a limited partner unless the individual has personal liability for the debts or the LLC has authority to contract on behalf of the LLC or participates in the LLC's trade or business for more than 500 hours during the taxable year.

S Corporation - An owner and employee of an S Corporation is treated as a regular employee to the extent the owner receives salary from the S Corporation. Any additional income flowing from the S Corporation to the owner would not be considered earnings from self-employment. Therefore, it is common for S Corporations to characterize a minimal amount of the S Corporation earnings as salary in an attempt to minimize the employment tax burden. The S Corporation earnings in excess of the salary is not subject to FICA or self-employment taxes. This is one of the main reasons why some advisors recommend the use of an S Corporation as opposed to a partnership or LLC.

C Corporation - All employees of a C Corporation, including the owners, are considered employees for employment tax purposes. Therefore, all salary paid to the owners would be subject to the normal employment tax rules. Any additional distributions to the owners would be taxed under the distribution rules discussed above, i.e. dividends.

TAX CONSEQUENCES UPON DISPOSITION OF INTEREST

1. Redemption by Entity

Sole Proprietorship - In a sole proprietorship, there is no “entity” to redeem any interest. The sole proprietor is the owner of the entire business. Therefore, redemption is not an option for a sole proprietor.

Partnership - When a partner's interest is redeemed by the partnership in complete termination of his or her interest, the payments received by the partner are divided into two categories under Code Section 736: “Section 736(a) payments” and “Section 736(b) payments.” The Section 736(b) payments are the payments made in exchange for the partner’s interest in partnership property. All other payments are Section 736(a) payments.

The Section 736(b) payments are taxed to the partner as distributions under the rules discussed above. As discussed above, generally no gain is recognized unless the partner receives money in excess of the partner's basis or in the event the partner receives a large

portion of “hot assets” as defined in section 751. Also, no loss is generally recognized upon the termination of the partner's interest unless the only property received by the partner is money and the amount of money received is less than the partner's basis in the partnership. The Section 736(a) payments are taxed as either distributive shares of income or guaranteed payments depending upon whether or not such payments are determined with regard to the income of the partnership.

When a partner disposes of only a portion of his or her interest, then the general distribution rules apply.

When a partner's entire interest is terminated, the income for the year may be allocated among the partners under one of two methods: the interim closing of the books method or the pro rata method. When a partner merely disposes of a portion of his or her interest, then the partners' varying interests during the year shall be used in allocating the income among them.

S Corporation - Generally, when a corporation distributes money or property to its shareholders, then Code Section 301 categorizes the distribution as a dividend to the extent of earnings and profits (E&P), then as a recovery of basis and finally as gain from the sale or exchange of property. However, certain corporate redemption transactions are excluded from this rule when the distribution occurs in one of the transactions enumerated in Code Section 302.

If an S Corporation shareholder transfers his or her stock to the corporation in a redemption described in Code Section 302(b), then the transfer is treated as a sale or exchange of the stock and not as a distribution under Code Section 301. If an S Corporation shareholder transfers his or her stock to the corporation in a transaction that does not qualify as a redemption described in Code Section 302(b), then special categorization rules apply under Code Section 1368. Under these rules, the distribution is not included in income to the extent that it does not exceed the shareholder's adjusted basis for the stock. The amount of the distribution which exceeds the adjusted basis is treated as gain from the sale or exchange of property. However, if the corporation has C Corporation E&P, then the shareholder could have to recognize some ordinary income under different special ordering rules for S Corporations with E&P.

C Corporation - As mentioned above, when a shareholder in a C Corporation redeems his or her stock to the company, the transaction will be treated as an exchange of property, not a dividend, if the transaction meets the redemption provisions of Code Section

302. If the transaction results in a complete termination of the shareholder's interest and there is no family attribution, then exchange treatment would be given and the transaction would be treated as a capital gains transaction.

If the redemption does not qualify as a Code Section 302 redemption, then under Code Section 301, the distribution would be treated as a dividend to the extent of E&P, then as a recovery of basis and finally as gain from the sale or exchange of property.

2. Sale to Other Owners or Third Parties.

Sole Proprietorship - A sole proprietor is the sole owner of the business and all of the assets so when a sole proprietor sells the “business” to another individual or entity, it is treated as though the sole proprietor sold each and every asset of the business. Therefore, the tax categorization of the sale of the entire business will have to be evaluated on an asset-by-asset basis.

Partnership - A partner may sell his or her interest in the partnership to a third party and the sale will be treated as a sale of a capital asset under Code Section 741, except to the extent that Code Section 751 applies for unrealized receivables and substantially appreciated inventory.

When a partner sells his or her entire interest in the partnership, then as to that partner, the partnership year closes for purposes of determining his income for that year under Code Section 706(c)(2)(A). This rule only affects the partner, not the partnership. However, certain sales can result in a termination of the partnership. If the sale results in the reduction of the number of partners to one (i.e. the partnership is a two person partnership and the sale is to the other partner), then the partnership will terminate because the business is no longer carried on by two or more partners. Furthermore, if 50% or more of the total interest in partnership capital and profits is sold or exchanged within a twelve month period, then the partnership is terminated for income tax purposes.

An LLC can result in a good compromise in structuring a sale of a business. For example, in Revenue Ruling 99-6, the IRS ruled that when a member in a two member LLC sells his interest to the other member or two members sell all of their interests to one individual, the transaction is treated as a capital transaction for the purposes of the selling member but for purposes of the buying member, it is treated as though the LLC had liquidated distributed the assets to the selling member and that the buying member then purchased the assets. This has the benefit of giving the purchasing member an increased

basis in the assets purchased. The LLC would then continue as a “disregarded entity.”

If the partnership has made an election to adjust the basis of its assets under Code Section 754, then Code Section 743 would require an adjustment to the basis of the assets of the partnership to the extent allocable to the purchased interest.

S Corporation - The sale of an S Corporation shareholder’s stock to another individual is simply treated as the sale of the stock and taxed accordingly. Generally, an S Corporation will have certain restrictions on the transfer of stock to ineligible shareholders to avoid disqualifying the corporation as an S Corporation. Absent such restrictions, the sale or transfer of the stock to an ineligible shareholder could result in termination of S status. The income for the year is allocated to the shareholders on a prorata basis over the entire year unless an election is made to close the books. The sale of the stock in the corporation has no effect upon the specific assets of the corporation.

C Corporation - C Corporation shareholders are generally free to transfer their stock to whomever they choose. Any such sale is treated as the sale or exchange of a capital asset. There is no tax impact on the corporation.

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