



Dbriefs U presents:

The Art and Science of Entity Choices

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Agenda

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Entity choice considerations

Business entity choices

Examples

Poll question

When setting up a new business enterprise, which of the following questions should all business owners consider?

- Who will be the other owners of the business?
- What type of legal documents must be filed to establish the business for state law purposes?
- What are the tax implications of selling the business (i.e., exit strategies)?
- All of the above

Poll answer

When setting up a new business enterprise, which of the following questions should all business owners consider?

- Who will be the other owners of the business?
- What type of legal documents must be filed to establish the business for state law purposes?
- What are the tax implications of selling the business (i.e., exit strategies)?
- **All of the above**

Some legal entities do not allow specific types of owners. Drafting the legal documents for a new business can be costly. Some entities require more work than others. Exit consequences are a tax consideration with all entity choices. The impact to the owners' overall taxable income can vary greatly upon exiting each type of entity.

However beautiful the strategy,
you should occasionally look
at the results.

— Winston Churchill

Entity choice — Non-tax considerations

- Who owns the business?
- Who bears the liability for business debts?
- What legal form and documentation are required?
- What happens if the owner dies or leaves the business?
- Am I concerned with transferring ownership?
- Where will start-up capital and additional capital needs be obtained?
- Is it easy to convert to another type of entity?
- What is the anticipated exit strategy?

Entity choice — Tax considerations

- How and where are business profits taxed?
- What restrictions exist for the type of entity chosen?
- Is the tax status automatic?
- If the business generates losses, how and when can they be utilized?
- Are tax-deductible fringe benefits available to owners that work in the business?
- When I sell or transfer my business, how will it be taxed?

Business entity choices

Some basic business entities:

- Sole Proprietorship
- Limited Partnership
- Limited Liability Company (LLC)
- C Corporation
- S Corporation

Sole proprietorship

- Advantages
 - Ease of formation
 - Tax efficient structure
- Disadvantages
 - Unlimited personal liability
 - Inability to easily raise large amounts of capital
- Other considerations
 - Only one owner
 - Dissolves automatically on owner's death
 - Freely transferable
 - Minimal amount of legal paperwork

Limited partnership

- Advantages
 - Ease of formation
 - Only general partners are personally liable for business debts
 - Can obtain investment capital from limited partners
- Disadvantages
 - Management restrictions on limited partner
- Other considerations
 - Liability issues
 - Minimum one general partner and one limited partner
 - Dissolves automatically on an owner's death unless stated otherwise in the partnership agreement
 - Start-up filing required; partnership agreement recommended
 - May change to a corporation or LLC generally tax-free

Limited partnership — Tax specifics

- Single level of tax
- Partners may generally utilize business losses to offset income from other sources
 - Must be “at-risk”
 - Must have sufficient tax basis to deduct losses
 - Active vs. passive investment
- Partners and employees may setup IRA or Keogh retirement plans
- Deduction for fringe benefits is limited
- When business is sold, taxed at individual level

Limited liability company (LLC)

- Advantages
 - No personal liability for members
 - No strict ownership requirements
 - Flow through tax treatment
 - Flexibility for multiple classes of units
- Disadvantages
 - Not all states respect single member LLCs
- Other considerations
 - Some legal formality
 - Flexible regarding how business is treated upon an owners' death
 - May elect corporate tax treatment generally tax free

Limited liability company (LLC) — Tax specifics

- Single level of taxation unless treated as a corporation
- Members may generally utilize business losses to offset income from other sources
 - Must be “at-risk”
 - Must have sufficient tax basis to deduct losses
 - Active in business vs. passive investment
- Fringe benefits treatment will vary based on tax status
- When business is sold, taxed at individual level, unless treated as a corporation

Poll question

Which of the following is **not** an advantage of forming an LLC:

- Members are not personally liable for business debts
- May change to general or limited partnership or corporation
- Business profits are taxed at one corporate rate

Poll answer

Which of the following is **not** an advantage of forming an LLC:

- Members are not personally liable for business debts.
- May change to general or limited partnership or corporation
- **Business profits are taxed at one corporate rate**

Business profits are taxed at the applicable tax rate of the members unless the LLC files IRS Form 8832 and elects corporate taxation. If corporate taxation is elected then the business profits are subject to double taxation once at the corporate rates and then again at the tax rates of the shareholders.

C Corporation

- Advantages:
 - No personal liability for shareholders
 - Ability to raise large amounts of capital
- Disadvantages:
 - Double taxation (tax on profits and on dividend distributions)
 - More complex formation requirements
- Other considerations
 - Legal formality
 - No effect to the entity on an owner's death
 - Transfer of stock may be limited
 - May change to a S corporation generally tax-free

C Corporation — Tax specifics

- Double level of taxation
 - Profits are taxed at corporate level
 - Dividends are taxed at shareholder level
 - When business is sold, two layers of tax as well
- Business loss deductible by corporation to the extent of income
 - Shareholders cannot deduct excess losses against other taxable earnings
- Full deductibility
 - Fringe benefits
 - Medical insurance premiums and
 - Reimbursed employee medical expenses

S Corporation

- Advantages:
 - Limited liability
 - Tax efficient structure – Generally, single layer of tax
- Disadvantages:
 - Strict requirements regarding number and type of shareholders, amount of passive income, and equity arrangements
- Other considerations
 - Legal formality
 - Transfer of stock may be limited to qualified shareholders
 - Cannot issue different economic classes of stock

S Corporation — Tax specifics

- Single level of taxation at individual level
- Shareholders may generally utilize business losses to offset other income
 - Must be “at-risk”
 - Must have sufficient tax basis to deduct losses
 - Active vs. passive investment
- Other considerations: Built-in gain tax, LIFO recapture, and excessive passive income tax
- When business is sold, normally taxed at individual level

Partnerships/LLCs vs. corporations

	Partnerships	LLCs	Corporations
Legal Characteristics	<ul style="list-style-type: none"> •Unincorporated entity created by a contractual agreement between two or more business associates •Partners can be individuals, corporations, other partnerships, LLCs, trusts, or estates •Legal entity that can hold title to assets and incur debt 	<ul style="list-style-type: none"> •Unincorporated entity formed under the laws of one of the 50 states or District of Columbia •Partners can be individuals, corporations, partnerships, other LLCs, trusts, or estates •Legal entity that can hold title to assets and incur debt 	<ul style="list-style-type: none"> •Generally treated as an entity apart from its owners for purposes of legal liability
Limited Liability	<ul style="list-style-type: none"> •Partners in a general partnership have unlimited personal liability for recourse debts incurred by the partnership •Partners in a limited partnership are liable only to the extent of his or her investment in the partnership plus any additional amounts he or she is obligated to contribute pursuant to the partnership agreement 	<ul style="list-style-type: none"> •Members in a LLC have limited liability and are not personally liable to repay any portion of any debt incurred by the LLC 	<ul style="list-style-type: none"> •Shareholders of a corporation are not personally liable to repay any portion of any debt incurred by the corporation
Taxation of Operations	<ul style="list-style-type: none"> •Taxable income flows through and is taxed to the partners •Single level of tax •Taxable income is measured and characterized at the entity level, but tax consequences are determined at the owner level 	<ul style="list-style-type: none"> •Same as partnerships 	<ul style="list-style-type: none"> •Corporations are taxed on their earnings •Shareholders are taxed on distributions received from the corporation •Two levels of tax

Partnerships/LLCs vs. corporations

	Partnerships	LLCs	Corporations
Accounting Periods	<ul style="list-style-type: none"> •Taxable year generally determined by the taxable year of the majority interest holder •If no majority interest holder, then taxable year is determined by the taxable year of the principal partners •If no principal partners, taxable year is the one that results in the least aggregate deferral 	<ul style="list-style-type: none"> •Same as partnerships 	<ul style="list-style-type: none"> •Generally can adopt any accounting period •Calendar year or fiscal year
Accounting Methods	<ul style="list-style-type: none"> •Permissible methods include cash, accrual, or hybrid method •Generally cannot use cash method if it has C corporations as partners 	<ul style="list-style-type: none"> •Same as partnerships 	<ul style="list-style-type: none"> •Generally must use the accrual method •Exceptions for those who are engaged in farming business, have gross receipts less than \$5 million, and certain personal service corporations
Filing requirements and other information	<ul style="list-style-type: none"> •Form 1065 •Schedules K-1 for partners 	<ul style="list-style-type: none"> •Form 1065 •Schedules K-1 for members •May elect to be classified as an association taxable as a corporation 	<ul style="list-style-type: none"> •Form 1120

Poll question

Many businesses use a combination of entity types to satisfy their tax and non tax objectives.

- True
- False

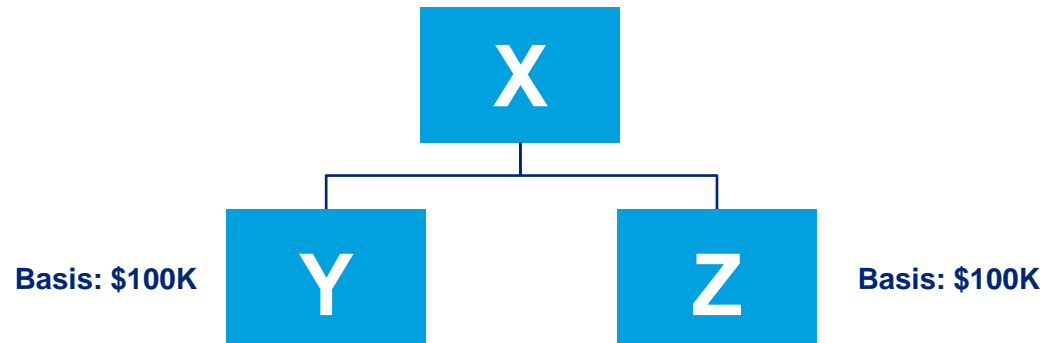
Poll answer

Many businesses use a combination of entity types to satisfy their tax and non tax objectives.

- **True**
- False

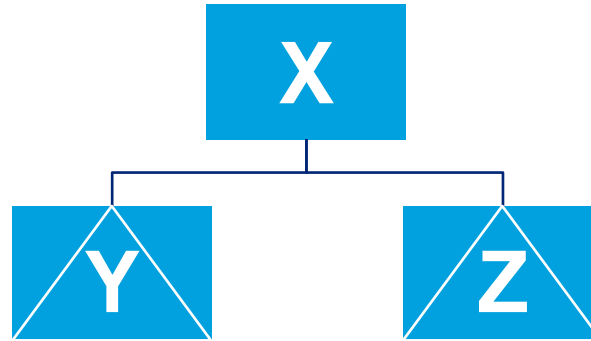
Many businesses today are becoming increasingly complicated with the formation and utilization of various entity types. Not only do large publicly held corporations utilize a mixture of entities but also closely held businesses. As a result, tax advisors today are expected to have significant technical breadth.

Example 1 — Before transaction



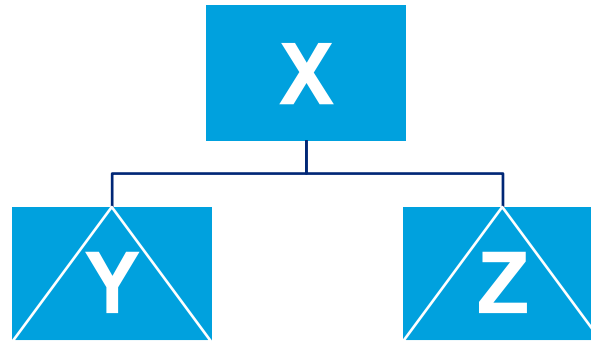
- Y and Z are currently 100% owned C Corporations
 - X files a separate company state tax return and has significant income
 - Y and Z have significant losses
- For operational and administrative reasons and to simplify structure, X would like to combine Y and Z
- Assume business purpose exists for restructuring (not a tax motivated transaction)

Example 1 — After transaction



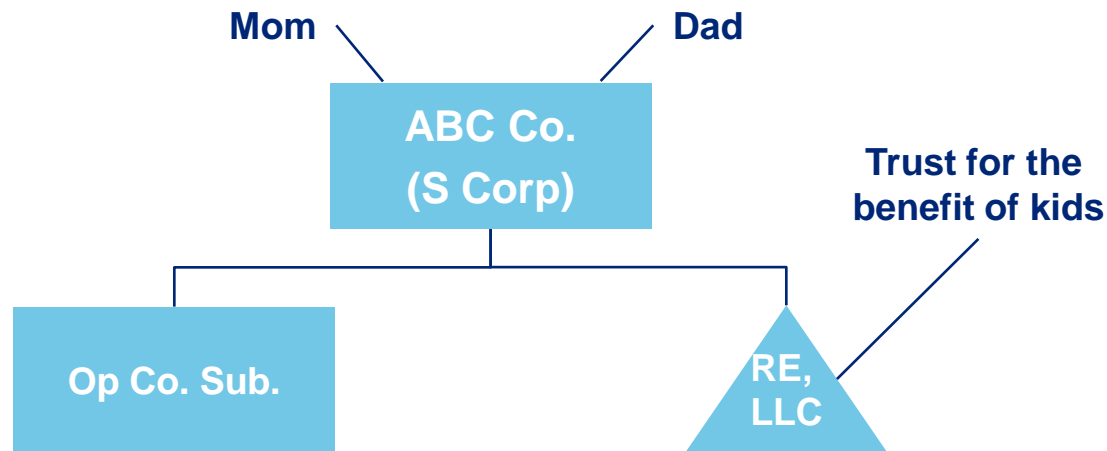
- A formal election is made to treat Y and Z as Single Member LLC (SMLLC)
 - Procedural requirement – File Form 8832 Entity Classification with the IRS
 - Y and Z are treated as divisions of X and their financial results are combined with X

Example 1 — After transaction (cont.)



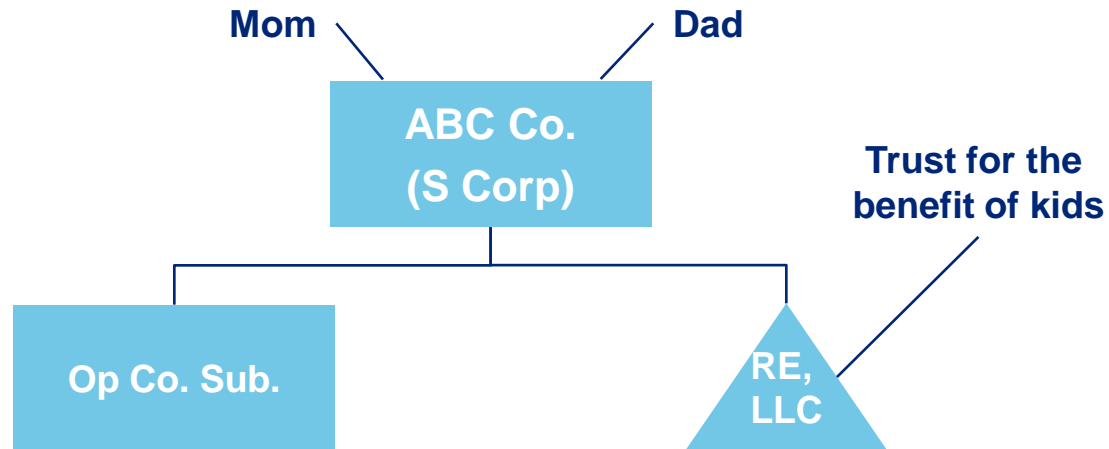
- Deemed tax-free liquidation (IRC §332)
 - Negative: X's basis in Y and Z is eliminated since Y and Z are now treated as divisions of X
 - Positive: Y and Z attributes will carryover to X (i.e., losses of Y and Z can be used to decrease state taxable income of X)

Example 2 — Closely held business



ABC Co., an S corporation, is a manufacturing company. As part of its operations, it also owns RE LLC, an entity which manages and rents the manufacturing plant to ABC Co. All of the manufacturing operations are maintained in a wholly owned subsidiary, Op Co. Sub.

Example 2 — Closely held business (cont.)



What are the benefits of this structure?

- Tax
- Non-tax
- Legal
- Estate planning

The *art* and *science* of entity choices

- No perfect solution — every organization must analyze and weigh its wants and needs
- Strategic decisions must consider both tax and non tax issues
- Most businesses (both private and public) use a combination of legal entities in their organizational structure
- As a tax advisor, we must evaluate organizational structure on a regular basis to confirm that it continues to meet the current wants and needs of the business and its shareholders

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