

**CHOICE OF ENTITY STRATEGIES
FOR TOUGH TIMES**

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This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

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1. THE BOTTOM LINE

The primary choice of entity issue is protection from liability. Tax issues are of secondary importance. New tax laws could change this.

2. TYPES OF ENTITIES

In California, the alternative forms of business are:

- ⇒ a sole proprietorship
- ⇒ a general or limited partnership
- ⇒ a registered limited liability partnership (for accountants, architects and lawyers)
- ⇒ a limited liability company (including a single-member LLC or a series LLC organized under the laws of another state), or
- ⇒ a corporation (taxed as a C corporation or an S corporation).

Other states have series LLCs, business trusts and limited liability limited partnerships.

See *Exhibit A* on page 28.

3. IS A BUSINESS ENTITY NEEDED?

- 3.1 A corporation or LLC is useful when liability can be imposed without wrongful action by the business owner.

3.1(a) Employees, like anyone else, are liable for their own wrongful acts.

Employers are also liable for wrongful acts that employees commit in the course of their employment, even if the employee is violating company policy or specific instructions when the wrongful act occurs.

3.1(b) All general partners are liable for all other **general partners' promises and contracts** involving the partnership business and for the wrongful acts of all **partners and employees** of the partnership in the course of the partnership business.

- **Limited partners** in properly organized and operated limited partnerships risk only what they invest in the partnership business.

3.1(c) **Strict liability** applies even if no wrong has been done. Examples are:

- **Product liability**, which applies to everyone in the chain of distribution of a product that injures someone, and
- **Environmental liabilities**, which can apply to all owners (and some lessees) of a parcel of property over time, even if the spilling or dumping occurred before they bought it or was caused by a tenant.

3.2 Changes in federal and California tax laws in the 1980s greatly reduced the **tax benefits of incorporating**. Although federal tax rates increased after 1993 and decreased somewhat after 2001, for most businesses saving taxes is *not* an important reason to incorporate. New tax laws could change this.

3.3 Generally, the **primary reason to incorporate or to use an LLC** now is the desire for limited liability: the desire to protect the investors' personal assets and/or the assets of other businesses from

creditors of the business. Other factors to consider include the availability and sufficiency of insurance and the fact that the personal guarantees of the shareholder/members generally will be required by lending institutions and possibly others.

This is important:

An owner cannot limit his liability for *his own* negligence or his other wrongful acts.

Again: An owner cannot limit his liability for *his own* negligence or his other wrongful acts.

But he *can* limit his liability for the wrongful acts of his partners and employees and for other no-fault liabilities.

He can also consider the ease with which his creditors can take his assets after there is a judgment against him.

- 3.4 Other **non-tax reasons to incorporate or to use an LLC** in certain situations include the availability of (a) continuity in the event of death, (b) centralized management, and (c) different forms of investment participation for investors with different financial needs (examples: common stock, preferred stock, priority returns and debt).

Also, forming a business entity can

- ⇒ Minimize the **probate** court's role in operating the business and
- ⇒ Facilitate **lifetime transfers** of business interests in connection with a succession plan.

4. INITIAL LIABILITY ANALYSIS

4.1 See *Exhibit B* on page 29 for a **flowchart** that shows how you might select an appropriate entity.¹

4.2 The first question is: “What are the liabilities that could result from the operation of this business?”

⇒ An **insurance agent** who is familiar with the business can help the client identify possible sources of liability.

4.3 If the possible liabilities are not significant, the business may be conducted as a sole proprietorship or general partnership. (“Keep is simple.”)

4.4 If the possible liabilities are significant, can adequate insurance be obtained at reasonably affordable premiums?

⇒ If so, insurance should be obtained and the business may be conducted as a sole proprietorship or general partnership. (“Keep is simple.”)

4.5 If not, whose actions may generate the liabilities?

4.5(a) If all of the activities which may generate liabilities will be conducted by the sole principal, *there is no protection to be gained from incorporating* and the business should be conducted as a sole proprietorship (“Keep it simple.”), whether or not adequate insurance is available.

¹ A complete elimination of the individual federal income tax on **dividends** that represent previously taxed income, as proposed by President Bush on January 7, 2003, would make C corporations more attractive than S corporations or LLCs in many situations. That proposal was not enacted. Instead, a 15% tax rate on certain types of long-term capital gain was enacted. If the tax rate on dividends increases, C corporations will become less attractive in comparison to S corporations and LLCs.

4.5(b) If liability may be imposed on the sole proprietor without wrongful action on his or her part, the business should be conducted in a corporation or LLC.

5. TAX BENEFITS OF INCORPORATING

5.1 Because **lower federal income tax rates** currently apply to the first \$75,000 of taxable income of a C corporation, the owners might pay *less tax* in the *short term* by incorporating their profitable business.²

⇒ However, depending upon their future plans for the business, any short-term tax rate advantages of incorporating as a C corporation might be overcome by the **double tax** that will be incurred when the business assets are sold or distributed to the shareholders.

5.2 A C corporation does not have the many **restrictions** that apply to S corporations (for example, the one-class-of-stock rule and eligible shareholder rules).

⇒ So a C corporation can issue convertible preferred stock to a venture capital company.

⇒ And the C corporation can issue different classes of preferred in various rounds of financing.

5.3 Certain tax-free **fringe benefits** are available to the owners of the business only if they are employees of a C corporation.³

² Note that “personal service corporations” cannot take advantage of these low rates. The highest corporate tax rate applies to all of the taxable income of these corporations.

³ See Section 8.2(f) below.

Note: In some cases, a successful business operated in an LLC should consider organizing a C corporation to provide management services and fringe benefits to the owner-managers.

⇒ As a corporation, the management company could offer incentive stock options.

- 5.4 The use of a **fiscal year** (for example, a year ending on March 31) by a C corporation that is not a personal service corporation may accelerate corporate tax benefits and defer the owners' personal income taxes.
- 5.5 **Family partnerships** which lease real estate or equipment to the corporation or LLC may permit the owners to redirect income to children or grandchildren at their lower tax rates (subject to the "kiddie tax" rules).

6. **DISADVANTAGES OF USING A CORPORATION**

6.1 The primary disadvantage of using a corporation is the dreaded "**double tax.**" Cash or property that a C corporation distributes to its shareholders will be taxed twice.

6.1(a) A C corporation pays tax on its own taxable income.

6.1(b) No corporate deduction is allowed for distributions to shareholders.

6.1(c) Shareholders generally pay tax on corporate distributions to them from a C corporation. *For corporations and shareholders in the highest tax brackets, the effective tax rate on distributed income exceeds 54%!*

Note: With appropriate tax planning, double taxation for a closely-held C corporation rarely occurs -- until it sells its business assets and liquidates.

⇒ The double tax problem is particularly acute if the corporation has appreciated property such as real estate or goodwill. See Section 7 below.

6.2 Additional legal and accounting **expenses** are generally incurred when a sole proprietorship converts to a partnership, LLC or corporation.

⇒ Organizing an LLC or partnership with a written agreement is somewhat more expensive than organizing a corporation.

6.3 Modest additional **employment taxes** are generally incurred when a sole proprietor becomes an employee of a business entity.

6.4 Corporate **formalities** must be observed to achieve limited liability.⁴

7. **MINIMIZE THE DOUBLE TAX ON CORPORATE PROFITS WITH A LIMITED LIABILITY COMPANY**

7.1 **Limited liability companies** are not subject to the double tax.⁵ Consequently, the double tax can be avoided by never using a corporation and using an LLC when limited liability becomes important.

7.2 Other benefits of LLCs as compared to S corporations:

7.2(a) No eligibility concerns after formation;

7.2(b) Ability to make a Section 754 election;

⁴ See “Achieving Limited Liability” below.

⁵ The tax discussion in this outline applies to LLCs that are classified as partnerships for tax purposes, and not as corporations. For domestic entities that are not corporations, the classification is determined by filing a corporate or partnership return under the federal “check-the-box” regs that California has adopted.

7.2(c) Easy to bring members in and out and to adjust interests;

7.2(d) Distributions and allocations can be tailored precisely (because there is no one-class-of-stock rule for LLCs and LLCs can have priority returns and special allocations);

7.2(e) Distributions of appreciated assets rarely trigger tax; and

7.2(f) Entity-level borrowings can give members basis in their LLC interest to absorb LLC losses.

7.3 The **conversion** of an S corporation or a C corporation to a partnership or LLC – no matter how achieved – is treated as a taxable liquidation of the corporation.

⇒ Consequently, a corporation with appreciated assets -- including goodwill -- will rarely convert to an LLC.

7.4 Since January 1, 2000, single-member LLCs (“**SMLLCs**”) can be formed under California law.

7.4(a) An SMLLC is “disregarded” for federal and California income tax purposes.

Note: Some states do not disregard SMLLCs for state tax purposes.⁶

◇ An SMLLC owned by an individual is taxed as a sole proprietorship.

◇ An SMLLC owned by a corporation is treated as a division. So it avoids the consolidated return rules.

⁶ Primarily Texas and Pennsylvania at this writing, but you should check before you set up an LLC that will be active outside California. California requires a single-member LLC to file Form 568 and to pay the annual minimum tax (currently \$800) and the “gross receipts” tax.

- An SMLLC owned by an S corporation avoids the concerns of a “qualified S corporation subsidiary” – especially when an interest in the subsidiary’s business is acquired by someone other than the parent.
- An SMLLC owned by a foreign corporation and doing business in the U.S. is taxed as a branch.

◇ How “disregarded” is an SMLLC?

- So disregarded that the Service has ruled that an individual can hold S corporation shares in an SMLLC. (But don’t do this!)

7.4(b) An SMLLC also is an ideal way to position a sole proprietorship for probate, since it is the least possible disruption in the business, yet insulates the executor or trustee from the liabilities of the business.

7.4(c) A successful **new business** developed by an existing corporation could be dropped into an SMLLC in the same way that the corporation would drop it into a new subsidiary to isolate liabilities. However, it might make more sense from a tax standpoint to get the new business out of the corporation entirely and set up a sister LLC.

7.5 Concerns about using LLCs:

7.5(a) The concern about LLCs and SMLLCs has shifted from a tax classification concern to a **liability concern**. The liability concern will linger until appellate courts issue published opinions respecting the liability limitation of LLCs and SMLLCs.

7.5(b) California imposes a flat \$800 **annual tax** and a “**total income**” (that is, gross receipts) tax on LLCs, including single-member LLCs.⁷

- ◇ These taxes apply even if the LLC has losses.
- ◇ Until 2007, the taxes applied even to receipts from activities outside California. Refunds are available for taxes paid on non-California receipts (or, possibly, all gross receipts taxes, depending how the courts view recent California legislation on the issue).⁸
- ◇ Note – Owners who operate a high-revenue, low profit business expect large profits in the future. Avoid the LLC because of the California gross receipts tax? No, *just pay it!* Using another form of entity to avoid this tax is shortsighted if the alterna-

⁷ Cal. Rev. & Tax. Code §§ 17941 (flat tax), 17942 (tax rates on “total income”). The current “total income” tax rates are:

| Total Income | Tax |
|-----------------------------------|----------|
| \$0-\$249,999 | \$-0- |
| \$250,000 -\$499,999 | \$900 |
| \$500,000 - \$999,999 | \$2,500 |
| \$1 million - less than \$5 mill. | \$6,000 |
| \$5 million or more | \$11,790 |

The constitutionality of the California total receipts tax was challenged as it applied to receipts from activity outside of California. The tax now applies only to receipts from activities in California.

⁸ The FTB issued a “Public Service Bulletin” on March 21, 2006 with a special procedure for filing protective refund claims. State Tax Reporter (California) (CCH) ¶ 403-983, March 17, 2006, or go to www.ftb.ca.gov and search for “Ventas.” Cal. Rev. & Tax Code § 19394 limits the refunds to the portion of the gross receipts fee based on non-California receipts.

tive entity makes it more likely that the owners will have to pay the liabilities of the entity.⁹

7.5(c) Some other states (for example, Texas and Pennsylvania) impose a corporate or franchise tax on LLC income.¹⁰

7.5(d) An LLC may not operate in California any business (and there are quite a few) subject to **licensing** under the California Business and Professions Code.

◇ Note that not all licensed businesses are licensed under the Business and Professions Code. For example, registered investment advisers are licensed under the Corporations Code and insurance brokers are licensed under the Insurance Code.

◇ The California Attorney General opined that this rule should apply only to professions that require special education. That distinction has not proven to be particularly helpful.

◇ Don't expect this rule to go away in the near future.

7.5(e) Active members of an LLC probably will be treated as general partners for **self-employment tax** purposes, and the portion of their share of LLC income that is attributable to the reasonable value of their services to the LLC probably is subject to self-employment tax.¹¹

⁹ See "Achieving Limited Liability" below.

¹⁰ See footnote 6.

¹¹ This unresolved issue was the subject of a Senate Finance Committee hearing on May 25, 2005. The search for Social Security funds could result in new legislation in this area for LLCs and S corporations. See Testimony of George K. Yin, Chief of Staff of the Joint Committee on Taxation, at a Hearing of the Senate Committee on Finance on "Social Security: Achieving Sustainable Solvency," May 25, 2005, as reported in *Daily Tax* (footnote continued on next page)

- ◇ LLC members may render management services to the LLC through an S corporation and take a modest salary from the S corporation to minimize the Medicare tax. But this is the kind of structure we hope to avoid by using an LLC!

7.5(f) The company with a **public offering** in its future probably should be a corporation and *not* an LLC.

- ◇ Venture capital companies and underwriters prefer to work with corporations, because corporations go public, and LLCs don't.

- But if the company could convince the VCs to take LLC interests instead of forcing a conversion to a corporation, then in the event of a sale of assets, everyone would pay less tax.

- ◇ Converting from an LLC to a corporation involves negotiations among the equity and debt holders. There may be **hold-outs**, high transaction costs and delay.

7.5(g) LLC membership interests cannot be **swapped tax-free** for corporate stock. In contrast, corporate stock can be swapped tax-free (subject to restrictions) for stock of other corporations.

7.5(h) Only corporations can have **incentive stock option** (“ISO”) plans, which permit employees to exercise their options without any regular tax (but maybe with AMT), and have the entire income element taxed as long-term capital gain.

(footnote continued from previous page)

Report (BNA), May 26, 2005, TaxCore – Congressional Documents – Reports. See generally Holo, Sandy, et al., *Self-Employment Taxes and Passthrough Entities: Where are We Now?*, Tax Notes Today (TNT) September 14, 2005 (Special Report).

- ◇ LLCs can have nonqualified stock options, but the tax treatment of these options is not straightforward.¹²
- ◇ Employees who receive equity interests in the LLC seldom appreciate the change from wage withholding to the estimated tax regime.

7.5(i) For these reasons, most venture capital firms would bet that their exit vehicle would be an IPO, stock swap or stock sale, and not an asset sale. For an IPO or a stock swap, the entity must be incorporated. A stock sale and a sale of LLC interests are about the same, tax-wise. The LLC is much better if there is an assets sale. The bottom line: LLC managers who want investors to allow the managers to continue the business in an LLC must convince the investors that an asset sale is more likely than an IPO or a stock swap.

7.6 A **foreign person** or **entity** doing business in the U.S.A. probably will not want to invest directly in an LLC classified as a partnership that does business in the U.S.A. This is because the U.S. business might be a “permanent establishment” for tax treaty purposes, which could subject the foreigner or the foreign entity to U.S. tax.

¹² In Notice 2000-29, May 11, 2000, the IRS asked for comments on the tax treatment of the exercise of an option to acquire a partnership interest. Guidance was issued in January 2003 for non-compensatory options. See *IRS Told Compensatory Options Treatment Should Match Nonqualified Stock Options*, DAILY TAX REPORT (BNA) No. 18 p. G-2 (January 29, 2004). Proposed regulations and a proposed revenue procedure on compensatory transfers of partnership interests were issued in May, 2005. IRS Notice 2005-43, Daily Tax Report (BNA), May 23, 2005 pages L-16 and L-26 (article on page G-7); June 17, 2005, G-17 (Treasury Seeking Input); August 31, 2005, TaxCore Documents (State Bar of Texas comments on the proposals); October 28, 2005, TaxCore Documents (New York State Bar comments on the proposals). Because the IRS expects legislation on the tax treatment of “carried” interests, it is not likely to finalize the compensatory option regs in the near future.

- 7.7 A **tax-exempt entity** probably would want to use a C corporation rather than a pass-through entity to conduct its **business activity that is unrelated to its exempt function**, because the C corporation's income will not flow through to the tax-exempt parent.¹³
- 7.8 A **series LLC** (not available under California law) is a single LLC that has within it separate "series" (like compartments or mutual funds). If the LLC is organized and operated properly, then under its home state's law the assets of one series are not available to satisfy claims arising from the activities of another series of the same LLC. The series can have common ownership or can be owned by different groups. A series can have different classes of membership interests.¹⁴
- 7.8(a) Although it could be argued that a series LLC with one or more series doing business in California should owe only one \$800 tax for all of its series, this is not the position that the FTB takes in the instructions to Form 568.
- 7.8(b) As compared with a separate LLC for each series, the series LLC might pay more or less California "gross receipts" tax.
- 7.8(c) No California court has addressed the insulation of one series from claims against another series of the same LLC. California courts probably will respect the liability limitation of the series LLC under the federal constitutional principal that each state must give "full faith and credit" to the laws of other states. However, the defending LLC might have to litigate all the way to the U.S. Supreme Court.
- 7.8(d) If one series enters bankruptcy, the entire LLC and all the series would probably enter the bankruptcy proceeding.

¹³ See Section 11 (Nonprofit Organizations) below.

¹⁴ See, for example, 6 Delaware Code Anno. § 18-215.

7.9 Restrictions apply to an LLC's use of a **taxable year** other than the calendar year.

8. MINIMIZE THE DOUBLE TAX ON CORPORATE PROFITS WITH AN S CORPORATION

An existing C corporation should consider electing “**S corporation**” status for tax purposes.

8.1 Advantages:

8.1(a) Generally, there is no federal income tax on an S corporation's income.

8.1(b) Lower or no state tax. A **lower 1.5% California franchise tax** rate applies to S corporations.¹⁵

8.1(c) Generally, there is **no tax on cash distributions** from the S corporation to its shareholders.

◇ However, distributions of appreciated *property* by the S corporation generate gains which are taxed to the shareholders.

◇ Distributions of C corporation earnings are also taxable to the shareholders.

8.1(d) Avoids possible exposure to federal accumulated earnings penalty tax (for post-election earnings).

8.1(e) Avoids possible exposure to federal personal holding company penalty tax (for post-election earnings).¹⁶

¹⁵ Compare this to the California 8.84% franchise tax on C corporations. The California franchise tax is deductible in computing federal income tax.

8.1(f) Also avoids the corporate alternative minimum tax.

8.1(g) Employment taxes may be reduced by taking a modest salary from the S corporation and receiving distributions of earnings instead.

8.1(h) S corporations can issue ISOs, and the conversion from S corp to C corp or back does not affect the qualification of the ISOs.

8.2 Disadvantages:

8.2(a) An S corporation cannot use the 15% and 25% federal corporate tax rates that apply to a C corporation's taxable income under \$75,000. Consequently, the first \$75,000 of an S corporation's income each year is subject to **higher individual rates** for federal income tax purposes.

⇒ A "personal service corporation" cannot use the lower tax rates for C corporations, so this is not a disadvantage for a "personal service corporation."

- This is a corporation (1) that performs services in the areas of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, (2) for which those services are substantially all of its activities, and (3) is owned by the people performing those services or their relatives.

- A typical California professional corporation would be a personal service corporation.

(footnote continued from previous page)

¹⁶ The corresponding S corporation "excess passive receipts" tax might be more manageable than the C corporation personal holding company tax.

8.2(b) An S corporation's income is **taxed directly to shareholders**, whether or not distributions are made.

8.2(c) **Eligibility requirements** must be satisfied and only one class of stock is permitted.

⇒ Every S corporation should be carefully monitored to avoid an inadvertent termination of the election or other adverse consequences.

⇒ Shareholders of an S corporation should enter into a buy-sell agreement to protect the **fragile S election**.

8.2(d) If a C corporation makes the S election, the pre-election appreciation (the "**built-in gain**") in assets acquired by the corporation before the effective date of the election generally will be taxed to the corporation if and when the assets are sold or distributed during its first ten S corporation years.

8.2(e) Restrictions apply to an S corporation's use of a **taxable year** other than the calendar year.

8.2(f) A corporation can deduct the costs of **fringe benefits** it provides for its employees, including employees who are also its shareholders, and for income tax purposes the employees of a C corporation do not include in their income the value of most of these fringe benefits. *If a corporation elects S status, employees who are also shareholders must include in their income the value of:*

◇ Group life insurance premiums,

◇ Accident or health plan premiums,

◇ Death benefits,

- ◇ Meals on the employer's business premises and
- ◇ Lodging furnished by the employer as a condition of employment.

8.3 **C corporation status** allows income from business operations to be taxed at lower rates (except "personal service corporations") and should be used for a business that:

- ◇ Will generate **losses** that can be carried back to recover taxes previously paid *and* is not rapidly appreciating in value; or
- ◇ **Will never appreciate** substantially in value.

8.4 Make or keep the **S election** (and avoid the temptation of lower tax rates on the first \$75,000 of corporate income each year):

8.4(a) To avoid a second tax on an eventual **sale of corporate assets** (including goodwill);¹⁷

8.4(b) In a sale of corporate assets, to pay substantially lower taxes on the **sale of goodwill** (because the individual long-term capital gain rate applies and not the corporate tax rate);

8.4(c) To minimize the gain on an eventual **sale of the stock** of a rapidly growing business (because the undistributed

¹⁷ For existing C corporations, the built-in gains tax can reduce or eliminate the benefit of S corporation status in an asset sale. The same concern applies to those S corporations that are already subject to the built-in gains tax or that become subject to the tax by acquiring assets in carry-over basis transactions from C corporations or tainted S corporations. However, for a growing business the built-in gain tax merely *freezes* the double tax problem, and appreciation *after* the effective date of the S corporation election is not subject to the double tax.

earnings will increase the shareholders' basis in their stock of an S corporation, but not a C corporation);¹⁸

8.4(d) If the business **throws off more cash** than (a) necessary to grow or maintain the business and (b) the shareholders can reasonably take as compensation, rent, royalties and other deductible payments (because the shareholders can receive tax-free cash distributions of S corporation earnings); or

8.4(e) If the business will generate **losses** that (a) cannot be carried back to obtain a refund of C corporation taxes and (b) can be used by the shareholders to offset their income from other sources (if they have sufficient basis in their shares and loans to the corporation and are not limited by the passive loss and at risk limitations).

9. **WHEN AN EXISTING BUSINESS ENTITY STARTS A NEW BUSINESS**

The liability analysis outlined above also applies to an existing business (or nonprofit) entity which is considering a new venture.

9.1 For business entities, the best arrangement is usually to have the individual owners of the existing business own directly interests in the new entity. (In other words, create a new **brother-sister** entity rather than a subsidiary.) This provides the individual owners with the maximum flexibility and avoids taxes generating by taking apart an affiliated group of corporations.

9.2 When creating a brother-sister arrangement is not possible, generally liability-prone businesses should be operated in separate **subsidiary** corporations or single-member LLCs.

¹⁸ The shareholders' gain on the sale of stock is not subject to the built-in gains tax (although the buyer takes the corporation with that tax problem, and so might require a purchase price reduction). This benefit of S corporation status is available even if the corporation is subject to the built-in gains tax.

The entity with the capital should own the shares or interest in the operating entity that conducts the business.

- 9.3 When a **holding company** structure is in place or is being implemented, the holding company should not operate any liability-prone business. See *Exhibit C* on page 30, Choice of Entity (holding company example).
- 9.4 S corporations can now have wholly-owned corporate subsidiaries that are disregarded. These “**Qsubs**” are less flexible and have more tax traps than SMLLCs.

10. CALIFORNIA ACCOUNTANTS, ARCHITECTS AND ATTORNEYS

- 10.1 The registered limited liability partnership (the “LLP”) is the **entity of choice** for groups of two or more accountants, architects or attorneys practicing in California. Creatures of a California statute that was enacted and became effective in October, 1995, LLPs are **general partnerships without the unlimited liability**. Because they are taxed as partnerships, they allow much more **flexibility** for adding and withdrawing members and changing members’ relative profit participation, as compared to C or S corporations. The Secretary of State, the Board of Accountancy, the Board of Architectural Examiners and the State Bar each has adopted rules and forms to implement the statute.
- 10.2 The **professional corporation** probably will be used only by solo practitioners -- who will then encounter tax problems getting out of their PCs if they join LLPs.
- 10.3 The built-in gains problem will continue to plague **cash-method C corporations** that consider electing S corporation status so that they can stop the hassle and anxiety of trying to “zero out” the taxable income each year.¹⁹

¹⁹ See Section 8.2(d) above.

11. NONPROFIT ORGANIZATIONS

- 11.1 For nonprofit organizations, limited liability and continuity concerns usually make a **nonprofit corporation** a more attractive vehicle than a nonprofit association or a trust.
- 11.2 For nonprofit entities engaging in a business venture, tax analysis is very important. Generally, activities generating substantial “**unrelated** business taxable income” should be isolated in **subsidiary C corporations** to reduce the threat to the nonprofit’s tax-exempt status.
- 11.3 The **SMLLC** is an ideal way for a nonprofit entity to isolate liability-prone “**related**” activities without subjecting them to corporate tax or obtaining another tax exemption for a nonprofit “subsidiary” (organized as a supporting organization of the parent).
- ◇ The SMLLC may qualify for a California property tax “welfare” exemption for certain charities if its member could qualify for the exemption.²⁰

12. ACHIEVING LIMITED LIABILITY

When a corporate or LLC structure is adopted principally to minimize the risk of personal liability, it is critical to **operate** the business in a way that minimizes the risk that a claimant will “**pierce the corporate veil**,” resulting in shareholder/member liability for the entity’s obligations.²¹

²⁰ Cal. Rev. & Tax. Code §§ 214, 214.01, 214.02, 214.5, 214.14; Cal. Code Regs. Title 18, § 136.

²¹ Is this a “real life” issue or just legal theory? A quick LEXIS search on 10-19-05 showed 94 appellate cases addressed this issue in the last five years in California state courts alone. This does not include cases that ended before an appellate decision, or were appealed and not published. Nor does it include any federal court or bankruptcy court cases. It’s a real issue. See Section 3 above for some of the risks involved.

12.1 Accordingly, particular attention must be directed to the **formalities** of conducting the business in the entity, such as:

⇒ for a corporation, regularly prepare shareholders' and directors' **minutes** (and for an LLC, provide in the operating agreement that no members meetings are required);

- for an LLC, consider eliminating in the operating agreement the requirement of annual meetings;

⇒ show the **corporate name** on all stationery, business cards and invoices;

⇒ shareholders who are also officers of a corporation must sign documents in their capacity as **officers** (not as “owners”);

- members who are also managers or officers of an LLC must sign documents in their capacity as **managers** or **officers** (not as “owners” or “partners”);

⇒ eliminate **references** to another shareholder/member as “my partner”;

⇒ maintain **separate** personal and corporate/LLC **bank accounts**;

⇒ carefully **document** and account for **transactions** between the shareholder/member and the corporation/LLC (such as salary, bonuses, rents, royalties, loans, contributions to capital and distributions to shareholders/members); and when there are multiple partnerships, LLCs and corporations under common control, **document transactions among the entities** with leases, invoices, promissory notes and corporate resolutions and account carefully for the transactions.

⇒ It is important to have the board of directors approve all dividends and distributions, *even routine S corporation distributions*.

12.2 In addition to these formalities, each entity must have an **adequate combination of capital and insurance** to satisfy reasonably anticipated claims against the business.

- ⇒ If the business does not have enough capital and can't afford sufficient insurance, the officers should document their attempts to obtain insurance.
- ⇒ Because S corporations, LLCs and partnerships can distribute earnings without adverse tax consequences, it is possible that the earnings will be distributed and not retained as capital. This may increase the need for insurance to avoid the "thin capitalization" problem. This factor should be considered in connection with the legal limitations on distributions.
- ⇒ However, a corporation or LLC operating a business generally should have no more capital than is necessary to run the business and to minimize the "alter ego" risk.

12.3 To avoid confusion regarding the capacity in which a particular document is executed, any document requiring the signature of the entity should identify the entity, the person signing on its behalf, and the office held by that person. The following is an example of a **proper signature block** for a **corporation**:

ANYCOMPANY, INC.,
a California corporation

By _____
Donna J. Any, President

- 12.3(a) This form of signature clearly indicates that the document is being signed by and on behalf of the corporation and not by an individual.
- 12.3(b) Signing properly helps to prevent individual liability for claims against the entity and helps to preserve its legal status as a separate entity.

12.3(c) For an **LLC**, the signature is similar:

ANYCOMPANY LLC,
a California limited liability company

By _____
Donna J. Any, Manager

12.3(d) For a **limited partnership** the signature is more involved (assuming that no individual wants to assume the unlimited personal liability that comes with being the general partner):

ANYCOMPANY LP,
a California limited partnership
By its sole general partner
ANY MANAGEMENT, INC.,
a California corporation

By _____
Donna J. Any, President

◇ *Note that if Donna abbreviates her signature block, she risks personal liability because she leads others to conclude reasonably that she is a general partner or sole proprietor:*

ANYCOMPANY
WRONG!!! =>
By _____
Donna J. Any

WRONG!!! =>

Donna J. Any, Anycompany

12.4 The failure of officers, directors and shareholders/members to conduct business as required by law may have serious adverse consequences.

- 12.4(a) Third parties could succeed in “**piercing the corporate veil**,” potentially resulting in shareholder/member liability for the entity’s obligations.
- 12.4(b) The corporation could be **disregarded as a taxable entity** in certain circumstances, resulting in direct taxation of the shareholders on corporate income.
- 12.4(c) In addition, significant transactions between the corporation and third parties could be attributed to the shareholders, resulting in tax consequences to the shareholders rather than to the corporation.
- 12.4(d) The form of transactions and agreements between the shareholders and the corporation could be disregarded, potentially resulting in various adverse income tax consequences (for example, unintended dividends to the shareholders).

13. LIQUIDITY EVENTS

13.1 Asset sales vs. Stock sales

- 13.1(a) Buyers want to buy assets, and to set up a brand new entity to hold these assets.
 - ◇ The buyer wants to amortize the goodwill and get a new basis in other assets with shorter useful lives.
- 13.1(b) Sellers do not want to have the corporate shell and get the best tax result from a sale of stock
- 13.1(c) There is no sales tax in a stock sale, but in an asset sale there can be sales tax on the tangible personal property not held for resale (that is, the furniture, computers, equipment and vehicles).

13.1(d) Shareholders of an S corp target can make a Section 338(h)(10) election to give the sellers a high asset basis and amortizable goodwill, while selling the stock, avoiding sales tax and triggering only one level of gain, in many cases.

14. LOSSES

14.1 S corp shareholders can absorb losses only to the extent of their basis in their shares and their loans to the corp. Corporate-level borrowing does not give them basis to absorb losses. They can make year-end loans to the corporation to allow them to absorb the losses, but (a) they might not have the cash and (b) even if they do, they might be throwing good money after bad, letting the tax tail wag the dog.

14.1(a) When S corp shares are transferred to a spouse in a divorce, the spouse can use the suspended losses attributable to those shares. For other transfers, the suspended losses cannot be used by the transferee and disappear when the transferor disposes of all of his or her shares (or dies).

14.1(b) The Section 108 discharge-of-indebtedness rules now apply to S corporations in a way similar to partnerships and LLCs.

14.2 C corp losses can be carried back (for federal tax purposes) to C corp years and can be carried forward, but do not offset other losses of the shareholders.²² Pass-through entities like S corps and LLCs allow this, subject to the basis, at risk and passive loss limitations.

²² For California tax purposes, net operating loss deductions are not allowed in 2008 and 2009 for businesses with more than \$500,000 of net business income.

15. **LIABILITY PROTECTIONS FOR THE SHAREHOLDERS/MEMBERS**

- 15.1 Corporations (whether S or C) provide stronger protection from liability for the shareholders than LLCs provide for the members. This is because there are more cases in more states confirming the protection of shareholders. For LLCs the protection of members is clear under the statutes, but not all states have had appellate courts affirm what the statute says – that members have the same protection from liabilities of the LLC as shareholders have for liabilities of the corporation. We do not yet have these cases in California.
- 15.2 Nevertheless, I have not met a corporate, bank or bankruptcy attorney who thinks that members of LLC will get any less protection than shareholders get.

[End of outline.]

Exhibit A
Alternate Legal Forms of Doing Business in California

1. **Sole proprietorship**
2. **Partnership** (two kinds for liability purposes, one kind for tax purposes)
 - General partnership (all general partners, no liability protection)
 - Limited partnership (with two kinds of partners)
 - ⇒ One or more general partners (who run the business and are personally liable for all of its obligations)
 - ⇒ One or more limited partners (“silent” partners who risk only their investment in the business, not their other assets)
 - ⇒ A **joint venture** is a partnership formed for a specific project.
3. **LLP**: a limited liability partnership for accountants, architects and attorneys.
4. **Corporation** (one kind for liability purposes, three kinds for tax purposes)
 - C corporation (the corporation pays tax on its income; the shareholders are taxed on distributions)
 - S corporation (low California corporate tax; generally no federal corporate income tax; instead, the shareholders pay tax on their shares of the corporation’s income; no tax when shareholders receive distributions)
 - Qualified subchapter S subsidiary (“Q-sub”) (disregarded for income tax purposes)
5. **Multiple-Member Limited Liability Company (“LLC”)**
(one kind for liability purposes, two kinds for tax purposes)
 - Members, who own interests in the LLC, are protected from liability like shareholders
 - Can be taxed like a partnership, which is usually best.
 - Can also be taxed like a corporation.
 - Usually “manager-managed,” but can be “member-managed”
 - All states recognize LLCs.
6. **Single-Member LLC**
 - Disregarded for federal income tax purposes.
 - Subject to state tax.
7. **Series LLC** (not formed under California law)
 - Separate “series” (like compartments) within the LLC are insulated from claims against assets in other “series.”

Exhibit B Choice of Entity Analysis

Choice of Business Entity Flowchart

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July, 2009

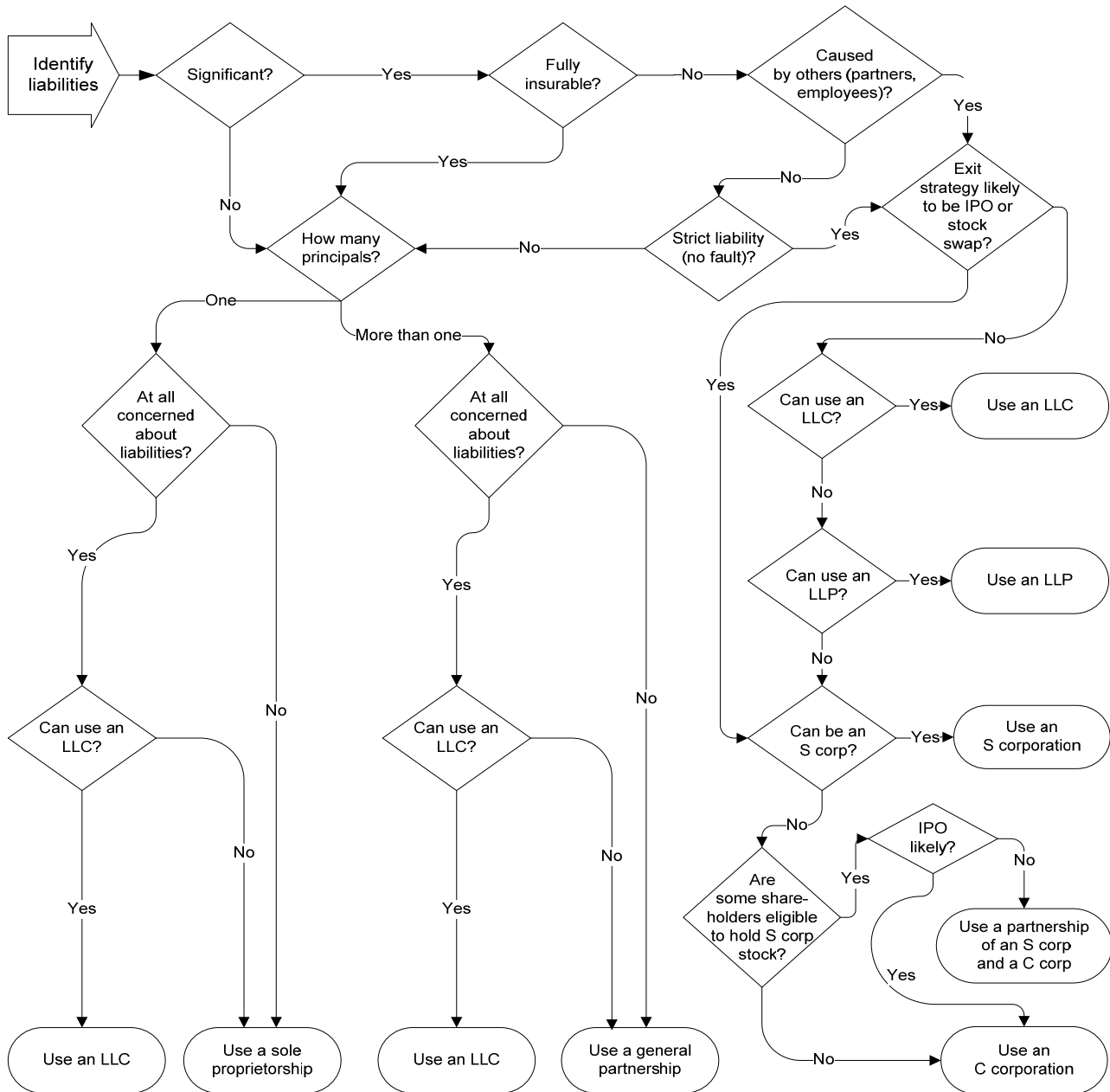


Exhibit C
Choice of Entity
(Holding company example)

Choice of Entity

Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

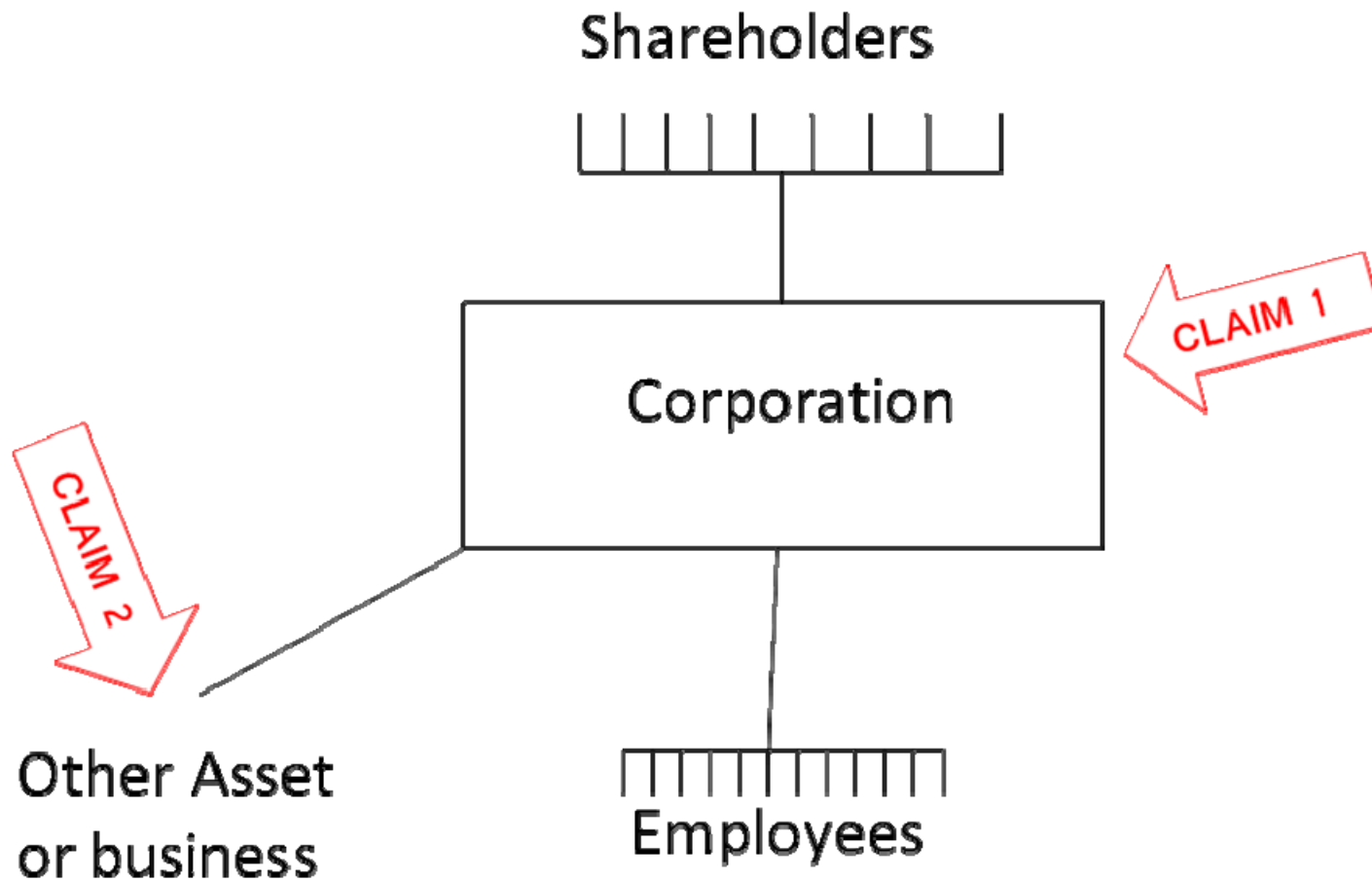
Concern: A claim against the operating business can be satisfied with the other valuable assets.

Tip: Create a holding company structure to isolate the operating business from the valuable assets.

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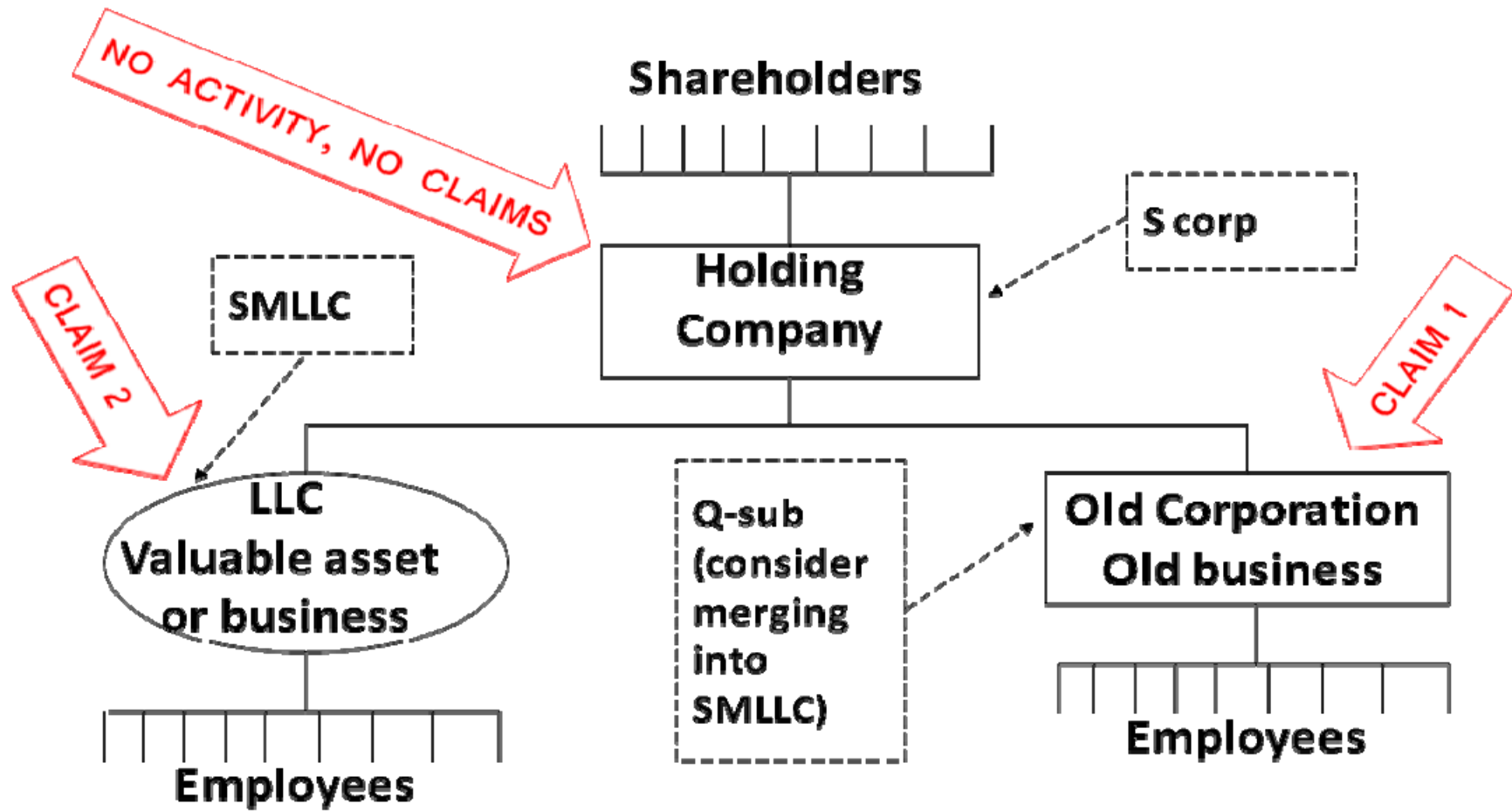
William C. Staley

Old Structure



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New structure



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[End of outline.]

ADDITIONAL INFORMATION

To receive additional information about these issues, please check the appropriate box(es) below, provide your address (or your business card) and return this sheet to Bill Staley -- or FAX it to Susan Rognlie at (818) 936-2990.

1. **Buy-Sell Agreements for Owners of a Closely-Held Business***
2. **Don't Treat S Corporation Distributions Like Partnership Draws***
3. **Disregarded Entities: Working with Single-Member Limited Liability Companies and Qualified Subchapter S Subsidiaries***
4. **Five Expensive Mistakes Business Owners Should Avoid***
5. **Incentive Compensation Arrangements (including the problems with using stock)***
6. **Hot Tax Planning Tips and Strategies***
7. **Limited Liability Companies: An Introduction***
8. **Limited Liability Companies – An Update***
9. **LLPs – Registered Limited Liability Partnerships for Accountants, Architects and Attorneys***
10. **Liquidating California Corporations, Partnerships, and Limited Liability Companies***

Name _____

Address _____

Telephone (_____)

* Available on www.staleylaw.com.