

# BUSINESS ENTITY SELECTION: BENEFITS AND PITFALLS

# Presenters

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# Presenters

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# Entities Generally

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- Entities (creature of state law)
  - Sole Proprietorship
  - General Partnership
  - Limited Partnership
  - Corporation
  - Limited Liability Company
- Note that the type of entity does not necessarily tell you the tax treatment

# Liability Generally

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- Sole Proprietorships and General Partnerships have unlimited liability for owners
- Limited Partnerships, Corporations and LLCs all provide liability protection for owners as owners, assuming corporate form is respected
  - Note that owners are still responsible for their own actions.

# Tax Overview

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	<b>Partnership (Including GP, LLC, LP, LLP)</b>	<b>S Corporation</b>	<b>C Corporation</b>
<b>Income</b>	Taxed once at the partner level	Taxed once at the shareholder level	Taxed at the corporate level and again at the shareholder level when distributed (no preferential rate for capital gains)
<b>Losses</b>	Pass-through to each partner to the extent of partner's basis (incl. partner's share of third party debt)	Pass-through to each partner to the extent of basis in stock and shareholder loans to corporation	Deductible to the corporation
<b>Tax on Sale of Interest/Stock</b>	Capital Gain except to the extent of section 751 Hot Assets	Capital Gain	Capital Gain
<b>3.8% Net Investment Income Tax</b>	A partner's distributive share of NII is subject to the tax	A shareholder's share of NII is subject to the tax	Dividends received by shareholder are subject to the tax
<b>Payroll / Self-employment Taxes</b>	<u>Yes</u> , unless the partner can be treated as a "limited partner" under section 1402(a)(13)	Salary is subject to payroll tax; however, S Corp must pay reasonable compensation	Salaries are subject to payroll taxes (subject to reasonable compensation limit, taxpayers are incentivized to maximize salary to minimize double taxation)
<b>Sharing Profits</b>	Most flexible entity for sharing profits	Single class of stock requirement	Can have multiple classes of stock with varying distribution and liquidation preferences
<b>Distributions</b>	Distributions of cash and marketable securities in excess of outside basis are taxable. Other in-kind distributions generally not taxable (but see section 751).	Taxable to the extent (i) of any built-in gain on distributed property and (ii) FMV of property distributed exceeds shareholder's stock basis.	Taxable to the extent (i) of any built-in gain on distributed property, (ii) of amounts treated as dividends, and (iii) FMV of property distributed exceeds amount treated as dividends and shareholder's stock basis.

# Affordable Care Act

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- Increased the Medicare portion of self-employment taxes from 2.9% to 3.8% on earnings in excess of \$250,000 for married taxpayers filing jointly (\$200,000 in the case of single taxpayers).
- Imposed a 3.8% tax on the lesser of (i) Modified Adjusted Gross Income in excess of \$250,000 for married taxpayers filing jointly (or \$200,000 in case of single filers) or (ii) Net Investment Income.
  - Net Investment Income is equal to the sum of:
    - gross income from interest, dividends, annuities, royalties, and rents, unless those items are derived in the ordinary course of a trade or business;
    - gross income from (i) a section 469 Passive Activity or (ii) a business which involves trading financial instruments or commodities; and
    - Net gain from the disposition of property not held in connection with an active business (other than a financial trading business).

# Limited Partner Exception to Self-Employment Taxes

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- Section 1402(a)(13): “[T]here shall be excluded [from self-employment taxes] the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments” and other payments for services.
- There is no definition of “limited partner” in section 1402.
  - ▣ Proposed Regulations Section 1.1402(a)-2 (1997)
- *Renkemeyer*: Tax Court held that the income of partners in a law firm organized as an LLP was subject to self-employment taxes because it “arose from legal services [the taxpayers] performed on behalf of the law firm” and not “as a return on partners’ investment.”
- Can members of an LLC be treated as limited partners for purposes of section 1402?
  - ▣ Due to the 3.8% rate of Medicare taxes on income above \$250,000 effective January 1, 2013, this question is of increased significance.



# State Tax Law Considerations

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- Some jurisdictions tax S Corps like C Corps
- Some jurisdictions require additional filings beyond the federal filing
- Some jurisdictions assess additional taxes/fees

# Ownership Restrictions (LLCs)

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- LLCs are the most flexible with respect to ownership structure
  - Voting interests versus non-voting interests
  - Different classes of membership interests
  - Priority distributions among members
  - Allocations can differ for various business units
- Terms of Operating Agreement can override most statutory default provisions
- Most business terms you can think of, you can accomplish with an LLC

# Ownership Restrictions (C Corps)

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- C Corps are similar to LLCs in their ownership flexibility, but are more structured
  - ▣ Voting and non-voting stock
  - ▣ Multiple classes of stock (i.e., preferred stock)
- Unlike with LLCs, difficult to separate economic benefits from stock ownership

# Ownership Restrictions (S Corps)

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- S Corps are the most restrictive
  - ▣ Single class of stock
  - ▣ In general, only warm bodies and certain trusts can be stockholders
  - ▣ US residents only
  - ▣ Limited number of owners (100)
- However, you can have different voting rights

# S Corp Issues – Second Class of Stock

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- Reclassification of certain arrangements as a second class of stock
- Safe Harbor for Warrants/Options
  - 1.1361-1(1)(4)(iii)(C): An option is not a second class of stock if, on the testing date (i.e., the date it is issued, transferred, or materially modified), the strike price of the option is at least 90 percent of the fair market value of the underlying stock on that testing date

# S Corp Issues – Transfer Restrictions

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- Transfer restrictions to avoid impermissible ownership
  - Designed to avoid inadvertent loss of S Corp status
  - May need a court order to void transfers
  - Not allowable if prohibited from placing conditions on ownership (e.g., SDVOSB and 8(a) programs)

# Management (LLCs)

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- As with ownership, LLCs are the most flexible with respect to management
  - ▣ Manager managed versus member managed
  - ▣ Board of managers or individual managers
  - ▣ Can have officers appointed by the manager(s)
- Terms of Operating Agreement can override most statutory default provisions
- Most business terms you can think of, you can accomplish with an LLC

# Management (C Corps and S Corps)

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- S Corps and C Corps are more structured
  - ▣ Must have a board of directors
  - ▣ Must have officers
  - ▣ Must have annual board and stockholder meetings
  - ▣ More rights statutorily reserved for stockholders



# Tax on Sale of Entity – Partnerships and Section 751

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- Section 751 - Gain from the sale of a partnership interest can be taxed as ordinary income to the extent the gain is attributable to Unrealized Receivables or Substantially Appreciated Inventory of the partnership.
  - Substantially Appreciated Inventory: If Partnership's inventory has aggregate FMV greater than 120% of its adjusted basis.
    - Anti-Stuffing Rule

# 338(h)(10) Election

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- Gain from the sale of corporate stock is generally taxed to the shareholder as capital gain.
- If an election is made under either section 336(e) or 338(h)(10), the sale of the stock may be recharacterized as a sale of corporate assets by the target corporation followed by a liquidation of the target corporation.
- Provides the purchaser stepped-up basis in the corporation's assets.
- Useful when Target is an S Corporation
  - Look out for: section 1374 built-in gains taxes; inside versus outside basis differentials; ordinary income assets.

# 336/338 Requirements Compared

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338(h)(10)	336(e)
Joint election required by seller and buyer	Joint election required by seller and target
Seller must be a member of a consolidated group or a nonconsolidated affiliated group, or target must be an S corporation	Seller must be either a domestic corporation or S corporation shareholder
Single acquirer must generally be a corporation	Can have multiple acquirers, which are not required to be corporations
Requires taxable purchase of 80% or more within a 12-month period	Requires any combination of sales, exchanges, and distributions totaling 80% or more within a 12-month period

# Conversions – Overview

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- Corporation to LLC
  - Full taxable transaction.
  - Treated as if corporation contributed its assets to the new LLC and distributed the LLC interests to its shareholders. Transaction is taxable to both the corporation (section 311(b)) and the shareholders (section 331).
- Partnership/LLC to Corporation
  - Taxation depends on the form of the transaction.
  - Assets Over – LLC transfers all of its assets and liabilities to corporation in exchange for stock; LLC distributes stock to its members in liquidation.
  - Assets Up – LLC distributes all of its assets and liabilities to its members in liquidation, members contribute assets and liabilities to corporation in exchange for stock.
  - Interests Over – LLC members contribute LLC membership interests to corporation in exchange for stock; LLC is liquidated.
  - Formless conversions under state law or under the “check-the-box” rules will be treated as Assets Over transactions.

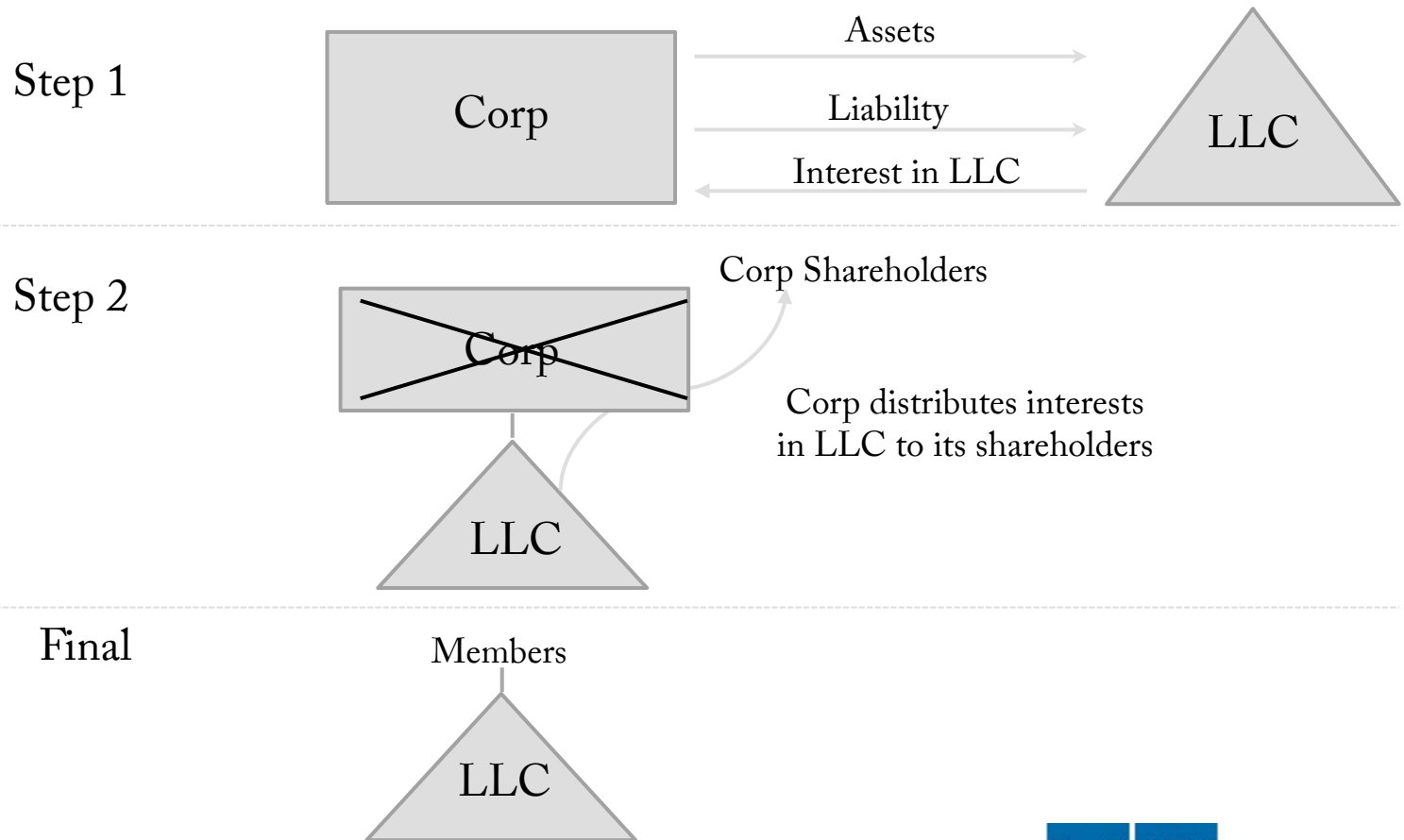
# Conversions – Basic Fact Pattern

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- A & B own converting entity equally (in case of partnership/LLC, any debt is also allocated equally).
- A & B each have \$100 outside basis in the converting entity equity interests.
- The converting entity owns a single capital asset with a fair market value of \$400, adjusted basis of \$160 and a fully recourse liability of \$200.

# Conversion of Corporation to LLC

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# Corporation to LLC Conversion

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- Step 1: Corporation transfers its assets and liabilities to LLC in exchange for membership interests
  - Nontaxable.
- Step 2: Corporation distributes membership interests to its shareholders (A&B).
  - Corporation is taxable as if it sold the membership interests for FMV. Corporation recognizes \$240 gain.
  - Shareholders taxed on the difference between their stock basis and the fair market value of the property they receive.

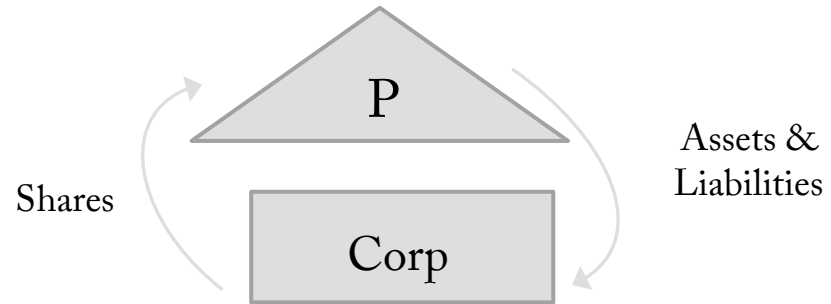
# Entity Conversions – “Assets Over”

## Incorporation of Partnership Rev. Rul. 84-111

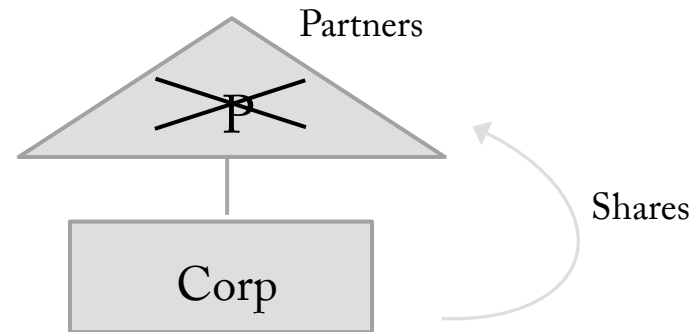
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Situation 1

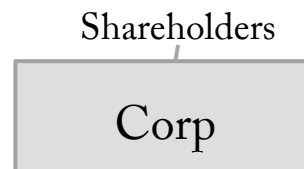
Step 1



Step 2



Final





# Partnership to Corporation – “Assets Over”

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- Step 1: PS contributes Asset to new corporation.
  - Though this transaction qualifies as a section 351 transaction, because the corporation is assuming liabilities in excess of adjusted basis (*i.e.*, liabilities are \$200 and adjusted basis is \$160), section 357(c) requires that PS recognize \$40 of gain.
  - PS’s basis in the stock is \$0: The basis of the capital asset it contributed (\$160) plus the gain recognized (\$40) less liabilities assumed by the corporation (\$200). Section 358.
  - PS gets tacked holding period with respect to the stock. Section 1223(1).
  - Corporation does not recognize gain or loss on the exchange of Asset for stock. Section 1032(a).
  - Corporation’s basis in Asset is equal to \$200: PS’s basis in Asset (\$160) plus gain recognized (\$40). Section 362.
  - Corporation gets tacked holding period with respect to Asset. Section 1223(2).
  - A and B each have \$20 basis in their PS interests following the contribution.
- Step 2: PS liquidates.
  - PS recognizes no gain or loss. Section 731(b).
  - The receipt of the corporate stock should be nontaxable to A & B. Section 731(a).
  - A and B have \$20 basis in their stock (section 732(b)) and get a tacked holding period (section 735(b)).

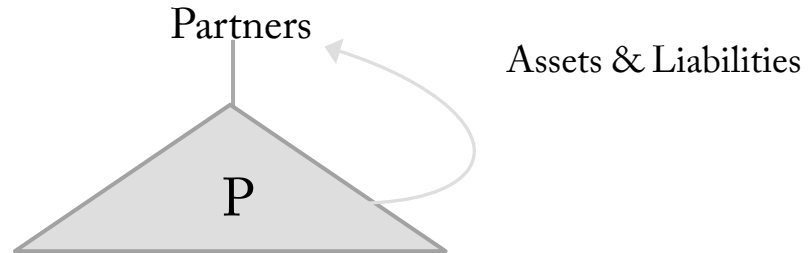
# Entity Conversions – “Assets Up”

## Incorporation of Partnership Rev. Rul. 84-111

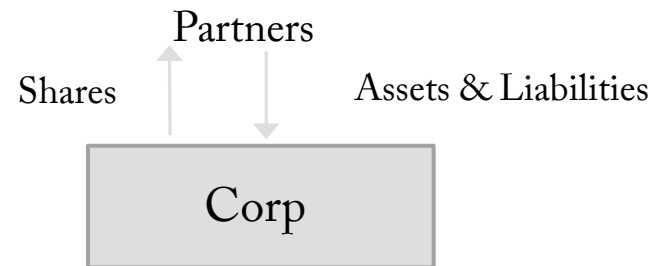
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Situation 2

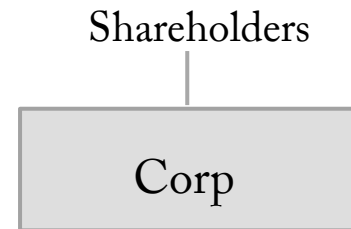
Step 1



Step 2



Final



# Partnership to Corporation – “Assets Up”

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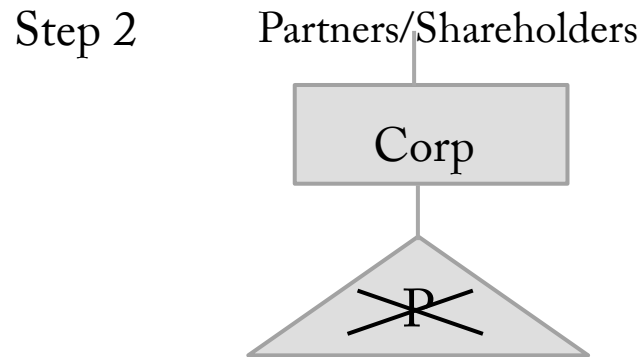
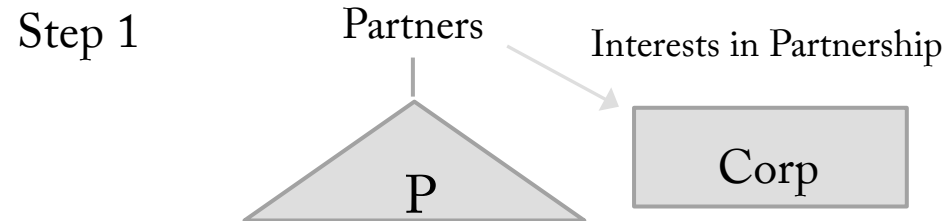
- Step 1: PS distributes a 50% interest in Asset to each of A and B.
  - PS recognizes no gain or loss. Section 731(b).
  - The receipt of Asset should be nontaxable to A & B. Section 731(a).
  - A and B should each have \$100 adjusted basis in their 50% share of Asset. Section 732(b)
    - PS liabilities assumed by the partners individually should offset the liabilities relieved as part of the liquidation.
  - A and B should also receive a tacked holding period. Section 735(b).
- Step 2: A and B contribute Asset to new corporation.
  - No gain or loss to A or B. Section 351. Liabilities do not exceed basis so section 357(c) does not come into play.
  - A and B each have basis in the stock received of \$0: Their basis in their share of Asset contributed (\$100) plus the gain recognized (\$0) less liabilities assumed by the corporation (\$100). Section 358.
  - A and B get tacked holding period with respect to the stock. Sections 735(b) and 1223(1).
  - Corporation does not recognize gain or loss on the receipt of assets. Section 1032(a).
  - Corporation’s basis in the asset is equal to \$200: A and B’s aggregate basis in Asset (\$200) plus gain recognized (\$0). Section 362.
  - Corporation gets tacked holding period with respect to Asset. Section 1223(2).

# Entity Conversions – “Interests Over”

## Incorporation of Partnership Rev. Rul. 84-111

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### Situation 3



# Partnership to Corporation – “Interests Over”

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- Step 1: A and B each contribute their PS interests to new corporation.
  - No gain or loss to A or B. Section 351. Liabilities do not exceed basis so section 357(c) does not come into play.
  - A and B each get a tacked holding period. Section 1223(1).
  - A and B each have \$0 basis in the corporate stock: Their basis in their interests contributed (\$100) plus the gain recognized (\$0) less liabilities assumed by the corporation (\$100). Section 358.
  - Corporation does not recognize gain or loss on the receipt of PS interests. Section 1032(a).
  - Corporation’s basis in PS interests is equal to \$200: A and B’s aggregate basis in their interests (\$200) plus gain recognized (\$0). Section 362.
  - Corporation gets tacked holding period. Section 1223(2).
- Step 2: PS liquidates.
  - Corporation’s basis in Asset is \$200: Corporation’s basis in the PS interests (\$200) plus gain recognized (\$0). Section 732.
  - Corporation gets tacked holding period with respect to Asset. Section 735(b).

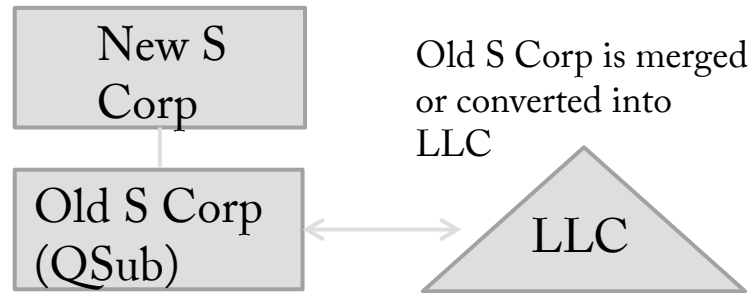
# Entity Conversions – F Reorg

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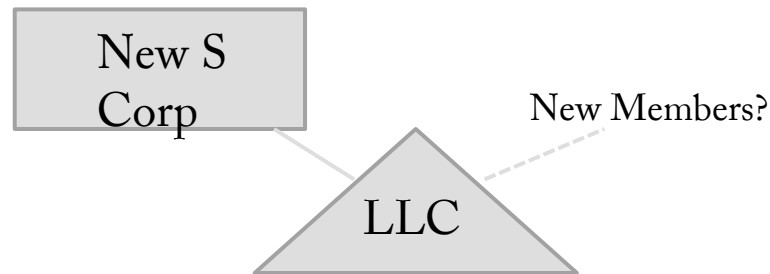
Step 1



Step 2



Final



# Conversion – State Law Considerations

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- Don't forget that type of entity is a creature of state law
  - Not all states allow for entity conversion
  - Where conversion is not allowed, may need to form a new entity and use a statutory merger
  - Keep up-to-date... Maryland recently adopted a conversion statute effective October 1, 2013

# Transferability of LLC Control Interests

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- § 18-702(a) of the Delaware LLC Act:
  - A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. *The assignee of a member's limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement* or, unless otherwise provided in the limited liability company agreement, upon the affirmative vote or written consent of all of the members of the limited liability company.



# Transferability Requires Specificity

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- VA Supreme Court of Opinion, Ott v. Monroe (<http://www.courts.state.va.us/opinions/opnscvwp/1101278.pdf>)
  - The operating agreement at issue in Ott. v. Moore contained, among other provisions, that “any Member . . . may transfer *all or any portion of the Member’s Interest* at any time to . . . [o]ther Members [or] [t]he spouse, children or other descendants of any Member.” (emphasis added). The court held that neither this nor any other provision of the operating agreement specifically permitted the transfer of control interests without the consent of the other members.
  - If you want to allow non-economic interests to transfer, references to “control interests”, “voting rights”, “participation in management and affairs” or like phrases should be included in the provisions allowing transfers of ownership interests.

# Questions?

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