

# **CHOICE OF ENTITY COMPARISON AND CONTRASTS**

**The Tax Section of The Florida Bar**

**Cristin Keane, Carlton Fields, Tampa**

**Guy Whitesman, Henderson Franklin, Fort Myers**

**November 16, 2016**

## **1) Introduction-Overview of Presentation**

- a) Business entities from which to choose-considerations
  - i) Governance
  - ii) Liability Protection
  - iii) Taxation
- b) Brief history of trends of choice of entity
  - i) Historically, C corps, S Corps, Partnerships (general and limited)
  - ii) Introduction of LLCs (Wyoming was first state to adopt)
  - iii) Explosion of LLCs since widespread introduction and IRS "check the box" regulations (flexibility, hybrid of partnership and corporate forms)
  - iv) Growth in Florida since repeal in 1998 of corporate income tax on LLCs electing to be taxed as partnerships or sole proprietorships

## **2) Corporations (C and S Corp)**

- a) Organization and formation
  - i) Formalities must be followed - filing of Articles of Incorporation, filing of annual report, etc.
  - ii) Organizational documents
    - (1) Bylaws
    - (2) Shareholders' Agreements - from simple to complex
  - iii) Perpetual existence until dissolved with state
- b) Liability of owner-shareholders
  - i) Limited liability from debts and claims of the corporation, regardless of participation in management of business
  - ii) Rights of owner-shareholder's creditors against interest in corporation
    - (1) May seize stock in company
    - (2) Rights of creditor as shareholder will depend on what rights the stock carries or terms of bylaws/shareholders' agreement, etc.
- c) Restrictions on transferability of stock
  - i) For C corps, depends on restrictions in governing agreements (articles, bylaws, shareholder agreements)
  - ii) For S corps, same, however restrictions also must consider whether transfer will defeat S election (discussed below)
  - iii) May wish to ensure that assignee generally will have no right to vote stock and is entitled only to distributions attributable to stock

- d) Major differences between S Corps and C Corps
  - i) **NOT** a state law difference, only a tax classification
  - ii) Eligible corporation (existing or new) can elect to be treated as S Corp
    - (1) Only one class of stock permitted, restricting ability to raise capital (i.e. through issuance of preferred stock), although can have differing voting rights.
    - (2) Restrictions on shareholders
      - (a) Limit on total number of shareholders (100, with certain family members treated as 1 shareholder) – restriction makes it ill poised to go public.
      - (b) Generally, only individual shareholders who must be US citizens or resident aliens
      - (c) Certain qualified trusts (rules are complex and detailed as to what kinds qualify – examples: grantor trusts – where owner is treated as shareholder, qualified subchapter S trust which can have only one current income beneficiary who must receive all income and must satisfy individual shareholder requirements), Electing Small Business Trust (trust is taxpayer, all S corporation income taxed at trust's rates)
      - (d) Certain tax exempt organizations (501(c)(3)/401(a))
    - (3) Pass-through taxation
      - (a) Avoids **most** "double taxation" issues
      - (b) Each shareholders tax return will report their pro-rata share of company income and deductions (some items treated at corporate, rather than shareholder level, rules can be complex).
- e) Why choose the corporate form?
  - i) C corporation
    - (1) Adverse tax consequences (double taxation, state tax) so should have a good reason to use
    - (2) When company is going to be public or intends to go public
    - (3) When there will be more than 100 shareholders
    - (4) When there will be shareholders that do not meet Subchapter S requirements (i.e. corporate shareholders, nonresident alien shareholder, etc.)
    - (5) If fringe benefits are going to be important part of compensation structure (limitations on deductibility or inclusion in gross income of S corp shareholder) – typically not an overriding factor
  - ii) S corporation - most common corporate form/filing
    - (1) Tax advantages
      - (a) Limits but does not eliminate double taxation (inside-outside tax basis)
      - (b) Reduce FICA taxes, by paying "reasonable compensation" (subject to employment taxes) and distributing remainder of profits as distribution not subject to employment taxes
      - (c) Can take advantage of tax-free merger/reorganization provisions of the code
      - (d) In case where company has cancellation of indebtedness may avoid income tax if company (as opposed to shareholders) is in bankruptcy or is insolvent.
    - (2) If remote possibility that company will go public preferable to start as an S corp, rather than another form

### 3) Partnerships

#### a) General partnerships

##### i) Organization and formation

(1) No requirement of a formal filing

(a) Exception for LLP (discussed below)

(2) Organizational documents

(a) Partnership agreement - simple to complex (may be oral)

(i) However, tax rules covering allocations (of items of income and items of expense) often require that the agreement be more complex.

(3) Must have at least two partners to form, but no restrictions on who (including other entities) may be a partner

(4) Cannot have unlimited duration, partnership dissolves upon withdrawal of a partner (also tax rules that required the deemed dissolution and formation of a new partnership).

##### ii) Liability of partners

(1) No liability protection. Debts of partnership are debts of the partners.

(a) Important exception - in Florida may elect to be a Limited Liability Partnership (requires formal filing) granting all partners limited liability against debts of partnership

(2) Rights of partner's creditors against partnership interest

(a) Creditor may be able to take over partner's rights in the partnership interest, including requiring the partnership to wind up and terminate partner's interest

##### iii) Transferability of interest

(1) A transfer will not cause dissolution of partnership

(2) However, unless partnership agreement says otherwise, no right of assignee to participate in management of business

#### b) Limited Partnerships

##### i) Organization and formation

(1) Must file Certificate of Limited Partnership

(2) Organizational documents

(a) Partnership agreement - simple to complex

(i) However, tax rules covering allocations (of items of income and items of expense) often require that the agreement be more complex.

(3) Must designate one or more "general partners" and remaining partners are "limited partners".

(a) Used to make a difference in that management of the company by a limited partner caused them to be treated as a general partner; no longer the case.

(b) Often structured so that general partner is, itself, a limited liability vehicle (i.e. an LLC or corporation).

(4) Must have at least two partners to form, but no restrictions on who (including other entities) may be a partner

##### ii) Liability of partners

(1) No liability protection for general partners. Debts of partnership are debts of the general partners. However, limited partners have limited liability for company debts.

- (a) Important exception - in Florida may elect to be a Limited Liability Limited Partnership (requires formal filing) granting all partners (general or otherwise) limited liability for debts of partnership
- (2) Rights of partner's creditors against partnership interest
  - (a) Sole remedy for a creditor of a partner is a "charging order". The judgment creditor is entitled to only those rights to distributions which debtor-partner would have had. Can make a limited partnership interest an unappealing "target" for a judgment creditor if the partnership agreement provides discretion as to distributions.
- iii) Transferability of interest
  - (1) A transfer will not cause dissolution of partnership
  - (2) Unless partnership agreement provides otherwise, a transferee is only an assignee unless membership in partnership is consented to by all other partners.
  - (3) If mere assignee, no right of assignee to participate in management of business
- c) Pros and Cons of partnership form
  - i) Single level of taxation - all items of income and expense flow through to individual taxpayer-partner's tax return
    - (1) However, rules governing partnership taxation are complex and compliance can be costly
    - (2) Issues of cancellation of indebtedness of partnership could cause "phantom" income to partners who are not themselves in bankruptcy or insolvent (measured at partner, not entity level).
  - ii) Increased flexibility in structuring agreement as between partner
    - (1) Can reduce or eliminate certain duties of partners (e.g. the duty of loyalty) permitting a partner to invest/participate in other business endeavors, even if in competition with company
    - (2) Can provide for special allocations of partnership profits or expenses (although must meet "economic substance" tax rules, which are very complex).
  - iii) Liability protection
    - (1) Inside liability
      - (a) Not good for partners in general partnership or general partner of limited partnership
        - (i) However, LLP and LLLP designation help alleviate. However, some states do not recognize LLP/LLLP status and if the entity is going to conduct business in those states may not have limited liability as regards operations and obligations that arise there.
    - (2) Outside liability
      - (a) Not great for general partnership; creditor of partner can essentially shut down and dissolve business.
      - (b) Much better for limited partnership; sole relief of a charging order has no impact on other partners and may even discourage creditor from attempting to secure charging order
  - iv) Use of partnership forms has been most heavily impacted by growth in use of LLCs

#### 4) Limited Liability Companies

- i) Organizational documents
  - (1) Operating Agreement - simple to complex
    - (a) However, tax rules covering allocations (of items of income and items of expense) often require that the agreement be more complex.
  - ii) Must have at least one member to form; no restrictions on who (including other entities) may be a member
  - iii) Can have unlimited duration
- b) Liability of members
  - (1) All members have limited liability for debts and obligations of company
  - ii) Rights of member's creditors against ownership interest-Florida Statutes
    - (1) Multi-member - sole remedy is a charging order (as discussed in limited partnership context).
    - (2) Single-member - Creditor of owner may be able to foreclose on membership interest and potentially reach underlying assets of company.
- c) Transferability of interest
  - i) Governed by operating agreement - can range from little restriction to complicated (i.e. buy-sell agreements, options to company and other members)
  - ii) If operating agreement is silent, default rule under Florida law is that transferee is a mere assignee of right to distributions (no management) unless other members consent to their admission
- d) Pros and Cons of LLC form
  - i) Choice of tax treatment, while maintaining limited liability protection regardless of that choice
  - ii) Most multi-member LLCs are taxed as partnerships under federal law (by default or election); partnership taxation can be complex depending on allocations in operating agreement
- e) Increased flexibility in structuring agreement as between members
  - i) Statutory scheme is a "default" scheme, meaning most rules can be changed by agreement of members (though there are approximately 17 rules that may not be waived, e.g., rights to records, good faith and fair dealing, breaches of fiduciary duty, judicial dissolution, derivative actions, etc.).
  - ii) Coupled with choice of taxation this flexibility provides for investors/members to structure a business that meets their needs and wants
- f) Liability protection
  - i) Inside liability
    - (a) Limited liability, essentially on a par with a corporation.
    - (b) All 50 states recognize LLCs, so can operate in "foreign" (i.e. non-Florida) jurisdictions without exposure to additional liability, as may be the case in a state that does not recognize the LLP or LLLP form.
  - ii) Outside liability
    - (1) Not great for single-member LLC; creditor of member can foreclose and dissolve business if they are able to establish to a court that charging order will not be sufficient to satisfy their judgment/claim.

- iii) Much better for multi-member LLC; sole relief of a charging order has no impact on other members and may even discourage creditor from attempting to secure charging order

**5) Remedial Elections**

- a) Rev. Proc. 2013-30 facilitates the grant of relief to late-filing entities by consolidating numerous other revenue procedures into one revenue procedure and extending relief in certain circumstances. This procedure provides guidance for relief for late:
  - i) S corporation elections
  - ii) Electing Small Business Trust (ESBT) elections,
  - iii) Qualified Subchapter S Trust (QSST) elections
  - iv) Qualified Subchapter S Subsidiary (QSub) elections
  - v) Corporate classification elections which the entity intended to take effect on the same date that the S corporation election would take effect
- b) Timeframe for relief up to 3 years and 75 days of the effective date of the election
- c) Beyond timeframe – relief under private letter ruling regime

- 6) **Uniform Voidable Transaction Act ("UVTA")** – Presently being discussed by Tax Section, Business Law Section and RPPTL – Concerns regarding potential voiding of entity selection based on theory that creation of entity and insertion of assets may have made it more difficult for creditors to collect debt-also applies to conversion of entity (e.g. from corporation to multi-member LLC to limit creditor remedies to charging order). Often conversions are used to protect S corporation status (i.e., ensuring ineligible shareholder/creditor does not attach shares). Comments to proposed UVTA are sweeping.