



Legal Issues for Small Businesses

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Corporate and Tax Overview

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Corporate and Tax Overview

Formation Issues

Costs

LLCs: The cost of filing Articles of Organization for an LLC is \$70.00. Unfortunately, California LLCs can only file Articles with the Secretary of State's office in Sacramento. An LLC does not have to pay a franchise tax on formation but an \$800 minimum tax is due on the 15th day of the fourth month following the date of formation. The graduated fee is paid with the Form 568 annually.

S Corps: S corporations must pay a \$100 filing fee and a \$15 over-the-counter fee upon formation. Unlike LLCs, Articles of Incorporation can be filed in local Secretary of State offices. Generally, the waiting time for Articles of Incorporation is less than for an LLC's Articles of Organization. The S corporation must pay an \$800 minimum franchise tax on the 15th day of the third month of its third income year. Starting January 1, 2002 corporations again have to make minimum franchise tax payments as under prior law.

Advantage – S Corporation



Corporate and Tax Overview

Names – LLCs

LLCS: The LLC database is separate from the limited partnership and corporate database. Therefore, many names which may be in use by other business entities are available to LLCs.

S Corps: S corporations are no different from any other California corporation and the practitioner must determine availability with the Secretary of State.

Advantage – LLCs



Corporate and Tax Overview

Securities Issues on Formation

LLCs: Corporation Code Section 25019 provides that the definition of "security" includes an interest in an LLC unless all of the members are actively engaged in the management of the limited liability company; provided that evidence that the members vote or have the right to vote or the right to information concerning the business and affairs of the LLC or the right to participate in the management will not establish, without more, that all the members are actively engaged in the management of the LLC. Most LLC interests are issued to 35 or fewer unaccredited investors, and a Notice of Transaction under Corporation Code Section 25102(f) is required.

S Corps: Generally all corporate stock satisfies the definition of security.

Advantage - LLCs



Corporate and Tax Overview

Types of Business

LLCs: A California LLC may engage in any lawful business. However, an LLC may not engage in a business which is registered, licensed or certified under the Chiropractic Code or the Business and Professions Code. As a result, professional LLCs are strictly prohibited in California.

S Corps: S Corporations can engage in any business including professional services.

Advantage – S Corporation



Corporate and Tax Overview

Eligible Owners

LLCs: There are no limitations on the types of owners. A membership interest may be held by an individual, estate, trust, corporation, partnership, S corporation, or another LLC.

S Corps: Code Section 1362(a)(1) limits the type and number of all eligible an S corporation may have. S corporations are permitted to have 75 shareholders and the shareholders can only be individuals, estates and certain types of trusts. An individual must be a U.S. resident or citizen. An estate generally means a decedent's estate or an estate under Title 11 of an individual shareholder. Grantor trusts, qualified Subchapter S trusts, testamentary trusts (for a period of two years) and voting trusts qualify as eligible S corporation shareholders. Corporations, partnerships, nonresident aliens, and foreign trusts cannot be shareholders in an S corporation.

Advantage - LLCs



Corporate and Tax Overview

Interest for Services

LLC's: An LLC can issue a profits, as distinguished from a capital interest, to a person who contributes services on behalf of the LLC and the receipt of the profits interest will generally not be a taxable event for the recipient. Normally the issuance of a capital interest would result in adverse tax consequences to the recipient member and potential gain or gift taxed to the transferring members.

S Corps: The receipt of stock in an S corporation for services will be taxed at fair market value unless the stock is burdened with restrictions or a risk of forfeiture. In such case, the value of the stock when the restriction or risk of forfeiture lapses will be included in the recipient's income at ordinary rates. An S corporation does not have the flexibility to grant a service provider an interest solely in profits.

Advantage - LLCs



Corporate and Tax Overview

Nontaxable Contributions of Property

LLCs: Generally property can be contributed at any time by members of the LLC. There is no "control" requirement. Subsequent distributions of property to the contributing member can result in a disguised sale under Code Section 707.

S Corps: For an S corporation, the transferor shareholder along with all the other shareholders making a contemporaneous property contribution must "control" the corporation immediately after the transfer. "Control" is defined as owning at least 80% of all classes of stock entitled to vote and least 80% of the total number of all other classes of stock of the corporation.

Advantages - LLCs



Corporate and Tax Overview

Contribution of Encumbered Property

LLCs: When a member contributes encumbered property to an LLC or the LLC assumes the member's liability in connection with the contribution of property, the contributing member is deemed to receive a cash distribution equal to the amount of the liability assumed and the contributing member is deemed to make a cash contribution equal to his share of the increased liability. The contributing member's basis increases or decreases by the amount of the net change in the liability. If the net decrease in liability exceeds the basis in the membership interest, the contributing member recognizes the excess amount as gain. Moreover, the other members' bases in their membership interests are increased by their share of the assumed liability. The increase plays out as a deemed capital contribution by all the other members in proportion to their respective shares of the LLC liability. Rarely does a contributing member recognize gain on a contribution of encumbered property. This will occur only when his allocable share of debt after the transfer is less than the excess of the debt transferred over the property's adjusted basis. Any gain recognized by the contributing member may or may not result in an increased basis in LLC property.

S Corps: A contribution of encumbered property to an S corporation is normally subject to the provisions of Code Section 351. Typically, a contribution of encumbered property results in nonrecognition unless the liability exceeds the shareholder's basis in the property in which case a gain is recognized under Code Section 357(c). The other shareholders are not affected by this transaction. Corporate tax basis in the contributed assets will be increased by any gain recognized by the contributing shareholder.

Advantages - LLCs



Corporate and Tax Overview

Remedial Issues

LLCs: Generally an LLC can amend its agreement to deal with problems with respect to the issuance of membership interests up to the due date of the LLC's tax return without extension (April 15 in most cases).

S Corps: Generally the receipt of stock by an S corporation shareholder is taxable when received. If stock is not granted at a time when the shares have a low value and a later grant is made, the shares are taxable upon receipt.

Advantage - LLCs



Corporate and Tax Overview

Operational Issues

Use of Debt Equity

LLCs: Each member of an LLC is entitled to include his or her share of LLC liabilities in basis. If the member is also the lender, the entire amount of the debt is generally allocated to such member. The members also get tax basis in their membership interests for cash contributed and the adjusted basis of property contributed to the LLC.

S Corps: Although S corporation shareholders are entitled to a tax basis in their shares for money and the adjusted basis of property contributed, entity level liabilities of the S corporation are not included in tax basis and do not give rise to a deduction for the flowthrough of losses. If a shareholder's tax basis is reduced to zero, excess losses are applied against the shareholders' bases in corporate indebtedness owed to them.

Advantage - LLCs



Corporate and Tax Overview

Types of Membership Interests or Type of Ownership Interests

LLCs: LLCs may issue any type of membership or ownership interest. LLCs may issue capital interests and profits interests. LLC interests may be issued to taxable or tax-exempt members.

S Corps: The most serious disadvantage faced by S corporations is the rule precluding an S Corporation from having no more than one class of stock. Thus, an S corporation may not provide a liquidation or distribution preference to any shareholder. Even buy-sell agreements and similar arrangements must be sanitized to avoid a prohibited second class of stock. An S corporation may only issue (1) straight debt; (2) nonvoting common stock; or (3) other types of equity not resulting from the issuance of stock including options, phantom stock, or stock appreciation rights.

Advantage - LLCs



Corporate and Tax Overview

Use of Multitier Structures or Affiliates

LLCs: LLCs are free to form multitier structures. An LLC may own subsidiary LLCs including single-member LLCs and achieve a desired segregation of business assets and creditors. However, an LLC (except certain single member LLCs) may not own stock in an S corporation.

S Corps: After the 1996 repeal of Section 1361(b)(2)(A), an S corporation may own any percentage of stock in a C corporation. Dividends to a parent S corporation are ineligible for the dividend received deduction, and other inter-company transactions are excluded from the application of consolidated return rules. A far greater benefit is that an S corporation may own all the stock of a subsidiary S corporation and achieve passthrough treatment if the parent S corporation elects to treat the subsidiary as a division. A qualified subchapter S subsidiary ("QSub") is a domestic corporation otherwise eligible to make an S election (1) all of the issued and outstanding stock of which is owned by an S corporation and (2) which the S corporation elects to treat as a QSub.

If the subsidiary existed before the first year in which the QSub election is made, the election is treated as a liquidation of a wholly-owned subsidiary into the S corporation parent. Generally, Code Sections 332 and 337 result in no gain or loss being recognized. Under Code Sections 334(b) and 381, the S corporation parent inherits the QSub's tax attributes and the adjusted basis of its assets. If the subsidiary were a C corporation, the deemed liquidation causes the parent S corporation to be subject to built-in gains tax under Code section 1374 with respect to the QSub's assets. The principal disadvantage of the QSub election may be disappearing basis from the standpoint that the difference between the tax basis of the target C corporation and its inside basis of its assets disappears under Code Section 334(b).

Advantage - LLCs



Corporate and Tax Overview

Tax Rate Comparison

LLCs: The present maximum marginal income tax rate of 35% can be imposed on an LLC member who is an individual. In addition, without proper planning, the individual member's net earnings from self-employment are also taxed at a rate of 15.3% on the first \$87,000 of income and 2.9% on all income in excess of \$97,500 unless the individual is treated as a limited partner. It is generally not possible to restrict the amount subject to self-employment taxes to amounts designated as wages. An individual who is a member of an LLC should be considered a limited partner unless the individual (1) is personally liable for the debts as a result of being a member, (2) has authority to contract on behalf of the entity under state law or the governing instrument, or (3) participates more than 500 hours of the year in the LLC's trade or business.

S Corps: The income of an S corporation can also be subject to the maximum federal tax rate of 35%. However, S corporations enjoy an advantage in the employment tax area. The combination of FICA and Medicare taxes for an employee, including S corporation employee-shareholders is 15.3% on the first \$97,500 of wages and the Medicare tax of 2.9% applies to compensation in excess of the FICA ceiling. By setting a reasonable salary, in this context one that is not unreasonably too low, an S corporation shareholder can avoid these employment taxes on his share of the corporation's income after salaries.

Advantage -- S Corporations



Corporate and Tax Overview

Certainty of Tax Status

LLCs: Under the IRS check-the-box regulations, an LLC formed under domestic law will automatically be taxed as a partnership if it has two or more owners. A single owner LLC is treated as a "disregarded" entity and does not have the obligation to file a separate tax return.

S Corps: Generally, an S corporation must file an election (Form 2553) within the first 2 1/2 months of its taxable year to be treated as an S corporation for its entire taxable year. Late elections are generally only effective for the following taxable year. Every shareholder must sign the Form 2553, even a shareholder with a community property interest. If an S corporation's status is lost, the corporation cannot reelect S status for five years unless the termination was inadvertent or the IRS permits an early reelection. For most reelections, substantial detriment is incurred in the form of the built-in gains tax under section 1374 for ten years after reelection.

Advantage - LLCs



Corporate and Tax Overview

Built-In Gains and Character Gains

LLCs: Generally, precontribution gain or loss must be allocated to the contributing member. Property, which is inventory in the hands of the member, must maintain that character in the hands of the LLC for five years. In addition sales to a controlled LLC will not be eligible for capital gains treatment to the selling member if the property will be ordinary income property in the hands of the LLC.

S Corps: All gain including built-in gain is allocable to all shareholders on a per-share per-day basis. Therefore it is possible to shift gain on contributed property from one shareholder to another. In addition, the character of the gain from property is generally determined with reference to the corporation's purpose in acquiring and holding the property. Thus, if a shareholder contributes inventory or dealer property to an S corporation, the dealer or inventory taint does not automatically remain. Property sold to the corporation by a controlling shareholder may be eligible for capital gains treatment even though the property will be ordinary income property in the hands of the corporation.

Advantage – S Corporations



Corporate and Tax Overview

Entity Levels Taxation

LLCs: LLCs, like partnerships, are not subject to federal income tax. Single member LLCs are disregarded for federal income tax purposes unless the owner opts for association treatment. California imposes an \$800 minimum tax plus a graduated fee at the following levels.

Total Income	Fee
Less than \$250,000 (1)	0
\$250,000 but less than \$500,000 (2)	\$900
\$500,000 but less than \$1,000,000 (3)	\$2,500
\$1,000,000 but less than \$5,000,000 (4)	\$6,000
\$5,000,000 and over (5)	\$11,790

Total income is no longer attributable to upper-tier LLCs (due to the enactment of AB 898 in 2001.) Most tax elections must be made by the LLC, and income and deductions are characterized at the entity level. The LLC's taxable year generally must conform to that of the majority interest of its members. Its taxable year will close on the termination or sale of 50% or more of the equity within one year and will also terminate with respect to a member who sells, exchanges or liquidates his entire interest.

S Corps: S corporations are generally not subject to corporate level taxes, including the alternative minimum tax, personal holding company tax, and accumulated earnings tax. The S corporation's taxable income is determined as if it were an individual and characterized with respect to the corporation's activities and purposes. C corporations that convert to S status are subject to some entity level taxes. Code Section 1374 taxes the corporation on net built-in gains recognized within ten years after the conversion, and Code Section 1375 imposes a tax on excess passive income if the corporation has undistributed earnings and profits. In addition, a corporation using the LIFO method of inventory accounting when it converts to S status must recapture the LIFO-FIFO spread over a four-year period. A corporation's taxable year must generally be a calendar year or one that is the same as its principal shareholder's tax year. At the election of the corporation and its shareholders the corporation may utilize the "close the books" method of calculating income when a shareholder terminates his interest or where a certain percentage of stock is sold over a defined period. S Corporations are subject to a 1.5% California franchise tax.

Advantage - S Corporations



Corporate and Tax Overview

Use of Cash Method of Accounting

LLCs: A literal interpretation of Code Sections 446(c) and 448(a) and the definition of "tax shelter" in Code Section 461(1)(3) could support the position that LLCs are not permitted to use the cash method of accounting. The IRS has, however, issued several favorable rulings permitting LLCs to use the cash method if (1) the LLC did not expect to generate losses, (2) the LLC members practice in a profession in which the LLC is engaged (not applicable in California), (3) the LLC was not formed for tax avoidance purpose, (4) the LLC interests were not syndicated, and (5) the equity partners managed the LLC.

S Corps: An S corporation may adopt the cash method of accounting unless it is a "tax shelter" under Code Section 461(1)(3). If inventories are used, the accrual method of accounting must be adopted unless the IRS permits otherwise.

Advantage -- S Corporations



Corporate and Tax Overview

Effect of Entity-Level Debt on Outside Basis and Loss Limitations

LLCs: Each member is entitled to include a proportionate share of entity-level debt in the member's outside basis. Debt is allocated based on the "economic risk of loss" analysis. If the debt of the LLC is nonrecourse, it is allocated among the members in proportion to their profit ratios. Debt that is recourse must be allocated to the member who makes a loan or guarantees the debt. Since the debt is typically without recourse, the members may not include it in their at-risk basis amounts unless they have personal liability for payments, have pledged property as security, or the debt meets the definition of "qualified nonrecourse financing" in Code 465(b)(6).

The application of the passive activity rules to LLCs is uncertain. Code Section 469(h)(2) precludes a limited partner from satisfying the material participation test except where the regulations lift this restriction under the regulations. A limited partner is active if he or she satisfies either (1) the 500-hour material participation test, (2) the 5 out of 10-year test or (3) the three-year rule applicable to service activities. A relatively recent Oregon District Court decision [Gregg, 87 AFTR2d 2001-31 1 (1 1/29/00)], ruled that an LLC member should not automatically be treated as a limited partner for purposes of applying the passive activity loss provisions.

S Corps: An S corporation shareholder may deduct corporate losses only to the extent of the sum of stock basis and adjusted basis in any corporate debt held by the shareholder. The shareholder may not add to stock basis any indirect contribution such as the proportionate share of corporate debt even if payment has been personally guaranteed by the shareholder. The shareholder only obtains basis by making an actual economic outlay. Losses that are limited are carried forward indefinitely. An S corporation shareholder is also subject to the at-risk limitation rules unless the S corporation shareholder has loaned the funds to the corporation. The passive activity rules are also applied to S corporations; however, each shareholder is allowed to determine to what extent he or she materially or significantly participates in each Code (Section 469 activity).

Advantage - LLCs



Corporate and Tax Overview

Distributions in Redemption of Stock or an LLC Interest

LLCs: Generally distributions of property reduce a member's basis in his LLC interest. Unless the LLC makes a disproportionate distribution of Code Section 751 property (unrealized receivables, depreciation recapture and certain appreciated inventory), it recognizes no gain or loss on a distribution to its members. A disproportionate distribution occurs if the distributee's interest in Code Section 751 property increases or decreases as a result of the distribution. In the event of such distribution, Code Section 751 property equal in value to the amount of such increase is deemed to be the subject of a sale between the member and the LLC. Generally, no gain or loss is recognized by a distributee member unless the distribution of money or money equivalent exceeds that member's basis in the interest. Marketable securities are treated as money to the extent of their fair market value. Generally, the character of the distributed property in the distributee's hands depends on the distributee's use or purpose in holding the property; however, gain or loss on the sale or exchange of unrealized receivables or inventory is ordinary, regardless of the distributee's use or purpose.

S Corps: Distributions received by a shareholder from an S corporation with no earnings and profits are not taxable to the extent of the shareholder's stock basis which is first adjusted for current year's income. A distribution in excess of basis is treated as gain on the sale of S corporation stock. If the S corporation has accumulated earnings and profits, distributions are excluded from gross income until the corporation has exhausted its accumulated adjustments account ("AAA"), which is essentially the sum of taxable income for its S corporation years.

If the corporation distributes appreciated property, it recognizes gain as if it had sold the property to the distributee at fair market value, and the gain is allocated among the shareholders as part of the corporation's taxable income for the year.

Advantage - LLCs



Corporate and Tax Overview

Distributions to Retiring or Deceased Shareholders or Partners

LLCs: Payments made to a retiring or deceased member can be classified in more than one way. A payment to a retiring member or successor-in-interest to a deceased member is considered to be a payment of a distributive share of LLC income if the amount is dependent on income, and the payment of a guaranteed amount under Code Section 707(c) if it is not dependent on LLC income. Such payments to a retiring member or deceased member are taxable as ordinary income and deductible by the LLC. Other payments made in liquidation of an entire interest of a retiring or deceased member are deemed to be made in exchange for the member's interest in LLC property. The taxability of such payments will be determined under Code Section 731, and the member will report capital gain or loss except to the extent that Code Section 751 applies.

S Corps: A redemption by the corporation will generally result in capital gain or capital loss to the shareholder or his estate. Payments made by the corporation to the shareholder or the shareholder's successor-in-interest will not be deductible by the corporation.

Advantage - S Corporations



Corporate and Tax Overview

Capital or Ordinary Treatment from the Sale of an Interest

LLCs: A member who disposes of his entire membership interest recognizes capital gain or loss. If the LLC holds inventory or receivables, some of the gain may be recharacterized as ordinary income under Code Section 751. In certain circumstances, an abandoned or worthless membership interest may lead to an ordinary loss deduction absent a sale or exchange.

S Corps: S corporation shareholders who dispose of their stock are generally treated as having disposed of a capital asset, leading to capital gain or capital loss. Code Section 1244 can benefit S corporation shareholders who sustain losses on their stock investment. If Code Section 1244 applies, up to a \$100,000 loss on a joint return in any taxable year may be treated as an ordinary loss instead of a capital loss.

Advantage - S Corporations



Corporate and Tax Overview

Special Allotments of Income or Loss

LLC's: An operating agreement can provide for special allocations that give a member a distributive share of a particular item or class of items that is different from the proportion in which the member shares other profits and losses of the LLC. As long as special allocations meet the "substantial economic effect" test, the IRS will respect the allocation.

S Corps: S corporations may only provide for an allocation of profits and losses to shareholders based on their pro rata share of stock ownership. Subchapter S does not permit special allocations of certain items to the shareholders. The only means by which an S corporation can "specially allocate" profits is by the payment of compensation to the intended recipients.

Advantage - LLCs



Corporate and Tax Overview

Adjustment to Basis of Entity's Assets on Sale or Exchange or Distribution of Property.

LLCs: A special election is available when there is a sale of an interest in an LLC or a distribution of LLC property to a member. This election permits a basis adjustment in the property held by the LLC. LLC property is allowed a basis step-up when the transferor member recognizes gain on the sale of his membership interest or the distributee member recognizes gain on the distribution to him of property by the LLC. A change in basis of the property distributed to the transferee member may also give rise to an adjustment to the basis of the LLC property. This is usually a beneficial adjustment that will reduce taxable gain and increase deductions to the members.

S Corps: S corporations are not permitted the above basis adjustments that are available to LLCs. If a shareholder sells his stock, any gain he recognizes will provide no benefit to the remaining shareholders or to the S corporation. The gain recognized by the seller will not give rise to an increase in the basis of the S corporation's assets.

Advantage - LLCs



Corporate and Tax Overview

Automatic Terminations.

LLCs: An LLC terminates for tax purposes when 50% or more of the total interests in the LLC's capital and profits are sold or exchanged within a 12-month period. Such termination can cause considerable complications as well as adverse tax consequences.

S Corps: S corporations do not have a rule similar to the above partnership/LLC rule. As with C corporations, stock in an S corporation may be sold or exchanged without causing any termination of the corporate entity.

Advantage – S Corporations



Corporate and Tax Overview

Mid-Year Changes in Ownership

LLCs: Under Code Section 706, when ownership percentages of an LLC change, each member is distributed a share of each item of income, gain, loss, deduction, or credit. This is determined by taking into account the varying interests of the members in the LLC during the year. Certain changes of ownership, such as a disposition of a member's entire interest in the LLC, may be accounted for using either the interim closing method or the pro rata method.

S Corps: S corporations allocate items on a per share, per day pro rata basis when there is a mid-year change in stock ownership. An election under Code Section 1377(a)(2) creates a deemed separate taxable year that ends on the close of the day in which the shareholder's entire interest in the S corporation terminates.

Advantage – S Corporations



Corporate and Tax Overview

Disguised Sale Rules.

LLCs: Although most of the distribution provisions pertaining to LLCs are beneficial, there are certain caveats. Under Code Section 707(a)(2)(B), a contribution of property to an LLC followed by a distribution can be characterized as a disguised sale or exchange between the member and the LLC. A direct or indirect transfer of money or other property by a member to the LLC with a related direct or indirect transfer of money or other property may be characterized as sale. The regulations contain a two-year presumption rule pursuant to which transfers between a member and an LLC made within two years of each other are presumed to be a sale unless an exception applies.

S Corps: Subchapter S does not contain a disguised sale rule. An S corporation shareholder may contribute property to the corporation and thereafter receive a distribution of cash without a presumption that the arrangement is a sale or exchange. Disproportionate distributions may raise a potential problem with respect to the one class of stock requirement.

Advantage – S Corporations



Corporate and Tax Overview

Distribution of Contributed Property to Another Owner.

LLCs: An extension of the contributed property allocation rules Section 704(c) require that gain or loss be recognized by a contributing partner if contributed property is distributed to another member within seven years of the contribution. The statute requires that gain on a distribution by an LLC of property contributed by a member be recognized as if the property had been sold by the LLC to the distributee and appropriate adjustments are made to the adjusted basis of the contributing member's interest in the LLC and to the basis of the property distributed by the LLC. A contributing member must recognize the precontribution gain, but only to the extent that gain or loss would be recognized if the LLC had sold the assets at the date of distribution. The character of the gain or loss is determined by reference to the character that would have been reported if the property had been sold by the LLC to the distributee.

S Corps: S corporations do not treat the distribution of contributed property in a manner similar to Code Section 704(c)(1)(B). When an S corporation distributes property, recognized gain is allocated proportionately among the shareholders according to their stock ownership. Gain is recognized as the difference between the property's fair market value and its adjusted basis at the time of distribution. There is no allocation of gain to the contributing shareholder.

Advantage – S Corporations



Corporate and Tax Overview

Distribution of Other Property to Contributing Owner.

LLCs: When built-in gain property is contributed by a member to an LLC and within seven years of the contribution date other property is distributed to the contributing member, such member must recognize gain. The gain that must be recognized is an amount equal to the lesser of (1) the excess of (a) the fair market value of the property received in the distribution over (b) the adjusted basis of that member's interest in the LLC immediately before the distribution reduced by the amount of money received in the distribution or (2) the net precontribution appreciation gain of that member.

S Corps: No similar rule applies to precontribution built-in gain in the S corporation context. If a shareholder of an S corporation receives a distribution of property, it is irrelevant whether he initially contributed the property to the corporation. If there is a distribution of property by the corporation, any built-in gain is allocated among the shareholders in proportion to their stock ownership and the shareholders do not recognize gain if they have AAA (when needed) and stock basis to absorb the distribution.

Advantage – S Corporations



Corporate and Tax Overview

Discharge of Indebtedness.

LLCs: In the case of a bankrupt or insolvent LLC, the debt discharge rules are applied at the member level and each member reports his share of debt discharge income unless the member personally meets the bankruptcy or insolvency exceptions. Therefore, the LLC may be insolvent, but a member may not exclude debt discharge income unless he meets personally the exclusion tests of Code Section 108.

S Corps: The insolvency rules are applied at the corporate level such that a bankrupt or insolvent corporation does not recognize debt discharge income. However the excluded income no longer increases the basis in the S corporation shareholders' stock. Gitlitz v. Commissioner, 87 AFTR 2d 2001-417, superseded by 2002 legislation (effective for post-10/11/01 debt discharges).

Advantage – S Corporations



Corporate and Tax Overview

Tax-Free Reorganizations.

LLCs: Generally an LLC cannot be a party to a tax-free reorganization. On May 16, 2000, the IRS issued proposed regulations under Code Section 1.368-2 looking at a merger of a disregarded entity into an acquiring corporation and a merger of a target corporation into a disregarded entity. The proposed regulations concluded that neither merger is treated as a tax-free reorganization under Code Section 368(a)(1)(A). In Revenue Ruling 80-198, 1980-2 C.B. 113, the IRS held that the incorporation of a sole proprietorship followed by a reorganization failed Code Section 351 because the transferor did not maintain “control.”

S Corps: S corporations may engage in tax-free reorganizations pursuant to Code Section 368. Generally, S corporation shareholders recognize no gain or loss on stock exchanges pursuant to a plan or reorganization. A reorganization also does not trigger a gain or loss to the S corporation.

Advantage – S Corporations



Corporate and Tax Overview

Estate Planning.

LLCs: LLCs like limited partnerships are entitled to significant discounts for lack of marketability and lack of control. Importantly the measurement of the gift is based on the value transferred to the donee, not the value given up by the donor. Any amount that a decedent owns at the date of death may be subject to an election under Code Section 754 to adjust the inside basis of assets to reflect the outside basis of the new holder of the interest. Importantly, since managers of LLCs are not required to hold membership interests, a member of an LLC may transfer all economic rights out of his or her estate yet still maintain control.

S Corps: Although S Corporation shares are also subject to discounts for lack of marketability, lack of control, and taxes on built-in gains, there is no election available to adjust inside basis of assets. As a result, built-in gain is triggered on the sale of an asset even if the shareholder has a high tax basis in his inherited corporate shares. A loss cannot be triggered to offset this gain, although taxes may be minimized or eliminated in some cases if the S Corporation is dissolved or the shareholder sells his interest during the year of sale.

Advantage – LLCs



Corporate and Tax Overview

Fringe Benefits.

LLCs: Members of an LLC may not deduct expenses incurred in providing fringe benefits to its members. Fringe benefits subject to this limitation include the Code Section 79 exclusion of the cost of up to \$50,000 of group-term life insurance and the Code Section 119 exclusion of meals or lodging furnished for the convenience of an employer. An LLC may deduct accident and health insurance premiums it pays on behalf of its members to the extent that it is paid for services and determined without regard to LLC income. Sixty percent of health insurance premiums may be deducted by the members in 2001 on the members' individual income tax returns.

S Corps: Generally the same restrictions apply to S corporation shareholders holding more than 2% of the stock of the S corporation. Accident and health insurance provided to the more than 2% shareholder employees of S corporations should be treated as compensation to the shareholder and reported as wages on Form W-2.

Advantage – S Corporations



Corporate and Tax Overview

Pension Plans.

LLCs: Members of an LLC may participate in a qualified plan sponsored by the LLC. Although Code Section 401(a) requires that a qualified plan be maintained by an employer for the exclusive benefit of its “employees,” a member of an LLC is generally considered to be an employee for purposes of this rule. For participating purposes, only net earnings from self-employment are used in the calculation of allowable contributions. An LLC may not deduct payments made for its members to retirement plans. These amounts will be reported on Schedule K-1 and deducted by the members on their individual tax returns.

S Corps: An S corporation is eligible to sponsor a qualified plan for its employees, just like a regular C corporation. The only distinction is that some transactions in which corporate plans may engage are prohibited for plans covering owner-employees. In particular it is a prohibited transaction for a plan to directly or indirectly (1) lend any assets to, (2) pay any compensation for services rendered to the plan to (3) acquire property for the plan from, or (4) sell any property to an owner-employee, a member of an owner-employee’s family or a corporation in which the owner-employee owns directly or indirectly 50% or more of the total combined voting power of all classes of stock or 50% or more of the total value of all the shares of the classes of stock. A contribution made by an S corporation for its shareholders is limited to actual compensation paid.

Advantage – S Corporations



Corporate and Tax Overview

Incentive Compensation Plans.

LLCs: LLCs may adopt any number of equity compensation plans. However, exercising an option to acquire an LLC interest may result in income to the recipient member as well as the LLC. To the extent that a member acquires a capital interest in an LLC at a discount, that capital shift will result in potential tax consequences to both the LLC and the acquiring member. Options for profits interests generally avoid many of these problems. The treatment of an employee who acquires an interest in an LLC is unclear.

S Corps: S corporations may adopt both incentive stock option plans and nonqualified stock option plans. In addition, many S corporations maintain phantom stock plans and stock appreciation rights plans. The existing rules pertaining to equity compensation plans provide a high level of certainty to both the S corporation and the employee.

Advantage – S Corporations



Corporate and Tax Overview

Corporate Formalities.

LLCs: An LLC is required to have an annual meeting of the member if set forth in the Operating Agreement or if the Operating Agreement is silent on meetings. Failure to hold meetings can be considered in piercing the LLC veil. However the Operating Agreement may provide that meetings are not required, and if not required, the failure to hold said meetings is not considered in piercing the LLC veil. Corp. Code Section 17101(b).

S Corps: All corporations (except statutory close corporations) must have annual shareholder and board of directors meetings. Failure to hold such meetings can be used in piercing the corporate veil.

Advantage - LLCs



Corporate and Tax Overview

Asset Protection.

LLCs: A creditor of a member may obtain a charging order. Corp. Code Section 17302. It is unclear whether the creditor can foreclose on the interest under Corp. Code Section 16504.

S Corps: All creditor remedies are available.

Advantage – LLCs



Corporate and Tax Overview

Dissolution.

LLCs: Generally a dissolution of an LLC does not trigger tax consequences to the remaining members unless a member receives cash or cash equivalent in excess of that member's interest in the LLC. A gain or loss triggered on the sale of assets in liquidation generally gets reflected in the member's basis in his membership interest. Dissolution of an LLC requires the filing of a certificate of dissolution and certificate of cancellation with the California Secretary of State's office. In addition, a tax clearance certificate is required.

S Corps: A distribution of appreciated property to the shareholders in liquidation will trigger recognition of S corporation income and may trigger a built-in gains tax if the S corporation is a former C corporation and has not had its election in effect for ten years. Gain or loss on liquidation will be reflected in the shareholders' bases in their shares, and shareholders will recognize gain or loss to the extent that they receive cash or property in excess of their stock basis. Dissolution requires formal corporate action and the obtaining of a tax clearance certificate.

Advantage – LLCs



Conclusion

Entity selection is more complicated and more critical than ever. Depending on the focus and sophistication of clients, no one entity is clearly superior to the other. Counselors and their clients must weigh carefully each characteristic of the different types of entities in making a recommendation or decision.

