Choice of Entity

Tim Smith, Godfrey & Kahn S.C.

Jordan Bergmann, Foley & Lardner LLP

Overview

- Key Characteristics of Entity Choices
- Key Federal Income Tax Changes
- Choice of Entity Considerations
- Converting to a Different Entity Type

Background on Entity Choices

- Three main choices for tax purposes:
  - C corporation, partnership, and S corporation
- Governance Considerations (non-tax)
  - C Corporations
    - Can be formed as an LLC or corporation under state law
    - Corporation statute typically has more formal requirements than an LLC
    - C corporation typically more flexible than an S Corporation for tax purposes
  - Partnerships (LLCs)
    - Permit easy designations of various distribution, liquidation and voting rights, etc.
  - S Corporations
    - Single class of stock (voting variations OK)
    - Limitations on who can be a shareholder
    - Limitations on debt
    - 100 shareholder limitation

C Corporations

- Corporation files tax returns and pays taxes at corporate level (Form 1120)
  - State and local taxes deductible for federal income tax purposes
- Distributions
  - Corporation recognizes gain/loss on distribution of property
  - Shareholders recognize income to extent of earnings and profits
  - Distributions subject to net investment income tax (“NII”)
- Sale of C Corporation
  - Proceeds from sale of stock generally eligible for lower long-term capital gain rates
  - Asset sale by corporation subject to two levels of taxation
  - Gain may be reduced/avoided if stock is “qualified small business stock” within the meaning of Section 1202

Partnerships (LLCs)

- Income
  - Partnership files an information return (Form 1065), but does not generally pay entity-level federal taxes Income allocated to owners who pay tax on personal returns
    - Income allocated to partners increases each partner’s tax basis, which reduces taxes paid on a distribution or sale of an interest
- Distributions
  - Not taxable to extent of basis
  - Distributions of property not taxable to partnership (LLC)
- Sale of Partnership (LLC)
  - Proceeds received from sale of partnership interest generally taxed as capital gain
    - Exception: “hot assets” such as depreciation recapture
  - Gain reduced by partners’ tax basis in partnership interest that increased from prior income allocations
  - Asset sale treatment for buyer

S Corporations

- Income
  - S Corporation files an information return (Form 1120S), but does not generally pay entity-level federal taxes
    - Income is allocated to shareholders who pay tax on personal returns
    - Income allocated to shareholders increases each shareholder's tax basis, which reduces taxes paid on distribution or on a sale of stock
- Distributions
  - Distribution of property treated as taxable with recognition of gain/loss at the corporation level
  - Cash distributions tax-free to extent of basis
  - Special limitations apply for former C-Corps which limit tax-free distributions to extent of undistributed S-Corp income ("AAA")
- Sale of S Corporation
  - Gain reduced by shareholders' basis in stock that increased from prior income allocations
  - Asset sale treatment for buyer if:
    - Legal sale of assets
    - Deemed sale of assets (e.g., Section 338(h)(10) election)

Key Federal Income Tax Changes

Tax Rates

Combined Federal & Wisconsin	
C Corporation (No Distributions)	27.24%
C Corporation (With Distributions)	50.12%
S Corp Shareholder / Partner / Sole Proprietor (199A Deduction)	41.05%
S Corp Shareholder / Partner / Sole Proprietor (No 199A Deduction)	44.65%

[1]Does not factor in active vs. passive
[2]Does not address payments for reasonable compensation
[3]Ignores deduction for self-employment taxes paid

- "Permanent" corporate rate reduction from max rate of 35% to flat rate of 21%
- Top individual/trust income tax rate reduced from 39.6% to 37% until 2026
- No changes to long-term capital gain rates (max 20%), NII (3.8%) or Section 1202 exclusion
- Itemized deduction for state and local income and property taxes capped at $10,000 until 2026 for individuals
- Standard deduction increased from $6,350 to $12,000 for single and $12,700 to $24,000 for married filers

Section 199A – QBI Deduction

- Deduction for up to 20% of qualified business income ("QBI") from flow-through entities or sole proprietorships through 2025
- Qualified business income means net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or businesses that is effectively connected with the conduct of a trade or business within the United States
- A qualified trade or business includes any business other than a specified service trade or business or trade or business of performing services as an employee
  - Adopts Section 162 standard

Section 199A – QBI Deduction, cont'd

- Specified service trade or business includes:
  - Services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners (Section 1202(e)(3)(A) – engineering and architecture excluded); and
    - Reputation or skill phrase limited by proposed regulations
    - Banks are presumably not in the field of "finance"
  - Services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities
- Taxpayers receiving income from these trades or businesses receive no QBI deduction if taxable income is above $207,500 (single) or $415,000 (joint)

Section 199A – QBI Deduction, cont'd

- Wage and Capital Limitations: Apply if taxpayer's total taxable income is above $157,500 (single) or $315,000 (joint)
  - QBI Deduction limited to the greater of:
    - 50% of the taxpayer's allocable share of W-2 wages with respect to the business, or
    - 25% of the taxpayer's allocable share of the W-2 wages with respect to the business plus 2.5% of taxpayer's allocable share of the unadjusted basis of all qualified property
- Overall Limitation: Total QBI deduction cannot exceed 20% of the excess of the taxpayer's taxable income over the sum of net capital gains for the year

Section 199A – QBI Deduction, cont'd

- Highlights from Proposed Regulations:
  - Applies on a trade or business basis (not entity-by-entity basis)
  - Allow for *de minimis* SSTB activities where less than 10% of gross receipts are attributed to activities that fall within the specified service trade or business definition
    - Reduced to 5% if more than $25 million in gross receipts
  - Aggregation of commonly controlled trades or businesses optional
  - Anti-abuse rules for establishing multiple trusts to maximize QBI deduction and avoid taxable income thresholds

Excess Business Loss Limitations

- Excess business losses are not currently deductible
- Excess business losses are the excess of:
  - (1) all of the taxpayer’s deductions attributable to trades or businesses of the taxpayer, over
  - (2) the sum of
    - (A) the total gross income or gain of the taxpayer attributable to trades or businesses and
    - (B) a threshold amount ($500,000 for married individuals filing jointly and $250,000 for others).
- Thus, business losses of a non-corporate taxpayer for a taxable year can offset no more than $500,000 (for married individuals filing jointly), or $250,000 (for other individuals), of non-business income of the taxpayer for that year
- Applies at the partner/shareholder level
- Excess becomes a NOL carryover subject to the NOL rules

Choice of Entity Considerations

Choice of Entity Considerations

- Prior to tax reform, partnerships were the most common entity choice for tax purposes
- After tax reform, there is still no single solution for all businesses
- C corporations are now generating more interest and may become a more common choice
- Caution should be exercised as there may be a high tax cost to converting out of a C corporation

Choice of Entity Considerations

- Consider the tax results:
  - upon formation
  - during operations
  - upon a sale or conversion
- Also consider state law entity type
  - LLCs can be partnerships or C or S corporations
    - Caution: Structuring an S Corporation as an LLC can be a recipe for a terminated S election if operating agreement is not carefully drafted
  - State law corporations cannot be partnerships for tax purposes

Key Factors Impacting Entity Choice

- Makeup of the investor base
- Debt and equity capitalization structure
- Borrowing requirements
- Likelihood of distributing earnings
- State tax rates
- Compensation and benefit considerations
- Participation of owners in the business
- Sale or exit strategies
- Estate planning strategies

Makeup of Investor Base

- Start-up companies with multiple seed rounds often end up as C Corporations due to pressure from investors
  - Multiple seed rounds more complex in a partnership
- Investors may prefer tax simplicity of owning a C corporation
- Shareholder limitations of S Corporations are impractical for many startups that have VC investors that are partnerships

Debt and Equity Capitalization Structure

- Debt capitalization
  - If debt will be used, consider where debt will be incurred (at owner level or company level)
  - With a partnership, debt incurred at the partnership level can increase outside tax basis for the partners
  - There is no similar outside basis increase for debt incurred by S corporations or C corporations
  - Limitations on loans from shareholder to S corporation
- Equity capitalization
  - More flexibility with C corporations and LLCs
  - S corporations are limited to single class of stock
  - Availability of profits interests with LLCs

Distribution Strategy

- Consider the distribution requirements of owners
- C corporation dividends are taxed at a 31.45% combined federal and Wisconsin tax rate
- Partnerships and S Corporations can generally make tax-free distributions to the extent of basis

State Tax Rates

- Treatment of state and local taxes for federal tax purposes
  - C corporations may still deduct state taxes in full
  - Owners of flow-through entities pay state income taxes on their share of flow-through income but cannot deduct state taxes in excess of $10,000
  - This difference is important for businesses that operate in higher taxing states, such as California, New York, or Minnesota
- Location of owners and business
  - Owners that live income tax-free states may prefer pass-through entity
  - Wisconsin
    - Corporate tax rate is a flat 7.9%
    - Individual rate tops out at 7.65%

Income Tax Rate Comparison (WI)

HIGHEST MARGINAL RATE COMPARISON	C CORPORATION		LLC/PARTNERSHIP	
Type of Tax	**Retains Income**	**Distributes Income**	**Non-Service**	**Service**
Federal Income	21.00%	21.00%	29.60%	37.00%
WI Income Tax	7.90%	7.90%	7.65%	7.65%
Deduction for State Taxes	-1.66%	-1.66%	0.00%	0.00%
Federal Distribution Tax	0.00%	20.00%	0.00%	0.00%
WI Distribution Tax	0.00%	7.65%	0.00%	0.00%
Self-Employment Tax	0.00%	0.00%	3.80%	3.80%
NII	0.00%	3.80%	0.00%	0.00%
Effective Rate	**27.24%**	**50.12%**	**41.05%**	**48.45%**

* Assumes full use of QBI deduction.

** Does not address payments for reasonable compensation.

*** Does not include deduction for self-employment taxes paid.

**** Total C Corporation rate w/distribution takes into account reduced income available for distribution.

Income Tax Rate Comparison (WI)

HIGHEST MARGINAL RATE COMPARISON	C CORPORATION		S CORPORATION			
Type of Tax	**Retains Income**	**Distributes Income**	**Non-Service & Active**	**Non-Service & Passive**	**Service & Active**	**Service & Passive**
Federal Income	21.00%	21.00%	29.60%	29.60%	37.00%	37.00%
WI Income Tax	7.90%	7.90%	7.65%	7.65%	7.65%	7.65%
Deduction for State Taxes	-1.66%	-1.66%	0.00%	0.00%	0.00%	0.00%
Federal Distribution Tax	0.00%	20.00%	0.00%	0.00%	0.00%	0.00%
WI Distribution Tax	0.00%	7.65%	0.00%	0.00%	0.00%	0.00%
Self-Employment Tax	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
NII	0.00%	3.80%	0.00%	3.80%	0.00%	3.80%
Effective Rate	**27.24%**	**50.12%**	**37.25%**	**41.05%**	**44.65%**	**48.45%**

* Assumes full use of QBI deduction.

** Does not address payments for reasonable compensation.

*** Does not include deduction for self-employment taxes paid.

**** Total C Corporation rate w/distribution takes into account reduced income available for distribution.

Compensation and Benefit Issues

- Reasonable Compensation
  - S Corporations must pay reasonable compensation to their shareholder/employees
  - IRS may challenge compensation paid to C Corporation shareholder/employees if considered unreasonably high (2009 7th Cir. Case – Menard Inc.)
- Employee Fringe Benefits
  - Health Insurance
  - Life Insurance
  - Disability Insurance

Participation of Owners in Business

- Self-Employment Tax Considerations
  - Active S Corporation Shareholder Advantage
- NII on Sale of Entity
  - Active S Corporation Shareholder Advantage
  - Trusts?

Impact of Basis Build-Up

- The build-up of basis in flow-through entities remains a valuable feature
  - Owners' basis in a flow-through entity increases as the entity recognizes income
  - Owners' basis in a flow-through entity decreases as losses are realized or as distributions are made
  - This basis build-up decreases gain on an ultimate sale of the flow-through entity
- No similar build-up in stock basis for C corporations
- Over time, basis build-up from a profitable entity reduces taxable gain upon an ultimate sale

Sale Considerations

- Buyer's purchase of stock of a C corporation generates basis in stock
  - Stock basis cannot be amortized
  - Produces no tax savings until stock becomes worthless or is sold (which may be never)
- Buyer's purchase of assets may generate tax deductions based on the mix of assets purchased
  - Cost recovery depends on type and life of asset purchased
  - Full expensing under Tax Act for qualifying assets
- Buyers can and do pay more for the NPV of these deductions
  - Rule of thumb <u>before</u> Tax Act: NPV of goodwill amortization is 15% - 20%
- With S-Corps and LLCs, sellers can deliver stepped-up basis to buyers with most proceeds still taxed as capital gains

Sale Considerations

- C corporations
  - Asset sales are still likely undesirable (50% combined tax rate) except if NOLs are present
  - Stock sales are likely preferred (29% combined tax rate), but no build-up in stock basis with C corporations
  - Potential exclusion of gain on sale (see next slide)
- Pass-through entities
  - Build-up in tax basis remains advantageous
  - Asset sales and equity sales generally have similar tax consequences (29% combined tax rate)
  - New risk of ordinary income treatment for self-created patents, secret processes, and recipes in asset sales

Sale Considerations

- Section 1202 Qualification
  - Allows taxpayers to exclude greater of $10 million or ten times (10x) the taxpayer's adjusted basis
  - Requirements:
    - The stock must be originally issued by a "qualified small business"
    - The taxpayer must have acquired the stock at its original issue in exchange for money, property, or as compensation for services provided to the corporation
    - During the time the taxpayer owns the stock, at least 80% of the corporation's assets must be used in the active conduct of one or more qualified businesses
    - The corporation must not have aggregate assets in excess of $50 million through and immediately following the issuance of the QSBS
    - The corporation must not have redeemed more than a de minimis amount of stock from the taxpayer (or certain related parties) during the four-year period beginning two-years prior to the issuance of stock to the taxpayer
  - Possible to qualify with conversion from LLC to C corporation

Estate Planning Considerations

- Ability to use tax distributions for wealth transfer strategies:
  - GRATs
  - Installment sales to intentionally defective grantor trusts

Other Factors

- Risk of legislative change
- Inability to change back from a C Corporation
- Potential Penalty Taxes
  - Accumulated Earnings Tax
  - Personal Holding Company Rules
- Foreign Operations

Converting Entities

Converting Existing Entities

- Existing businesses may want to reconsider entity choice for tax purposes
- A state law entity conversion may or may not be required to change tax treatment of entity
- Some conversions for tax purposes may be done solely by filing tax elections
- Conversions may or may not have tax consequences

Partnership to C or S Corporation

- Partnership to C or S corporation is generally tax-free
- Some tax may be triggered if the partnership has liabilities in excess of basis at the time of conversion
- Conversion can be done any time during the tax year
- If converting to a C corporation, potential to qualify for Section 1202 gain exclusion
- A state law LLC can elect to be a corporation for tax purposes and remain an LLC under state law
- Or, a state law LLC can convert into a state law corporation

S Corporation to C Corporation

- S corporation to C corporation conversion is generally tax-free
- Conversion may be done during the taxable year by intentionally terminating S election
- Otherwise, conversion must coincide with beginning of tax year
- Five-year waiting period before re-electing S corporation status
- No state law entity conversion required

C Corporation to S Corporation

- C corporation to S corporation generally does not trigger an immediate tax liability
- LIFO inventory may be taxed over four years
- A built-in gain tax applies for 5 years after conversion
  - Built-in gain must be measured at conversion
  - Corporate-level tax if gain is recognized within 5 years
  - State law may vary
- Corporation must be eligible to elect S corporation status (single class of stock, fewer than 100 eligible shareholders)
- Conversion must coincide with beginning of tax year
- No state law entity conversion required

C Corporation to Partnership

- C corporation to partnership is generally taxable
- Conversion is treated as a taxable liquidation of the corporation
- Taxed at both the corporate and shareholder levels (50% effective tax rate)
- With reduced corporate tax rates, these conversions may now be more feasible
- Corporate NOLs may offset some of the gain on conversion