Choice of Business Entity:

How Owners Can Limit Taxes and Liability

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Tax attorney Peter J. Guy specializes in federal income tax law. Mr. Guy has extensive experience providing federal income tax advice to public and private companies with a particular emphasis on mergers, acquisitions, securities offerings and divestitures. He advises real estate funds, private equity funds, hedge funds, limited liability companies, partnerships, S corporations and similar entities on tax issues relevant to the formation and operation of such entities. He has experience advising real estate investors and developers on tax issues arising out of the ownership and operation of real estate, including certain tax credit advice. His experience includes advising domestic and international clients regarding cross border tax issues and certain New York state and local tax issues. Mr. Guy also has experience advising clients that have special tax considerations such as real estate investment trusts and tax-exempt entities. Prior to joining Ellenoff Grossman & Schole LLP, Mr. Guy was associated with the law firms of Paul, Weiss, Rifkind, Wharton & Garrison, LLP and Bryan Cave, LLP. Mr. Guy is admitted to practice in the state of New York and is a member of the American Bar Association's Section of Taxation. Mr. Guy received his Juris Doctorate from Harvard Law School where he graduated *cum laude* and his Bachelor of Science degree from Northeastern University where he graduated *summa cum laude.*

Typical Business Entities

- Regular "C" corporation
- Subchapter "S" corporation
- Limited Liability Company
- Limited Partnership
- General Partnership
- Sole Proprietorship
- Joint Ownership of Property
- Special entities – Real Estate Investment Trusts (known as "REITs"), Mutual Funds, Business Trusts, Others.

Basic Tax Considerations

- Corporate entities are generally subject to tax unless special rules apply (S corporations, REITs are two examples)
- Pass-through entities generally do not pay tax but their owners must pay tax on their appropriate share of the entity's income
  - Partnerships (Limited and General)
  - Limited Liability Companies (unless it elects otherwise)
  - S corporations
  - Sole proprietorships and joint ownership
- Distributions of cash from C corporations are taxed as dividends to the extent of corporate earnings
- Cash distributions of earnings from passthrough entities are not taxed a second time

Basic Liability Limitation

- Some entities provide liability protection by law
  - Corporations
  - Limited Liability Companies
  - Limited Partnerships (except for the General Partner)
  - REITs
- Others have no layer of protection between the liabilities of the entity and its owners
  - Sole proprietorships
  - General Partnerships
  - Joint ownership
- The default rules can sometimes be altered by agreement
  - Personal guarantees of corporate loans by shareholders
  - Indemnities for liabilities from one owner to another

C corporations

- Liability protection for shareholders
- Corporate tax on income of company
  - “two layers” of tax because income taxed again when distributed to shareholders
  - Tax burden can be reduced by payment of reasonable compensation to shareholders or through shareholder loans
- Not a common model for most small businesses
- May be more attractive for non-US investors who wish to avoid filing US tax returns

S corporations

- Many of the benefits of C corporations without the tax inefficiencies
- Passthrough taxation on income
- Losses passed through subject to limitations
- Limits on who can own
  - Must be US citizen or resident
  - Must be individual or certain trusts only
  - Limited to 100 shareholders
- Can only have one class of stock (no preferred stock financing)
- Distributions of appreciated property may be taxable

Limited Liability Company

- Most flexible of the passthroughs
- Allows for single layer of tax on income and passthrough of losses
- Limitations on loss passthrough easier to satisfy (get basis for company debt)
- No limitations on ownership and can have any number of classes of equity
- Generally no tax on distribution of property other than cash
- Cash taxed only if in excess of basis

Limited Partnerships

- One of the first non-corporate passthroughs to allow limited liability
- Must have at least one General Partner with unlimited liability
- Similar to LLCs in flexibility and greater loss passthrough (basis for debt)
- Often used for investment funds
- Distribution rules same as LLCs

General Partnerships

- Original partnership structure
- Requires very little in the way of formal agreements to establish
- No liability protection for any partner
- Fairly rare in modern entity formation practice
- Distribution rules same as LLCs

Sole Proprietorship

- “Mom-and-Pop” business model
- Also requires little to no formal documentation to establish (outside of minimum business licensing requirements)
- Individual proprietors report business profits and losses on their own tax returns (1040, Schedule C)
- No liability protection

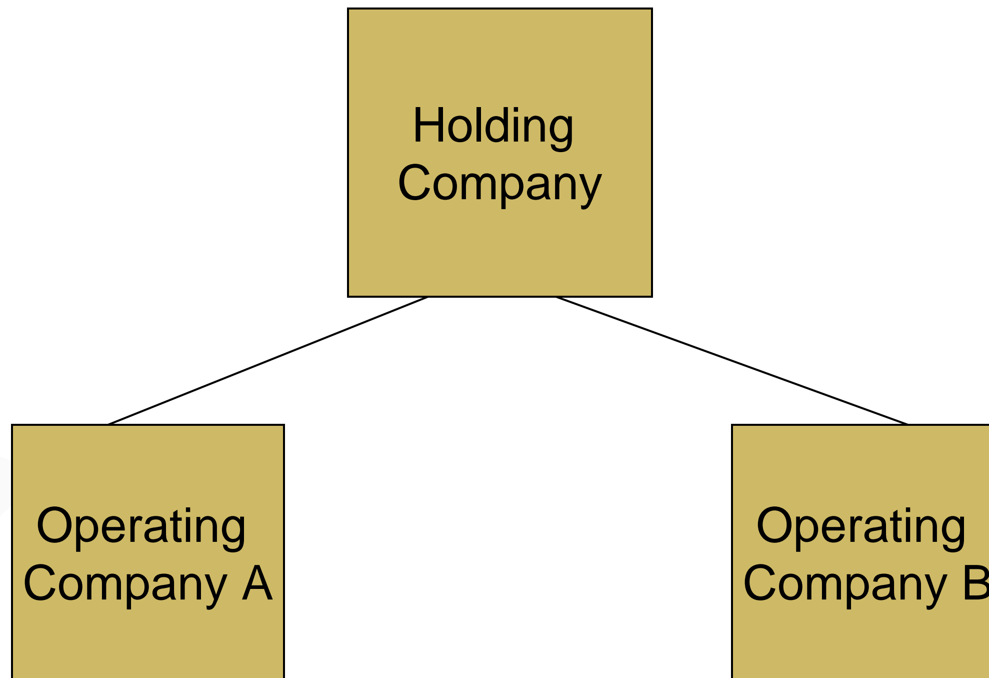
Joint Ownership of Property

- Similar to general partnership
- Usually used for real estate ownership or securities
- Less documentation
- No liability protection
- Can provide tax advantages over ownership through other pass-through entities – 1031 Like-Kind Exchanges of Real Estate

Special Entities - REITs

- Special entities created decades ago to allow investors to pool money and invest in professionally-managed real estate funds (“mutual fund” for real estate)
- Must predominantly invest in real estate assets
- Numerous other technical requirements
- Pass through income but not losses (but generally only one layer of tax)
- No 15% tax rate on dividends (35% rate applies), and property distributions may trigger tax

Use of Holding Companies to Isolate Liabilities



Not all Pass-Through Entities are Equal

- All feature single layer of tax on profits
- Some are better at passing through losses than others
  - Basis limitation on losses
  - LLCs and partnerships allow entity debt to count as basis
    - Example: Investors A and B contribute $10 each to form an LLC. The LLC borrows $80 and, together with the $20 contributed by A and B, buys a $100 real estate asset. A and B can claim deductions and losses up to the full $100 investment (subject to passive loss rules and other loss limitations)
  - S corporations, REITs do not allow entity debt to count as basis
    - Example: Assume the same facts except A and B form an S corporation instead of an LLC. A and B can only claim $20 of losses. Losses and deductions attributable to the $80 of debt are suspended until a later time (additional basis or dissolution).
  - Passive Loss rules, other loss limitations

Debt vs. Equity

- In some cases debt can be used to capitalize a corporation and effectively distribute profits with one layer of tax
- Investors in unincorporated entities with unlimited liability can limit their exposure through loans (bank loan to entrepreneur – bank is only at risk for amount loaned)
- Must avoid “earnings stripping” and lender liability issues

Exit Issues

- Corporate entities are easier counterparts for traditional tax-free merger transactions
- LLCs and other noncorporate passthroughs offer considerably more flexibility on exit (subject to publicly traded partnership rules)
- Possible IPO tax benefits through basis step up
- Gain on sale may be treated differently between corporate and noncorporate entities
- Noncorporate entities are easier to split apart

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