Lisa Powers, CPA; M.S., Law of Taxation
January 17, 2019

THE IMPORTANCE OF FORMATION

OVERVIEW OF AN "ENTITY"

"A thing with a unique and independent existence". Controlled by state law of formation.

As a taxpayer may choose, within restrictions:

- Type of entity; corporate, partnership, LLC, trust, non-profit
- Method of accounting: cash, accrual, hybrid, percentage of completion & others –most all are available to any type of entity
- Taxable year; restrictions for flow-through entities

SUMMARY OF WHAT OPTION IS BEST IN CERTAIN SITUATIONS:

Operating business with multiple employees, one owner or more, and a need for structure: S CORPORATION

Simple business, often service, with one owner: LLC filed on Individual Return

Simple business, often service, with two or more owners: LLC using PARTNERSHIP TAX RULES

"SPV" (Special Purpose Vehicle), Real Estate, or Asset of Value being held with little operating activity: LLC using PARTNERSHIP TAX RULES

Real Estate Operating Activity – with such activity to be conducted by entity separate from the owner of property: LLC using PARTNERSHIP OR CORPORATE TAX RULES (s corp. or c corp.)

Ways to incent employee/non-owners in an equity fashion:

PROFIT/PERFORMANCE INTERESTS WITHIN AN LLC

When IRC Section 1202: Qualifying Small Business Stock classification is being pursued: unquestionably …. C CORPORATION

201 California Street, Suite 490 San Francisco, CA 94111 Tel 415-397-1115 Fax 415-397-9418
www.powersequity.com

When toggling back and forth between c corp. and s corp. be careful of:

- Built In Gain = a return to partial double taxation
- S corp. taint on QSBS stock
- Inadvertent termination of an s corp. by admitting non-qualified shareholder
- 5 year hold on re-electing s corp. status once terminated to c corp. status
- S corp. requirement: only one class of stock

The Limitation of Liability Imperative

“S” vs. “C” CORPORATION

Why to be a “c” corporation:

1. Lower statutory tax rate, present law
2. Do not qualify to be an “s” corporation; non-qualifying or too many shareholders
3. Possibility to take advantage of IRC Sec. 1202 exemption of gain on sale of stock
4. Conversion to “s” could cause a “built-in gain” corporate level tax in addition to a flow-through shareholder tax

Why NOT to be a “c” corporation:

1. Primarily and still, double taxation – even with current 21% corporate tax rate
2. Personal Holding Company status risk may be present (less than 5 owners hold 50% or more of common stock; or 60% of adjusted income is PHC is present)
3. “Unreasonable compensation” trap when paying all most of net income to achieve a lower tax cost at corporate level – an unintended consequence

Why to be an “s” corporation:

1. All items of income, gain or loss flow through and are taxed on each shareholder’s Individual Tax Return = lowest tax cost possible to allow for equity retention for growth rather than to pay income taxes
2. Ability to attract new (individual) shareholders due to optimal tax scheme

Why NOT to be an “s” corporation:

1. Complexity of keeping track of tax “basis” in s corporation shares of stock, year after year
2. Risk of inadvertent termination by allowing in a “disqualified shareholder”
3. Possible shareholder personal liability for s corporation debt by lender(s)
4. Desire to have more than one class of stock for equity raise provisions
5. May not have more than 100 shareholders.

TO LLC OR NOT?:

Benefits:

1. Legal limit to business liability of the amount invested in the LLC entity – yet n/a for a personally committed act resulting in a personal injury to another
2. May bolster liability limitation by adding insurance protection
3. Ability to reward non-owner employees with profit or performance interests in LLC profits or in equity; extremely flexible; results in LTCG to employees rather than ordinary income as would be ISO's, NQO's, SAR's
4. Ability to toggle from tax form (from one to another)
5. If a "disregarded entity", meaning in CA owned by one person or two married people, may file / often required to file, tax information on the Individual return
6. Respected by business community as a protective entity – especially for real property where LLCs are used more and more to hold property
7. May choose tax reporting from Sole Proprietorship, LLC or corporation – either s or c

Drawbacks:

1. In California, have only been allowed for 20 years. Lack of good body of case law testing common law meaning of "limited liability" in certain situations; hence, little guidance – to date
2. Can be higher CA tax cost due to Gross Receipts Tax plus annual LLC fee of $800. Example: $2 m gross receipts with $200K net income:
   "s" corp. CA only Tax of $3,300 per year
   LLC CA only Tax of $6,800 per year
3. If investment LLC, all are "members" with a "Managing Member" functioning much like a general partner; can be lack of control or influence
4. If "disregarded entity", tax filing must be done on Individual return, where if an s corporation, such exposed business income and deductions are reported on a separate return

Other:

1. Separation of LLC's: asset holding LLC's vs. operating LLC's:

Asset Holding LLC:	Operating LLC:
Owns asset; leases/hires Op. LLC to manage its assets, reduces risk	Owns no assets; simply manages assets owned by others

201 California Street, Suite 490 San Francisco, CA 94111 Tel 415-397-1115 Fax 415-397-9418
www.powersequity.com