CHOICE OF ENTITY

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ISSUE ARISES:

- When beginning a new enterprise.
- When outside considerations suggest a change.
- When owner or entity circumstances change.

At the outset:

- What is the enterprise strategy?
  - What is the enterprise intended to do?
  - Where, how and from whom is it going to acquire capital and other resources?
  - What are the economics: Profits, Losses and When?
  - How are contributions going to be compensated?
  - Who is going to control it?
  - Who is going to operate it?
  - How is it going to operate and for how long?
  - How big is it expected to get?
  - What are the contingency plans?
  - What is the succession strategy?
  - What is the exit strategy?
  - What distributions are intended, will they be possible and how will they be made?

At the outset (continued):

- Think realistically about:
  - the talents of the people, the “plusses” and the “minuses”.
  - how the needs of the enterprise may evolve and whether the people and the entity will be able to evolve with it.
  - how disputes and disagreements are going to be resolved (“We’re going to be 50%/50% partners, we see “eye to eye” on everything and have always gotten along”--rather like, “We’re in love, we’ll always be in love, we won’t be the ones to get divorced!”--but more than 50% do).

At the outset (continued):

How are the "inputs" to be acquired, differentiated and compensated over time?

- Capital and capital equivalent inputs.
  - Cash or cash equivalents.
  - Tangible assets.
  - Intangible assets.
    - » Technology.
    - » Contacts.
    - » Other intellectual property.
- Labor (agreement to provide effort, diligence and loyalty as an employee over time).

Considerations:

- Non-tax issues:
  - Ability to acquire capital and capital equivalent contributions at reasonable rates (stock, partnership and member interests—they are not "monopoly money").
  - Ability to attract and retain appropriate human resources.
  - Ownership, control and management: Ability of certain owners to control the enterprise.
  - Free transferability of interests (or restricted, "Hello, I'm your new partner and, by the way, my deceased husband may have trusted you but I never did.").
  - Successor and exit strategies; continuity of life.
  - Limitation of liability.
  - Ability of owners' creditors to reach underlying assets of the entity.
  - Costs and formalities required; thin capitalization; "piercing the corporate veil".
  - Estate planning.

Considerations:

- Tax issues:
  - Treatment of earnings, gains and losses--active and passive.
  - Transfer tax valuation.
  - Ability to combine with or to break-up into separate entities without a recognition and/or a realization event.

The Law Evolves

- "A hundred years ago. . ."
  - A corporation required an act of a state legislature and generally was authorized to operate solely within a state.
  - The issue, the <u>privilege of limited liability</u>.
  - The Sherman "Anti-Trust" Act, 15 U.S.C. § § 1-7, July 2, 1890, not the Sherman "Anti-Corporation" Act.

- "Fifty years ago . . ."
  - Sole Proprietorships, General Partnerships, Limited Partnerships, Corporations.
  - The issue, <u>capital formation and national recognition</u>.

TODAY:
Almost Complete Flexibility to Augment any Business Purpose

- HOWEVER . . .with flexibility comes the need to choose wisely and more effort and diligence is required to think through the issues.
  - Each entity form provides different opportunities, requirements, restrictions and detriments.
  - Care must be taken to think carefully about what is desirable to accomplish, what should be avoided and why.

Virginia: At Least Fifteen Entity Types

- Sole Proprietorships
- Partnerships
  - General
  - Limited
  - Limited Liability Limited
- Limited Liability Companies
  - Single & Multiple Members
  - Member Managed & Manager Managed
  - Professional & Non-professional
- Corporations
  - Stock and Non-Stock
  - Professional
- Business & Land Trusts

"C" and "S" Corporations

- Do not be confused--these are "shorthand" names for state law (almost always) entities referred to for federal tax purposes as "C" or "S" corporations.

  – A "C" corporation is a *per se* corporation under state law ("Inc.," "Incorporated," "Corporation"), or an association electing to be taxed as a corporation, taxed for purposes of federal taxation under Subchapter C of the Internal Revenue Code (the "IRC").

  – 26 U.S.C. § 1361(a)(2) "C corporation. For purposes of this title, the term 'C corporation' means, with respect to a taxable year, a corporation which is not an S corporation for such year."

  – An "S" corporation is a corporation, as above, meeting the requirements to be taxed under Subchapter S of the Internal Revenue Code that has made the necessary election.

"S" Election Requirements

- 26 U.S.C. § 1361(b)(1): "Small business corporation":
- In general. For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--
  - (A) have more than 100 shareholders,
  - (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
  - (C) have a nonresident alien as a shareholder, and
  - (D) have more than one class of stock.
- All must consent--important in re tax and distributions.

"Busted S" Election

- Treatment of terminations of qualified subchapter S corporation:
  - In general, treated as a new corporation acquiring all of its assets and assuming all of its liabilities immediately before such cessation from the S corporation in exchange for its stock.
  - It becomes taxable as a "C" corporation.

Entity Classification for Federal Tax Purposes

The "Check the Box" Regs. (Treas. Reg. § 301.7701-1 *et. seq.)*

<u>First Issues:</u>

- Is the entity separate from its owners?
  - Matter of federal law independent of state law classification.
- Is the entity a "business entity"?
  - A business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner) that is not properly classified as a trust or otherwise subject to special treatment under the Internal Revenue Code.

Business Entities: Federal Tax Purposes

- A business entity with one owner (which may be a sole proprietorship or affiliate) is disregarded or classified as a corporation.
- A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.
- An association not automatically taxed as a corporation (such an association may elect its treatment for federal tax purposes); LLCs.
- A corporation: *generally* a *per se* corporation under a federal or state statute or a federally recognized Indian tribe if the statute refers to the entity as a "corporation" or as "incorporated" , a publicly traded partnership or a foreign entity.

Entity Characteristics

	"C" CORP	"S" CORP	LP	LLP	LLC
Non-tax Considerations:					
Limited Liability	Y	Y	Y/N	Y/N	Y
Retention of Control	Y/N	Y/N	Y	Y	Y
Voting Restrictions	Y	Y	Y	Y/N	Y+
Management Restrictions	Y	Y	Y/N	Y/N	Y+
Continuity of Life	Y	Y	Y/N	Y/N	Y+
Transferability Restrictions	Y/N	Y+/N	y	Y	Y
Protecting Personal Assets	Y	Y	Y	Y	Y
Protecting Corporate Assets	Y	Y	Y	Y	Y
Ease and Expense	Y	Y	N	N	Y/N
Tax Considerations:					
Partnership Tax Treatment	N	N+	Y	Y	Y
Tax Free Formation	Y	Y	Y	Y	Y
Tax Free Contributions	N/Y	N/Y	Y	Y	Y
Tax Free Withdrawals	N	N/Y	Y	Y	Y
Adjustment to Basis	N	N	Y	Y	Y
Discounts & Premiums	Y-	Y	Y	Y	Y+
Income Tax	N	Y-	Y	Y	Y+
Self-Employment	N	N	Y/N	Y/N	Y/N
Distributions Required to Pay Tax	N	Y	Y	Y	Y

Popularity of Limited Liability Companies

- Partnership tax treatment.
- No restrictions on Ownership.
- No restrictions on Capital Structure.
- Tax-Free Formation, Contributions & Withdrawals.
- Basis: “inside basis,” “outside basis” and “adjustments”.
- Discounts & Premiums: marketability, control and private enterprise.
- Self-Employment Tax: Member Managed vs. Manager Managed.
- Conversion to stock corporation—merger, entity conversion & share exchanges: “Going Public”.

Raising Capital & Entity Structure —A Note of Caution— Securities Issues

- "Pass the Hat" money--friends and family.
- "Angel" money.
- Venture Capital Funds.
- Private Capital Funds.
- Going Public

The Securities Issues

- No matter the structure, there are securities issues:
  - Definition contained in Sec. 2 of the Securities Act (‘33 Act) and Sec. 3 of the Securities Exchange Act (‘34 Act).
  - SEC v. W.J. Howey Co., 326 U.S. 293: “An investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or third party.
  - Scotch whiskey, self-improvement courses, condominiums, cosmetics, earthworms, beavers, muskrats, rabbits, chinchillas, fishing boats, vacuum cleaners, cemetery lots, cattle embryos, recording contracts, animal feeding programs, pooled funds and fruit trees.