

## Business Entity Selection

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### General Issues

A corporation can generate “double taxation” as profits are taxed at the corporate level and again as dividends at the shareholder level. LLCs and S Corps generally do not pay income tax. They file their own tax returns (except single member LLCs/QSUBS). Their profits, losses, deductions, and/or credits “flow through” (on Schedule K-1) to the owners and are reported on their personal income tax returns. There is generally no “double taxation” with LLCs/S Corps.

### Executive Summary

#### 1) C Corp:

##### **Pros:**

- a) Venture Capital: Venture funds usually prefer investing in C Corps over S Corps and LLCs. S Corps can inhibit venture investment because: (i) S Corps cannot have partnerships, corporations or non-U.S. persons as shareholders and (ii) S Corps cannot issue preferred stock. LLCs create tax problems for foreign investors and nonprofit investors. LLC income is unrelated trade or business income to a nonprofit and taxable (dividends are not taxed). LLC income allocated to foreign investors is U.S.-source income, triggering a U.S. tax filing obligation.
- b) Qualified Stock Options: C Corps (and S Corps) can issue ISOs. LLCs cannot.
- c) Tax Only When Cash (Dividends) Received: Unlike S Corps and LLCs, shareholders generally incur tax only when cash is received or stock is sold.

##### **Cons:**

- a) Double Taxation: Profits are taxed at the corporate and shareholder level
- b) Losses: Do not flow through to the shareholder

## 2) **S Corp:**

### **Pros:**

- a) **Avoid FICA:** Biggest tax advantage (and one of its only tax advantages) over the LLC. The owner of an S Corp can often avoid paying SS/Medicare on portion of the S Corp's earnings (LLC owners participating in business must pay SS/Medicare on all LLC earnings).
- b) **Simpler:** Forming an S Corp and preparing S Corp tax returns is much simpler than forming an LLC (cheaper)
- c) **Possible Tax-Free Exit:** An S Corp (and C Corp) owner may be able to avoid paying taxes on his/her exit if the corporation is acquired in a tax-free re-org

**Cons:** Too many to list. That said, for some deals, S Corps are the way to go.

## 3) **LLC:**

### **Pros:**

- a) **Flexibility:** Non pro-rata allocations of income, deductions, losses, credits among members
- b) **Easier to deduct losses:** To extent the business doesn't make money in early years, it's easier for owners to deduct losses in an LLC
- c) **Tax-free Distribution of Appreciated Property:** An LLC can distribute appreciated property (e.g. buildings, land, etc) tax-free to its owners. **Golden Rule: Never put appreciating property (buildings, land, etc) in an S Corp.**

### **Cons:**

- a) Owners of an LLC who participate in the business owe FICA on all their LLC earnings
- b) Expensive to do it right (proper accounting for LLCs is difficult, operating agreements are more complicated)

## S Corp vs. LLC The Major Considerations:

### 1) **The FICA Thing:** *Social Security and Medicare Tax Considerations*

#### FICA Tax Rates:

*Social Security:* 12.4% of first \$117,000

*Medicare:* 2.9% of everything (additional 0.9% for high earners (\$200,000 single, \$250,000 joint))

- i) LLC: LLC Owner who participates in the business pays FICA on both wages and net earning distribution (exceptions: rentals, interest, dividend, capital gains, limited partners).
- ii) S Corp: S Corp owner pays FICA on wages received from the S Corp but not on net S Corp earning distributions.

The FICA Example: Chris owns a clothing store and is the store's only employee. The store has \$100,000 in earnings after paying all expenses except for Chris's time/effort.

LLC : Chris pays SS/Medicare (approx. 15.3%) on all \$100,000 (approx \$15,300)

S Corp: Chris sets his wages at \$70,000 and takes remaining \$30,000 as profit distribution. Chris avoids SS/Medicare on \$30,000 provided \$70,000 is "reasonable" compensation. (Savings of approximately \$4,600).

**Bottom Line on The FICA Thing:** If you choose an S Corp instead of an LLC the owner of the S Corp may be able to avoid paying FICA on a portion of the S Corp's earnings. The owner must set his/her S Corp wages at a "reasonable" level and pay FICA on the wages but not on any additional S Corp earnings. IRS/Congress is watching...

## 2) Formation Issues: *Slight Advantage LLC – no 80% Requirement*

**Overarching Issue:** Can I form a business tax free?

- i) Services for Equity Ownership: Can I contribute services in exchange for equity interest in LLC/S Corp without paying tax?
- ii) Property for Equity Ownership: Can I contribute appreciated property to an LLC or S Corp in exchange for an ownership interest without owing tax on the contribution?

*The Formation Example:* Chris and Jill form a restaurant. Chris contributes the building (he bought for \$1,000, now worth \$10,000) in exchange for a 50% ownership interest, Jill agrees to serve as chef in exchange for 50% ownership interest. Do Chris and Jill owe taxes on receipt of ownership interest?

**General Answers:**

- i) Services for Equity Ownership: Always taxable compensation to service provider (LLC or S Corp).

*The Formation Example (continued):* Jill's receipt of 50% equity interest in the restaurant (she now owns half the building) in exchange for services as chef is treated as taxable compensation to Jill.

**Golden Rule #1:** Receipt of equity interest in a business in exchange for services is always taxable income (Whether S Corp or LLC)

- ii) Appreciated Property for Ownership: this can usually be done tax-free, but it's a little easier with an LLC.

*The Formation Example (continued):* Jill's receipt of a 50% ownership interest for services as chef is taxable compensation, however is Chris's receipt of 50% ownership interest in exchange for an appreciated building tax-free?

LLC: Chris receives his 50% interest in business tax-free if organized as LLC.

LLC Formation Rule: Neither the LLC nor the owner recognizes income upon the transfer of property to the LLC in exchange for ownership.

S Corp: Chris owes tax on the building's built-in gain (\$9,000 difference between what Chris paid for building and the \$10,000 its now worth) upon contributing the building to the S Corp for a 50% interest in the S Corp.

S Corp Formation Rule: One or more people/entities (the "Transferors") can transferor property tax-free to S Corp only if the *transferors of property* own 80% or more of the S Corp immediately after the exchange.

Here: Chris transferred "property"; Jill transferred "services". Chris did not own 80% or more of the S Corp after the transfer (he owned 50%). Cash is considered property. If Jill had transferred cash to the S Corp in exchange for stock, instead of transferring her *services* as chef, Chris and Jill would have both received their S Corp stock tax-free because they both would have been considered transferors of "property", who in the aggregate owned 80% or more of the S Corp after the transfer. If shareholder transfers services and property, property cannot be of "relatively small value" (10%) in comparison with stock already received or to be received for services.

**Bottom Line on Business Formation**: Both S Corps and LLCs allow individuals to contribute money/property to the S Corp/LLC in a tax-free in exchange for ownership interest, however it is much easier with an LLC (No 80% Control Requirement).

The Fine Print on Formation Issues:

1) *What is Chris' Cost Basis in his LLC/S Corp Interest?*

Rule: If the owner's transfer of property in exchange for his/her ownership interest qualifies as tax-free, the owner's cost basis in LLC/S Corp interest received is same as cost basis in the property transferred.

The Formation Example: Chris' cost basis in the LLC interest would be \$1,000 - - the same as the cost basis in the building transferred. The same goes for Chris' S Corp interest if it had qualified as a tax-free transfer.

2) *Tax-Free Exception Where Property Subject to Excess Liabilities*:

Rule: You cannot transfer property tax-free to S Corp/LLC if the property transferred is subject to liabilities in excess of its adjusted basis.

*The Formation Example:* If Chris owed \$2,000 on the building (building's cost basis was \$1,000) and transferred the building to LLC/S Corp, and the LLC/S Corp assumed this liability from Chris, Chris would have taxable income of \$1,000 (excess of liability assumed (\$2,000 over his \$1,000 cost basis). Chris's cost basis in S Corp/LLC interest received would be \$0.

3) *Other Obscure Rules I Need to At Least Mention:*

i) Tax-Free Exception for "Boot":

Rule: Transferor of appreciated property pays tax on property's built-in gain to the extent of "boot" (money or other property) received.

*The Formation Example:* If Chris transferred the building (with built-in gain of \$9,000) and received \$1,000 from LLC, in addition to a 50% ownership interest, Chris would have \$1,000 of taxable gain (general rule is that transfer is tax-free but there's an exception causing Chris to owe tax on the built-in gain to the extent of "boot" received. Chris received \$1,000 of "boot").

ii) LLC Tax-Free Exception for "Disguised Sale":

Rule: The LLC owes tax where the owner contributes appreciated property to LLC in exchange for ownership followed by a corresponding distribution of money/ property from the LLC to the same owner (2 year presumption)

*The Formation Example:* Chris contributed the appreciated building to the LLC in exchange for ownership interest and two months later the LLC also distributes \$10,000 cash back to Chris, this is a presumed disguised sale of building from Chris to the LLC.

iii) LLC Tax-Free Exception for "Contribution-Distribution" Rule:

*The Formation Example* Chris contributes appreciated building to the LLC and the LLC distributes the building to Jill w/in 7 years of the contribution, Chris may be taxed on appreciation.

## 3) Profits/Losses/Distributions from Operations:

### **Profits:** Advantage LLC

- *Profits Taxed Even if Cash is not Distributed (S Corp and LLC):*

IE: C&J Company earns a net profit of \$30,000, but does not distribute any cash to Chris or Jill. Profits flow through to Chris and Jill's personal income tax return even if the \$30,000 is never distributed.

- *S Corp Pro-Rata Limitation:* All allocations/distributions must be pro-rata, in proportion of each owner's ownership interest. The S Corp cannot make special allocations of income, gains, losses, deductions and/or tax credits.

IE: If Chris owns 50% of C&J S Corp, Chris must get 50% of the S Corp's income, gains, losses, tax credits, etc.

- **\*\*\*LLC Allows Special Allocations:** LLCs can make special allocations of income, gains, losses, deductions and/or tax credits among owners of the LLC.

IE: If Chris and Jill formed C&J LLC. Chris contributed \$1,000 cash for 50% of LLC and Jill contributed her know-who for 50% of LLC. The LLC's Operating Agreement could provide that Chris gets the first \$1,000 of income from the LLC and thereafter all profits are distributed 50-50.

### **Losses:** HUGE Advantage LLC\*\*

**Golden Rule #2:** It's easier to deduct losses with an LLC

- *S Corp and LLC's "Basis" in Entity:* "Basis" is very important:
  - i) *Loss Deductions on Personal Income Tax Returns:* An owner of an S Corp or LLC can only deduct her losses (ordinary or capital) from the S Corp/LLC to the extent of her "basis" in the S Corp or LLC
  - ii) *Tax-free Distributions:* Owners of S Corps and LLCs can get tax-free distributions of cash to the extent of their "basis" in the S Corp/LLC
- *Huge LLC Advantage:* Owner's Basis Includes:
  - i) Financial investment in the LLC/S Corp (e.g. invest \$10K)
  - ii) Any cash loans from owner directly to LLC/S Corp (Shareholder/LLC Member promise to pay/demand note does not create basis)
  - iii) **\*\*LLC: Owners share of LLC's debts to 3<sup>rd</sup> P.**  
**\*\*S Corp Owner does not get basis credit for S Corp's debts to 3<sup>rd</sup> P (even if shareholder guarantees the S Corp debt)**

IE: Chris and Jill form C&J LLC, each contributing \$50. C&J acquires a building for \$100 cash and a \$900 Mortgage. By choosing an LLC, Chris and Jill each have a \$500 “basis” in the LLC investment. If the LLC loses money this year Chris and Jill can each take up to a \$500 deduction on their personal income tax return (assuming passive activity rules and at-risk rules are met). If C & J was formed as an S Corp, Chris and Jill would each have a \$50 basis in the S Corp (the amount of their initial investment only) and would only be able to deduct up to \$50 of losses each. Any unallowed losses held in suspense until sufficient basis (e.g. until sell building). Any unallowed losses held in suspense due to the basis limitation rule are lost when Chris or Jill sell their shares.

### Passive Loss Rules: (Both S Corp and LLC)

Even if you have sufficient basis, in order to deduct LLC/S Corp losses against earned income (e.g. wages from another job) or portfolio income (interest, dividends, etc) you must “materially participate” in the LLC/S Corp. If you do not “materially participate” in the S Corp/LLC any losses are “passive” and can only be deducted against passive income. Any accumulated losses that are unallowed under the passive loss rules are allowed in the year Chris/Jill sell their S Corp stock to an unrelated buyer.

IE: Chris starts a side business with Jill, C&J’s. If it suffers losses the first year of its operations. In order for Chris to be able to deduct his share of C&J losses against his salary from being a lawyer, Chris must materially participate in C&J (whether its an LLC or S Corp) in addition to have sufficient basis in his investment in C&J. If he doesn’t materially participate, he can only deduct the “passive losses” against other passive income.

## **Distributions: Huge Advantage LLC**

**Golden Rule #3: NEVER put appreciating property in an S Corp!!!!**

- *Tax-Free Distributions of Appreciated Property from LLC:*

An LLC can distribute its appreciated property tax-free to LLC members through normal distributions or through complete/partial redemptions. The LLC member inherits the same cost basis in the property distributed as the LLC had. LLC member’s cost basis in LLC interest is reduced by cost basis in property received.

IE: Chris and Jill form C&J LLC, each contributing \$50. C&J acquires a building for \$100 cash and a \$900 Mortgage. Chris and Jill each have a \$500 basis in the LLC investment. Now the building has increased in value to \$1,500. Chris and Jill decide they want to own the building as individuals. C&J distributes building to Chris and Jill tax-free. Chris and Jill inherit C&J’s cost



basis in the building of \$1,000. Chris and Jill's basis in their LLC interests each reduced from \$500 to \$0.

- *Taxable Distributions of Appreciated Property from S Corp:*

Shareholder pays tax on any gain on distribution of appreciated property. The S Corp can pay tax too if it used to be a C Corporation at some point in the past.

IE: Chris and Jill form C&J S Corp, each contributing \$50. C&J acquires a building for \$100 cash and a \$900 Mortgage. Chris and Jill each have a \$50 basis in the S Corp investment (no basis credit for S Corp's debts). Now the building has increased in value to \$1,500. Chris and Jill decide they want to own the building as individuals. C&J distributes building to Chris and Jill. An S Corp's distribution of appreciated property is treated as deemed sale and C&J incurs \$500 of taxable income, allocated to Chris and Jill (\$1,500 value - \$1,000 cost basis).

## 4) Sale of S Corp Stock/LLC Interest: Advantage S Corp

### 1) S Corp: Capital gain on sale of S Corp Stock.

IE: Chris decides he wants to sell his S Corp stock to a third party. Gain on the sale is treated as a capital gain.

### 2) LLC: Generally selling member gets capital gain treatment. However, the portion of the gain attributable to the LLC's "hot assets" (inventory, A/R, depreciation on machinery/equipment) is taxed at ordinary rates and portion of the gain attributable to depreciation recapture on building taxed at 25% rate.

Possible Termination of LLC: If more than 50% of the LLC changes hand in one year, the partnership has a deemed termination which generally means the partnership has file two tax returns in the year of the sale (one tax return ending on the sale and second tax return for the short year ending 12/31). The termination is generally tax-free, however the successor LLC must depreciate the remaining adjusted basis of tangible assets at the time of termination as newly acquired assets, placed in service on the termination date, while it can continue to amortize intangibles using the same rates and schedules as the terminated LLC. However, qualified property or 50% bonus depreciation property, is eligible for an additional 50% bonus depreciation deduction in the first tax year of the new partnership.<sup>1</sup>

## 5) Conversions: Advantage S Corp: If you have a C Corp, it's cheaper to convert it to an S Corp than to an LLC:

### 1) C Corp Converts to S Corp: (Possible Tax)

#### i) *Tax on Built-In Gain on Assets if Sold w/in 5 years after Conversion:*

IE: C&J C Corp has a building worth \$10,000 with a cost basis of \$1,000. C&J converts to an S Corp. If C&J S Corp sells the building during the next 5 years after the S Corp conversion, the S Corp pays an actual tax on the \$9,000 gain and S Corp shareholders pay a tax on the net gain (\$9,000 gain less S Corp tax).

#### ii) *Tax Attributes from C Years generally Lost until S Corp Terminates (but can be used to offset built in gains tax during S Years).*

### 2) C Corp Converts to LLC: Impractical in most cases (unless no appreciated assets). Double taxation at corporate and shareholder level. The corporation pays tax on any appreciated assets, shareholders pay tax on deemed liquidation distributions.

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<sup>1</sup> Treas. Reg. §1.168(k)-1(f)(1)(ii).

IE: Chris and Jill want to convert Restaurant C Corp into Restaurant LLC. They did not invest any of their own money in the business. The business paid \$100K for its assets that are now worth \$1.1M. At conversion, the business pays a 35% tax rate on the \$1M appreciation (or \$350,000 in taxes), there is a deemed taxable distribution of \$750K to Chris and Jill (\$1.1M less \$350K corporate taxes). Chris and Jill owe 15% capital gain tax on the \$750K distribution or \$112.5K in taxes. The net tax on the conversion is \$462.5K.

*What Does This Mean?* Generally, impractical to convert from a C Corp to an LLC

- 3) LLC to S Corp: Generally tax-free if business owners own more than 80% of the S Corp after conversion. (Rev. Rul. 84-111).
- 4) S Corp to LLC: Owners generally owe tax (Remember distributions of appreciated from an S Corp result in tax)

**Bottom Line on Conversions:** It is generally possible to convert to an S Corp tax-free (LLC to S Corp, C Corp to S Corp). Owners generally owe tax on a conversion of an S Corp to an LLC or a C Corp to an LLC, unless the business does not have appreciated assets.

## 6) Other Issues

### 1) **Health Insurance Paid by LLC/ Corp to 2% Owner-Employee:** ADV S Corp LLC:

- a. Considered taxable income to Owner
- b. Owner gets corresponding tax deduction on her personal income tax return provided he/she is not eligible for subsidized coverage through his/her spouse.<sup>2</sup>
- c. Subject to self-employment tax on the value of the premiums<sup>3</sup>

### S Corp:

- a. Reported on W-2 as taxable income to Owner (provided owns at least 2% of S Corp)
- b. Owner also gets corresponding tax deduction on her personal income tax return provided he/she is not eligible for subsidized coverage through his/her spouse.<sup>4</sup>
- c. Is **not** subject to FICA, FUTA (not included in medicare or social security wages on Form W-2).

### 2) **Single Member LLC:** (LLC with one owner):

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<sup>2</sup> 26 USC 162(1)(2)(B).

<sup>3</sup> 26 USC 162(1)(4).

<sup>4</sup> 26 USC 162(1)(2)(B).

- Disregarded for federal tax purposes. Income and deductions reported directly on the owner's tax return (Single Member LLC does not file its own tax return)
- Advantage over S Corp with a single shareholder because the S Corp would have to file a separate tax return and also file payroll tax returns (unless a QSSS).

### 3) QSSS: (Qualified Subchapter S Subsidiary)

- An S Corp that is 100% owned by another S Corp
- Makes an election to be treated as a QSSS. The QSSS is disregarded for tax purposes and all its income, losses, credits, etc are aggregated with the parent S Corp.
- Sometimes useful if buying an S Corp. Parent and subsidiary S Corps file same tax return.

## Take Away Points

- C Corps: preferred by venture capitalists
- FICA: S Corps can allow owners to avoid some FICA taxes (profit distributions over and above reasonable compensation are FICA tax-fee).
- Contributing Appreciated Assets for Ownership Interest: Can be done tax-free in either an S Corp or an LLC but its easier with an LLC (no 80% control requirement).
- LLC allows non-pro-rata distributions of profits, losses, deductions, etc: S Corp distributions must be pro-rata in accordance with ownership interests.
- It's easier to deduct losses with an LLC: LLC owner's "basis" includes his share of the LLC's debt (e.g. LLC's mortgage on its building).
- NEVER put appreciating assets (e.g. land, building, patents) in an S Corp or a Corp: Appreciated assets can be distributed tax-free to the LLC's owners in ordinary distributions or in partial/full redemptions.
- Conversions to an S Corp are generally tax-free, Conversions to an LLC are generally taxable unless there are no appreciated assets or sufficient NOLs to offset the gain:

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