

Choice of Business Entity

A. BASIC FACTORS AFFECTING SELECTION

1. There are numerous factors that must be considered by the owners of interests in a closely held business when selecting the entity for the operation of the assets to be so organized.
2. The selection of a form of entity must carefully address the business and personal factors involved, and the measuring of these factors and the goals of the owners against the available state law and tax choices. This will not always point to a clear choice; in many situations no one entity will fit all of the factors. However, this process will often reveal one or two predominant factors that will govern the entity choice. Still, all of the relevant possibilities must be considered before the decision can be made.
3. The factors affecting entity choice involve both tax and nontax considerations, such as:
 - a. Formational
 - The number of owners and the level of involvement of each owner in the daily management of the business
 - The nature of the business, including any restrictions that may be imposed on who may be an owner (such as with a liquor license)
 - The capital structure – contributed equity versus debt
 - b. Operational
 - The nature, amount, and timing of income and/or losses that are expected
 - The management of the business and how each form of business matches the personality of the owner or owners
 - c. Compensation and Other Owner Transactions
 - Whether the owner is to receive wages or a distributive share
 - The desired fringe benefits
 - The manner and timing of distributing excess profits
 - d. Termination of Interest or Entity
 - How ownership and management is to be transferred, and to whom, upon withdrawal of the owner from the business

B. MANAGEMENT AND OPERATIONAL ASPECTS

1. The interaction between owners, both at the entity level (i.e., management) and the individual level (i.e., as owners) may be the most important factor in whether a business succeeds or fails. The various aspects that affect management and operational decisions in selecting an entity form include:
 - State law considerations affecting the relationships of the interest owners and their business goals
 - The management structure desired for operation of the entity and the power relationships among the owners

Choice of Business Entity

- State law aspects of converting an existing entity into the entity of choice
- The method and timing of transferring the entity ownership and management structure upon death, retirement or withdrawal, of an owner
- How much of the income is to be retained for future operational needs and how much can, or must, be distributed

C. INCOME TAX ASPECTS OF ENTITY SELECTION

1. The taxation of profits and losses will often vary among the different types of business forms.
 - Comparison of income tax rates for each form of business
 - Comparison of other taxes, such as the employment tax on wages versus the self-employment tax
 - The possibility of income-splitting among family members
 - Double taxation of entity income in the C corporation
 - Tax treatment of business losses, and availability of them to entity interest owners
 - Available fringe benefits, such as pensions, health and life insurance plans, and other perquisites
 - The effect of state income taxes at the entity and individual levels, including the desirability of mandating distributions to pay the taxes of the owners that arise from the pass-through business forms
 - The desire of the owners for different treatment of the tax attributes of the business among themselves
 - Tax aspects of converting an existing entity into the entity of choice
 - Tax aspects of a possible future division of the business among the owners, or their heirs

D. RESTRICTIVE AGREEMENTS

1. Written agreements to protect the integrity of the entity, and the long-run benefit of the business to the interest owners must be considered, and commonly address the following issues:
 - Restricting the ability to transfer interests in the entity to third parties in a manner that may be prejudicial to the other interest owners
 - Restrictions on the transferability of interests in the entity that may affect the agreed tax allocations or the availability of a favorable tax option, such as the S corporation election
 - The effect of the entity choice on buy-sell agreements among the owners
 - Provisions that offer a particular protection to minority interest holders, limited partners, and silent investors, beyond that extended by state law

Choice of Business Entity

- A buy-sell agreement to anticipate the retirement, withdrawal or death of an interest owner, and the related need to address the funding of the purchase of the departing owner's interest
- Funded or unfunded retirement plans, the availability (and applicable limitations) of which varies with the form of entity

E. ESTATE PLANNING ASPECTS OF ENTITY CHOICE

1. The owners of interests in the entity must have an eye out for the effect of the entity on their individual estate plans. Factors which will have an impact on the succession of ownership of interests in the entity among members of the family or other heirs of each interest owner, and the estate planning of each such individual, include:

- The basic agreements among the parties for liquidation of an owner's interest in the entity at his or her death
- The effect of the organization and control of the entity on the owners' gift and estate plans, both tax and non-tax
- The valuation of the entity for estate and gift tax purposes, the effect on valuation of agreements restricting the transfer or sale of ownership interests, and the valuation of individual ownership interests
- The willingness of the owners to accept family members or other heirs of the owners into the entity ownership and management structure upon death, retirement or withdrawal, and the method for transferring ownership and management
- Mutually agreed retirement plans affecting all owners, and the individual retirement planning of the owners
- The desire of the owners for free transferability of interests in the entity for gift planning purposes
- Estate planning for the owners of interests in the business, including valuation of the entity and entity interests and transferring ownership and management of the business



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Applicable Factor	C Corporation	S Corporation	Sole Proprietor	Partnership	LLC
I. FORMATION					
A. Method	Articles of Incorporation	Articles of Incorporation	None	Partnership agreement	Operating agreement
B. Owner Eligibility					
1. Number of Owners	No limit	Up to 100, with election to treat a family as 1 shareholder	One	Two or more partners, at least one of whom is general partner	One or more members
2. Type of Owners	No limitation	Only individuals, certain trusts and estates, and certain tax-exempt organizations	Individual	No limitation	Depends on tax status
3. Affiliate limits	No limitation	May own subsidiaries; qualified sub-chapter S subsidiary is treated as same tax entity as parent	No limitation	No limitation	Depends on tax status
C. Capital Structure					
1. Equity	No limitations (multiple classes permitted)	Only one class of stock	No stock	No limitations (multiple classes)	Depends on tax status
2. Debt	No specific limits on debt/equity ratio	Safe-harbor for debt	No specific limits	No specific limits	Depends on tax status
D. Status Determination					
1. Election by Entity	None	Election required	None	None	Depends on tax status
2. Owner Consents	None	All owners must consent	None	None	Depends on tax status
E. Liability	Limited to shareholders' capital contribution	Limited to shareholders' capital contributions	Unlimited	General partners jointly and severally liable. Limited partners generally limited to capital contributions	Limited to members' capital contributions

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F. Management	Board of Directors and Officers	Board of Directors and Officers	Owner managed	Equal vote by each partner unless otherwise agreed	Flexible: Managed by manager, members or corporate-style
II. OPERATIONAL PHASE					
A. Tax Year	Any year permitted (limitation on personal service corporations)	Generally calendar year	Calendar year	Generally calendar year	Depends on tax status
B. Tax on Income	Corporate level	Shareholder level	Individual level	Partner level	Depends on tax status
C. Elections	Corporate level	Corporate level	Individual level	Partnership level	Depends on tax status
D. Allocation of Income/Deductions	Not permitted (except through multiple equity structure)	Pro rata per share	N/A	Permitted if substantial economic effect	Depends on tax status
E. Character of Income/Deductions	No flow-through to shareholders	Flow-through to shareholders	Flow-through to individual	Flow-through to partners	Depends on tax status
F. Net Operating Losses	No flow-through	Flow-through to shareholders (limited to basis)	Flow-through to individual	Flow-through to partners (limited to basis)	Depends on tax status
G. Net Capital Losses	May only offset capital gain, but can be carried to other years	Flow-through to shareholders	Flow-through to individual	Flow-through to partners	Depends on tax status
H. Effect of Statute of Limitations	Imposed at corporate level	Imposed at shareholder level	Imposed at individual level	Imposed at partner level	Depends on tax status
III. COMPENSATIONS ARRANGEMENTS					
A. Fringe Benefits	Shareholder-officers qualify for benefits	Certain benefits includible in 2% shareholder's income	Generally subject to limits applicable to individuals	Limited participation for partners	Depends on tax status

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B. Retirement Benefits	Shareholder-officers included in qualified plans	Certain limits on shareholder-employees; can have ESOP (but certain tax breaks available to C corporations will not be available).	Generally subject to limits applicable to individuals	Certain limits applicable to partners	Depends on tax status
C. Compensation	Wage	Wage and distributive share	Withdrawal of profits	Guaranteed payment and distributive share	Depends on tax status
D. Reasonable Compensation Limits	Applicable to shareholder-employees	Applicable to shareholder-employees	N/A	May apply to a family partnership where capital is a material factor	Depends on tax status
IV. TRANSACTIONS WITH OWNERS					
A. Distribution of Cash	Dividends to extent of earnings and profits	No effect until previously taxed income fully recovered	No effect	Reduces basis; income after basis reduced to \$0	Depends on tax status
B. Distribution of Property	Dividend treatment; gain recognition to entity	Gain recognition to entity	No effect	Generally, no gain or loss to entity; substituted basis	Depends on tax status
C. Purchase of Owner's Interest					
1. Partial Interest	Probable dividend treatment	Tax-free; but gain on proceeds in excess of basis	N/A	N/A	Depends on tax status
2. Entire Interest	Capital gain treatment with exceptions	Capital gain treatment after basis recovered	Cannot sell entity interest; sale of business is viewed as a sale of each asset	Capital gain treatment except for ordinary income assets and certain payments to retiring or deceased partners	Depends on tax status

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D. Property Sales to Entity by Owner	Possible dividend treatment or contributions to capital	Any excess value treated as distribution or contribution	N/A	Any excess value treated as distribution or contribution	Depends on tax status
E. Property Sales to Owner by Entity	Possible dividend treatment or contributions to capital	Any excess value treated as distribution or contribution	N/A	Any excess value treated as distribution or contribution	Depends on tax status
V. TERMINATION OF ENTITY OR OWNER INTEREST					
A. Sale of Interest by Owner to Third Person	Capital gain; no effect on basis of corporation's assets	Capital gain; no effect on basis of corporation's assets	Cannot sell entity interest; sale of business is viewed as a sale of each asset	Capital gain subject to §751 ordinary income treatment and elective basis adjustment to partnership assets	Depends on tax status
B. Death of Owner	Estate becomes shareholder: FMV at date of death is new basis of shares; no effect on basis of corporation's affects	Estate becomes shareholder: FMV at date of death is new basis of shares; no effect on basis of corporation's assets	Estate takes over business	Estate becomes partner subject to agreement; FMV at date of death is basis for interest	Estate becomes member subject to agreement, FMV at date of death is basis for interest
C. Liquidating Distributions					
1. Effect to Entity	Gain recognized if appreciated property is distributed	Gain recognized if appreciated property is distributed; increase in shareholder basis for gain	N/A	Generally, no gain recognition on distributions of assets (other than cash in excess of basis)	Depends on tax status

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2. Effect to Recipient	Capital gain on excess value received over basis	Capital gain on excess value received over basis	N/A	Election to substitute asset basis to equal basis in partnership interest; gain may be recognized if certain types of assets are distributed	Depends on tax status
D. Reorganization	Tax-free to shareholders if qualifying as a reorganization	Tax-free to shareholders if qualifying as a reorganization	N/A	Generally, tax-free for merger or division of partnership	Depends on tax status
E. Carryover of Tax Attributes	Carryover of tax attributes to successor entity if tax-free reorganization	Carryover of tax attributes to successor entity if tax-free reorganization	N/A	Carryover of tax attributes to successor entity if tax-free reorganization	Depends on tax status



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