Considerations in Selecting Business Entities

Outline prepared
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**Introductory Considerations.**

The type of entity a client chooses for the family business has implications from both business and estate planning perspectives. The entity choice affects: (a) the determination of the value of interests for transfer tax purposes; (b) the income tax consequences while the entity is in existence, as well as when the entity is liquidated; (c) the liability of the owners for the entity’s debts, obligations, and liabilities; (d) the control over the entity, including day-to-day operations and distributions; and (e) the expenses incurred to establish and maintain the entity.¹

The following entity choices are available to operate a family business: (1) the sole proprietorship; (2) the general partnership; (3) the limited partnership; (4) the limited liability partnership; (5) the limited liability company; (6) the S corporation; and (7) the C corporation. In addition, personal trusts, business trusts and land trusts can be used to hold property.² Personal trusts, business trusts and land trusts will not be discussed in great detail here. Naturally, the facts and circumstances surrounding each client’s choice of entity will differ. Taking the following factors³ under consideration will likely help when counseling a client with regard to selecting the most appropriate entity for that client’s unique family business.

- **Is a new business being created or is the form of an existing business being changed?**

A cost benefit analysis may need to be completed as the tax consequences of converting an existing business may outweigh any benefits secured under the new entity’s form.⁴

- **What is the projected number of prospective owners?**

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⁴ Id. at 9.
Generally, if there is but one owner, the entity choice will likely be limited to a sole proprietorship, some corporate form, or possibly a limited liability company. However, if there are going to be multiple owners, the form can be one of several forms of partnership, a limited liability company, or some corporate form.\(^5\)

- **Will any of the prospective owners be other business entities?**

  Typically, if the owners will be one or more corporations, partnerships or limited liability companies, an S corporation, absent an exception, will not be an option in most cases.\(^6\)

- **What is the projected nature of the prospective business?**

  Generally, if the business will be a personal service business, there are special provisions in the Internal Revenue Code (“IRC”) that will apply to the entity if it is operated in corporate form.\(^7\)

- **What is the projected duration of the prospective business?**

  Normally, if the business is going to be operated for the short term, a joint venture, which is treated similarly to a partnership, may be preferable over an entity in the corporate form.\(^8\)

- **What are the projected profits or losses of the prospective business?**

  Typically, the S corporation may be a better option than either a partnership or a limited liability company if no losses are expected. In contrast, a partnership or a limited liability company may be a better option than the S corporation if loss is expected, as the partners or members, respectively, receive bases for the debt of the entity.\(^9\)

- **What are the projected capital requirements of the prospective business?**

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\(^5\) *Id.*
\(^6\) *Id.* at 9-10.
\(^7\) *Id.* at 10.
\(^8\) *Id.*
\(^9\) *Id.*
Usually, if the capital requirements are high, then the owners will want an entity that affords them the ability to withdraw the capital later without unfavorable tax consequences. If that is the case, a partnership or a limited liability company is generally an appropriate choice. However, if it is projected that the prospective business will be accumulating large amounts of profits in the business out of current profits, a C corporation may be the appropriate choice as it will generally allow that accumulation at a lower tax rate. Notice however, that a C corporation generally creates a double taxation situation during operation and liquidation, whereby the business is taxed at the entity level and the owners are taxed at the shareholder level.  

- **Will the prospective owners be active participants or inactive investors?**

  Generally, if the owners are simply going to be passive investors, a general partnership is not advisable as they usually want some form of limited liability that is only available in the limited partnership, limited liability company, or corporate forms. The active investors may desire the limited partnership or limited liability company form as both would allow income to be allocated in a manner other than on a pro rata basis. Both the limited partnership and the limited liability company might require registration with the Securities Exchange Commission (SEC) under state law, unless exempt. General partnerships usually are not required to register with the SEC.  

- **Will the prospective owners make different types of contributions (e.g., cash, property, or services)?**

  If a person exchanges personal services for an equity interest in the business, it might be more beneficial to use a partnership or limited liability company where he or she receives an interest in future profits for the services rendered rather than a share of the capital. Receiving an

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10 *Id.;* See also Goldberg, *Choice of Entity for the Family Business*, at 8-9.
interest in future profits in a partnership or limited liability company may not result in any current taxable income. On the other hand, if a capital interest is received, income tax consequences are immediate, whether as a shareholder, partner, or member.\textsuperscript{12}

- \textbf{Will the prospective owners or others make loans to the prospective business?}

Generally, if owners will be making loans to the business, then under an S corporation, the shareholders are allowed to increase their bases for deducting losses by the amount of those loans. If it will be third parties providing the loans, then under a partnership or limited liability company, the partners or members, respectively, are allowed to increase their bases by their respective shares of the loans. If the business is in the form of a C corporation, then shareholder provided loans are generally better suited, from a tax perspective, for raising capital than issuing shares.\textsuperscript{13}

- \textbf{What is the income tax bracket of the prospective owners?}

Normally, if the owners are in lower tax brackets, pass through entities such as general partnerships, limited partnerships, limited liability partnerships, limited liability companies, and S corporations (in most cases) result in lower income tax on profits accumulated in the entity. A pass through entity allows taxable income of the business, and oftentimes the losses, to pass directly to the partners or members as the case may be.\textsuperscript{14}

- \textbf{What is the wealth of the prospective owners?}

\textsuperscript{12} \textit{Id.} at 10.
\textsuperscript{13} \textit{Id.} at 11.
\textsuperscript{14} \textit{Id.} at 9, 11.
Sometimes owners may have substantial wealth, yet remain in a lower income tax bracket and desire cash flow more than tax deductions. In contrast, others may be in high income tax brackets and desire tax deductions more than cash flow.\textsuperscript{15}

- **What is the family status of the prospective owners (especially for estate planning)?**

Depending on the age of the owners, transfer tax savings may be of interest when attempting to transfer ownership interests to younger generations in the family. Using a form of partnership or limited liability company can assist in simplifying the process of making the transfers, especially if real estate is involved.\textsuperscript{16}

- **Where is the prospective business projected to be located in the United States?**

It is important to be aware that not all states recognize S corporation status for state income tax purposes and that some states may tax a limited liability company’s income at the entity level or even have greater franchise taxes on a limited liability company when compared to a limited partnership.\textsuperscript{17}

- **Is the prospective business projected to involve any foreign business?**

A multitude of other issues become relevant if the domestic family business will have foreign-source income or engage in business outside the United States.\textsuperscript{18}

- **What is the projected form of compensation to be paid to the prospective owners and others (e.g., salary, interest, rent, dividends, or royalties)?**

\textsuperscript{15} Id. at 11.
\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{18} Id.
C corporations typically face a double taxation regime. However, if it is desirable, creative payment methods can sometimes allow a C corporation to operate similar to a pass-through entity.\(^\text{19}\)

- Is it projected that there will be distributions of capital in the near future as a result of refinancings, redemptions, or partial liquidations of the prospective business, or other transfers to the owners?

Generally, distributions of this nature have little or no negative tax consequences when performed by an entity formed as a sole proprietorship, partnership, or limited liability company. For instance, a partnership or limited liability company can be dissolved and liquidated without tax consequence. On the other hand, if a family decides to dissolve and liquidate a C corporation, tax at both the entity and shareholder level will likely result.\(^\text{20}\)

- Will there be restrictions on transfers of ownership in the prospective business?

Normally, if free transferability is desired, an S corporation will be less appropriate, as maintaining the S election requires that the initial shareholders restrict distributions to eligible shareholders only. Instead, a general partnership may be appropriate. While stock in a C corporation is easy to transfer, the C corporation will not have the income tax benefits of a partnership, limited partnership or limited liability company. On the other hand, if restriction on transferability is desired, stock restriction agreements may be used in conjunction with partnerships, including the limited partnership and limited liability partnership, as well as the limited liability company.\(^\text{21}\)

- What form of management is the prospective business projected to have?

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\(^\text{19}\) Id. at 8-9, 12.
\(^\text{20}\) Id. at 5-6, 12.
\(^\text{21}\) Id. at 12.
Typically, the corporate form provides centralized management, whether in the form of a C corporation or S corporation. The owners (shareholders) do not manage the business, but rather elect a board of directors who appoint officers to manage the business. Centralized management is also attained in the limited partnership form. The general partners have management rights that cannot be separated from their general partnership interest without their consent. Generally, to retain limited liability, the limited partners must refrain from management. In the case of a manager managed limited liability company, the members may vote on who will be the manager (depending on the operating agreement) and leave management to that manager.22

In contrast, a general partnership provides non-centralized management as all the owners (partners) participate in managing the business. Further, a member managed limited liability company may also decentralize management by giving all owners a voice in management based on their respective ownership interest.23

**Client Goals.**

In addition to the foregoing list of factors that should be considered, a client’s specific estate planning and business goals should also be considered when selecting the proper entity for a client’s unique family business. The following goals24 are common amongst family business owners.

- **Control of the prospective business.**

  Older family members generally want to keep control over the business operations and investments and out of the hands of the younger generation for as long as possible. Transferring assets to an entity like a limited partnership, limited liability company, or some type of

22 *Id.* at 12; See also Goldberg, *Choice of Entity for the Family Business*, at 10-11.
23 *Id.*
24 *Id.* at 14-15.
corporation allows the older generations to retain control over those assets. Further, it will prevent the creditors of the younger generation (the donees) from accessing the assets. Moreover, it can prevent the donee from simply selling the assets, or may protect the assets from a donee’s spouse, or from going to a party the donor may not have chosen if the donee has an untimely death.25

The older generation may retain control by being the only general partners in a limited partnership, the only managing members of a limited liability company, or the only directors of a corporation.26 Notice the correlation between management (control) and estate planning considerations. Specifically, for estate tax purposes a decedent’s assets will be valued at fair market value, but if the assets are a fractional interest in a business entity, those assets oftentimes can be valued at a discount for tax purposes due to a lack of marketability and potentially for lack of control.27 Notice also that control can also be achieved by being the trustee over a trust, but if the trustee serves as trustee with discretionary power over the distribution of income and principal, any transfer tax benefits may be lost due to that power.28

• **Limited Liability for the projected owners of the prospective business.**

Owners will typically want some form of limited liability. The limited partnership, limited liability partnership, limited liability company, or a corporate form can protect the owners from liability arising from torts and trade creditors. Yet, in the closely held business context, it is difficult for the owners to secure limited liability regarding borrowing unless the entity has assets of its own to serve as collateral. Only the limited partners in a limited

25 *Id.* at 5; See also Howard M. Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01[2][a] (4th ed. 2010).  
partnership are shielded from liability. However, a corporation or LLC could be used as general partner to provide extra insulation from liability, but that adds an additional entity.29

Generally, depending on state law, judgment creditors of a partner in a partnership or member of a limited liability company will only be entitled to a charging order giving the creditors the right to receive distributions to which the partner or member would have been entitled, but no right to manage the business or to cause the liquidation of the entity.30

- **Valuation discounts on interests in the prospective business for taxation purposes.**

Older family members generally want discounts for transfer tax purposes, so lack of marketability and lack-of-control and/or minority discounts will be important. As mentioned above, for estate tax purposes, a decedent’s assets will be valued at fair market value, but if the assets are a fractional interest in a business entity, those assets oftentimes can be valued at a discount for tax purposes due to a lack of marketability and potentially for lack of control.

- **Simplicity in the formation, continued operation, and structure of the prospective business.**

Owners typically want an entity that provides simplicity so that enormous amounts of time are not spent on formalities and so they understand the structure of the entity. All entity choices will require some formalities such as regular meetings of the directors, shareholders, partners, managers and members, as the case may be, along with keeping minutes.31 Typically, a limited partnership or limited liability company is more flexible than a corporation with regard to formalities, as changing certain provisions in connection with a corporation generally requires certain formalities. If allowed by state law and the partnership agreement for a limited partnership, or operating agreement for a limited liability company, changing the operative

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29 *Id.* at 6-7.

30 *Id.*; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01[2][a]-[b].

31 Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 9.02[2][b].
agreement can be handled at any time by a simple majority of the partners or members.\textsuperscript{32} The partnership and limited liability company are not required to elect directors annually as are corporations and can establish a management structure initially that is constant throughout the life of the partnership or limited liability company.

- **Minimal costs for maintaining and operating the prospective business.**

  Clearly, the owners will want an entity that meets their objectives but also falls within their budget. Some costs to consider include accounting costs, legal fees, filing costs, and syndication costs. However, using an entity to hold family assets can actually reduce administration expenses. For example, a limited partnership or limited liability company owning real property will avoid ancillary estate administration and may avoid state estate and death taxes on real property located outside the state of the transferor’s residence. Notice that real estate typically has to be probated in both the state of the decedent’s domicile and the state where it is located, but interests in a business entity are personal property that only must be probated in the state where the interest holder is domiciled, even if the entity holds only real estate. Further, a limited partnership or limited liability company owning real property allows gifts of partnership and limited liability company interests through deeds of gift, avoiding any need to record deeds at the courthouse when real estate is involved.\textsuperscript{33}

- **Transfer restrictions on ownership interests in the prospective business.**

  Owners usually want transfers of ownership in the business to be restricted, at least while the business is developing. Each entity provides a method to meet this objective. For example, a limited partnership, limited liability company, or a corporation can allow older family members to restrict the right of other owners to transfer their interests, voluntarily and involuntarily, to


\textsuperscript{33} \textit{Id.} at 6; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 9.02[2][b].
nonfamily. In this regard, family or the entity itself may be given a right of first refusal to purchase any interest another family member wants to transfer. Further, a donee can retain a partnership or limited liability company interest as separate property, excluding it from inclusion in marital property in the event of divorce or in the augmented estate in the event of death.\(^\text{34}\)

- **Tax-free withdrawals from the prospective business.**
  Owners generally want the ability to liquidate their interests in the business with the most favorable tax result and lowest nontax cost. Partnerships and limited liability companies taxed as partnerships typically can be liquidated tax-free.

- **Tax benefits related to the choice of entity for the prospective business.**
  Generally, if the business expects to have tax losses early, then owners may wish to have the losses pass through to them directly. In that case, a pass through entity would be desired. On the other hand, if the business expects to have profits, the owners will want those profits taxed at the lowest level possible. Again, this is likely achieved with a pass through entity, like a partnership, limited liability company taxed like a partnership, or an S corporation (absent some exception). Again, C corporations generally involve a double tax regime—tax on the earnings and profits at the entity level and tax on the dividends at the shareholder level. Additionally, C corporations are taxed at the entity level upon liquidation and at the shareholder level upon distribution.\(^\text{35}\)

- **Tax-free cash flow from the prospective business.**
  Owners may desire to have any cash the business generates flow to them while avoiding negative tax results. A partnership, limited liability company, or S corporation will generally


\(^{35}\) Id. at 1-2; See also Goldberg, *Choice of Entity for the Family Business*, at 8-9.
meet this objective. However, certain loans from a C corporations may provide cash that is not taxable on a temporary basis to shareholders if the proper formalities are met. ³⁶

- Passive income opportunities from the prospective business.

In some instances, the owners may be looking for passive income to offset passive losses. ³⁷

Generally, from an estate planning perspective, the most important entity forms for operating the family business or holding investment assets include limited partnerships, limited liability partnerships, limited liability companies, S corporations, and C corporations. ³⁸ While the sole proprietorship and general partnership are common entities for operating a business, neither provide liability protections or very favorable valuation discounts; ³⁹ therefore, neither will be discussed in great detail here.

**The Sole Proprietorship.**

A sole proprietorship is typically the simplest form of operating a business if there is only one business owner. ⁴⁰

**The General Partnership.**

A general partnership, likewise, is typically the simplest form of operating a business if there are multiple owners. In the case of a general partnership, when no written partnership agreement exists, the state’s law on partnerships applies. Oftentimes, the state’s law will be

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³⁷ Id. at 15.
³⁸ See Mezzullo, Guidelines for Choosing the Most Favorable Entity, at 18.
³⁹ Id.
either the Uniform Partnership Act ("UPA") or the Revised Uniform Partnership Act ("RUPA").

The Limited Partnership ("LP").

An LP is state law created. Normally, an LP is created by filing a Certificate of Limited Partnership with the Secretary of State. Generally, the partners enter into a partnership agreement that sets forth operation and management terms between the partners. The partnership agreement is analogous to an operating agreement used by a limited liability company. An LP can only be dissolved by the general partners. Further, normally only the general partners have a right to withdraw from the partnership and receive value for their partnership interest at any time. Limited partners may not have a reciprocal right under state law.

Typically, only the general partners are subject to personal liability for the debts, obligations, and liabilities of the LP. Normally, the limited partners will not be personally liable for the debts, obligations, and liabilities of the LP, but certain formalities must be followed for limited liability to apply. For example, limited partners must refrain from actively participating in the conduct of the business or they may be considered general partners under the state’s partnership law, exposing them to liability. Oftentimes, state law will be the Revised Uniform Limited Partnership Act (RULPA) or the Uniform Limited Partnership Act (ULPA).

For taxation purposes, LPs and other partnerships are more flexible and generally act as pass through entities, creating only one level of tax at the partner level. Generally, an LP can be liquidated tax-free. Fringe benefits available to C corporation shareholder-employees are not

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41 Id.
42 Id. at 2-3, 12, 33.
43 Id. at 2-3, 12; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01[1].
available to partners in an LP. Complex rules apply relative to the allocation of company debt and the allocation of profits and losses to the partners. However, the LP form allows for special allocations of income, gain, loss deduction and credit to its partners. A partner’s basis generally will include his or her share of liabilities of the business. Normally, contributions and distributions of property to and from the entity are less likely to involve taxable gain. Further, only a partnership can adjust inside basis of its assets when a partnership’s interest is acquired in a sale or exchange, or at the death of a partner.

A family’s passive investments should oftentimes be held in LPs (or limited liability companies if state law is favorable), as normally, there is lower concern for exposure to liability with such assets. If a limited liability company is more likely to experience an event of withdrawal causing dissolution, then an appraiser might assign a lower value to an otherwise equivalent interest in an LP. Some state’s limited liability company acts require a limited liability company to dissolve upon the death, retirement, expulsion, bankruptcy, or dissolution of a member unless all or a majority-in-interest of the remaining members agree to continue the business. On the other hand, in most states, LPs dissolve only upon the death, retirement, expulsion, bankruptcy, or dissolution of the sole remaining general partner, absent consent of all or a majority of the remaining limited partners.

Moreover, using an LP (limited liability companies and partnerships generally) can assist in simplifying the process of making gifts, especially annual exclusion gifts. A simple deed of gift may be used whereby a donor transfers a percentage of his or her interest in the LP to the

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45 See Mezzullo, Guidelines for Choosing the Most Favorable Entity, at 18-19; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01.
donee, eliminating real estate deeds and a trip to the courthouse, when real estate is involved. Using an LP (limited liability companies and partnerships generally) may reduce the value of gifts because of minority and lack of marketability discounts. An LP can also allow older family members, as general partners, to retain control. Notice however, that since a general partner typically has the right to cause a liquidation of an LP under state law, valuation discounts available for LP interest transfers held by those elder general partners (both during life and at death) may be reduced as compared to if they were simply limited partners.\footnote{See Mezzullo, \textit{Guidelines for Choosing the Most Favorable Entity}, at 18-19; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01[2][a].}

\textbf{The Limited Liability Partnership (“LLP”).}

An LLP is basically a general partnership registered with the state as a limited liability partnership so as to remove a general partner’s personal liability for acts or omissions of other partners, employees, and agents of the LLP. In some states, general partners in an LLP are not personally liable for the LLP’s liabilities either. LLPs are allowed in every state and some states even allow for a Limited Liability Limited Partnership (“LLLP”).\footnote{See Mezzullo, \textit{Estate Planner’s Guide to Family Business Entities: Family Limited Partnerships, Limited Liability Companies, and More}, at 12.} The LLP mirrors the LP in most respects but adds an additional layer of liability insulation for the general partners.

\textbf{The Limited Liability Company (“LLC”).}

An LLC is also created by state law. Generally, an LLC requires few formalities to form. Normally, an LLC is created by filing Articles of Organization with the Secretary of State. Generally, the members enter into an operating agreement which sets forth operation and management terms between the members. The operating agreement is analogous to a partnership agreement. LLCs may be structured as a general partnership, an LP or corporation. The LLC may be member-managed, meaning that any or all members have a right to participate in
management, or it may be manager-managed, meaning that the members have decided to appoint a manager who will oversee the operations of the company. A manager does not need to be a member (owner) in the LLC and may be a person or entity. Similarly, members may be individuals, trusts, corporations, partnerships, other LLCs or other entities. 49

Neither the members nor the managers of an LLC are liable personally for the debt obligations, or liabilities of the LLC. However, if a member is personally responsible for the act or omission that causes damage to a third party, or personally guarantees a debt or becomes liable under state or federal law, then that member can be personally liable. Moreover, like a corporation, the protection of an LLC can be pierced if the LLC is formed or operated as a sham. 50

The LLC provides ownership, operation tax and liability benefits in a way the LP and S corporation cannot. LLCs that are taxed as partnerships act as a pass through entities, creating only one level of tax at the member level, providing the same benefits as an LP, with additional benefits. LLCs taxed as partnerships typically can be liquidated tax-free as well. A member’s basis will be increased by the debts of the LLC so long as the member did not guarantee the debt. This allows members to receive tax-free distributions of loan proceeds as well as take losses greater than their contributions to the LLC. Moreover, many LLC acts give members a right under state law to withdraw and receive value for his or her interest. Subject to state law, an LLC may be dissolved upon the death, retirement, expulsion, bankruptcy, or dissolution of a member. Similar to LPs, fringe benefits available to C corporation shareholder-employees are

49 Id.
50 Id. at 2.
not available to members in an LLC. Like LPs, complex rules apply relative to the allocation of company debt and the allocation of profits and losses to the members.

If there is any chance that operating the business may place the owners at risk for exposure to liability, the LLC will be the entity of choice in most cases. All members (owners) of an LLC will be insulated by limited liability. Further, the LLC affords its members the income tax benefits of a partnership for federal tax purposes and in some cases may provide a better result. Notice, however, that some states may not treat an LLC as a partnership for income tax purposes. Members may be actively participating in the conduct of the business under the passive loss rules without risking liability. Members may also materially participate in the LLC’s management without risk of becoming personally liable for the LLC’s debt and liabilities.

Moreover, using an LLC (and partnerships) can aid in simplifying the process of making gifts, especially annual exclusion gifts. A simple deed of gift may be used whereby a donor transfers a percentage of his or her interest in the LLC to the donee, eliminating real estate deeds and a trip to the courthouse, when real estate is involved. Using an LLC (and partnerships), especially an LP may reduce the value of gifts because of minority and lack of marketability discounts.

**The S Corporation (“S Corp”).**

An S Corp is treated the same as a C corporation for state corporate law purposes but is taxed similar to a partnership for federal income tax purposes. An S Corp may be taxed similar

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51 Id. at 2-3, 12, 33; See also Mezzullo, *Guidelines for Choosing the Most Favorable Entity*, at 19; and Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01.


53 See Mezzullo, *Guidelines for Choosing the Most Favorable Entity*, at 19; See also Zaritsky, Tax Planning for Family Wealth Transfers, at ¶ 10.01[2][a].
to a partnership for state income tax purposes as well, but it depends on the state. One unique advantage of an S Corp is an ability of a shareholder-employee to decrease his or her compensation, within reason, to minimize payroll tax.54

**The C Corporation (“C Corp”).**

The C Corp is treated as a regular corporation under state corporate law but may have undesirable tax consequences such as double taxations as discussed above. Except for a personal service business, a C Corp typically should be avoided unless the objectives of the owners can only be met through it. However, if an operating business is likely going public or is to be held in the family for a long time, a C Corp may be preferable. In these instances, earnings can be accumulated for the reasonable needs of the business at lower tax rates. Moreover, certain fringe benefits can be provided to the shareholder-employees tax-free. In contrast, no more than two percent (2%) of shareholders in an S Corp are entitled to these fringe benefits and no members of an LLC, or partners in a general or LP are entitled to these fringe benefits. 55

Nonetheless, there are nontax benefits to the corporate form, including limited liability for all shareholders regarding debts, obligations, and liabilities of the corporation. Further, a shareholder does not have a right to withdraw and receive any value for his or her stock and this may reduce the value of the shareholders interest when considering transfer taxes.56

For purposes of this discussion, the main focus will be on exploring the beneficial and detrimental differences between the S Corp and the partnership forms (including the LP, LLP, and LLLP), as well as the LLC form.

54 See Goldberg, *Choice of Entity for the Family Business*, at 15.
56 *Id.* at 2.
Comparing S Corps and partnerships (including LPs, LLPs, and LLLPs) and LLCs.

Formation.

a. Partnerships.

Generally, partnerships are formed without creating a taxable event. Unlike S Corps, there is no restriction on the type or number of owners of a partnership. Partners can include individuals (including nonresident aliens), corporations, other partnerships, any kind of trust, and estates. The amount of partners is unrestricted. Further, there is typically no constraint on the capital structure of a partnership, so interests in the business with preferences pertaining to distributions can be issued without risking partnership status for income tax purposes. 57 This permits the partners in a partnership, or members in an LLC for that matter, to adjust risk and reward among themselves by creating priority distributions and/or to maximize return and minimize risk. In contrast, the S Corp cannot have two classes of shares, so the preferential distributions of a partnership or LLC are simply incompatible with the S Corp form.

b. S Corps.

Generally, S Corps are formed without creating a taxable event if the corporation is not treated like an investment company and the transferor receives only stock and, immediately after the contribution, owns eighty percent (80%) or more of the voting power of the corporation and the value of the stock. There are limitations on who may own stock in an S Corp in order to maintain the S election. Only individuals who are citizens or resident aliens, estates, and certain qualified trusts can own stock in an S corp. Further, the number of shareholders is constrained to

one hundred (100). The capital structure of an S Corp is also limited to one class of stock, but there can be voting and nonvoting common stock. 58

**Operation.**

**a. Partnerships.**

The partnership form is generally more flexible than that of an S Corp. Like most S Corps, a partnership is a nontaxable entity. Income, gains, losses, and deductions pass through to the partners in the partners’ taxable year that includes the end of the partnership taxable year. The partners are responsible for income tax in their separate or individual capacities. As such, the various items of income, gain, deduction, loss and credit included in the partner’s distributive share are taken into account by the partners individually. 59

Losses generally can be deducted by the partners to the extent of their bases in the partnership. Typically, a partner’s basis in the partnership (outside basis) will equal the amount of cash transferred to the partnership, increased by the partner’s basis in any property transferred to the partnership and decreased by any liabilities the property is subject to or which the partnership assumes pertaining to that property. General partners share in recourse liabilities based on their share of the economic risk of loss regarding such liabilities. Limited partners or members of an LLC share in recourse liabilities only to the extent they are obligated to make contributions to the partnership, pay the creditor directly, restore a deficit balance in their capital account upon liquidation, or reimburse another partner or member pursuant to a indemnity arrangement. Following allocations to reflect minimum gain and built-in appreciation, general

58 *Id.* at 20; See also Goldberg, *Choice of Entity for the Family Business*, at 15-17.
and limited partners both (and members of an LLC) share nonrecourse liabilities to the extent of their share of the profits of the partnership or LLC.\textsuperscript{60}

A partner’s basis will go up due to his or her distributive share of partnership income and will go down due to losses, nondeductible expenditures, and distributions to the partner from the partnership. When a partner’s share of liabilities is decreased, it is treated as a distribution of cash that decreases his or her basis. In contrast, when a partner’s share of liabilities is increased, it is treated as a contribution of cash that increases his or her basis. A partnership has the ability to allocate items of income, gain, loss, deduction, or credits in any manner it wishes, so long as the allocation has substantial economic effect, and if family members are involved, the allocation satisfies the family partnership rules.\textsuperscript{61}

\textbf{b. S Corps.}

S Corps, except those that were formerly C Corps, are normally a nontaxable entity. Similar to a partnership, an S Corp’s items of income, gain, loss, deduction, and credit pass through to the shareholders; however, those items cannot be specially allocated to various shareholders. Allocations to shareholders are based on their stock ownership and according to the number of days of the year that the shareholders have held their stock.\textsuperscript{62}

Loss deductions are limited to the shareholder’s basis in his or her stock. Typically, the shareholder’s basis will equal the amount of cash, increased by the shareholder’s basis in any property that he or she transferred to the S Corp in exchange for stock and decreased by any liabilities assumed by the S Corp or which the property was subject. For loss deduction purposes, the shareholder’s basis includes loans made to the S Corp. Unlike partnerships and LLCs, a

\textsuperscript{60} Id. at 21.
\textsuperscript{61} Id.
\textsuperscript{62} Id. at 21-22.
shareholder’s stock basis does not include the shareholder’s share of corporate liabilities. The passive loss rules and at-risk limitations also may apply to losses generated by an S Corp.  

Transfers of Interests.

a. Partnerships.

Generally, capital gain is recognized by a partner in a partnership following the sale or exchange of his or her interest in the partnership. Notice that a partnership may elect to adjust the basis of its assets with respect to a purchasing partner or successor of a decedent partner to reflect the difference between the acquiring partner’s outside basis (purchase price) in his or her partnership interest plus his or her share of partnership liabilities and the acquiring partner’s share of the partnership’s basis in its assets (inside basis).

b. S Corps.

Generally, capital gain is recognized by a shareholder in an S Corp following the sale or exchange of his or her stock. Unlike a partnership, the purchasing shareholder’s inside basis (his or her share of the basis of the S Corp in its assets) cannot be adjusted to reflect the difference between his or her outside basis and his or her inside basis. Moreover, the S Corp may lose its pass through tax advantage if a shareholder passes shares to a non-qualified holder and it loses its S election. The partnership forms do not have this issue, nor does an LLC, because LLCs generally have check-the-box regulations.

Contributions of Property.

a. Partnerships.

Generally, a partner will not recognize gain or loss upon the contribution of property to a partnership. However, if the contribution is a disguised sale, it will be treated as such and gain

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63 Id. at 22.
64 Id. at 22-23.
65 Id. at 23.
or loss will be recognized. The income, gain, loss, and deductions regarding property contributed by the partner to the partnership must be shared amongst the partners. In effect, this will reflect the variation between the partnership’s basis in the property and its fair market value at the time it was contributed. 66

b. S Corps.

A shareholder contributing property to an S Corp in a tax-free exchange will effectively shift a portion of the resulting tax consequences pertaining to any inherent gain or loss that is built-in to that property to the other shareholders. However, if the shareholder contributes property with built-in gain to an S Corp in a transaction that fails to meet the requirements of a tax-free exchange, he or she will recognize gain equaling the built-in appreciation. 67

**Distributions.**

a. Partnerships.

Unless a distribution of cash to a partner exceeds his or her outside basis, there will be no resulting taxable income to that receiving partner. Likewise, a distribution of property that includes something other than cash to a partner will result in no taxable income to that receiving partner except when the cash distributed exceeds that partner’s outside basis in the partnership. Partners recognize loss following a distribution only if it was in complete liquidation of his or her partnership interest and the only property distributed is cash and unrealized receivables and inventory. Notice that a partnership typically will not recognize gain or loss following a distribution of cash or property to a partner except when there is a deemed sale of its interest in unrealized receivables or substantially appreciated inventory. 68

b. S Corps.

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66 *Id.*
67 *Id.* at 23-24.
68 *Id.* at 24-25.
When an S Corp does not have subchapter C earnings and profits, distributions of cash and other property will be tax-free to the shareholder up to his or her basis in the stock of the S Corp with any excess being capital gain. Notice that an S Corp will realize gain or loss (unless the loss is otherwise denied) upon distribution of appreciated property to a shareholder. That gain or loss will be reflected in the shareholder’s basis in his or her stock. In effect, this avoids double taxation or double loss. Moreover, unlike a partnership, an S Corp or its shareholders will recognize at least one level of taxable gain upon the distribution of appreciated property to its shareholders. 69

Liquidations.

a. Partnerships.

As discussed previously, the liquidation of a partnership generally will not involve taxable gain to partners unless the amount of cash distributed exceeds a partner’s basis in the partnership. 70

b. S Corps.

An S Corp will recognize taxable income in a liquidation if appreciated property is distributed to shareholders. However, gain typically will not be recognized twice, as the shareholder’s basis will be increased by the amount of income recognized except when the income and loss are of different character. 71

Comparing LPs and LLCs.

Treatment of liabilities.

a. LPs.

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69 Id. at 25.
70 Id. at 27.
71 Id. at 27-28.
Limited partners receive an increase in basis for nonrecourse liabilities as only specific assets of the partnership are subject to the liability. 72

b. LLCs.

Members of an LLC are not personally liable for debts, obligations, or liabilities of the LLC absent an agreement to the contrary. As such, each member receives an increase in his or her outside basis in the LLC for his or her share of the debts, obligations, and liabilities of the LLC. 73

Passive Loss Rules.

a. LPs.

Limited partners who materially participate in the business of the partnership, within the meaning of the passive loss rules, risk exposure to liability as a general partner for the partnership’s obligations. 74

b. LLCs.

While a member of an LLC may be treated as a limited partner under the passive loss rules, a member of an LLC may still materially participate in the LLC so that the income and losses passed through to the member will be considered active income and losses under the passive loss rules and still not risk exposure to personal liability. 75

Distributions to withdrawing partner or member.

a. LPs.

If capital is not a material income-producing factor, payments to a general partner in liquidation of his or her interest in the partnership’s goodwill may be treated as a distribution of
partnership income or as guaranteed payments. This, in turn, reduces the taxable income of the remaining partners. 76

b. LLCs.

It remains unclear how a liquidating distribution to a member of an LLC is treated. Hopefully, a manager-member in a manager-managed LLC and a member in a member-managed LLC would be treated like a general partner. 77

Characterization of income for self-employment tax purposes.

a. LPs.

Currently one can separate a partner’s share of the partnership’s net income into self-employment income and non-self-employment income, but the partner must own both a general and a limited partnership interest. Similar results may be possible in an S Corp in the case of a shareholder-employee who receives compensation income and dividends. 78

b. LLCs.

It remains unclear whether distributions to members of an LLC will be subject to self-employment tax. 79

Valuation rules under Chapter 14 of the IRC.

Chapter 14 was enacted as part of the Revenue Reconciliation Act of 1990 (“RRA 90”). Chapter 14 contains valuation rules for determining whether a gift has been made, and the value of such gift, when older generations in a family transfer partnership interests (including LLC interests), corporate interests, and trust interests to the younger generations in the family. To determine the value of the transferred interest in property (including a family business), one

76 Id.
77 Id.
78 Id. at 30.
79 Id.
subtracts the value of any interest retained by the transferor from the fair market value of the transferred property.\textsuperscript{80}

**Valuing transfers of LLC, partnership and corporate interests.**

Special valuation rules under Chapter 14 are used to figure out the value of minor equity interests in LLCs, partnerships, and corporations transferred to a member of the transferor’s family if that transferor or an applicable family member retains a superior equity interest in the entity that gives the holder an applicable retained interest (either a put, call, conversion, or liquidation right) or in a controlled entity, a distribution right other than a qualified payment right. An applicable retained interest is valued at zero under the special valuation rules.\textsuperscript{81}

A controlled entity is an LLC, partnership, or corporation controlled immediately prior to the transfer by the transferor, any applicable family members, and any lineal descendants of the parents of the transferor or the transferor’s spouse. Holding at least fifty percent (50\%) of either the capital interest or profits interest in the entity is synonymous with control. Specific to an LP, holding any interest as a general partner is also synonymous with control. While no such authority is directly on point, member managers in a manager-managed LLC and members of a member-managed LLC will likely be considered general partners for this purpose as well.\textsuperscript{82}

Neither a qualified payment right, nor a guaranteed payment right, is subject to the special valuation rules. Qualified payment rights are the right to receive a fixed amount on a periodic basis. Guaranteed payment rights are rights to receive a fixed amount from a partnership or LLC irrespective of the income of the partnership or LLC. The payment cannot be contingent as to amount or time.\textsuperscript{83}

\textsuperscript{80} Id. at 99.
\textsuperscript{81} Id.
\textsuperscript{82} Id. at 100
\textsuperscript{83} Id.
A frozen LLC or partnership interest refers to an equity interest retained by an older generation family member after transferring residual interests to younger generations in the family. Future growth in the value of the business will inure to the benefit of the holder of the residual interests. The idea is to have the frozen interests remain at the identical value as the date on which it was created. There are at least two scenarios where that is the case:

(1) A new business with a low value that is expected to increase in value quickly into the future. Here the older family member holds the frozen interest in the entity while providing the younger family members the residual interests. The older family member’s frozen interest will be valued at zero either because he or she does not keep a qualified payment right or a guaranteed payment right, or elects out of qualified payment right treatment. Since the value of the business is low at the time of creating the frozen interest, the value of the residual interest that is treated as a taxable gift will not be burdensome, even though it represents the entire value of the business.84

(2) A business is expected to grow quickly enough to pay the older family member either a qualified payment or a guaranteed payment. Here the value of the residual interests transferred to the younger family members would not include the present value of the qualified payment right or the guaranteed payment right. Future growth in the business, to the extent it exceeded the value of the qualified payment right or the guaranteed payment, would inure to the benefit of the younger family members holding the residual interest, providing transfer tax savings to the older family member in effect.85

Rights and restrictions.

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84 Id. at 100-101.
85 Id.
Under the special valuation rules of Chapter 14, for purposes of estate, gift, and generation skipping transfer taxes, the value of property is determined without considering any right or restriction relating to the property. A right or restriction is an option, agreement, or other right to obtain or use the property for a fee below that property’s fair market value, or any restriction on the right to sell or use that property. These restrictions are oftentimes found in the partnership agreement or operating agreement but may also be implicit in the structure of the entity. Prior to the special valuation rules, family members could be tempted to understate the values of interests in intrafamily buyout agreements. This temptation was especially true in the case of older generation owners who were understating the value of their interests to make it appear lower than it truly was for estate tax purposes upon their death.86

However, there are two (3) exceptions to the special valuation rules. Under the statutory exception, a right or restriction is not disregarded if: (1) it is a bona fide business arrangement; (2) it is not a device to transfer the property to the natural objects of the transferor’s bounty for less than full and adequate consideration in money or money’s worth; and (3) at the time it is created, the terms of it are comparable to similar arrangements entered into by persons in an arm’s length transaction. Under the regulatory exception, a right or restriction is considered to meet each of the above three (3) requirements if more than fifty percent (50%) by value of the property subject to it is owned directly or indirectly by individuals who are not members of the transferor’s family. Thus, while it may be possible for federal estate tax purposes to get valuation discounts for interests in partnerships, LLCs, and even for corporate interests, the IRS will not allow game playing.87

86 Id. at 102; See also Goldberg, Choice of Entity for the Family Business, at 18.
87 Id.