CHOICE OF BUSINESS ENTITY FROM

A LOUISIANA BUSINESS AND

FEDERAL TAX LAW PERSPECTIVE

By:

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CHOICE OF BUSINESS ENTITY FROM A LOUISIANA BUSINESS AND FEDERAL TAX LAW PERSPECTIVE[1]

I. INITIAL CONSIDERATIONS

The decision as to which form of organization one should conduct his or her business from is one which should not be oversimplified. It should be arrived at only after careful consideration by the client in consultation with his or her attorney and CPA. There is no standard recommendation an advisor can make in counseling the business client who comes to him for advice on this issue. Each time a client walks in the door for consultation on these issues, the advisor is confronted with a situation not unlike working with a jigsaw puzzle. Each client's situation is made up of different pieces, all scrambled up, and it is for the advisors to sort them out and try to put them together to arrive at the best result.

The choice of entity process was further complicated by the development of the Limited Liability Company ("LLC") and the Registered Limited Liability Partnership ("RLLP") under the various states laws beginning in 1987 when Wyoming became the first state to adopt legislation authorizing the formation and operation of the LLC. With the adoption of the so-called "Check-the-Box" regulations by the IRS in 1997, the LLC has so revolutionized the area of business organizations that some legal scholars have suggested that the proliferation of state business organization statutes could be reduced to only two statutes, one designed to provide governance rules for public companies and one designed to provide governance

1 This paper was presented at a seminar sponsored by Lorman in December of 2005.

rules for nonpublic companies.[2] In the February 1997 issue of The Business Lawyer, there was published an edited version of comments made by lawyers and law professors who participated in an Internet symposium entitled "On-Line Symposium on the Future of Limited Liability Entities" in which this idea was suggested by a number of the participants.[3] It was suggested that this could happen because (i) all closely held entities - LLCs, limited partnerships, closely held corporations, general partnerships, limited liability partnerships (LLPs), and the limited liability limited partnership (LLLP) - share the same governance issues, which can be accommodated in one statute; and (ii) the differences in governance between closely held entities and publicly held entities is enormous and not comfortably accommodated in one statute (hence the development of closely held corporation statutes in some states).[4] Another participant commented that "[t]he taxation provisions were the tail wagging the dog. With this problem out of the way, there seems to be little need for statutes creating several business association forms."[5]

In the same symposium, professor Bernard Black, of Columbia University School of Law, suggested that "limited partnerships will be almost dead as a vehicle for new enterprises in five years..." Indeed, in the experience of this writer, since the LLC legislation was adopted in Louisiana, the use of the limited partnership seems to be limited to family limited partnerships used in estate planning circles and, in

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2 Larry E. Ribstein and Mark A. Sargent, "Check-the-Box and Beyond: The Future of Limited Liability Entities," a Symposium published in The Business Lawyer, Section of Business Law, American Bar Association, pp. 605-652, @ p. 610.

3 Id.

4 Id. at p. 611.

5 Id. at p. 612, comment of Harold Federow of the University of Washington.

the early days of the LLC, (i) when the client was a promoter who was simply more accustomed to the limited partnership form of operation and didn't feel comfortable with his own lack of experience with LLCs and (ii) for certain FHA/HUD real estate projects because those agencies were said to still be somewhat unfriendly to the LLC form of ownership as opposed to the limited partnership. As each year passed after the creation of the LLC in the U.S., the resistance to their use has given way to complete dominance in the field.

Depending upon circumstances such as the number of persons to be involved in the ownership and management of the business, among other factors, the menu of forms of business ownership now generally includes the following:

1. Sole proprietorship;
2. Co-ownership in indivision;
3. General partnership;
4. Limited partnership;
5. Registered limited liability partnership;
6. Limited liability company;
7. C corporation;
8. S corporation;
9. Real Estate Investment Trusts;
10. Real Estate Mortgage Investment Companies;
11. "Close Corporation" under Delaware, California, New York and Texas law.

Note that the "joint venture" is not listed as one of the choices which are available. This is because it is a term which does not appear in Louisiana statutory law, and although it is commonly used by parties in agreements and by the courts, it is not technically consistent with Louisiana's civil law system.

Essentially, a joint venture is, according to Louisiana case law, is a partnership under Louisiana law. The jurisprudence has established that the essential elements of a joint venture are generally the same as those of partnership, i.e. two or more parties combining their property, labor, skill, etc. in the conduct of a venture for joint profit, with each having some right of control, and at mutual risk vis a vis losses. ***Walker v. Simmons***, 155 So. 2d 234 (La. App. 3rd Cir. 1963); ***Marine Services, Inc. v. A-1 Industries***, 355 So. 2d 625 (La. App. 4th Cir. 1978).

The requisites for the establishment of a partnership, under the case law, are applicable to a joint venture, and are as follows:

(1) A contract between two or more persons;

(2) A juridical entity or person is established;

(3) Contribution by all parties of either efforts or resources;

(4) The contribution must be in determinate proportions;

(5) There must be a joint effort;

(6) There must be mutual risk vis-a-vis losses;

(7) There must be a sharing of profits.

The logical considerations in selecting the form of a business enterprise include the organizational and management structure, the capital structure, methods of financing the business, the availability of limited liability for the owners, continuity of existence, transferability of interests, flexibility, complexity, cost considerations and tax considerations. The fact that tax considerations play an important role in the deliberative process should be a warning to the legal advisor that if he or she does not have expertise in the field of tax law, then the legal advisor must get the client's CPA or tax advisor involved in the process. However, the decision is not one to be made solely on the basis of tax motivations.

In choosing the best form of business entity for a particular client's needs, one must consider basic ownership issues, objectives and goals.

A. Factors to be considered.

1. Will the owners create a new business or convert an existing business?

2. The number of owners of the business.

3. Will any of the owners be other business entities such as corporations, LLCs, or partnerships?

4. What will be the nature of business to be operated by the entity? For example, if it is a personal service business, special provisions in the Internal Revenue Code will apply to the entity if operated in a corporate form. A C Corporation may be subject to personal holding company tax if the income is principally investment income. The nature of business also may affect the application of the passive activity loss rules.

5. The duration of the enterprise.

6. The projected profits or losses of the business. If significant losses are projected, a pass-through entity such as the partnership or S Corporation (including the LLC taxed as either) may be preferable to facilitate deduction of the losses at the individual owner level. Even within the choices of pass-through entities, one taxable under Subchapter K of the IRC (partnership taxation) may be preferred since the partners or members receive outside tax basis for their allocable share of debt of the partnership.

7. The capital requirements of the business. The greater the capital requirements, the more likely the owners will want an entity that allows them to withdraw the capital at a later date without tax consequences, such as a partnership or S corporation (including the LLC taxed as either). On the other hand, if significant funds are to be accumulated in the business out of current profits, a C corporation will generally allow the accumulation at a slightly lower tax rate.

8. Will the owners be active participants or passive investors? If the owners are not going to be active in the business, then a general partnership may be inadvisable. It may be desirable to use a limited partnership or LLC that allows allocation of income other than on a pro rata basis.

9. <u>Will the prospective owners make different types of contributions; i.e., cash, property, or services</u>? If a person will be rendering personal services in exchange for an equity interest, it may be better to use a partnership or LLC in which he or she receives an interest in future profits as a result of the contribution of services, rather than a share of the capital. A receipt of a share in the capital may result in immediate income tax consequences to the owner contributing services.

10. <u>Will there be loans to the business from owners or others</u>? If the loans will be from the owners, then an S corporation form will allow its shareholders to increase their basis for deducting losses by the amount of such loans. If there will be loans from third parties, then the partnership form (including the LLC taxed as a partnership) will allow its partners or members to increase their basis by their respective shares of the company loans.

11. <u>The income tax brackets among the owners and the enterprise</u>.

12. <u>The wealth of the owners</u>. Do they have anything to lose?

13. <u>The family status of the owners; in particular, estate planning objectives and considerations</u>. Income shifting is not as beneficial as it once was. The creation of ownership interests in younger family members may reduce the size of the older family member's federal gross estate for estate tax purposes.

14. <u>The domestic location of the U.S. business</u>. Not all states recognize S corporation status for state income tax purposes. Although it took several years to reach this point, all 50 states now formally have adopted limited liability company legislation. There may, however, be substantial differences between states as to certain aspects of limited liability company law.

15. <u>The form of compensation to be paid to the owners; i.e., salary, interest, rent, dividends, royalties, etc.</u>

16. <u>Will there be distributions of capital in the near future as a result of refinancing, redemptions, partial liquidations of the business, and other transfers to the owners</u>? The partnership, LLC, or sole proprietorship allows such distributions to be made with few unfavorable tax consequences.

17. <u>Will there be restrictions on transfers of ownership</u>? If free transferability of interests is desirable, an S corporation may not be the best choice, since shareholders should generally restrict transfers to only eligible shareholders to protect the S election.

18. The form of management desired. Are all owners to have equal say in the management; is there to be centralized management; and do the organizers want the multiple tiered management structure provided by corporate law?

B. Goals of the owners.

1. Limited Liability. The owners generally want limited liability. It will be difficult for the owners to achieve limited liability with respect to significant borrowing unless the entity has substantial assets of its own to serve as collateral. Nonetheless, insulation from liability for torts and trade creditors may be achieved through the use of either a limited partnership, a corporation or LLC.

2. Simplicity. The owners do not like to spend a great deal of time on the formalities of the governance of the entity.

3. Low Cost. Cost items include accounting costs, legal fees, filing costs, and syndication costs.

4. Transfer Restrictions. The owners generally want restrictions on ownership transfers, unless they are looking to tap into public capital markets.

5. Tax-free Withdrawals. Owners generally want the ability to liquidate their interests in the business with the least amount of tax and non-tax costs.

6. Tax Benefits: Losses. Owners often want the tax benefits of having losses pass through to them directly.

7. Tax Benefits: Profits. The owners want the lowest tax on profits, taking into account the double taxation generally inherent in using the C corporation.

8. Tax-Free Cash Flow.

9. Passive Income. Owners may be seeking passive income to offset passive losses.

II. WHY TAX FACTORS MUST BE CONSIDERED

Aside from the rules applicable to REIT's, REMIC's, and trusts, which are beyond the scope of this program, there are basically three different classifications of business organizations for tax purposes, each with its own subchapter of the Internal Revenue Code ("IRC") containing specialized rules relating how they are taxed. If you include the sole proprietorship, there are four:

1. Sole proprietorship;
2. C corporation;
3. S corporation;
4. Partnership.

Generally only the C corporation pays income taxes as a separate entity. However, because the S corporation, the partnership and the limited partnership have specialized rules relating to transactions between the entity and its owners and the method of determining the allocation of profits and losses among the owners, each has its own set of advantages and disadvantages under the tax laws.

Over many years of tax administration, the tax dynamics of the choice of entity process have tended to flip flop with variations in individual and corporate tax rates and other corporate and individual tax attributes. Advisers trained more than 25 years ago learned that use of C corporations and the accumulation of earnings inside the C corporation was the best advice.[6] This was at a time prior to 1979 when maximum individual tax rates were 70% and maximum corporate tax rates were 46%. The dynamics

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6 Calvin H. Johnson, Tax Notes, May 17, 2004, p. 872.

of choice of entity from a tax standpoint are driven by the relationship between corporate, individual and capital gains tax rates. Fluctuations in the relationship of these rates and their relationship to one another have resulted in fluctuations in what is the best entity form.

Professor Calvin H. Johnson, of the University of Texas, describes the optimum strategy at the beginning of this period as the "accumulation-bailout" or "growth stock" strategy.[7] "Accumulation-bailout" refers to the strategy of retaining earnings inside a C corporation over many years and then taking advantage of the "bailout" technique that was available under the tax law at the time which allowed one to sell the assets of a C corporation, liquidate the C corporation and pay only one level of tax. This was available under what was known as the *General Utilities Doctrine*, named after a U.S. Supreme Court decision of 1934, which was later codified in former IRC §337.

Professor Johnson indicates that since 1979, the changes in the tax laws have resulted in five flip flops in the optimum tax vehicle.[8] He suggests that after 1979 and through 1986, a pass through tax regime was better than a C corporation for distributions during the life of the taxpayer. Then, with the passage of the Tax Reform Act of 1986, avoiding corporate tax yielded the best result, whether savings were taken out during the life of the taxpayer or after death.[9] Increases in the individual tax rates in 1993 resulted in "accumulation-bailout" becoming, once again, the optimum strategy for post-death distributions, but not

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7 *Id.* @ 873.

8 *Id.* @ 877.

9 *Id.*

for life time distributions. The reduction in the capital gains rates to 20% in 1997 made accumulation-bailout again the best strategy for life time distributions. Finally, the reduction in individual rates in 2003 made individual current distribution of income (zeroing out C corporation earnings, if in a C corporation) the optimum strategy.

The five major tax law revisions which impacted the choice of entity decision most dramatically over this 25 year period were the following:

1. The Economic Recovery Tax Act of 1981 reduced the maximum tax rate on investment income from 70 percent to 50 percent. The capital gains tax rate dropped from 28% to 20% under this law. The 50% maximum individual rate compared to a 46% maximum corporate tax rate. These rates were too close to create any significant tax detriment from using the corporate form as the bail out strategy was still available, but combined with the capital gains tax break this structure resulted in avoiding the C corporation as being the best strategy.

2. The Tax Reform Act of 1986 created "rate inversion," meaning that corporate rates were for the first time higher than individual tax rates. This rate inversion meant that there was no tax advantage to using the corporate rate form for business operating in the maximum tax rate environment. The 1986 Tax Reform Act reduced the maximum corporate tax rate from 46% to 34% and also reduced the maximum rate on individual income from 50% to 28%. The tax rate on capital gains was increased from 20% to 28%. Perhaps more significantly, the Act repealed the General Utilities Doctrine thus eliminating the "bail out"

strategy by making it impossible to exit the C corporation without paying taxes at both the corporate level and the individual level.

3. The Omnibus Budget Revenue Reconciliation Act of 1993 ended rate inversion by increasing the individual maximum rate up to 41%. The act created a new 39.2% bracket which, when combined with the phase out of the itemized deductions for higher income taxpayers, added an additional 1.2% to the maximum bracket. The 1993 Act also added a new 35% tax rate for corporate income exceeding $10 million per year. According to Professor Johnson, the rise in the individual tax rate "reduced the advantage of the individual-tax only regime by enough that the corporate accumulation became viable, at least for estate-planning purposes."[10]

4. The Taxpayer Relief Act of 1997 reduced the maximum rate on capital gains from 28% to 20%.

5. In 2003 The Jobs and Growth Tax Relief Reconciliation Act reduced the maximum rate on individuals from 41% to 36% and the capital gains rate from 20% to 15%. According to Professor Johnson, the "drop in capital gains rates favored accumulations, but the drop in individual tax rates overwhelmed that advantage and caused a flip once more, against the corporate form for life-use savings."[11] Congress also defined dividends as capital gain, allowing dividend distributions from C corporations to benefit from the 15% capital gain

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10 *Id.* at 880.

11 *Id.*

rate.

Thus, from World War II to 1986, the maximum individual rate exceeded the maximum corporate rate by at least 20%; then the Tax Reform Act of 1986 flipped the relationship, with the maximum corporate rate being 34% and the individual rate being 28%. The OBRA 93 changed the playing field on practitioners and taxpayers again in the choice of entity analysis when it increased the maximum individual tax rates above the maximum corporate tax rates (39.6% maximum individual rate compared to a maximum corporate rate of 35%. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the "2003 Tax Relief Act") changed the dynamics again by narrowing the gap between corporate and individual rates by lowering the maximum individual tax rate, and reducing tax rates on capital gains and corporate dividends.

On October 4, 2004, the president signed into law the Working Families Tax Relief Act of 2004. Also in October of the same year, Congress passed the American Jobs Creation Act of 2004 which includes some significant revisions to Subchapter S which, once again, modified the dynamics of the choice of entity process.

The basic rate structures under current law are as follows:

1. Corporations with less than $10,000,000 in taxable income are subject to graduated income tax rates. The marginal rate is 15% on the first $50,000 in income, 25% on the next $25,000, and 34% on income between $75,000 and $100,000. A rate of 39% is applied to taxable income between $100,000 and $335,000, which is designed to offset the benefit of the 15% and 25% graduated rates for corporations with larger taxable income. Taxable income between $335,000 and $10 million is taxed at

a rate of 34%. A rate of 35% is applied to taxable income between $10 million and $15 million; and a rate of 38% is applied to income of $15 million to $18,333,333. The 38% rate is, once again, designed to offset the benefit of the graduated rate structure for the corporations with taxable income over $15 million. Corporations with taxable income over $18,333,333 are taxed at a flat rate of 35%. Most corporations are taxed at marginal rates of either 34% or 35%.

2. Under the 2003 Tax Relief Act, individuals are now taxed at a maximum individual rate of 35%, down from the 39.6% maximum rate introduced by OBRA 93. The 2003 Tax Relief Act reduced the tax rates for the top four individual brackets to 25%, 28%, 33% and 35% (from 27%, 30%, 35% and 38.6%), retroactive to January 1, 2003. The phase out of itemized deductions for higher income taxpayers increases the effective rate for the top bracket taxpayers to 36%. Under pre-2003 Tax Relief Act law, individuals paid tax at ordinary income rates on dividends. The 2003 Tax Relief Act taxes qualified dividend income at the same rates that apply to net capital gain

3. Prior to July 28, 1997, the maximum rate applicable to an individual's net long term capital gains was 28%. IRC § 1(h). Under the provisions of the Taxpayer Relief Act of 1997, capital gains were subjected to various rates, depending on the type of asset and the length of time the asset was held.

- Assets held one year or less were taxed at the individual taxpayer's regular tax rate, i.e. up to 39.6% federal tax at the time the Act was passed..
- Assets held more than one year but less than 18 months were taxed at a maximum rate of 28%.
- Assets held more than 18 months (adjusted net capital gain) were taxed at 10%

or 20%.

- Gain on sale of collectibles was taxed at a maximum rate of 28%.

- Gain attributable to depreciation of section 1250 property (buildings) was taxed at a maximum rate of 25%.

After the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Relief Act"), an individual's adjusted net capital gain was taxed at a maximum rate of 20%. However, adjusted net capital gain was taxed at a maximum rate of only 10% to the extent it would have been taxed at 10% or 15% if it had been ordinary income. For qualified five year gain, i.e., adjusted net capital gain from capital assets held for more than five years before sale, the 10% rate was reduced to 8%. The 20% rate was reduced to 18% if the holding period for the capital asset began after December 2000. Adjusted net capital gain was net capital gain for the tax year (i.e. the excess of net long-term capital gains over net short-term capital gain) that is taxed at a maximum rate of 28% (gain on the sale of most collectibles and gain on the unexcluded part of IRC §1202 small business stock) or 25% (unrecaptured §1250 gain, i.e. gain attributable to real estate depreciation).

The 2003 Tax Relief Act reduced the 10% tax rate on adjusted net capital gain to 5%, and reduces the 20% tax rate on adjusted net capital gain to 15%. The 2003 Tax Relief Act eliminated the 8% and 18% maximum rates on qualified five year gain. The Act did not lower the 25% maximum rate on unrecaptured §1250 gain, or the 28% maximum rate on "28% rate gain". For tax years beginning after 2007, and before 2008, the 5% rate on adjusted net capital gains is reduced to 0%.

4. 50% of an individual's gain on sale of "qualified small business stock" held for more than

5 years is excluded. IRC § 1202. The definition of "qualified small business stock" is highly restrictive, limiting the availability of the 50% exclusion to few businesses.

a. Stock must be acquired by the taxpayer at original issue in exchange for (i) money or other property (except stock) or (ii) compensation for services to the corporation other than underwriting services. IRC § 1202(c)(1).

b. "Qualified small business corporation" is generally a C Corporation with aggregate gross assets not exceeding $50,000,000 any time after August 9, 1993 and through the issuance of its stock. IRC § 1202(c)(2)(A), (d)(i)(A).

c. Corporation must meet active business requirement unless it is an eligible corporation licensed under § 301(d) of the Small Business Investment Act of 1958.

d. Active business requirement test requires:

(i) At least 80% of corporation's assets used in an active trade or business other than: personal services; banking, insurance, financing, leasing, investing, or other similar business; farming; any business involving the production or extraction of products subject to depletion allowances; and any business of operating a hotel, motel, restaurant, or similar business.

(ii) Corporation must be one other than: a DISC or former DISC; a corporation that has in effect an election to claim a possession tax credit or has a subsidiary that has such an election in effect; a cooperative.

(iii) The corporation fails the active business requirement at any time during which it holds: more than 10% of assets in excess of liabilities in stock or securities in corporations other than its own subsidiaries, except for working capital; or more than 10% of its assets in real estate which is not used in the active conduct of a "qualified trade or business." Active conduct of qualified trade or business does not include owning, renting, or dealing in realty. IRC § 1202(e)(7).

III. EXAMINATION OF THE ADVANTAGES AND DISADVANTAGES OF EACH ALTERNATIVE FORM

A. Tax and Non-Tax Advantages And Disadvantages Of The Sole Proprietorship

a) Non-Tax Advantages of the Sole Proprietorship

(1) Simplicity - for the unsophisticated client, sole proprietorship may offer an advantage since the owner does not have to concern himself with the need to learn the different legal requirements as to how a corporation (whether C or S) or an LLC functions. Since prior to 1997, the Louisiana LLC statute required at least two members, it was generally not available to the sole proprietor although there may have been ways for the sole proprietor to get around this limitation. With the advent of the Check-the-Box Regulations in 1997 and the single member LLC under the Louisiana statute allowed by way of an amendment to the statute in 1997 following the adoption of the Check-the-Box Regulations, there is little reason for the sole proprietor not to choose the LLC as a form of entity if he otherwise would have chosen to do business as a sole proprietor. The sole proprietorship was often the best choice for some clients who simply could not manage to keep up with the various legal and tax requirements of the separate legal entity. Many of the comments that are listed below now apply equally to the single member LLC.

(2) Cost of operation - with the sole proprietorship, you don't have to pay a lawyer to set it up and teach you how to operate it. Only one set of books and only one income tax return are required.

(3) Centralized management - sole proprietor is king of the hill, but can delegate to others to act as his agent if he so chooses.

(4) Flexibility - should the sole proprietor decide to bring in another person as partner or co-owner, he has the freedom to choose from among any of the types of entities available without having to worry about how to get there from here. For instance, if the sole proprietor later decides to bring another person into his business who has property which he would like to contribute to the business in return for his ownership interest, generally, the two parties can freely choose from among the various forms of business entities in order to combine their interests. They will generally be able to do so without any legal impediments and usually minimal tax impediments.

b. Tax Advantages of the Sole Proprietorship

(1) Simplicity-only one income tax return is required and the business owner does not have to learn the corporate or partnership tax rules.[12]

(2) No Double Taxation-unlike the C corporation, an individual may operate as a sole

[12] Although practically every businessman will rely on his CPA or other tax professional for the expertise, every client should be made to realize that to be an effective and successful businessman he must study and learn the general tax rules which affect his business.

proprietorship under a trade name and not have to worry about the separate corporate tax. Money or property can be taken out of the business or used in the business at any time without having to look to the C corporation, S corporation, or partnership tax rules to determine the tax consequences.

(3) Flexibility-should the sole proprietor decide to bring in another person as partner or co-owner, he has the freedom to choose from among any of the types of entities available without having to worry about how to get there from here. In most cases, this can be done as a tax free transaction, whether it be in a corporate form (IRC §351) or a partnership form (IRC §721) for tax purposes.

c) Non-Tax Disadvantages of Sole Proprietorship

(1) The Obvious-Unlimited Liability - with the sole proprietorship, the owner is liable for each and every debt or obligation of the business, and his only protection is through insurance.

(2) Sources of Financing - usually limited to bank loans. No access to the public funding markets such as publicly offered securities. However, should the sole proprietor decide to pursue financing from outside investors, because he is operating as a sole proprietor, he does have the flexibility to incorporate his business in order to do so.

(3) Absence of Separate Entity Flows Both Ways - debts of the individual are debts of the business and vice versa. If there is a separate legal entity such as a corporation or partnership, the owner may seek bankruptcy relief without the assets of the corporation or partnership coming under the direct administration of the bankruptcy estate. The converse is also true - that the corporation or partnership may seek bankruptcy relief without the assets of the owners coming under the jurisdiction of the bankruptcy court (See U.S. Bankruptcy Code §§101(41), 109 & 541).

(4) Lack of Continuity of Existence - this distinction may only be technical in nature depending upon the size of the sole proprietor's business. Technically speaking, the sole proprietorship terminates with the death of the owner, but if the owner has built up an organization of sufficient size, the business may continue to be operated by his successors through the succession administration process.

(5) Sole Proprietor Can Now Be a Limited Liability Company - note that prior to the 1997 Legislative Acts, La. Rev. Stat. §12:1304 provided that: “Two or more persons capable of contracting may form a limited liability company...” Therefore, the sole proprietor had only three choices available to him: (i) the sole proprietorship; (ii) the C corporation; and (iii) the S corporation. In 1997 this provision was amended to read: “[o]ne or more persons capable of

contracting may form a limited liability company..." Therefore, because the single member LLC may be formed quite inexpensively, the question we should ask is "why not choose an LLC for those who otherwise might have chosen to operate as a sole proprietor?"

d. The Tax Disadvantages of Sole Proprietorship

(1) Tax Cost of Sale of Business - when a sole proprietor sells his business, he sells each component part (plant, equipment, receivables, good will, etc) some of which may be taxed at ordinary income rates and some may be taxed at capital gains rates. The sale by a partner of his partnership interest will generally be treated as the sale of a capital asset eligible for capital gain or loss treatment, except to the extent of the gain on unrealized receivables and inventory items held by the partnership. (IRC §741). The sale of corporate stock will generally be taxed as the sale of a capital asset also. The significance of this distinction has not been that great in recent years, but is more significant since capital gains tax breaks were brought back into the tax laws in 1997 and have now been liberalized even more by the 2003 Tax Relief Act.

Also, the manner of transferring the business is limited to the sale of individual assets and assumption of liabilities, while in the sale of a corporate business, for instance, the owners may sell the corporation's assets or may sell the stock of the corporation. The asset sale is generally considered to be slightly more expensive than the stock sale from a closing cost/legal work standpoint, although depending on the amount of diligence exercised by the parties to the transaction, this may often not be the case.

(2) No Ability to Provide Tax Free Fringe Benefits - shareholder/employees of a C corporation may receive certain tax free fringe benefits without restriction such as employer provided health care, certain meals and lodging, and life insurance. The same benefits are not available to the sole proprietor except that self-employed individuals are allowed a deduction for the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse and dependents. This is a deduction that prior to 2003 was allowed only at reduced percentages (60% for years through 2001, 70% for 2002 and 100% for years thereafter). IRC §162(l).

(3) Limitation on Deduction of Investment Interest - the deduction by an individual of investment interest is limited to the amount of investment income of the taxpayer for the taxable year. Any amount not allowed as a deduction for the year is carried forward to be allowed as a deduction in future years where there is investment income against which it may be offset (IRC §163). C corporations are not subject to this limitation, while the effect of the S corporation tax rules would be to pass the interest deduction through to the shareholders where it would be subject to the limitation of §163.

(4) Passive Activity Rules Apply-the only entity to which the passive activity rules do not apply is the non-closely held C corporation.

(5) Higher individual income tax rates - 35% maximum individual rate compared to 34% maximum rate for most C corporations (but with graduated rates of 15% on the first $50,000 in income, 25% on the next $25,000, and 34% on income between $75,000 and $100,000, etc.). On top of this, Self Employment taxes are imposed on all active trade or business income of the sole proprietorship. IRC §1401 (15.3% on self-employment income up to the contribution and benefit base for the year and 2.9% on amounts in excess thereof (without limit). In the sole proprietorship format, there is no ability to escape Self Employment tax. This is important considering that the 2.9% medicare tax on trade or business income applies to all such income without limit.

B. CO-OWNERSHIP IN INDIVISION

a. Availability

This form of ownership is really only available for the ownership and management of real estate investments or other specific items of movable property because it would be nearly impossible to conduct a going concern type business as co-owners in indivision without the relationship being found to be one of partnership under state law as well as the tax law.

1. La. C.C. Art 2801 defines a partnership as "a juridical person, distinct from its partners, created by a contract between two or more persons to combine their efforts or resources in determined proportions and to collaborate at mutual risk for their common profit or commercial benefit."

(i) Essential elements of a partnership;

(1) Consent and intent of the parties to form a partnership. A partnership may be inferred if the elements of one are present and intended even if the parties did not consciously consider or intend it to be a partnership.

(2) Partners must share the risk as well as the profits.

(3) Each partner must make a contribution that has economic value.

There are no clear cut rules in making a determination of whether a partnership exists and each case is judged on its own individual facts. *Carr vs. Masters*, 469 So.2d 147 (La. App. 4th Cir. 1985). The legal relationship of parties is not conclusively controlled by terms which parties use to designate their relationship, especially with regard to third parties; rather, courts look to the totality of the circumstances and not just the written agreement to determine whether a joint venture was entered into.

Perhaps more importantly, when two or more persons or concerns enter into an agreement which the law defines as a partnership or joint venture, it becomes a juridical entity, and liability of parties is determined by the law relating to partnership or joint venture, **even though parties may not have thought of such consequences and even sought to avoid such consequences as sales tax implications and liability to third parties.** *Cajun Electric Power Co-Op, Inc. v. McNamara*, 452 So. 2d 212 (La. App. 1st Cir. 1984).

Thus cases have held that certain relationships constituted a partnership under the law even where the written agreement between the parties disclaimed any intention to create a partnership or joint venture. Cases have also held that certain relationships did not constitute a joint venture or partnership even though the written agreement between them claimed that the parties intended that a partnership be established. One such case of the latter type involved a situation where the court found that one party did not assume any risk of losses in the venture and thus there was no joint venture or partnership formed. *Hodges v. Decoteau*, 314 So.2d 500.

2. Whether the parties have used the word "partnership" or not is immaterial in determining whether the effort is a partnership. *Marie vs. Savoie*, 470 So.2d 367 (La. App. 5th Cir. 1985); *Harris v. Wallette*, 538 So.2d 728 (La. App. 2d Cir. 1989)

3. Consent to form a partnership may be inferred from circumstantial evidence. *Carr v. Master*, 469 So.2d 1147 (La. App. 4th Cir. 1983).

4. In a partnership the parties mutually consent to form a partnership and to participate in the profits which might accrue from property, skill or industry, furnished to the business in determined proportions by them; the parties agree to share in the losses as well as the profits of the venture; the property of the enterprise forms a community of goods in which each party has a proprietary interest; the parties agree to proceed at their mutual risk. *Amacker v. Kent*, 80 So. 717 (La. 1919); *Darden v. Cox*, 123 So.2d 68 (La. 1960); *Gravois v. New England Ins. Co.*, 553 So.2d 1034 (La. App. 4th Cir. 1989), La. C. C. Art. 2801.

A close reading of the above cases illustrates that it is difficult for two or more people to go into a business together and not fall within the definition of a partnership.

b. Non-Tax Advantages of Co-ownership in Indivision

(1) Simplicity - Co-owners share the fruits and products of the thing held in indivision;

when fruits and products are produced by a co-owner, other co-owners are entitled to their shares of the fruits or products after deduction of the costs of production. C.C. Art 798. Use and management of the thing held in indivision is determined by agreement of all the co-owners; if it is not determined by an agreement of all the co-owners and partition is not available, a court, upon petition by a co-owner, may determine the use and management. C.C. Arts. 801 & 803.

Just like the sole proprietorship, co-owners are generally free to place their co-owned property into a business entity should they determine to do so, and this can often be done without adverse tax consequences regardless of which type of entity is chosen.

(2) Partition Generally Available to Terminate Co-Ownership - No one may be compelled to hold a thing in indivision with another unless the contrary has been provided by law or juridical act. C.C. Art 807. The parties may stipulate to exclude partition for up to fifteen years, or such other period as provided in R.S. 9:1702 (99 years for co-owned nuclear generating plant), or other specific law. C.C. Art 807.

(3) Transferability of Fractional Ownership Interest - A co-owner may freely lease, alienate, or encumber his share of the thing held in indivision, but the consent of all the co-owners is required for the lease, alienation, or encumbrance of the entire thing held in indivision. C.C. Art. 805. However, note that property of the former community which is subject to co-ownership with a former spouse is subject to special rules enacted pursuant to Act 433 of the 1995 Regular Session of the Legislature as Civil Code Articles 2369.2 through 2369.8. Generally, a spouse may not alienate, encumber, or lease former community property or his undivided community interest in that property without the concurrence of the other spouse, except as provided in these articles. In the absence of such concurrence, such alienation, encumbrance, or lease is a relative nullity. The rules allow for a spouse to alienate, encumber, or lease a movable issued or registered in his name and movables which are alienated, encumbered or leased in the regular course of business of a former community enterprise by the spouse who is a sole manager of the former community enterprise. Otherwise, court approval is required.

(4) Co-Owners are Accountable to One Another for Expenses of Management - A co-owner who on account of the thing held in indivision has incurred necessary expenses, expenses for ordinary maintenance and repairs, or necessary management expenses paid to a third person, is entitled to reimbursement from the other co-owners in proportion to their shares. La. C.C. Art. 806. A co-owner is responsible to his co-owners for his share of necessary management expenses paid to a third person. The co-owner may be entitled to receive compensation for his own management of the thing that is held in indivision under a management plan adopted by agreement of all the co-owners, by judgment, or under the law of unjust enrichment. See comments to C.C. Art. 806. Under the doctrine of unjust enrichment, a party who has received a benefit from the actions of another may be required to compensate such person if the following factors are

established:

(i) the defendant must be enriched, either by a benefit received or detriment avoided;

(ii) the plaintiff has been impoverished;

(iii) defendant's enrichment and plaintiff's impoverishment must be causally connected;

(iv) neither the enrichment nor the impoverishment were justified;

(v) there is no other adequate remedy at law. *Fidelity & Deposit Co. of Maryland v. Smith*, 656 F.2d 1076 (5th Cir. 1984); *Diggs v. Hood*, 772 F.2d 190 (5th Cir. 1985); *Minyard v. Curtis Products, Inc.*, 205 So.2d 422 (1967); *Edmonston v. A Second Mortgage Company of Slidell, Inc.*, 289 So.2d 116 (La. 1974); *Cahn v. Cahn*, 468 So.2d 1176 (La. 1985).

(vi) However, the theory of unjust enrichment cannot be applied to compel a co-owner of property to pay rent to another co-owner. A co-owner has the right to occupy the premises without the obligation of paying rent to the other co-owners for occupancy of their undivided interests. The non-possessory co-owners' remedy in the event of a dispute is to seek partition. *Juneau v. Laborde*, 82 So.2d 693 (1955); *Stewart v. Crump*, 59 So. 903 (1912); *Cahn v. Cahn*, supra, and *Campbell v. Pasternack Holding Co. Inc.*, No. 92-CC-3244, 625 So.2d 477 (La. 1993).

(5) Continuity - There is, of course, no entity to be terminated, however, successful operation and/or co-existence as co-owners in indivision is in large part dependent upon relationships. The death, bankruptcy or incapacity of a co-owner will likely cause disruption of the operation. A bankruptcy filing by one co-owner can result in the sale of the entire interest in the property (including the non-filing co-owner's interest) by a bankruptcy trustee if partition in kind is impracticable, sale of the debtor's undivided interest would realize significantly less than sale of the property free of the interest of the non-filing co-owners, the benefit to the estate outweighs the detriment, if any, to the non-filing co-owners, and the property is not used in certain power generation facilities. If the property is former community property, the debtor's spouse has the right to purchase the property at the price at which the trustee sale is to be consummated. 11 U.S.C. §§363(h) & (i).

(6) Capital Structure - Basically the same as the sole-proprietorship except that financing which involves the granting of security interests in the co-owned property will normally require joint action by the co-owners. Although a co-owner may grant a security interest in his undivided interest, lenders will substantially discount the value of that interest in valuing it as collateral.

c. Tax Advantages of Co-Ownership in Indivision

(1) Simplicity-Each co-owner reports his revenue, expenses and general tax consequences from the co-owned property in proportion to his percentage of ownership in the property on his own individual tax return the same as he would if operating as a sole proprietor. No double taxation.

(2) Like Kind Exchanges - Note that in comparison to real property investments held in a partnership, an owner of an undivided fractional interest in immovable property may engage in a tax free like kind exchange of his interest in the property for other real property, whether the acquired property be in full ownership or as co-ownership in indivision. IRC §1031. However, the tax free like kind exchange is not available for exchanging partnership interests. IRC §1031(a)(2). Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal law and does not depend on whether the entity is recognized as an entity under state law. Treas. Reg. §301.7701-1(a)(1). A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom, but the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. Treas. Reg. §301.7701-1(a)(2). A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. In ***Bradford v. Commissioner***, 12 F.3d 166 (9th Cir. 1993), the court held that a co-ownership arrangement among 78 investors in computer equipment subject to a 7 year lease managed by a third party manager constituted a partnership for federal tax purposes. See also ***Accord Bussing v. Commissioner***, 88 T.C. 449 (1987), aff'd on reh'g, 89 T.C. 1050 (1987); ***Alhouse v. Commissioner***, T.C. Memo 1991-652. Among the factors the courts consider are the limitations on the co-owners to sell, lease, or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through a remarketing fee) and losses (through advances).

With the popularity in recent years of the tax free like kind exchange in the real estate investment area, particularly under the deferred exchange rules, a new market has been created for fractional interests in real estate offered by national firms seeking to fill the need for investors who prefer not to get involved in the direct management of the real property or who need a quick deal to get in within the 45 day deadline for identifying replacement property under the deferred exchange rules. These firms offer undivided fractional interests in major real estate properties which are managed under a management contract.

The proliferation of these arrangements and the uncertainty which can surround the determination of whether these interests will be treated as undivided ownership interests in real estate (eligible for tax free like kind exchanges) or partnership interests (not eligible for like kind exchange) resulted in the IRS issuing guidance on the issue. In Rev. Proc. 2000-45, 2002-2 C.B. 438, the Service first indicated that it would not issue advance rulings or determination letters on the issue. The Service came back two years later and issued Rev. Proc. 2002-22 in which it indicated that it will consider ruling requests on the subject if the request satisfies certain conditions. Among the more significant conditions that must be shown to exist are:

(a) Co-owners must hold title as tenants in common under local law.

(b) The number of co-owners can not exceed 35 persons.

(c) The co-owners may not file a partnership or corporate tax return, conduct business under a common name, execute an agreement identifying the co-owners as partners, shareholders, or members of a business entity or otherwise hold the group out as a partnership or other entity.

(d) Co-owners may enter into a limited co-ownership agreement that may run with the land which may provide for rights of first refusal on sale of an interest in favor of the other co-owners, the sponsor or a lessee, or providing that certain decisions of the co-owners may be made by majority vote of the co-owners (subject to limitations below).

(e) Co-owners must retain the right to approve the hiring of any manager, the sale or other disposition of the property, any leases of the property, and the creation of a blanket lien. Any sale, lease, or re-lease of a portion or all of the property, negotiation or renegotiation of indebtedness secured by a blanket lien, hiring of any manager or negotiation of any management contract must be by unanimous approval of the co-owners. For all other actions, the co-owners may agree to be bound by a majority vote of the co-owners. A co-owner who has consented to an action in conformity with these requirements may grant a power of attorney to the manager or other person to execute documents, but may not provide the manager or other person with a global power of attorney.

(f) Each co-owner must have the rights to transfer, partition, and encumber the co-owner's undivided interest in the property without agreement or approval of any person, subject to the right to provide for rights of first refusal.

(g) If property is sold, the proceeds after payment of any blanket lien must be distributed to the co-owners.

(h) Each co-owner must share in all revenues and costs in proportion to their undivided interest in the property.

(i) Co-owners must share in debt secured by a blanket lien in proportion to their undivided interests.

(j) A co-owner may issue an option to purchase the co-owner's interest provided the exercise price is at fair market value as of exercise date. A co-owner may not have a put option to sell his or her interest to the sponsor, lessee, another co-owner or the lender.

(k) Co-owners activities must be limited to those customarily performed in connection with the maintenance and repair of real property.

(l) Co-owners may enter into management or brokerage agreements which must be renewable no less frequently than annually, with an agent, who may be the sponsor or a co-owner, but who may not be a lessee. The management agreement may allow for maintenance of a common bank account for collection of rents and payment of expenses, however, the manager must disburse to the co-owners their shares of net revenues within 3 months of the date of receipt of those revenues.

(m) All leasing arrangements must be bona fide leases for federal tax purposes.

(n) The amount of any payment to the sponsor for acquisition of the co-ownership interest must reflect the fair market value of the co-ownership interest (or the services rendered) and may not depend in whole or in part on the income or profits derived by any person from the property.

d. Non-Tax Disadvantages of Co-Ownership in Indivision

(1) Unlimited Liability of Co-Owners - There is no separate legal entity to separate the co-owners from third parties, and therefore, co-owners are liable for all debts incurred by them in connection with the co-owned property. Note, however, that one co-owner may not obligate the other co-owner to third persons, but may seek reimbursement from other co-owners for necessary expenses, expenses for ordinary maintenance and repairs, or necessary management expenses paid to a third person.

(2) Partition is Available - Just as partition was listed as an advantage of co-ownership in indivision, it may likewise be listed among the disadvantages, depending upon which side of a dispute one happens to be on.

(3) Owner controls only his own interest - no power to bind co-owners contractually - no majority rule. This places limitations on the ability of co-owners to gain access to various methods of capitalization and/or financing without unanimous consent and action of the co-owners.

e. Tax Disadvantages of Co-Ownership in Indivision

(1) Inability to Make Special Allocations of Profits and Losses - partners in a partnership may agree among themselves to allocate items of income, deductions, credits, and gain or loss in proportions other than in proportion to their capital interests. As long as the special allocations have "substantial economic effect", a substantial amount of tax saving can be effected between partners who are otherwise in different tax situations. This is not available to co-owners in indivision.

C. GENERAL PARTNERSHIP

a. Non-Tax Advantages of The General Partnership

(1) Separate Juridical Entity - Although the general partnership does not afford one the same limited liability that may be offered by a corporation or an LLC, the partnership is a separate juridical entity from its partners. As such, a partnership as principal obligor is primarily liable for its debts. A partner is bound for his virile share of the debts of the partnership but may plead discussion of the assets of the partnership. La. C.C. Art. 2817.

(2) Flexibility. Flexibility under state law to design the partnership agreement relative to governance (majority rule), termination, transferability of interests, rights upon withdrawal, procedures for capital calls, continuity of existence, etc.

(3) Financing. In dealing with lenders, some sophisticated lenders may prefer the partnership form because of the lower overall tax burden on the entity as compared to C corporations.

(4) Simplicity in Operation. Informal method of governance and operation -contrasted to the corporation, partnership law imposes no particular requirements concerning the calling or conducting of partnership meetings.

(5) Ability to compel expulsion of a partner for just cause. C.C. Art. 2818 & 2820.

(6) Generally, securities law will not be applicable because generally not a "security" if each partner participates in management.

(7) Cost of credit may be less because of personal liability of members - as compared to Corporation or LLC - although the same thing can be accomplished with Corporation or LLC by use of personal guarantee and without exposing members to unlimited liability to all creditors including tort creditors.

(8) Abundance of case law allows for predictability in certain litigation contexts, at least as compared to the LLC.

(9) Capital Structure. Financed generally through partner contributions to capital, partner loans to partnership (note, if unsecured, they are subordinated to all other creditors - C.C. Art. 2833) and conventional lending. However, flexibility both from legal and tax standpoint allows for conversion to corporation or LLC if necessary to enable access to venture capital through private or public markets.

b. Tax Advantages of the General Partnership

(1) No Double Taxation - a partnership is not a taxable entity. It merely reports its income and losses on an information return (IRS Form 1065) and the individual partners include on their own individual tax return their share of partnership items of income, deduction or loss which are passed through to them by the partnership. The individual partner's income from the partnership is taxed under rules that apply to individuals generally.

(2) Partner Can Deduct Share of Partnership Losses - subject to the passive activity rules, if the business operations result in a loss a partner may deduct the loss against his personal income. The loss may be deducted only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurred, subject to the at risk limitations. If the partner's share of losses generates a net operating loss on the partner's individual income tax return, the loss may be carried back three years and forward fifteen years.

(3) Optional Adjustment to Basis of Partnership Property for Certain Distributions to Partners, and for Certain Transfers of Partnership Interests - under IRC §§734, 743 and 754 of the IRC, the partnership may adjust its basis in partnership assets in order to give a purchaser of a partnership interest a cost basis in his share of partnership assets. Basis adjustment is also available for step up in basis at death of a partner. Property (such as a partnership interest) passing from a decedent at death takes a tax basis in the hands of the heirs equal to fair market value at the date of death. Under §743, if an election is filed under §754 by the partnership, the partnership’s basis in its assets, to the extent allocable to the partnership interest which has passed at death, is increased to fair market value of the partnership interest Similar basis adjustment is available in the case of gain or loss on certain distributions of partnership property to a partner.

(4) Ability to Make Special Allocations of Income, Expense and Credit Items - partners may agree among themselves to specially allocate any item of income, deduction, credits or gain or loss as long as the allocations have “substantial economic effect”.

> Example: Partner A contributes $10,000 cash to the partnership, and Partner B contributes depreciable property worth $10,000 but with a basis of $2,000. The partners can agree that, on a sale of the property, the first $8,000 of gain on the sale is to be allocated only to Partner B. In fact, under §704(c) as amended by the Tax Reform Act of 1984 and the §704(c) regulations which became final in December of 1993, the partners are required to allocate “built-in” gain or loss such as this on contributed property to the contributing partner.

(5) Contributions of property in exchange for partnership interests are generally tax

free except where property is subject to indebtedness. A shareholder must recognize gain on the contribution of appreciated property to an S corporation unless immediately after the transfer, the transferors of property to the corporation, as a group, own at least 80% of the corporation's stock by vote and by value. IRC §§ 351, 368. A partner who contributes appreciated property to a partnership generally recognizes no gain regardless of the proportion of ownership interests in the partnership. IRC § 721. But see section 704(c) allocating built in gain to the contributing partner when the partnership sells the property or if the property is distributed to another partner within five years of contribution and section 707(a)(2) causing a partner to recognize gain or loss on a disguised sale of property to a partnership.

(6) No gain or loss generally recognized by partnership upon distribution of partnership property to a partner. An S corporation recognizes gain on the distribution of appreciated property to a shareholder. IRC §§ 311(b) and 336(a). The distribution of appreciated property from a partnership to a partner generally is tax free to the partnership. IRC § 731(b). But see IRC § 751(b) triggering gain or loss on a disproportionate distribution of certain "hot assets" in partial or complete liquidation of a partner's interest in the partnership.

(7) Flexibility

(8) Availability of qualified pension plans and contribution limits are now generally same as for corporations.

(9) Partners who perform services for the partnership are treated as employees for purposes of tax free fringe benefits under section 132 consisting of:

(i) no-additional cost services provided by employer to an employee;

(ii) qualified employee discounts;

(iii) working condition fringe benefits provided, in property or services, to an employee.

(10) Entity calculations and tax returns with pass through to partners of income, loss, gain, deduction and credits with maintenance of character at individual level.

(11) Receipt of partnership interest for services <u>may</u> be tax free if the partnership interest is subject to a substantial risk of forfeiture or is non-transferrable under IRC §83. The receipt of an interest in partnership profits-only may be non-taxable to the service provider under certain circumstances. See IRC §721, *Campbell v. Commissioner*, TC Memo 1990-162, rev'd 943 F2d 815 (8th Cir. 1991); Treas. Reg. § 1.721-1(b)(1); Rev. Proc. 93-27, 1993-24 IRB 63;

Rev. Proc. 2001-43, 2001-34 IRB. However, see Prop. Reg. §1.721-1(b)(1), the preamble thereto, and IRS Notice 2005-24 IRB. Under these proposed regulations, to the extent a partnership interest is transferred to a partner in connection with the performance of services rendered to the partnership, it would be treated as a guaranteed payment for services under IRC §707(c). IRC §721 generally would not apply and the transaction would be one to which IRC §83 and its regulations apply. Under Proposed Reg. §1.83-3(l), a partnership and all of its partners may elect a safe harbor under which the fair market value of an interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest.

(12) Note that because the IRS has long recognized that general and limited partnerships can convert from one form to the other without causing a termination - if after the conversion the old partnership's business is continued and % interest in profits, losses, etc. remains the same, IRS has ruled in PLR's that conversion to LLC doesn't terminate the partnership for tax purposes if these requirements are met. PLR 91-19-029; PLR 90-29-019; PLR 90-10-027. Therefore, professional and other general partnerships may convert to LLC without terminating the historic tax partnership.

(13) A major advantage which the partnership has over the S corporation is the ability to include in a partner's basis of his partnership interest his allocable share of partnership debts. Unless the S corporation shareholder resides in the 11th Circuit, the shareholder may not include, either in stock basis or in the basis of any indebtedness from the corporation to the shareholder, any share of corporate liabilities, even if the shareholder is personally liable for repayment of the liabilities unless the debt is in the form of a direct loan from the shareholder to the corporation. Compare *Selfe v. U.S.*, 778 F.2d 769 (11th Cir. 1985) with *Harris v. U.S.*, 902 F.2d 439 (5th Cir. 1990); *Est. of Leavitt v. Comm'r*, 875 F.2d 420 (4th Cir. 1989), aff'g 90 TC 206 (1988); *Brown v. Comm'r*, 706 F.2d 755 (6th Cir. 1963). The significance of the basis provisions includes:

a. A partner may deduct his or her share of partnership losses only to the extent of the partner's basis in his or her partnership interest. IRC § 704(d).

b. Likewise, a shareholder in an S corporation may deduct his or her share of losses of the corporation only to the extent of the shareholder's basis in his stock or basis in any indebtedness of the corporation to the shareholder. IRC Section 1366(d).

c. By allowing the partner to include partnership debt in basis, the partner's ability to deduct partnership losses is enhanced as compared to the S corporation. Although the at risk rules and the passive activity rules have reduced some of the importance of the distinction, the partnership offers advantages to investors who have assumed personal liability for business debts or who have used qualified nonrecourse financing and either materially participate in the business or can take advantage of the $25,000 active real estate exception to the passive activity loss rules. IRC §§ 465 and 469.

d. Note, however, that a limited partner does not qualify for the active real estate exception unless and until the regulations provide otherwise. IRC § 469(i)(6). A member in an LLC probably will be considered a limited partner for purposes of the passive activity loss rules. Treas. Reg. 1.469-5T(e)(3)(B) - treating a partnership interest as a limited partnership interest if state law limits the holder's liability for partnership obligations to a "determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership)."

e. The inclusion of partnership debt in the basis of the partner's interest in the partnership also enhances the partner's ability to receive tax free distributions from the partnership. Under IRC 731(a)(1), in general, distributions from the partnership to a partner are tax free to the extent of the partner's basis in his or her partnership interest). Likewise, under §1368, distributions from an S corporation to a shareholder are generally tax free to the extent of the shareholder's basis in his stock.

(14) A partnership may, under certain circumstances, treat payments in liquidation of a partner's interest that exceed the partner's interest in partnership property as the retiring partner's distributive share of partnership income or as a guaranteed payment. IRC 736(a). Payments received as a distributive share divert partnership income from the remaining partners. Treas. Reg. 1.736-1(a)(4). Payments received as a guaranteed payment are deductible by the partnership and are ordinary income to the recipient. Therefore, there is added flexibility available in structuring a retiring partner's liquidating distributions.

c. Non-Tax Disadvantages of Partnerships

(1) Partners in general partnership have unlimited liability for their virile share of partnership debts. Even in a partnership in commendam, there must be at least one general partner who has unlimited liability.

(2) Lack of continuity of existence - reduction of membership to one person will terminate partnership. This can occur through the death, interdiction, bankruptcy, withdrawal of one or more partners, or seizure of a partnership interest that is not released within 30 days, whereby there is left only one partner. C.C. Arts. 2818, 2819 & 2826. Chapter 7 bankruptcy

order for relief to the partnership also terminates same.

(3) Lack of free transferability of partnership interests. Unless otherwise provided in the partnership agreement, admission of new partner requires unanimous agreement of partners.

(4) The corporate vehicle is better known and understood by investors and their advisors, and the law relating to corporations is more developed and better defined than the law relating to partnerships.

(5) Acts of any partner in ordinary course of business bind the entity, and indirectly, the other partners for their virile share. Restrictions on this authority are not binding on good faith third parties. C.C. Art. 2814. Therefore, every partner can make his own decision and bind the partnership with third parties.

(6) If a partnership has been constituted without a term, and in the absence of agreement otherwise, a partner may withdraw from the partnership without consent of his partners at any time, provided he gives reasonable notice in good faith at a time that is not unfavorable to the partnership. Entitles the withdrawing partner to the value of his share at the time membership ceased. Thus, partners may be forced to buy out a partner while compared to a corporation, no such right exists unless provided by shareholder agreement, or through exercise of dissenter's rights. Even in most negotiated partnership agreements there is some mechanism designed to allow withdrawal of partners. Partnership interest is terminated by death, interdiction, bankruptcy or seizure of his interest (creditor of partner can compel liquidation of interest). These events can compel a buyout of the interest which may be devastating if partner's interest is large. C.C. Art. 2823 & 2824 require payment in cash plus legal interest from date of termination of interest.

(7) The sometimes vague nature and parameters of the fiduciary duties of partners in a partnership provide flexibility to the courts but uncertainty to planners and partners.

(8) In the absence of contrary agreement, partnership law gives to every partner, regardless of the size of his capital investment, equal vote in the management of the partnership, equal share in the profits, losses, benefits and distributions of the partnership. Therefore, from the drafting standpoint, the partnership agreement is more difficult and comprehensive an undertaking as compared to an incorporation.

(9) Claims of partners against the partnership in their capacity as unsecured creditor are automatically subordinated to the claims of other creditors.

d. Tax Disadvantages of Partnerships

(1) Complexity - the tax laws relative to partnerships are very complex.

(2) Certainty as to Treatment - there are many issues which commonly arise in partnership taxation for which there may not be clear answers. This may be true now more than ever with the anti-abuse regulations contained in Treas. Reg. §1.701-2. In May of 1994 the IRS released these regulations which contain a very broad rule that would permit the IRS to recast transactions that use a partnership to achieve a result that is inconsistent with the intent of Subchapter K:

(i) The regulation is effective, for the most part, for transactions occurring on or after May 12, 1994. The provisions of subpart (e) and (f), which include rules on "abuse of entity treatment" and specific examples relative to those rules apply to transactions that occur on or after December 29, 1994. The anti-abuse rule provides that if a partnership is formed or availed of with a principal purpose of substantially reducing the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of Subchapter K, the Commissioner can recast the transaction, even if the taxpayer complies with the literal language of the IRC or the regulations.

(ii) The regulation states that the intent of subchapter K is to permit taxpayers to conduct business for joint economic profit through a flexible arrangement that accurately reflects the partners' economic agreement without incurring an entity-level tax, but not to achieve tax results inconsistent with the underlying economic arrangements or the substance of the transaction. All facts and circumstances are taken into account in determining the purposes for structuring the transaction.

(iii) The regulations contain a broad list of ways in which the transaction may be recast, including disregard of the partnership, treatment of purported partners as not partners, treatment of partners as owning directly a share of partnership assets, or disregard of the partnership's allocation provisions.

(3) No tax free reorganization rules for partnerships as there are for corporations.

(4) Traps for the Unwary - for example, termination of partnership for tax purposes in the event of a sale or transfer of a 50% or more interest in the partnership.

(5) Certain fringe benefits that are available to owner/employees in a C corp. are not available to the partner in a partnership:

(i) Until 2003, ability to receive tax deductible medical benefits was limited for the partners. IRC §162(l) self-employed persons (which includes partners in a partnership) are allowed a deduction on their individual return an amount equal to the applicable percentage of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse and dependents. Based upon the latest amendments to IRC §163(l), for 1999 through 2001 the applicable percentage limit was 60%; for 2002 the limit was 70%; for 2003 and thereafter, such expenses are 100% deductible. These limits were amended in each of the years between 1995 and 1998.

(ii) Exclusion from income under IRC §119 of employer provided meals and lodging is generally not available for partners in a partnership. §119 allows for exclusion from income of meals and lodging provided by an employer to an employee for the convenience of the employer if the meals are furnished on the business premises of the employer or, as to lodging, the employee is required to accept such lodging on the premises of the employer as a condition of employment. The exclusion applies only to employees and their spouses or dependents. The Tax Court and the Fifth Circuit have held that partners (and by extension S Corporation shareholder-employees) can be treated as employees. *G. Papineau*, (1951) 16 TC 130, *not acq.* 1952-2 CB 5; *A. Armstrong v. Phinney*. 21 AFTR2d 1260, 394 F.2d 661, 68-1 USTC ¶9355 (5th Cir. 1968). However the IRS, as well as a number of other courts, disagree. *Rev. Rul. 80, 1953-1 CB 62; Comm'r v. Doak*, 49 AFTR 1491, 234 F.2d 704, 56-2 USTC ¶9708 (4th Cir. 1956), rev'g (1955) 24 TC 569; *Comm'r v. Robinson*, 5 AFTR2d 315, 273 F.2d 503, 60-1 USTC ¶9152 (3rd Cir. 1959), re'g (1958) 31 TC 65, *cert. den.* (1960) 363 U.S. 810; *U.S. v. Briggs*, 50 AFTR 667, 238 F.2d 53, 56-2 USTC ¶10,020 rev'g (1955, DC Co) 51 AFTR 1084, 56-1 USTC ¶9164.

(iii) Partners not treated as employees for cafeteria plan purposes.

(iv) Exclusion from income for value of qualified transportation under IRC 124 not available to partners.

(6) Passive activity rules apply to income and losses passed through to partners.

(7) §108 - income from discharge of indebtedness is passed through to partners and the insolvency exception is determined at the partner level rather than at the entity level.

(8) Note that the American Jobs Creation Act of 2004, passed by Congress in October 2004, made a change in the tax consequences of transactions where the partnership issues a partnership interest in satisfaction of partnership debt. Under pre-2004 Jobs Act law, no IRC provision required a partnership that transferred a capital or profits interest in the partnership in satisfaction of a debt to realize debt cancellation income. It was, therefore, unclear whether a partnership in these transactions had to recognize debt cancellation income. The 2004 Jobs Act

provides that, for purposes of determining whether a partnership has debt cancellation income, if the partnership transfers a capital or profits interest in the partnership to a creditor of the partnership in satisfaction of its indebtedness, whether recourse or non-recourse, the partnership is treated as having satisfied the debt wtih an amount of money equal to the fair market value of the partnership interest. IRC §108(e)(8) as amended by 2004 Jobs Act §896(a). If debt cancellation income is recognized, it is included in the distributive shares of the taxpayers that were partners immediately before the discharge.

> Example: ABC Partnership with three partners owes a creditor $100,000. ABC Partnership satisfies the debt by transferring to the creditor a partnership interest that has a FMV of $70,000. ABC is treated as having satisfied the debt with $70,000 in cash and thus has cancellation of indebtedness income of $30,000. $10,000 cancellation of indebtedness income is included in the income of A, B & C.

(9) Note that the 2004 Jobs act also includes changes designed to prohibit basis reduction to basis of corporate stock in a corporation that is a partner in the partnership. In allocating any basis reduction in partnership property under IRC §743(b) as a result of a distribution: (1) no allocation may be made to stock in a corporation that is a partner in the partnership, or to the stock of any person related to the corporation; and (2) any amount not allocable to stock because of the rule in (1) is allocated to other partnership property. This provision was included to address a perceived abuse which came to light in the Enron debacle.

(10) The 2004 Jobs Act also changed the law on allowance of losses from built-in loss property contributed to a partnership. The act provides that if built-in loss property (basis in excess of FMV at time of contribution) is contributed to a partnership: (1) the built-in loss is taken into account only in determining the amount of items allocated to the contributing partner; and (2) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to its fair market value at the time of contribution. Thus, a partner contributing built-in loss property to a partnership cannot transfer the loss to another person by transferring his partnership interest. If the partnership interest is transferred, the built-in loss is eliminated.

(11) In a related change, the 2004 Jobs Act provided for mandatory basis adjustment to partnership property on the transfer of partnership interests with substantial built-in losses. Under prior law, the basis of partnership property was not adjusted as a result of a transfer of a partnership interest unless the partnership made a §754 basis adjustment election. If a §754 election was in effect, basis adjustments were made relating to the transferee partner in order to

account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee partner's basis in its partnership interest. These adjustments were intended to approximate the result of a direct purchase of the property by the transferee partner. In the absence of an election, if a partner bought an interest in a partnership with a built-in loss, the transferee partner could be allocated a share of the loss when the partnership disposed of the property (or depreciated the property} even though the price it paid for the partnership interest had already taken that built-in loss into account. The 2004 Jobs Act provides that the basis adjustment is now mandatory if the partnership has a substantial built-in loss after the transfer. For this purpose, a partnership has a substantial built-in loss relating to a transfer of a partnership interest if the partnership's adjusted basis in its property exceeds the fair market value of the property by more than $250,000.

Additionally, under prior law a partnership distribution was generally a tax-free transaction in which neither the partnership or the partner recognized gain or loss. Where a partner received a distribution in liquidation of his interest, the basis of the property distributed to the partner was equal to the partner's adjusted basis in his partnership interest (minus any cash distributed in the transaction). In a nonliquidating distribution, the distributee partner's basis in the distributed property was equal to the partnership's adjusted basis in the property immediately before the distribution, but could not exceed the partner's adjusted basis in the partnership interest (minus any cash distributed). No adjustments were made to the basis of the partnership's undistributed properties unless the partnership made a §754 election. If a §754 election was in effect, adjustments were made by the partnership to increase or decrease the adjusted basis in the remaining partnership assets to reflect any increase in the adjusted basis of the distributed properties in the hands of the distributee partner (or gain or loss recognized by the distributee partner). To the extent the basis of the distributed properties increased (or loss was recognized), the partnership's basis in its properties was decreased by a like amount; likewise, to the extent the basis of the distributed properties decreased (or gain was recognized), the partnership's basis in its remaining properties was increased by a like amount. Under these rules, a partnership with no IRC §754 election in effect could have distributed property with a basis lower than the distributee partner's proportionate share of the adjusted basis of all partnership property and left the remaining partners with a smaller net built-in gain or a larger net built-in loss than before the distribution.

The 2004 Jobs Act provides that the basis adjustment is mandatory if there is a substantial basis reduction. There is a substantial basis reduction relating to a distribution if the sum of (i) the amount of the partner's loss on the distribution and (ii) the basis increase to the distributed properties is more than $250,000. Once again, this change was to remedy what Congress perceived to be abuses of the partnership laws in the tax shelter area.

e. Some Other General Features of Partnerships

(1) When a partnership issue is not addressed directly in Title XI of Book III of the Civil Code, the Civil Code Articles on Obligations govern. See also LSA 9:3401-9:3427.

(2) As a general rule, each partner participates equally in profits, commercial benefits, and losses of the partnership, unless agreed otherwise. Absent a contrary agreement, a partner's contribution to capital is restored to the partners according to the contribution made. C.C. Art. 2803

(3) Partners have complete freedom to contract regarding the manner and extent to which they participate in profits, benefits, assets and losses of the partnership. For example, the partnership agreement can limit the participation of a partner in profits to twenty-five percent, but remain silent as to losses. In this situation, it is presumed that the partner's participation in losses is also twenty-five percent.

(4) A partnership is free to adopt a name with or without the inclusion of the names of any of the partners. When no name is adopted for the partnership, the business must be conducted in the name of all the partners. C.C. Art. 2805.

(5) An immovable acquired in the name of a partnership is owned by the partnership if, at the time of the acquisition, the partnership contract is in writing. If the contract of partnership was not in writing at the time of the purchase of the immovable, the immovable is owned by the partners. As to third parties, the individual partners shall be deemed to own immovable property acquired in the name of the partnership until the contract of partnership is filed for registry with the secretary of state. C.C. Art. 2806. Under Act No. 136 of the 2005 Regular Session of the La. Legislature, whenever immovable property is acquired by one or more persons acting in any capacity for and in the name of any partnership which has not been created by contract as required by law and the partnership is subsequently created by contract in accordance with Title XI of Book III of the Civil Code, the partnership's existence shall be retroactive to the date of acquisition of an interest in such immovable property, but this is without prejudice to the rights validly acquired by third parties in the interim between the date of acquisition and the date the partnership was created by contract. See C.C. Art. 2807.5.

(6) The Louisiana Civil Code requires unanimity, unless otherwise agreed, on four types of major partnership decisions:

i. Decisions to amend the partnership agreement;
ii. Decisions to admit new partners;
iii. Decisions to terminate the partnership;
iv. Decisions to permit a partner to withdraw without just cause if the partnership has been constituted for a term.

All other partnership decisions can be made by majority vote, although this can be amended by contract also. C.C. Art. 2807.

(7) A partnership contract is required to be filed with the Secretary of State and the recorder of mortgages in the parish in which the partnership maintains its principal place of business and has several specific requirements:

(i) Name and Tax Identification Number of the Partnership;

(ii) Municipal address of the partnership's principal place of business in the state; and

(iii) Name and address of each partner, including partners in commendam, if any. LSA 9:3402, 9:3403, 9:3406.

(8) When all fees have been paid, the secretary of state shall register the partnership contract, and issue a certificate of registry certifying that the contract of partnership is filed and registered. This certificate shall be conclusive evidence of due registration. LSA 9:3405.

(9) A contract of partnership filed for registry with the secretary of state within five (5) days of execution, exclusive of legal holidays, is deemed filed for registry on the month, day, year and hour of execution. LSA 9:3408.

(10) One of the most important provisions of the partnership laws is contained in Article 2817 of the Louisiana Civil Code. While a partnership is primarily liable for the partnership debts, each partner is bound for his virile share of the debts of the partnership. However, a partner may plead discussion of the assets of the partnership. If a partner properly pleads discussion, then the claimant may only recover against the partner if the partnership's assets have been exhausted or the partnership has been dissolved. The partner has the burden of pointing out the partnership assets. The partners are not solidarily liable, but rather each is liable only for his virile share, except where solidary liability is imposed under some other theory, such as a contractual agreement.

(11) A partnership may be a debtor in bankruptcy in a case under Chapter 7 and 11. 11 U.S.C. §§101(41) and 109(a). A partnership may be a debtor in a bankruptcy case under Chapter 12 if more than 80% of its gross income during the immediately preceding taxable year prior to commencement of the case was from a farming operation and more than 50% of the equity in the partnership is held by one family, or by one family and the relatives of the members of such family, and such family or such relatives conduct the farming operation, and (i) more than 80% of

the value of its assets are related to the farming operation; (ii) its aggregate debts do not exceed $1,500,000 and not less than 80% of its aggregate noncontingent liquidated debts arise out of the farming operation; and (iii) interests in the partnership are not publicly traded. 11 U.S.C. §§ 101(18) & (20) & § 109(f). A partnership does not, however, receive a discharge in a bankruptcy case under Chapter 7. 11 U.S.C. §727(a)(1).

(12) In 1992 the Legislature enacted Louisiana Revised Statutes 9:3441-3447 concerning the merger and consolidation of partnerships. Some of these provisions were amended in 1995 under Act 847 of the Regular Session. Generally, any one or more partnerships or partnerships in commendam may merge or consolidate with or into a domestic business or nonprofit corporation, limited liability company, partnership, or partnership in commendam.

D. LIMITED PARTNERSHIPS (THE PARTNERSHIP IN COMMENDAM)

a. Non-Tax Advantages of Limited Partnership

(1) Limited liability for owners.

(2) Centralized management in one or more general partners.

(3) May use corporate general partner to totally avoid unlimited liability of individuals. For tax purposes, prior to adoption of the so-called "check-the-box" regulations, one had to be aware of rules on associations taxable as corporations and take those into consideration when forming a limited partnership using a corporate general partner. Treas. Reg. sections 301.7701-2, 301.7701-3 (1967); Rev. Proc. 89-12, 1989-1 C.B. 798. Corporate characteristics were:

(i) Associates;

(ii) An objective to carry on business and divide gains therefrom;

(iii) Continuity of life;

(iv) Centralized management;

(v) Liability for corporate debts limited to corporate property;

(vi) Free transferability of interests.

A strict numerical test was applied to the foregoing, such that if the entity being tested had "more corporate characteristics than noncorporate characteristics," it was an association; otherwise it was a partnership.[13] Each characteristic had equal weight, and ties were resolved in favor of partnership classification unless other factors of major significance indicated that association classification was more appropriate. Note that a dummy corporate general partner could result in a finding that liability for debts was limited to corporate property. Rev. Proc. 92-88.

Now, under the "check-the-box" regulations, effective January 1, 1997, the limited partnership will always be treated as a partnership for tax purposes unless it elects to be taxed as a corporation.

(4) If partnership agreement does not entitle limited partners to appoint and remove general partners, they may be in a weaker position than shareholders in a corporation or members in an LLC. Whether this is an advantage or a disadvantage depends upon who your client is.

(5) Subject to contrary agreement, limited partners may have greater rights of inspection than shareholders in corporation. C.C. Arts. 2813, 2807, 2818-22, & 2836, and greater rights than shareholders to withdraw and compel liquidation of their interest.

(6) Civil Code provisions allow for adoption of corporation-like rules on the election of general partners and transfer of limited partnership interests, without risking unlimited liability.

b. Tax Advantages of Limited Partnerships

(1) See all of those listed for general partnerships.

(2) Limited partners may receive basis for proportionate share of non-recourse liabilities.

(3) As compared to S corporations, the partnership does not have a limitation on the number of permitted partners. There is no restriction on the type or character of partners that are permitted. Non-resident aliens may own limited partnership interests. A partnership can own 100% of the stock of another corporation, as long as it is not an S corporation.

c. Non-Tax Disadvantages of Limited Partnerships

(1) See some of those listed as advantages, depending upon who you represent.

(2) Risk of exposure to unlimited liability for limited partners who participate in

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[13] Former Treas. Reg. section 301.7701-2(a)(3).

management. Note, however, the adoption, through Act 847 of the 1995 Regular Session of the Legislature, of an amendment to Article 2844 of the Civil Code to liberalize and more specifically define the circumstances under which a limited partner may involve himself in management without exposing himself to unlimited liability of a general partner. Article 2844 now provides as follows:

> A. A partner in commendam is not liable for the obligations of the partnership unless such partner is also a general partner or, in addition to the exercise of such partner's rights and powers as a partner, such partner participates in the control of the business. However, if the partner in commendam participates in the control of the business, such partner is liable only to persons who transact business with the partnership reasonably believing, based upon the partner in commendam's conduct, that the partner in commendam is a general partner.
>
> B. A partner in commendam does not participate in the control of the business within the meaning of Paragraph A of this Article solely by doing one or more of the following:
>
> > (1) Being a contractor for or an agent or employee of the partnership or of a general partner.
> >
> > (2) Being an employee, officer, director, or shareholder of a general partner that is a corporation or a member or manager of a general partner that is a limited liability company.
> >
> > (3) Consulting with and advising the general partner with respect to the business of the partnership.
> >
> > (4) Acting as surety for the partnership or guaranteeing or assuming one or more specific obligations of the partnership.
> >
> > (5) Taking any action required or permitted by law to bring or pursue a derivative action in the right of the partnership.
> >
> > (6) Requesting or attending a meeting of partners.
> >
> > (7) Proposing, approving, or disapproving, by voting or otherwise, one or more of the following matters:
> >
> > > (a) The continuation, dissolution, termination, or liquidation of the partnership.

(b) The alienation, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the partnership.

(c) The incurrence of indebtedness by the partnership other than in the ordinary course of its business.

(d) A change in the nature of the business.

(e) The admission, expulsion, or withdrawal of a general partner.

(f) The admission, expulsion, or withdrawal of a partner in commendam.

(g) A transaction involving an actual or potential conflict of interest between a general partner and the partnership or the partners in commendam.

(h) An amendment to the contract of partnership.

(i) Matters related to the business of the partnership not otherwise enumerated in this Paragraph, which the contract of partnership states in writing may be subject to the approval or disapproval of partners.

(8) Liquidating the partnership.

(9) Exercising any right or power permitted to partners in commendam under this Chapter and not specifically enumerated in this Paragraph.

C. The enumeration in Paragraph B does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by such partner in the business of the partnership.

(3) For limited partners, the inability to participate in management is a disadvantage, although this has been significantly ameliorated by the amendments to Article 2844.

d. Tax Disadvantages of Limited Partnerships

(1) Complexity of the tax rules.

(2) Risk of reclassification as association taxable as a corporation was a disadvantage prior to January 1, 1997, if drafter of the contract was not knowledgeable in the tax law and

engaged in the use of dummy corporate general partners. This risk has now been eliminated by the adoption of the "check-the-box" regulations.

(3) Cannot use a limited partnership in a public offering, or in publicly held company engaged in active trade or business. IRC §7704 deems publicly held partnerships to be corporations for tax purposes except for those which have more than 90% of their income from passive income sources.

(4) IRC §469(h)(2) states that except as provided in regulations, limited partners do not materially participate in the business. Under Temp. Reg. §1.469-5T(e)(2) this rule can be overcome, but the ways of overcoming the rule are more restrictive than for general partners. Therefore, ability to overcome passive activity loss rules for limited partners may not be acceptable. Treas. Reg. §1.469-5T(e)(3) defines a limited partnership interest as an interest with respect to which the liability of the holder is limited under state law to a determinable amount. It is unclear whether this applies to LLC members.

e. Some Other Features of Limited Partnerships

(1) To the extent not inconsistent with the partnership in commendam rules, the general rules of partnership also apply. Query: whether limited partners are subject to the same fiduciary duties imposed upon general partners. There is nothing in the Civil Code or in the Louisiana published cases to indicate otherwise. Judge Mary Ann Vial Lemmon of the U.S. District Court for the Eastern District has ruled in an unpublished opinion in the context of a motion for summary judgment that because C.C. Art. 2809 ("partner owes fiduciary duty to the partnership and to his partners") is not inconsistent with the provisions governing partnerships in commendam, limited partners have the same fiduciary duty that general partners have.

(2) For the liability of a partner in commendam to be limited as to third parties, the partnership must have a name that appears in the partnership contract; and it must include language that clearly identifies it as a partnership in commendam, such as "limited partnership" or "partnership in commendam" and the name must not imply that the partner in commendam is a general partner. C.C. Art. 2838.

(3) Partner in commendam must agree to make a contribution to the partnership. It may consist of money, things, or performance of non-managerial services. The partnership agreement must state either its agreed value or a method of determining it. The contract should also state the time or circumstances upon which the money or other things are to be delivered, or the services are to be performed, and if it fails to do so, payment is due on demand. C.C. Art. 2840.

(4) A contract of partnership in commendam must be in writing and filed for registry

with the secretary of state. Until the contract is filed, partners in commendam are liable to third parties in the same manner as general partners. C.C. Art. 2841.

E. THE REGISTERED LIMITED LIABILITY PARTNERSHIP ("LLP").

In 1992, the Louisiana Legislature enacted Louisiana Revised Statutes 9:3431-3433 to allow certain partnerships to apply for status as a registered limited liability partnership.

A Louisiana partnership can convert to an LLP by a mere filing with the Secretary of State. An LLP gives its partners the protection from liability due to the errors, omissions, negligence, incompetence or malfeasance committed by another partner or partnership representative on a basis similar to that provided to shareholders of professional corporations under Title 12. While the LLP does not limit the liability of a partner for any other debt or obligation of the partnership, it allows a partnership to obtain limited protection generally afforded the corporation entity without the extra expense and tax consequences of organizing a corporation.

The remainder of the advantages and disadvantages of the LLP would be the same as those set out above for the partnership, but add to them the disadvantage of a lack of substantial jurisprudence interpreting this law.

It is important to note, however, that the liability protection offered by the LLP is easily lost if the partnership fails to file its annual election with the secretary of state. However, expiration of the LLP registration does not affect the juridical personality of the partnership which makes the election, and the registration as a limited liability partnership does not by itself create a separate juridical entity. See ***Hart v. Theus, Grisham, Davis & Leigh, L.L.P.***, 38,503 (La. App. 2 Cir. 7/2/04), 877 So.2d 1157. In this case a Monroe law firm operated under a written partnership agreement since 1987. The partnership agreement contained a mandatory arbitration clause. In 1993 the partnership registered as a limited liability partnership. When one of the partners later withdrew from the partnership he tried to get around the mandatory arbitration clause by arguing that the registration as an LLP terminated the prior partnership and created a new one. The 2nd Circuit noted that the registration as an LLP is simply the means by which a partnership may obtain the limited liability protection provided by the statute. The court was persuaded by the language of La. R.S. 9:3435 which provides that LLP's are regular partnerships governed by the Civil Code and that upon lapse of an LLP's registration, the LLP continues to function under the Civil Code's general laws of partnership.

F. THE LIMITED LIABILITY COMPANY ("LLC")

a. Non-Tax Advantages of LLC's

(1) Because the LLC does not have the same types of rules concerning the issuance of ownership interests, or discrimination within classes and series of such interests, some commentators believe that the LLC affords more flexibility in capital structure than do corporations.[14]

(2) Limited liability for members.

(3) The LLC is generally not subject to the same restrictions as corporations in the context of distributions to owners. Corporations are limited to paying dividends or redeeming their own stock out of surplus (R.S. 12:§§55 and 63) while the LLC is limited only by solvency concerns and any preferential rights of certain members or classes of members in liquidation. (R.S. 12:§1327). The LLC has significantly more flexibility in the design of its management structure. There is no required separation of powers between owners (stockholders) and tiers of management (directors and officers) unless the organizers desire to design the same into the management structure of the LLC. No rules concerning discrimination within classes and series of ownership interests like with corporations except to the extent the organizers wish to build such limitations into

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14 See Keatinge, Ribstein, Hamill, Gravelle and Connaughton, "The Limited Liability Company: A Study of the Emerging Entity," The Business Lawyer, Vol. 47, February, 1992, p.375,386.

the design of the LLC; thus there is more flexibility in design of the capital structure.

(4) Unlike the Limited Partnership - members do not lose limited liability by participating in management. Moreover, the LLC statutes expressly authorize limitations on the liability of members and managers for breaches of duty, while the partnership law contains no such express authorization. (See R.S. 12:§1315 as compared to La. Civ. Code Art. 2809).

(5) For what its worth - note the distinction between §1328 - Liability of member or manager <u>to the LLC</u> for unlawful distribution versus §§92 and 93 - Liability of director or shareholder <u>to corporation or creditors of corporation</u>.

(6) Right of member under default rules to withdraw and receive fair value of the member's interest as of the date of the member's withdrawal. (§1325). Prior to amendment of §1325 pursuant to Act 847 of the 1995 Regular Session of the Legislature, this section provided that upon withdrawal, the withdrawing member was entitled to the fair value of his capital contribution. Anyone who drafted an LLC operating agreement relying upon the former default rule should examine those agreements to determine how this change in the law may affect the rights of the members. See ***Sage v. Radiology and Diagnostic Services, L.L.C.***, 2001-2445 (La.App. 1 Cir. 11/8/02), 831 So.2d 1053, in which the 1st Circuit ruled that the amendment to the default rules was prospective only, meaning that any LLC formed prior to the effective date of the amendment which did not opt out of the default rule, is governed by the original version of the statute.

(7) As compared to Limited Partnerships - Members or managers managing LLC's have more freedom in removing managers than limited partners in removing managing general partners because general partners in a Limited Partnership are owners and have to be bought out to be removed while an LLC can simply replace one manager with another.

(8) Unlike a corporation §1321 allows a member's contribution to the LLC to be made in form of obligation to perform services in future. Note that under §1322B, if a member does not make the required contribution of services, "he or his personal representative is obligated, at his or his personal representative's option, to either contribute cash equal to that portion of value of the stated contribution which has not been made or forfeit his entire membership interest, or, in the case of a personal representative, forfeit all rights in such membership interest to which he may otherwise be entitled."

(9) Securities Laws Applicability -

The Securities Act of 1933, the Securities Exchange Act of 1934, and the Louisiana Blue Sky Laws have defined "security" in broad terms, including such phrases as "investment contract" and "any instrument commonly known as a security."[15] The broad construction which courts have given to the meaning of terms such as "investment contracts" led to a rapidly expanding application of the term "security" to numerous, unrelated commercial activities.

This question of what is an investment contract is of significant practical importance. If partnership and LLC interests are securities, they cannot be offered or sold without registration or exemption therefrom under the federal and state securities laws. If they are securities, substantial disclosure obligations are triggered along with the risk of liability under the antifraud provisions of the securities laws.

The U.S. Supreme Court has said that an "investment contract" is "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

In the Fifth and Eleventh federal circuits, the common enterprise requirement is satisfied if a single investor is dependent upon the expertise of a single promoter. *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121 (11th Cir. 1983); aff'd en banc, 730 F.2d 1403; *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1974). The investment may be any tangible and definable consideration in return for an interest which has substantially the characteristics of a security. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979).

The term "solely" has created difficulties in the courts because its literal application would mean that only purchasers who have remained entirely passive would be considered to have purchased securities. This would exclude many situations in which the economic realities of the transaction would require even an engaged investor to rely on the entrepreneurial or managerial skills of the promoter. Nevertheless, it is this aspect of the test which will no doubt be most crucial to the determination of whether an LLC membership interest is a security.

Some courts have found a "security" where the investors had significant control powers, but the investors were unsophisticated or otherwise unable realistically to exercise these powers. *SEC v. Aqua-Sonic Products Corp.*, 687 F.2d 577; *Hecht v. SEC*, 459 U.S. 1086 (1982).

The test for whether the investment success is "solely from the efforts of a promoter or third party", at least in the 5th Circuit, is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success

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[15] See 15 USCS §§ 77b(1), 78c(a)(10), and La. R.S. 51:702(15(a).

of the enterprise." *SEC v.Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974). In the partnership context, some cases have held that the partners' ability to exercise their powers is determinative. One leading case relied exclusively on the powers granted the general partner under the partnership statute or agreement, without regard to the partner's exercise of these powers. *Goodwin v. Elkins & Co.*, 730 F.2d 99 (3rd Cir.) cert. denied 469 U.S. 831 (1984). Under this analysis, it does not matter whether a partner has actually exercised the managerial power or delegated it to others such as management or an executive committee.

The 5th Circuit, however, has held that "the mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws." *Williamson v. Tucker,* 645 F.2d 404 (5th Cir.),cert denied, 454 U.S. 897 (1981). Although the court noted that the partner who claims his general partnership interest is an investment contract has a difficult burden to overcome, three examples of how this could be established were offered:

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers. 645 F.2d at 424, n. 15.

Other courts, while emphasizing these powers, have allowed some room for extrinsic evidence as to whether the partner realistically could exercise such powers. *Rivanna Trawlers Unlimited v. Thompson Trawlers*, 840 F.2d 236 (4th Cir. 1988); *Koch v. Harkins*, 928 F.2d 1471 (9th Cir. 1991).

There is thus a notion that a general partnership interest is at least close to a per se "non-security". In summing up the case law, it seems that as long as the partnership agreement leaves at least a majority of the partners with ultimate control, then the general partnership interests will not be considered securities, unless it can be shown that it was "not possible" for the partners to exercise their powers. *Rivanna Trawlers*, at 241. Analysis of the efforts of others criterion necessitates consideration of the general partner's statutory control rights, contractual rights and actual behavior.

On the other hand, limited partnership interests are ordinarily considered securities because a limited partner who exercises too much control loses his limited liability, and as such, the limited partners must be dependent on the efforts of others to generate profits from the enterprise. See

Mayer v. Oil Field Sys. Corp., 721 F.2d 59 (2d Cir. 1983); *SEC v. Holschuh*, 694 F.2d 130 (7th Cir. 1982); *SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980); *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978); *Hirsch v. DuPont*, 396 F.Supp. 1214 (S.D.N.Y. 1975) aff'd 553 F.2d 750 (2d Cir. 1977). There are a few cases that suggest that a limited partnership interest may not be an investment contract if: (1) the limited partners in fact exercise substantial control over the limited partnership; and (2) there are only a small number of limited partners.

Similar concepts are being applied to LLC's. If member-managed: perhaps there the strongest argument would seem to be non-security because by definition, members manage and don't rely on others for success or failure of their investment. <u>But</u> without the personal liability which a general partner has, there may be less incentive to be highly informed about the business. At the same time, personal liability discourages involvement of unsophisticated investors.

As with general partnerships and limited partnerships, the key question is whether the LLC members rely on the efforts of others. LLC's are at least analogous to limited partnerships. The lack of state law prohibition on participation in control of the LLC would indicate that there should be no presumption that the LLC members are dependent on the efforts of others for the success or failure of the venture.

If the LLC is manager-managed, obviously there is a stronger argument that the membership interest of a non-manager member is a security. Therefore, it might follow that LLC's have greater securiti es law exposure than general partnerships, but may be free of regulation if member-managed. If management of the LLC is not structured where reliance on the efforts of others is involved, the interests in the LLC are not likely to be deemed securities. In this respect, interests in LLCs are significantly different than stock in a corporation. In ***Landreth Timber Co. v. Landreth***, 471 U.S. 661 (1995), the Supreme Court rejected the "sale of business" doctrine for sale of a corporation's entire stock, on the basis that "stock" is listed as a security in the definition of "security" in the securities laws, and that the form of a transaction could not override the definitional aspects of the securities laws. Interests in partnerships and LLCs are not included in the definitional provision of the federal securities laws. In ***Great Lakes Chemical Corp. v. Monsanto Co.***, 96 F.Supp.2d 376 (D.Del. 2000), the court ruled that the purchaser of 100% of the interests in an LLC could not rely on the ***Howey*** analysis as the owner of the interest s, the plaintiff could not claim that its future expectation of profits would depend on the efforts of others.

In ***SEC v. Parkersburg Wireless, Ltd, Liability Company***, 991 F.Supp. 6 (D.D.C. 1997), the court applied the ***Howey*** test to find that a "security" existed for the purposes of the federal securities law. In ***SEC v. Shreveport Wireless Cable Television Partnership***, Fed.Sec. L.Rep. (CCH) ¶90,322 (D.D.C. 1998), the court applied the ***Williamson v. Tucker*** analysis to reach the same conclusion.

By comparison, in a case that did not involve SEC enforcement, ***Keith v. Black Diamond Advisors, Inc.***, Fed.Sec.L.Rep. (CCH) ¶90,448 (S.D.N.Y. 1999), the court concluded that the LLC interests were not securities for the purposes of the 1993 Securities Act because under the ***Howey*** test, the members had broad powers, and therefore could not expect that their profits would be dependent upon the efforts of others.

For now, the case law on the issue in the LLC context is scant. For a more in depth look at the case law and a couple of varying opinions on how that case law should be applied to LLC's, see "Are Limited Liability Company Interests Securities?", M. A. Sargent, 19 Pepp. L. Rev. 1069-103, April '92; "The LLC as a Security," M. I. Steinberg, K.L. Conway, 19 Pepp. L. Rev. 1105-22, April '92; Robert R. Keatinge et al, "The Limited Liability Company, A Study of the Emerging Entity", 47 Bus. Law. 378 (1992).

The state of California enacted legislation in 1994 to include securities law coverage of LLCs. Essentially following the traditional investment contract concept, California amended the section of its law defining a security to include the following:

> Security means...interest in a limited liability company and any class or series of such interests (including any fractional or other interest in such interest), **except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company**; provided that evidence that members vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company... (Emphasis added).

As of the Spring of 1996, approximately 28 states had enacted legislation of some type addressing the securities law treatment of LLC interests. The approach of those states that have legislated on the issue varies significantly from state to state. Therefore, anyone dealing with solicitation of LLC members outside of Louisiana should consult the state statutes for individual treatment. As of the end of 2005 regular legislative session, Louisiana has not legislated on the issue.

A few other cases from around the country have been reported on the issue. In ***Nelson v. Stahl***, 173 F.Supp.2d 153 (S.D.N.Y. 2001), the plaintiffs alleged securities fraud in connection with the sale of their stock in a corporation and their interests in several LLCs. Applying the ***Howey*** test, the court concluded that the interests in the LLC were not securities. The court stated that, whether or not the members in fact abdicated their authority, the legal structure they selected precluded a finding that the membership interests were securities. The plaintiffs owned, in the aggregate, 60% of the membership interests in the LLCs and the LLC agreements vested management in the members. The members had access to information regarding the affairs of the LLC and had ultimate control over the LLC's affairs. The court declined to treat the purchase of the LLC interests as part of the purchase of the stock in a related entity so as to entertain the Rule 10b-5 action with respect to all of the transactions.

In ***Great Lakes Chemical Corporation v. Pharmacia Corporation***, 788 A.2d 544 (Del. Ch. 2001) the plaintiff alleged that the seller warranted in the purchase agreement that the ownership interests the plaintiff purchased were securities. The court held that a reference to the interests as "equity securities" in the section of the agreement warranting title to the interests did not constitute a warranty that the interests were securities under the federal securities laws.

In ***Tschetter v. Berven***, 621 N.W.2d 372 (S.D. 2001) the South Dakota Supreme Court applied the ***Howey*** and ***Williamson*** tests to conclude that the plaintiff's membership interests in the LLC in question (a restaurant) were not securities under South Dakota law. The court pointed out that the operating agreement vested management in the members and gave the members substantial power and authority. The court also stated that the record established that the plaintiffs were informed and active in the affairs of the LLC and were aware of and capable of exercising their powers as members. Although the LLC's management was contracted out to another entity, the court said the LLC retained the ability to terminate the management contract upon a failure to perform as required, and the members retained substantial power and the ability to conduct the necessary oversight of the LLC's operations. A dissenting opinion characterized the situation as one in which the plaintiffs had very little control and concluded that a question of fact existed as to whether the membership interests were securities.

In ***KFC Ventures, L.L.C. v. Metairie Medical Equipment Leasing Corp.***, No. Civ.A. 99-3765, 2000 WL 726877 (E.D. June 5, 2000), the issue was whether the plaintiff's LLC membership interest was a security under federal securities laws. In response to the defendants' motion for failure to state a claim for securities fraud, the court held that it was possible that the plaintiff's membership interest was a security. The focus was upon whether the investment involved an expectation of profits to be derived solely from the efforts of others. The LLC in question was manager-managed, and the operating agreement gave the manager full power and discretion to manage the affairs of the LLC. The operating agreement did not permit a member to act as the LLC's agent and largely limited the member's role to voting on extraordinary matters such as dissolution. The manager was also an 85% member of the LLC. Thus, the court concluded the membership interest might be a security. However, the plaintiff's allegations of fraud lacked particularity, and the court dismissed the claims subject fifteen days for the plaintiff to amend and plead with sufficient particularity.

(10) The LLC affords the members tremendous flexibility in designing the management scheme and system of internal governance to suit the desires of the members. They may custom design their management procedures to be as simple as management through its members according to the default rules of the statute or they can design the LLC to function exactly like a corporation does. An overriding principle that is clearly set forth in the rules of construction in §1367 of the LLC statute is that <u>"[i]t is the policy of this Chapter to give maximum effect to the principle of freedom of contract</u>."

(11) With the amendments to the LLC statute in 1997, LLC's under the Louisiana statute are available to sole proprietors as a single member LLC. Formation of an LLC for a single member can be extremely simple and inexpensive, thus leaving little reason for the sole proprietor not to choose this form of entity where, otherwise, he might have chosen to remain as a sole proprietor rather than incur the expense of incorporation as well as the formalities of operation that go along with it. Under the Louisiana statute, prior to July 8, 1997, it took two or more persons to form an LLC. §1304. There were some state statutes which allowed for single member LLC's at the time their LLC statutes were enacted. In response to the adoption of the so-called "Check-The-Box" regulations which became effective on January 1, 1997, the Louisiana legislature

amended the provisions of §§ 1301(10) & 1304 to allow for single member LLCs under the Louisiana statute. In the single member context, the LLC offers simplicity as one of its major advantages. In most cases, a written operating agreement will not be necessary. There are no stock certificates to be prepared, no organizational meetings to be documented and the articles of organization can be fairly standardized from the practitioner's standpoint.

(12) Under the Louisiana default rules, a judgment creditor may apply to a court for an order charging a membership interest of a member with payment of the unsatisfied amount of a judgment with interest. §1331. The statute provides that, to the extent so charged, the judgment creditor shall have only the rights of an assignee of the membership interest. An assignee is entitled to receive such distributions, to share in such profits and losses, and to receive such allocation of income, gain, loss, deduction, credit or similar item to which the assignor was entitled to the extent assigned. §1330A. The statute does not indicate whether the judgment creditor can also proceed to cause a sheriff's sale of the member's interest but, assuming that the creditor can do so, presumably, all that could be sold would be the rights of an assignee unless the members approve the purchaser for admission as a member. See §1332A. Also, note that until the assignee of an interest in a LLC becomes a member, the assignor continues to be a member. This means that a member's interest might be seized and sold at a sheriff's sale by a seizing creditor in which case the creditor, if it purchased the interest at the sheriff's sale, might find itself paying income taxes on profits allocated to the membership interest while the debtor/member continues to vote the membership interest, including the vote on decisions such as whether to make distributions. Could the members get together and decide to amend the operating agreement to create different classes of members for purposes of distributions to the prejudice of the seizing creditor? These are among the many questions which will have to be dealt with in the courts as time and experience with the LLC law progress. In ***Herring v. Keasler***, 563 S.E.2d 614 (N.C.App. 2002), the court granted a charging order, but the court concluded that the North Carolina LLC act did not authorize the forced sale of the interest. The court quoted from the statute to the effect that a charging order entitles the judgment creditor to receive distributions and allocations to which the judgment debtor would be entitled, but does not dissolve the LLC or entitle the judgment creditor to become or exercise any rights of a member. The court's reasoning for finding forced sale was not permitted was that the forced sale of a membership interest to satisfy a debt would "necessarily entail the transfer of a member's ownership interest to another, thus permitting the purchaser to become a member" in violation of statutory provisions that require consent of all members to admit a person as a member. See, however, *In the Matter of Daugherty Construction, Inc.*, 188 BR 607 (Bankr. D.Neb. 1995); *Broyhill v. DeLucca (In re: DeLcca)*, 194 BR 65 (Bankr. E.D. Va. 1996); *In re: Garrison-Ashburn, L.C.*, 253 BR 700 (Bankr. E.D.Va. 2000); *In re: IT Group, Inc.*, 302 BR 483 (Bankr. D.Del. 2003); and *In re Ehman*, 319 BR 200 (Bankr. D.Ariz. 1/13/05), for the interaction of the bankruptcy statutes on executory contracts and assumption thereof and the provisions of LLC law relative to transferability of membership interests.

Given the Louisiana statutory framework, there is the potential to use the LLC to affect discounting in the determination of fair market value which would come into play in assessing creditors' rights in several settings, including negotiations with a seizing creditor and in valuation of LLC membership interests for bankruptcy purposes. Simply by virtue of the differences in state law applicable to LLC membership interests such discounts might be greater than minority interest, liquidity and marketability discounts which would be otherwise available if the same thing were done with corporate stock. These same valuation principles and statutory aspects of LLCs carry over into the estate tax area to make LLCs a worthwhile instrument to examine for implementing estate tax planning objectives. [16]

b. Tax Advantages of LLC's

(1) Generally, for LLCs formed after January 1, 1997, unless the LLC elects to be taxed as a corporation, it will be treated as a partnership for tax purposes governed by subchapter K of the IRC. LLCs formed prior to January 1, 1997 are subject to a different set of rules. Revenue Ruling 88-76, 1988-2 C.B. 360 held that an LLC formed under Wyoming's LLC law would be treated as a partnership for federal income tax purposes. A similar conclusion was reached by IRS in PLR 8937010 for an LLC formed under Florida law. Subsequently, IRS issued a number of favorable rulings on LLC's formed under a number of different state laws, including Louisiana. See PLR 94-04-021 (November 1, 1993) (Louisiana LLC). Note that in Rev. Rul. 94-5, 1994-2, IRB 21, the Service warned that because of the flexibility afforded by the Louisiana LLC statute, a Louisiana LLC could be classified as a partnership or as an association taxable as a corporation depending upon the provisions included in the organizational agreements. Prior to January 1, 1997, whether an LLC was taxed as a partnership or as a corporation depended upon whether the LLC was designed in a way that it complied with the myriad of these and other revenue rulings and private letter rulings where the IRS had ruled that LLC's formed under the laws of many of the states qualified for taxation as partnerships. Qualification for partnership taxation was dependent upon application of former treasury regulations known as the "Kintner Regulations". Former Treas. Reg. Section 301.7701-2.

The Kintner regulations identified four corporate characteristics which distinguished associations taxable as a corporation from partnerships. Those corporate characteristics were:

i. Continuity of life;
ii. Centralized management;
iii. Limited liability; and

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16 Caution is advised here as the tax rules in this area are extremely complicated, beyond the scope of this outline, and the IRS has, since January of 1997, embarked upon an all out attack on the transfer tax benefits of family limited partnerships and family limited liability companies.

iv. Free transferability of interests.[17]

If more than two of these corporate characteristics were found to exist, the LLC would be taxed as a corporation. Because the LLC statute allows for flexibility in designing the LLC, one had to be extremely wary of the possibility that customized designs might run the risk of losing the partnership taxation treatment. For instance, the IRS in Rev. Rul. 88-76 found that the Wyoming LLC lacked free transferability of interests. An organization possessed the corporate characteristic of free transferability if a member was able to substitute another person for themselves "without the consent of other members." Rev. Rul. 88-76. That ruling held that the LLC lacked the corporate characteristic of free transferability because the consent of all members was required in order for an assignee of an interest to become a substitute member of the LLC.

Therefore, if the drafter decided to provide in the organizational agreement that no consent was required for an assignee to become a member, the law allowed that to be done. However, in doing so, the organization would then have the additional corporate characteristic of free transferability of interests, and therefore could end up being treated as a corporation for federal tax purposes. Free transferability of interests could be traded off for centralized management by reserving to the individual members management authority under §§1316 & 1317 and perhaps save the partnership tax treatment.

Prior to the adoption of the IRC §7701 Check the Box regulations this area was a malpractice case looking for a place to happen. If the client had come to you and decided to go with the LLC form of entity because of its partnership tax treatment, he would be talking to a malpractice attorney if that turned out not to be the case.

On January 1, 1997, the so-called "Check the Box" regulations [26 CFR 301.7701-2(b)(1)] became effective which dramatically simplified the determination of whether the LLC and other unincorporated associations are to be taxed as corporations or as partnerships. Essentially, under these regulations the entity may simply elect to be taxed as either a corporation or a partnership without regard to the corporate characteristics. Thus an LLC is treated similar to a corporation for liability purposes but as a partnership for tax purposes under federal law. Under these regulations, the LLC is taxed as a partnership unless it elects to be treated as a corporation for tax purposes.

Perhaps one of the most important developments brought about by the Check the Box regulations was the treatment of single member LLC's. The regulations indicate that, for federal tax purposes,

17 See Former Treas. Reg. Section 301.7701-2(a)(3).

an LLC which has a single owner and does not elect to be treated as a corporation is, for federal tax purposes, disregarded as an entity separate from its owner.

(2) An LLC is able to achieve similar benefits of consolidation for tax purposes which are available to C corporations through owning subsidiary LLC memberships in single member LLCs but without certain disadvantages arising under the consolidated tax return regulations. Wholly owned subsidiary LLCs that have not "checked the box" to be taxed as a corporation are disregarded for tax purposes and treated as one LLC taxed as either a partnership or a C corporation, depending upon how the ultimate parent LLC has elected to be taxed.

(3) An LLC will be entitled to use the cash method of accounting unless its members are C corporations or the LLC is a tax shelter. IRC §§448 and 446.

(4) The LLC taxed as a partnership, in contrast to the C corporation, is not subject to the accumulated earnings tax (IRC §§531-537) and the personal holding company tax (IRC §§541-547).

(5) See the Tax-Advantages of the General Partnership discussed above. All of these being available to the LLC taxed as a partnership, they can be listed here as tax advantages of the LLC. Likewise, as the LLC may elect to be taxed as a C Corporation, any advantages listed under that entity also apply to the LLC, but the LLC then has the additional flexibility afforded by the state statute to design the LLC to operate in ways a corporation cannot.

(6) The single-member LLC owned by an individual, now available in Louisiana under the 1997 amendments to the LLC statute, is treated as a sole proprietorship under the "check-the-box" regulations and is essentially disregarded altogether for tax purposes. The individual member of a single member LLC simply reports all of his income and expenses of the LLC on a Schedule C to his individual Form 1040 just like a sole proprietor would.

(7) A major advantage which the LLC in Louisiana has over the C Corporation and the S Corporation is that the LLC pays no franchise tax under Louisiana's franchise tax statute. For state income tax purposes, an LLC "is treated and taxed in the same manner that it is treated and taxed for federal income tax purposes." R.S. 12:1368.

(8) Under partnership taxation, the LLC has all of the basic advantages of partnership taxation which include the ability to make special allocations of profits, gains, losses, deduction and credit items among its members, enhanced basis rules allowing for inclusion in the members tax basis for their membership interest, their pro rata share of debt inside the LLC, and general pass through taxation.

(9) The IRS has ruled that an LLC owned entirely by a husband and wife under community property laws may be treated as a disregarded entity or as a partnership. ***Rev. Proc. 2002-69 (IRB 2002-4, Nov. 4, 2002).*** A qualified entity is a business entity that is wholly owned by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States and in which no other person would be considered an owner for federal tax purposes and which has not elected to be treated as a corporation under Treas. Reg. §301.7701-2. If the entity and the husband and wife as community property owners, treat the entity as a disregarded entity for federal tax purposes, the IRS will accept the position that the entity is a disregarded entity for federal tax purposes. If the entity and the husband and wife as community property owners, treat the entity as a partnership for federal tax purposes and file the appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes. If the parties change their reporting positions, the change will be treated as a conversion of the entity.

(10) Rev. Rul. 2004-41, 2004-18 I.R.B. 845, held that the IRS may not collect the employment tax liability of an LLC from the members of the LLC if those members are not liable for the LLC's debts under state law. The IRS warned that LLC members may be exposed to liability in connection with fraudulent transfers of assets from the LLC and under the trust fund penalty provisions of IRC §6672 which allows the IRS to assess the trust fund portion of the employment taxes against any "responsible person."

c. Non-Tax Disadvantages of LLC's

(1) Uncertainty as to what types of circumstances, if any, beyond those or less than those used in the normal corporate veil piercing cases will give rise to personal liability. This is represented by the limited jurisprudence addressing these issues in the LLC context.

(2) Until all states adopted LLC legislation there was potential for personal liability to exist where interstate business was conducted. This concern is not as much of a concern as it was in the first few years of the LLC development in the law. Now all 50 states have LLC statutes.

(3) Uncertainty represented by the lack of jurisprudence, generally, interpreting the LLC Law.

(4) <u>Cost Considerations</u>. This writer finds the multi-member LLC generally more expensive to form than the basic incorporation simply because of the number of decisions that have to be made in designing and customizing the LLC to fit the needs and desires of the organizers. On the other hand, this writer has found that the formation of a single member LLC takes less time, effort and cost to the client than does the incorporation for the one-shareholder corporation

(5) <u>Complexity</u>. For the multi-member LLC, the LLC is considerably more complex

in the formation process than a corporation, although depending upon the design, it may be much more simple in its operation. Because of the flexibility allowed in the design of the management provisions and the provisions dealing with the rights of the members in relation to one another, in this writer's practice there seems to be considerably more customization of both the operating agreement and the articles of organization.

d. Tax Disadvantages of LLC's

(1) For those LLCs formed prior to January 1, 1997, there was a risk of being reclassified as an association taxable as a corporation if the drafter was not careful. This is no longer a concern for those LLCs formed after January 1, 1997.

(2) An LLC may be required to use the calendar year (or year used by its partners) unless a "section 444" election is made to use a fiscal year (requiring that interest be paid on any deferral).

(3) Sale or exchange of 50% or more terminates LLC/Partnership for tax purposes.

(4) Under the Check the Box regulations, it would seem clear that for the LLC taxed as a partnership, IRC §108, dealing with the treatment of income from the discharge of indebtedness, would apply to the LLC as though it were a partnership. §108(a)(b) & (g) indicate that the affect of discharge of indebtedness and the insolvency determination for purposes of determining whether income from discharge of indebtedness is recognized or not apply at partner level for partnerships but at corporate level for S Corporations. In a partnership under state law it makes sense to make insolvency determination at the individual partner level because partners have liability for partnership debts. Creditors can pursue partners after partnership assets have been exhausted. However, the same is not true for the LLC. Members are not liable for LLC debts. Thus, the rule applicable for S Corporations would make more sense for the LLC.

(5) Unless Reg. 1.469-5 T is amended to change rule for LLCs, in order to materially participate for passive activity loss limitations, LLC member should expect to have to show he participated for more than 500 hours in LLC's Trade or business.

(6) Income allocated to members of an LLC engaged in active trade or business will be treated as self-employment income for members actively involved in the business, contrasted to the owner employee of a corporation, be it a C or S corporation, who is treated as an employee in which case the corporation pays one-half of the total FICA and Medicare payroll tax. Definitive guidance has yet to be issued by the IRS regarding the ability of an LLC member to receive non-self employment income distributions from an LLC in which the member is actively engaged in management. Self employed persons pay the full FICA and Medicare tax as self-employment tax and do receive a deduction for one-half of the self-employment tax, however, through that

deduction they only receive pay back to the extent of the income taxes saved. The employee of the corporation pays no part of the employer share of these taxes and has no taxable income from the employer's payment of them. This could be a significant disadvantage of the LLC in an active trade or business context.

(7) There are many individual examples of situations in which the provisions of subchapter C of the IRC may be more advantageous or disadvantageous than the provisions of subchapter K depending upon the context of a given situation. In addition to those noted above, a few other examples can be found in areas such as (i) use of profits interests as compensation to executives; (ii) use of equity interests as compensation to executives; (iii) acquisitions and exit strategies, and (iv) foreign operations. For an excellent discussion of some of these areas, see Melone, "Subchapter K in a Subchapter C World: Operational Issues," Journal of Limited Liability Companies, Winter 1997, Vol. 4, Number 3, at p. 100.

(8) As noted in an earlier footnote, the 2000 session of the Louisiana Legislature, in grappling with a substantial budget deficit, saw the introduction of a bill (H.B. 130) that would have imposed regular C corporation taxation and corporate franchise taxes on the LLC at the state level. This would have eliminated the advantageous tax benefit of having an entity with limited liability taxed as a flow through entity at the state level. There were at least two previous attempts in the legislature to impose the franchise tax on the LLC, each of which failed. With the number of corporations that have converted and continue to be converted for the purpose of avoiding the state corporation franchise tax, it remains uncertain how long the legislature can continue to allow those dollars to be drained from the state budget.

(9) In regard to IRS collection actions against LLCs, the IRS Office of Chief Counsel issued **CCM 2002235023 (June 28, 2002)** to clarify the application of collection procedures against LLCs in five different scenarios:

(A) Who is liable for the tax resulting from the operation of a multi-member LLC? The treatment of a multi-member LLC will depend on whether the LLC has elected to be treated as a corporation. If the LLC has not elected to be treated as a corporation, the Chief counsel held that in a multi-member LLC that the members qua tax partners will be liable for the income taxes on the income of the LLC, and the LLC as employer would be liable for employment taxes. Because the employment tax is a liability of the LLC it is asserted against the LLC not the individual members. Unlike the employment taxes of a general partnership, those taxes may not be asserted directly against the members because members are not liable for the obligations of the organization under state law. The CCM goes on to note, "These members, however, may be liable for the trust fund recovery penalty, depending on the facts and circumstances of each case." If the LLC has elected to be taxed as a corporation, the LLC is liable for both income and employment tax from operations. While the members are not directly liable for the obligations of the LLC, including the tax liability of the LLC, as a result of state law, they may be liable for the trust fund recovery penalty under IRC §6672, depending on the facts and circumstances. Of more recent vintage, see Rev. Rul. 2004-41, 2004-18 I.R.B. 845, discussed above, which held that the IRS may not collect the employment tax liability of an LLC from the members of the LLC if those members are not liable for the LLC's debts under state law.

(B) Who is liable for the tax resulting from the operation of a single member LLC? Determining who is the taxpayer for the liability arising from a single member LLC will depend on the LLCs election. If the LLC has not elected to be treated as a corporation, the LLC will be disregarded for federal tax purposes and the single member is the taxpayer. In this case, the IRS may recover the tax liability for both income and employment taxes attributable to the operations of the LLC from the property and rights to property of the member. As with multi-member LLCs, the liability of the members will turn on whether the LLC has made an election to be taxed as a corporation. This conclusion is consistent with ILM 199922053 (April 16, 1999) in which the Chief Counsel confirmed the holding of Notice 99-6 that, although, as a general rule, members of LLCs are not personally liable for employment taxes incurred by the LLC unless a single member LLC elects association status under the "check-the-box" regulations, the single member is liable for employment taxes incurred by the LLC. While not addressing the question of whether the property of the single member LLC may be reached by the government in order to satisfy the member's other tax liabilities, the Chief Counsel noted, ". . but the single member owner under state law has no interest in the assets of the LLC. In short, the Service may not look to the LLC's assets to satisfy the tax liability of the single member owner. The service, however, may take collection action against the single member's ownership interest in the LLC." This position confirmed its holding in ILM 199930013 (April 18, 1999) in which the Chief Counsel held that as a general rule the service may not levy on the assets of a single member LLC (regardless of whether it is disregarded for tax purposes) to collect a tax liability of its owner. If the LLC elected to be taxed as a corporation, then the LLC is liable for the income and employment taxes. As in the case of a multi-member LLC, the member will not be directly liable for the obligations of the LLC, but may be liable for the trust fund portion under §6672, if the factual requisites are present.

(C) If the Service makes an assessment against a disregarded LLC is that a valid assessment against the single member owner? The Chief Counsel held that an assessment made against a disregarded LLC is valid assessment against the single member owner. "In effect, because of the close relationship of the disregarded LLC to the single member owner, an assessment against the disregarded LLC is tantamount to an assessment against the single member owner."

(D) If the IRS files a Notice of Federal Tax Lien ("NFTL") naming the disregarded LLC as the taxpayer, is that a valid NFTL against the single member owner? A NFTL identifying the disregarded LLC as the taxpayer may be a valid notice against the single member owner, depending on the facts of each case. While the CCM sets forth the government's position is that a NFTL need not precisely identify the taxpayer; rather, the NFTL is valid if it substantially complies with the filing requirement so that constructive notice is provided to third parties and does not need to identify the member specifically, it recommends that the NFTL be filed in the name of the single member owner for the tax liabilities generated by the disregarded LLC.

(E) Are there state law theories that the IRS could use to collect the single member owner's liability from the disregarded LLC? In those circumstances in which the IRS is attempting to reach the assets of a single member LLC to satisfy the obligations of the member, it may either (1) levy upon the member's ownership interest in the disregarded LLC and sell that interest, (2) file suit to foreclose the federal tax lien against the ownership interest, (3) assert alter ego liability against the LLC (sometimes referred to as "reverse piercing") or (4) seek to hold the LLC liable under nominee or transferee liability.

CCM 200216028 (March 20, 2002). The Office of Chief Counsel advised that if the IRS makes an assessment against a disregarded single member LLC and provides a collection due process notice to the disregarded LLC, the IRS should issue a separate collection due process notice to the single member owner of the LLC if his name is added to the assessment, even when the single member owner received actual notice and was not prejudiced by the IRS's error.

G. THE C CORPORATION

a. Non-Tax Advantages of C corporation

(1) Limited liability for the owners.

(2) Centralized management.

(3) Free transferability of interests.

(4) Unlimited in terms of types and methods of financing through the public markets, with the exception that the corporation cannot offer flow through taxation that a partnership, LLC and limited partnership can offer to investors.

(5) Wealth of jurisprudence on various issues provides for greater certainty of the

applicable law.

(6) Unlike Partnerships and LLC's, unless the shareholders have agreed otherwise through buy/sell agreement, shareholder is not entitled to withdraw and compel payment of fair value of his interest in corporation. Thus - greater potential for oppression of minority. Therefore, whether this feature is an advantage or a disadvantage depends upon the circumstances of the particular client.

(7) No limit, unless stated in articles of incorporation, as to continuity of existence.

(8) Many business people are generally more familiar with corporate law and in many instances prefer the corporate form simply because its what they know best and feel most comfortable with.

b. Tax Advantages of C corporation

(1) Tax rules are simpler than the rules for S corporations and partnerships.

(2) For a corporation with modest annual taxable income below the $100,000 level, coupled with the intention not to distribute earnings any time soon, there may be a near-term benefit to take advantage of the graduated corporate tax rates. Such a plan should be weighed against the effects of (i) a second tax on the distribution of earnings at a later time, and (ii) the repeal of *General Utilities* should the assets of the business be sold at a later time.

(3) To some extent, the effect of double taxation may be avoided for owner/employees of the corporation who may be able to pay out much of the earnings in the form of deductible compensation such as salaries and bonus. Beware, however, of the tax rules on reasonable compensation. It is a favorite tactic of the IRS to propose adjustments on audit reducing the amount allowed as deductible compensation on the basis that salaries are excessive and are in fact dividend distributions which do not generate a deduction for the corporation.

(4) C corporations are not subject to the passive activity loss rules that apply to individuals unless it is a closely held C Corp. or a personal service corporation. A closely held C Corp is one more than 50% of stock of which is owned by 5 or fewer individuals. Personal service corporation means a corporation the principal activity of which is the performance of personal services substantially by employee-owners. Employee-owner being any employee owning stock.

Useful if one wants to have an affiliated group of corporations filing consolidated tax returns to permit income and losses realized from multiple businesses to be offset against one another without exposing the assets of one business to the risks of another.

(5) Fringe benefits may be received by shareholder-employees of a C corporation tax free, including:

a. $50,000 of coverage under group-term life insurance policy. IRC §79.

b. Health and disability insurance premiums. IRC §106.

c. Reimbursements for medical expenses, whether paid by employer provided insurance policy or by the employer. IRC §§104(a)(3), 105(b).

d. Qualified transportation fringes: $60 per month of transit passes and transportation to and from work in a commuter highway vehicle and $155 per month in parking. IRC §132(a)(5), (f).

e. Benefits provided under a cafeteria plan. IRC §125.

f. These benefits, if provided by an LLC to a member (if the LLC is taxed as a partnership), a partnership to a partner or an S corporation to a 2% shareholder, generally are taxable to the employee-owner of the business. See IRC §105(g) (health and disability benefits are not tax free to self-employed individuals); §132(f)(5)(E) (qualified transportation fringes may not be received tax-free by self-employed individuals); Prop. Treas. Reg. 1.125-1, Q & A - 4 (benefits under a cafeteria plan are not available tax free to self-employed individuals). A member of an LLC, a partner in a partnership, and a 2% shareholder in an S corporation may receive up to $50,000 of group term life insurance from the pass-through entity only if the employee-owner meets the definition of "employee" under IRC §3401(c) for purposes of the withholding tax. See Treas. Reg. §1.79-0; §31.3401(c)-1(e). To qualify the employee owner must be subject to the control and direction of the entity for which the employee-owner performs services. See Treas. Reg. §31.3401(c)-1(b). Generally, doctors, attorneys, other professionals, contractors, subcontractors and others who are in an independent trade or business, or profession in which they offer their services to the public, are not employees who may receive group-term life insurance tax free.

g. The member of an LLC, a partner in a partnership, and a 2% shareholder in an S corporation are now permitted to deduct up 100% of health insurance premiums paid during the taxable year under IRC §162(l).

h. The LLC member in an LLC taxed as a partnership, the partner in a partnership and the shareholder in an S Corporation may not be eligible for the exclusion from income of meals and lodging provided by an employer which were discussed earlier in this outline while the employee/owner of a C Corporation is eligible for this exclusion. IRC §119.

6. Stock based retirement plans such as stock bonus plans and ESOP's and incentive stock option plans are available only to corporations. See IRC s 409 (ESOPs), 422 (incentive stock bonus options), and 401(k) (cash or deferred arrangements that are part of stock bonus plans).

7. If an individual investor is in a high tax bracket, the business is expected to operate at a profit or generate passive losses which the investor will not be able to use, and there are no plans that the business will make distributions, prior to 2003, a C corporation might be the best choice. With the reduction in the maximum individual tax rate in 2003 from 39.6% to 35%, the advantage is minimal.

a. Business profits are taxed at the maximum federal corporate rate of 35% (34% for most corporations), rather than the 35% (39.6% prior to 2003) top individual rate.

b. an individual shareholder may liquidate his or her investment, recognizing capital gain on a sale of the stock, taxed at advantageous capital gains rates instead of 35% on ordinary income items composing the individual assets of a business if one is comparing the sole proprietorship, single member LLC (taxed as a sole proprietorship) or the partnership form. Beginning in 2003, some net long term capital gain tax rates have been reduced further.

c. Only stock in a C corporation can qualify as qualified small business stock, which if sold five or more years after its purchase, will result in gain taxed at 14% rather than 35%.

d. If the shareholder holds onto the stock until death, heirs will inherit stock with FMV basis under IRC §1014(a) and can sell the stock without recognizing gain.

e. If the stock is IRC §1244 stock, up to $50,000 ($100,000 on a joint return) of loss recognized on the sale, exchange, or worthlessness of the stock is an ordinary loss. IRC §1244.

c. Non-Tax Disadvantages of C Corporation

(1) As compared to general partnerships and LLC's where management is reserved to members, the shareholders have only indirect control in management by virtue of their election

of board of directors. While majority rule generally prevails, from the stockholders' standpoint, the only things they control directly are the election of directors and the approval of certain major corporate transactions such as merger, liquidation, and sale of substantially all of the assets.

(2) As compared to sole proprietorship, the C corporation is more complex and expensive.

(3) Shareholders do not have the right to withdraw and demand payment for their stock as compared to partners in a partnership or members in an LLC who may be able to do so.

(4) As compared to the LLC, the corporate form requires adherence to much more formality in operation and documentation of corporate decision making process in order to maintain limited liability protection.

d. Tax Disadvantages of C corporation

(1) Double taxation assured through the repeal of the *General Utilities* doctrine.

(2) The corporate AMT. For corporate business income sheltered by rapid depreciation for tax purposes, the adjustments set forth in IRC §56(g) provide significant exposure to corporate AMT. In most cases, the marginally higher individual AMT rate (21% vs. 20%) will not militate in favor of C corp. status.

(3) In cases in which a corporation's management proposes to distribute earnings, S Corp., LLC or partnership status is generally preferable.

(4) Penalty taxes such as §531 tax on unreasonable accumulations of earnings equal to 15% (28% prior to the 2003 Tax Relief Act) of the accumulated taxable income; and the personal holding company tax under §541 equal to 15% (28% prior to the 2003 Tax Relief Act) of undistributed personal holding company income.

(5) The '86 Act included a number of changes in the accounting area, one of which generally requires the use of the accrual method of accounting for C corporations other than qualified personal service corporations and corporations with less than $5,000,000 in gross receipts. IRC §§446 & 448.

(6) Losses suffered by C corporation are not passed through to shareholders but may be carried forward under the net operating loss provisions of §172.

(7) Pass through taxation may be preferable if the investors are individuals who are in

31% tax bracket or lower, since the corporation will pay tax on its taxable income at a rate of 34% on income in excess of $75,000 up to $10,000,000 and 35% on amounts in excess of $10,000,000. If the corporation is a qualified personal service corporation, it is not eligible for graduated tax rates, and must pay tax at rate of 35% on all of its income. IRC §11(b)(2). A qualified personal service corporation is any corporation substantially all of the stock of which is held by: (i) employees performing services for the corporation in connection with the activities in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, (ii) retired employees who had performed such services for the corporation, (iii) the estate of such individuals, or (iv) any other person who acquired stock from such a person.

(8) If the business plans to make distributions, a pass through entity, particularly one taxed under Subchapter K (Partnership or LLC) will be preferable to a C corporation, regardless of the tax brackets of the owners. This is because distributions from an LLC taxed as a partnership are generally tax free, both to the LLC and the members. IRC 731. On the other hand, the income of the corporation is subject to double tax.

(9) If the business will have deductions that exceed its income, a pass through entity such as an LLC taxes as a partnership may be the better choice. Losses of the LLC or partnership are passed through to the members/partners and may be available to offset income from other sources.

(10) C Corporation capital gains are taxed as ordinary income while individuals now have substantial savings on capital gains pursuant to the provisions of the Taxpayer Relief Act of 1997.

H. THE S CORPORATION

a. Non-Tax Advantages of S corporation

(1) Business owners prefer the corporate form of ownership, and S corp. gives them that with flow through taxation.

(2) Limited liability for active owners. Limited liability is more predictable than with the LLC because of abundance of case law outlining circumstances where corporate veil will be pierced.

(3) All of the other corporate attributes:

(i) centralized management;
(ii) continuity of existence;

(iii) free transferability of shares (subject to S corp. limitations on who can be a shareholder and number of shareholder's).

(4) In some respects, the tax status is more assured than with partnerships or LLCs, although new provisions were added to the law in the Small Business Job Protection Act of 1996, tax reform acts which have followed the 1996 Act and regulations promulgated since then which are designed to liberalize the tax rules applicable to qualification as an S Corporation and to reduce the likelihood and adverse consequences of an inadvertent termination of S status. Prior to the adoption of the so-called "Check the Box" regulations, the requirements of Subchapter S were more easily satisfied with greater certainty than the partnership tests under the IRC §7701 regulations on associations taxable as corporations when comparing the S Corporation to the LLC. That can really no longer be said for LLCs formed after January 1, 1997.

b. Tax Advantages of S Corporation

(1) Flow through taxation. Corporation generally does not pay a corporate level tax.[18] Income and loss is generally passed through to shareholders and reported on their personal returns. An S corporation is required to compute its income or loss for federal income tax purposes in the same manner that individuals compute their income, with several statutorily created exceptions.

(2) S corporations can be parties to tax free corporate reorganizations under IRC §368 while partnerships and (including LLC's taxed as partnerships may not).

(3) Although with the present circumstances where the maximum federal individual income tax rates on ordinary income are hardly any different than the maximum federal corporate income tax rates, considering the effects of the corporate AMT and the repeal of the *General Utilities* doctrine, in many cases, the S corporation should be considered. Since the capital gains of the S corporation are passed through and reported on the individual shareholder’s return, the capital gains will be taxed much more favorably under the recently added capital gains breaks available to individuals

(4) A common use of the S corporation election is to pass through to s/h's the operating losses that may be anticipated in the start up phase of a corporation's business. The same principle may be applied to anticipated losses from a predictable downturn for an existing C corporation. Since losses can be sustained only for a finite period, the decision to utilize the S corporation election during a loss period should take into account planning considerations for

18 Note that S Corporations with a prior C Corporation history may under certain circumstances pay a corporate tax, such as on built in gains which are recognized after a conversion to S Corp. status.

subsequent periods in which income is expected. Among the considerations is the fact that, once terminated, a new S election generally requires a five year waiting period.

(5) If an existing C corporation has net operating loss carryovers, a decision to make an S election should perhaps be deferred to enable the corporation to utilize the carryovers, since they cannot be used by the S corporation or its shareholders. This should certainly be weighed against the effect of a delay on the amount of potential built-in gain.

(6) S corporation election effectively reverses the reasonable compensation issue in the audit context. Instead of the IRS seeking to minimize compensation to stockholder employees by alleging compensation is unreasonably high so as to reduce deductible compensation and create net taxable income subject to corporate taxes, the IRS ends up arguing that compensation to shareholder employees is unreasonably low because shareholder employees are trying to avoid payroll taxes on their income by having it pass through as net income on their K-1's. The S Corporation election tends also to have a similar affect on thin capitalization or debt/equity issues which may be present in a C Corporation.

(7) A difference as to voting rights does not disqualify an S corporation. IRC §1361 (c)(4) provides that a corporation is not treated as having more than one class of stock solely because there are differences in voting rights among the shares of common stock. So there can be two classes of stock solely for voting purposes.

(8) So long as the holder does not have any proprietary interest, phantom stock does not constitute a second class of stock. See *Berkwitz v. Humphrey*, 163 F. Supp. 78 (ND Ohio, 1958); PLR's 8907032, 8838049, and 8834085, which held that phantom stock plans did not create a second class of stock since the employees did not have voting rights and their rights were not assignable.

(9) Fringe benefits which may be received tax free by an employee owner of an S corporation include:

a. Meals and lodging furnished on the business premises and for the convenience of the employer. IRC §119; *Armstrong v. Phinney,* 394 F.2d 661 (5th Cir. 1968). But see the cases and ruling cited above which hold otherwise. The IRS has not acquiesced in the Armstrong decision.

b. Benefits under educational assistance programs. IRC §127(c)(2).

c. Dependent care assistance. IRC §129(e)((3).

d. No additional cost services, qualified employee discounts, working condition fringes, on-premises athletic facilities, and de minimus fringes excluded from income under §132. Treas. Reg. §1.132-1(b)(1), (2)(ii), (3) & (4).

(10) Capital gains are passed through and reported on individual stockholders' tax returns where they will be eligible for capital gains tax breaks made available under the Taxpayer Relief Act of 1997.

(11) S Corporation is the only flow through form of entity available for banking businesses.

c. Non-Tax Disadvantages of S corporation

(1) Limitation on the number of shareholder's (under the 2004 Jobs Act limited to 100).

(2) Limitation of who may be a shareholder (only individuals, estates and certain trusts). Certain liberalized rules were adopted in the Small Business and Job Protection Act of 1996 to allow a Qualified S Subsidiary to have an S Corporation as a shareholder and to liberalize a few of the other rules on who may be a stockholder of an S Corporation. Nevertheless, there remain significant limitations here that may make the S Corporation unavailable for many clients. This often spills over into banking relationships where pledge of the stock is required for a loan. If bank executes on pledge and takes stock, S corporation status will be terminated.

(3) Potential adverse implications to outside shareholder's who must report and pay taxes on their share of corporation's income, but who may have no assurance that funds will be distributed by the corporation with which to pay the taxes. Beware of potential problems for shareholder's of the S Corporation in Chapter 11 Bankruptcy. Net operating losses will have been passed through to stockholders and used to offset other income. Therefore, unlike the C Corporation which will often have NOL carryovers to shelter profits needed to bring the company out of the reorganization process, the S Corporation will have none, and if the shareholder's have used their NOL's against other income, they may have to pay income taxes on those profits without the benefit of distributions from the corporation to pay the taxes.

(4) Record-keeping and accounting functions tend to be slightly more complex than the C corporation.

d. Tax Disadvantages of S corporation

(1) S corporation status limited to corporations:

(i) with no more than 100 shareholders;

(ii) which do not have as a shareholder a person (other than an estate and certain trusts) who is not an individual (unless the S Corporation is a qualified Subchapter S subsidiary, a "QSub");

(iii) which do not have a nonresident alien as a shareholder;

(iv) which have no more than one class of stock.

Prior to January 1, 1997 the limit on the number of shareholders was 35. In 1997 it was increased to 75. Now, the 2004 Jobs Act has liberalized the rules even further. It increases the number of shareholders an S corporation may have to 100. <u>In addition, the 2004 Jobs Act provides that a family may elect for all family members to be treated as one shareholder</u>. This applies regardless of whether the family member holds the stock directly or is treated as a shareholder by reason of being a beneficiary of an electing small business trust or a qualified subchapter S trust. Family members include the common ancestor, lineal descendants of the common ancestor, and the spouses (or former spouses) of the lineal descendants or common ancestors. An individual is not considered a common ancestor if, as of the later of the effective date of this rule or the time the S corporation election is made, the individual is more than six generations removed from the youngest generation of shareholders who would (but for this limitation) be family members. For this purpose, a spouse (or former spouse) is treated as being of the same generation as the individual to which such spouse is (or was) married. The election for all family members to be treated as one shareholder may be made by any family member and remains in effect until terminated as provided by the IRS in regulations to be promulgated. IRS has authority to waive an inadvertently invalid election for all family members to be treated as one shareholder. IRS was also given additional authority to waive inadvertantly invalid QSub elections or terminations of such elections. In order to receive relief, the QSub and its shareholder (the S corporation parent) must: within a reasonable period after discovering the circumstances causing the invalidity take steps so that the corporation qualifies as a QSub and agree to IRS prescribed adjustments consistent with the treatment of the corporation as a Qsub during the relevant period.

(2) The following corporations are ineligible to be S corporations:

(i) financial institutions as to which IRC §§585 or 593 apply and which use bad debts reserves (large banks that may not use bad debt reserves and small banks that use the specific charge off method of accounting for bad debts may elect S corporation status after the Small Business Job Protection Act of 1996, if they otherwise qualify for S status);

(ii) insurance companies;

(iii) corporations as to which election under IRC §936 (Puerto Rico and possession tax credit) is in effect;

(iv) a DISC or former DISC (Domestic International Sales Corporation).

(3) Possibility of inadvertent terminations of S corporation status. Shareholder buy/sell agreements and/or transfer restrictions in articles of incorporation are essential to protect against this. However, see IRC §1362(f)(1)(B) for rules authorizing the IRS to grant relief from certain inadvertent terminations.

(4) Shareholders must pay tax on corporate income, regardless of whether or not the corporation distributes funds to them with which to pay the tax. Shareholder agreements are essential here also.

(5) Basis Limitations. While the S corporation and partnership share the restriction that investors may not deduct losses in excess of the basis of their ownership interests, an S corporation shareholder receives no basis on account of corporate-level indebtedness - even if the shareholders guarantee the debt. ***Uri V. Commissioner***, 91-2,USTC ¶50,556 (10TH Cir. 1991) The portion of operating losses financed by shareholder guaranteed debt may be carried over until such time as the shareholder's basis is increased, e.g., as a result of future operating income, additional capital contribution or loan by the shareholder, or a lender's call on the guaranty. In order to provide basis to the shareholder, the shareholder must borrow the funds and, in turn, loan them to the S corporation.

(6) S corporation may not make special allocations of income, loss, gain, deduction and credits like the partnership can. Single class of stock limitation limits S corporation to allocation of income and loss on a strict per share basis. Special allocations may, to some degree, be accomplished through multiple entities such as combinations of partnerships with S corporations.

(7) S corporation must recognize gain on the distribution of appreciated assets. By contrast, gain or loss is not generally recognized by a partnership when it distributes property to its partners. Except for built-in gain from a prior period of operations as a C corporation, the gain to the S corporation is passed through to the shareholders and added to the basis of their stock. Built-in gain from prior C corporation years is recognized on a distribution is taxed at the corporation level within ten years after a conversion from C to S.

(8) An S corporation may face difficulty in liquidating a target corporation with acquisitions in taxable stock acquisitions. See PLR 8818049.

(9) An S corporation will be deemed to have more than one class of stock if all the outstanding shares do not confer identical rights to distributions and liquidation proceeds. Reg. §1.1361-1(1).

(10) An S corporation's election is terminated if more than 25% of its gross receipts are passive investment income for more than three years and has subchapter C earnings and profits, and there is also a corporate level tax on the excess passive investment income in such cases.

(11) Prior to January 1, 1997, S corporation could not be a member of an affiliated group of corporations, i. e. it could not own 80% or more of the stock of another corporation. This was repealed by the Small Business Job Protection Act of 1996. Prior to this repeal, an S corporation could achieve some of the same benefits of consolidation through ownership of limited partnership interests (e.g. with its s/h's), this approach had several limiting factors: (i) no participation in management; (ii) a portion of the income or loss is diverted to the other partners; (iii) this structure places some limitations on the transfer of funds between businesses. However, S corporation could use an LLC more effectively to achieve such objectives.

I. REAL ESTATE INVESTMENT TRUSTS ("REIT'S")

a. Although beyond the scope of a general seminar on business entities, a general understanding of the REIT should be acquired if only to know that it is out there should the client have a need for it.

b. The REIT is a fiction of the tax law. For state law purposes, a REIT may be organized as a corporation or an unincorporated trust or association. Taxation of the REIT's is covered by sections 856-860 of the IRC. The statute applies conduit principles to the extent REIT income is distributed to the beneficial owners on a current basis. Such income is taxable to the distributees, rather than to the REIT, and its character as capital gain or ordinary income is preserved in the hands of the distributee. Entity concepts control if the REIT generates a net operating loss or if REIT income is not distributed in full, net operating losses are not passed through to the owners and undistributed income is taxed to the REIT rather than to its owners. The REIT was created by congress to encourage widespread ownership of passive real estate investments by small investors.

c. The REIT must be a corporation or association that but for the REIT provisions of the Code, would be taxed as a corporation for federal tax purposes. It must be managed by trustees or directors, and its beneficial interests must be represented by transferrable shares or certificates of beneficial ownership. After its first taxable year, it must have at least 100 beneficial owners, and no five individuals' ownership may total more than 50% of the value of the REIT's beneficial interests. At least 95% of the gross income of the REIT must be derived from dividends, interest, rents on real property, gains from sale or other disposition of stock, securities, interests in real property, and interests in mortgages on real estate among a few others. At least 75% of the REIT's assets must be real property, mortgages on real property, interests in other REIT's, cash and cash items, and government securities. During each taxable year, a REIT must distribute no less than 95% of certain types of income.

J. REAL ESTATE MORTGAGE INVESTMENT COMPANIES ("REMIC'S")

a. REMIC's are governed by sections 860A-860G of the Code. They are intended to hold fixed pools of mortgages secured by interests in real property and to issue multiple classes of interests therein. A REMIC is not a taxable entity for federal income tax purposes, and the income of a REMIC is taken into account by the owners of the REMIC.

The IRC defines a REMIC as any entity which meets the requirements set out in the code. Therefore, a REMIC may, for state law purposes be a corporation, partnership, trust, an LLC or simply a segregated pool of assets that is not a separate entity.