



A Comparison of Entity Taxation

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Sole Proprietorships

Single Owner



Advantages

- Easy to form - limited filings, elections, and registrations
- Simple to operate – owner manages business and has no one to report to
- Easy to sell the assets of the business
- Few administrative burdens
- Income is reported by owner and taxed at personal rates



Disadvantages

- May have limited sources of capital
- **No limited liability**
- No structured continuity beyond the proprietor
- All business net income subject to self-employment tax



Tax Advantages

- Wages paid to children
 - Children under 18 are exempt from FICA
 - Children under 21 are exempt from FUTA
 - Child does not owe the employee portion of FICA
 - Allows the proprietor to reduce business income for both income tax and self-employment tax with no FICA or FUTA tax that apply to other employees
 - Since child's income is earned it can be sheltered by standard deduction (\$5,700 in 2010)
 - Child could fund an IRA or Roth IRA



Example

- Sean, a proprietor, employs his 15 year old son Evan to perform odd jobs after school for his junk collecting business. Sean pays Evan \$7 per hour. Evan earns about \$4,000 during the year based on these wages – about what other people are paying for this type of work.



Example (cont.)

- The \$4,000 is not subject to FICA or FUTA tax, since Evan is under 18. Assuming he has no other income Evan would also be exempt from income tax since earnings are less than \$5,700.
- Sean's deduction for wages on Sched C has reduced income tax and self-employment tax without owing any FICA or FUTA tax liability.
- The wages earned by Evan can be used to fund an IRA or Roth IRA.



Tax Advantages (cont.)

- Tax-advantaged accident and health benefits to owner, spouse, and dependents
 - Set up accident and health plan that covers employee, employee's spouse (owner), and employee's dependents (owner's children).
 - IRS concedes that the cost of the plan can be deducted, while the spouse (the owner's spouse) can exclude the benefit from taxable income (Rev. Rul. 71-588; Ltr. Rul. 9409006)
 - Possibility of deducting medical plan on Sched C thus reducing self-employment tax (versus normal self-employment deduction)
 - Could also provide for a medical reimbursement plan (out of pocket medical expenses not subject to 7.5% floor)



Example

- Richard is a proprietor of a heat and air service business. His wife Kristi works about 35 hours a week as his bookkeeper for pay commensurate with the same position in another firm. Richard has established medical insurance and reimbursement plans for all of his employees. Richard pays 100% of the family medical insurance premiums for full-time employees (35/hrs wk). Richard will also reimburse up to \$2,500 of out-of-pocket medical expenses for each full time employee.



Example (cont.)

- Richard is allowed to fully deduct his medical insurance premiums and up to \$2,500 of out-of-pocket expenses on his Schedule C. Otherwise, Richard would be deducting medical insurance as an above the line deduction on page 1 and out-of-pocket medical expense on Sched A once they reached 7.5% of his family AGI.



Tax Advantages (cont.)

- Proprietorships are not faced with gain recognition that occurs at the entity level when a corporation (C or S) distributes appreciated assets to its owners.



Tennessee Taxation

- Sole proprietors are not subject to TN Franchise and Excise (FAE) Tax



Partnerships & Limited Liability Companies

General Partnerships (GP)

Limited Partnerships (LP)

Limited Liability Companies (LLC)

Single-member Limited Liability Companies (SMLLC)

Characteristics



- Partnerships

- More than one partner
- Optional partnership agreement
- Can be minimal cost to set up

- LLCs

- One or more members
- Articles of organization or operational agreement
- May cost several thousand dollars to set up
- Can elect to be taxed as a corporation



Characteristics (cont.)

- Governed by agreements and votes
- Capitalization by multi-owner assets & loans
- Transferability of ownership as provided by agreements
- Transfer of ownership can cause a technical termination
- Generally must be calendar year entities



Agreements

- Names & addresses
- Entity Name
- Definitions
- Purpose & objectives of entity
- Term of operation
- Continuity of Entity
- Date operations commence
- Partner/member meeting procedures
- Partner/member interests in assets, debt and revenues



Agreements (cont.)

- Nature of contributed capital
- Liability of partners
- Designation of managing partner or management committee
- Designation of tax matters partner
- Entitlements and Benefits
- Restrictions on draws and maintaining working capital
- Loans to the entity and interest paid thereon



Liability

- GP
 - Unlimited
 - Insurance should be obtained to protect the owners assets
- LP & LLC
 - Limited
 - Limited partners can lose limited liability if they are active in the LP.



Federal Taxation

- SMLLCs (owned by an individual) report on form 1040, Schedule C
- GP/LP/LLC report on form 1065
- Income/losses reported on form 1065 flows thru to the partner/member via Schedule K-1
- Separately stated items flow thru via K-1
 - Interest & dividend income
 - Guaranteed Payments
 - ST and LT capital gains/losses
 - Section 179 expense



Federal Taxation (cont.)

- Not subject to AMT at the federal level, but AMT must be reported to the partners/members



Tax Advantages

- Step-up in basis allowed
- Moving assets in and out of the entity is usually tax free, and can be simple
- Special allocation of income/losses allowed
- No double taxation of income at the federal level
- No personal holding company tax
- No accumulated earnings tax
- No unreasonable compensation issues



Tax Disadvantages

- Income may be subject to SE tax
- Section 179 limitations apply at both the federal level and at the partner/member level
- Owner fringe benefits are usually not deductible
 - Can be subject to SE tax



Basis

- Increases
 - Contributions of cash
 - Contributions of property (adjusted basis)
 - Increase in debt
 - Distributive share of profits
- Decreases
 - Distributions of cash
 - Distributions of property
 - Decrease in debt
 - Distributive share of losses



Basis (cont.)

- Distributive share generally corresponds to ownership percentage
- May have a difference between inside and outside basis
- Recourse debt affects basis to the extent that the economic loss will fall to the partner/member
- Limited partners are generally not allocated basis for recourse debt, but can be in certain circumstances.
 - Even if guaranteed, they may be able to pursue reimbursement from the GP



Basis Adjustments

- §743(b)
 - Transferee partner/member obtains ownership by sale, exchange or death
 - Must make irrevocable §754 election to take advantage
 - Transferee partner/member benefits
 - Adjust entity property where the appreciation has occurred (i.e. land, fixed assets, inventory, etc.)
- §734(b)
 - Distribution of property to partner/member
 - Must make irrevocable §754 election to take advantage
 - Remaining partners/members benefit
 - Adjust property that is similar in nature to the property distributed (i.e. 1231, capital, land, etc)



§754 Example

M & E Landscaping, LP

Assets

Cash	\$50K
Land	\$10K

Liabilities & Capital

Capital-Marcie	\$30K
Capital-Eric	\$30K

* FMV of land is \$50K

- Marcie sells ownership to Jenny for \$50K.
- Marcie recognizes gain of \$20K (\$50K-30K)
- Jenny has outside basis of \$50K, but inside basis of land and cash is still \$30K (1/2 of total)
- Step-up increases capital to \$50K and creates another “land” asset of \$20K specifically allocable to Jenny.





Passive Activities

- Passive if no material participation
 - IRS has 7 rules to determine material participation
 - Grouping of activities can avoid passive treatment
 - Rev. Proc. 2010-13
- Rental is always passive unless operated as a real estate professional
- Passive losses can only be offset by passive income
- Passive losses are released upon the sale of an entire activity
 - Be careful of grouping



Tennessee Taxation

- Franchise & Excise Tax (FAE)
 - GPs are not subject
 - LP/LLC/SMLLC are generally subject
 - FONCE election tightened
 - Rents included as passive income only include residential and farm (no commercial or industrial)
 - 2% “reasonable rents” limitation
 - LP/LLC/SMLLC can elect to be an exempt obligated member entity and not be subject
 - Election must be made prior to the 1st day of the taxable year for which the election is made



Tennessee Taxation (cont.)

- Taxable income is reduced by amount of income subject to SE Tax
- TN Hall Income Tax
 - GP, LP, LLC, SMLLC are all subject
 - Interest, capital gain distributions & dividends
 - Credit on FAE for Hall tax paid



S Corporations



Requirements

- Domestic Corporation
- No more than 100 shareholders
- Shareholders must be:
 - Individuals who are U.S. citizens or residents
 - Estates
 - Certain types of trusts
 - Certain tax-exempt organizations
- Has only one class of stock



Requirements (cont.)

- Not an ineligible corporation by definition
 - Financial institutions using a bad debt method under IRC Sec. 585
 - Insurance companies, other than certain casualty insurance companies
 - Domestic international sale corporations (DISCs)
 - Certain corporations using the tax possession credit under IRC Sec. 936
 - Entities classified as a taxable mortgage pool



Nontax Considerations

- Limited Liability
 - In most cases liability is limited to corporate assets
- Administrative Burden
 - Preparing and filing articles of incorporation
 - Adopting bylaws and related agreements among shareholders (buy/sell document)
 - Holding an organizational meeting, and documenting transfers of assets to the corporation in exchange for stock issuance
 - Naming a board of directors
 - Holding annual stockholder meetings
 - Maintaining minutes of the board of directors' meetings



Nontax Considerations (cont.)

- Management and Control
 - Multiple owners provide a greater pool of management resources for the business
 - Stockholder disputes become more difficult to deal with
- Continuity of Existence and Transferability of Ownership
 - Corporations have an indefinite life – death, bankruptcy, or retirement of one or more shareholders does not dissolve
 - Transfer of ownership is generally easier though in the case of a closely held corporation the market might be small and some would prefer to limit transferability



Tax Advantages

- No Double Taxation
 - Probably the most significant tax advantage
 - S Corporations that were formerly C Corporations may be subject to built-in gains tax - intended to mirror the double tax of C Corps
- Pass-thru to Shareholders
 - Long term capital gains passed through are at individual rates versus ordinary corporate rates in a C Corporation. Losses can be taken in an S Corp instead of being trapped in a C Corp
- No Personal Holding Company or Accumulated Earnings Tax
- No Excess Compensation Issues



Tax Advantages (cont.)

- Ability to Reduce Payroll Taxes
 - However, in Tennessee this advantage is mitigated by the Hall Income Tax on distributions (discussed later)
- Ability to Use the Cash Method In Many Cases
 - Allows for year end planning of expenses to reduce income
 - In general, service businesses, for which the production, purchase, or sale of merchandise is not an income producing factor, are permitted to use the cash method
- No Corporate AMT
- No Personal Service Corporation Rules
- Deductibility of Shareholder Interest Expense on Purchase of Stock
 - Potentially fully deductible as trade or business interest vs. C Corp interest which would be treated as investment only and deductible only to the extent of investment income



Tax Advantages (cont.)

- Tax-free Withdrawals of Equity
 - Basis is increased each year by any income from business
- Possible Ordinary Loss Treatment for Stock Losses on IRC Section 1244 stock
- Capital Gain Rates on Stock Disposition
 - Unlike a proprietor or partner who disposes of an interest in a business sale of stock will always be capital in nature (instead of allocating some ordinary income to receivables, inventory or Section 1245 dep recapture)



Tax Disadvantages

- Fringe Benefits
 - Any shareholder owning 2% of stock lacks access to fringe benefits - attribution to non-shareholder employees who own no stock
- Tax Year-end
 - Generally required to be calendar year end unless a business purpose exists and 25% of gross income received within the final two months of the year for the prior three consecutive years
 - Willing to choose a Sept, Oct or Nov tax year and make deposits based on deferral gain calculation at highest individual rate + 1% due each May
- Built-in Gains Tax on former C Corps
 - Taxed on certain property at highest corporate tax rate if sold within 10 years after C to S conversion (changed to 7 years for '09 & '10)
- Excess Net Passive Income Tax



Tax Disadvantages (cont.)

- **Pass-through Losses Limited to Shareholder Stock and Debt Basis**
 - Limits amount of corporate loss that can be deducted by each shareholder
 - Determines the gain or loss upon disposition of the stock or repayment of debt
 - Governs the amount of distribution that can be received tax free from an S Corp
 - Shareholders only receive basis in debt if they acquire debt and contribute to S Corp – not if obtained directly by S Corp
- **Basis Is Reduced Even if No Tax Benefit**
 - Basis must be reduced by all items of loss and deduction regardless of whether amounts can be deducted on shareholder's current return



Tax Disadvantages (cont.)

- Distributions Do Not Reduce Debt Basis
 - Distributions in excess of stock basis would be capital gain unless considered repayment of loan from shareholder
- Computing Debt Basis with Multiple Loans
 - Complex set of rules regarding allocation
- No Tax-free Liquidation
 - Any distribution of property in liquidation treated as though it had been sold at FMV with gains passing through to shareholders



Tennessee Taxation

- Subject to Tennessee FAE Tax
- Distributions from TN S Corps are subject to the Hall Income Tax at a rate of 6%
 - Less incentive than some other states to make distributions as opposed to paying wages to shareholders



C Corporation



Nontax Considerations

- Limited Liability
 - In most cases liability is limited to corporate assets
- Administrative Burden
 - Preparing and filing articles of incorporation
 - Adopting bylaws and related agreements among shareholders (buy/sell document)
 - Holding an organizational meeting, and documenting transfers of assets to the corporation in exchange for stock issuance
 - Naming a board of directors
 - Holding annual stockholder meetings
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Nontax Considerations (cont.)

- Management and Control
 - Multiple owners provide a greater pool of management resources for the business
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Tax Advantages

- Tax Rates
 - In certain lower income ranges in a company that doesn't pay dividends tax burden will be lower than a flow through situation or proprietor where income will be taxed at individual rates
- Self-employment Tax Savings
- Fringe Benefits for Employee-owners
 - Accident and health plans including long-term care insurance
 - Group-term life insurance
 - Dependant care assistance
 - Disability Insurance
 - Educational assistance programs
 - Qualified transportation benefits
 - Cafeteria plans



Tax Advantages (cont.)

- Flexibility to Select a Fiscal Year-end
- Treatment of Passive Losses
 - C Corps other than Personal Service Corporations (PSCs) can deduct passive losses in full
- Dividends Received Deduction
 - Qualified dividends received from domestic corporations are partially deductible by C Corps
 - Deduction is normally 70% but increases to 80% if the investor owns more than 20% of the stock in the distributing corporation and to 100% if paid to a member of the same affiliated group



Tax Advantages (cont.)

- Section 1244 Ordinary Stock Loss
 - Eligible for ordinary loss if aggregate basis of cash and property received by the corporation for its stock and as paid in capital does not exceed \$1 million
 - Maximum of \$100,000 on joint returns and 50,000 for others



Tax Disadvantages

- Double Taxation of Corporate Earnings
 - Taxed in the corporation and as a dividend to the shareholder
 - Current reduced rates on dividends are helpful but no guarantees moving forward
 - Shareholder basis in C Corp does not increase with earnings or payment of dividends
 - C Corp losses do not flow through to shareholders nor do they affect stock basis



Tax Disadvantages (cont.)

- Losses Stuck Inside C Corp
 - Any losses must either be carried back to offset prior year income or carried forward to future years (by election) to offset what will hopefully be future gains
- Double Taxation of Inside Gains
 - Distributions of appreciated property to shareholders in a liquidation – corporation treated as though it sold property at FMV – gain or loss recognized at corporate level



Tennessee Taxation

- All C Corps are subject Franchise & Excise Tax (FAE)

Questions?



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