



**GRAY REED**  

---

**GRAY REED & MCGRAW, P.C.**

**CHOICE OF ENTITY:  
*TAX, LIABILITY AND FUNCTION*  
*DRIVERS FOR ENTITY SELECTION***

Austin C. Carlson, JD, CPA

BUSI 462, Rice University, Jones School of Business  
October 27, 2016

# Objectives

---

1. Understand how state **choice of entity** interacts with federal **tax status** and the voluntary and involuntary ways to change tax status.
2. Understand the main drivers for choice of entity:
  - Tax;
  - Liability; and
  - Entity Functionality.



GRAY REED  

---

GRAY REED & MCGRAW, P.C.

# OBJECTIVE ONE

Understand how state choice of entity interacts with federal tax status and the voluntary and involuntary ways to change tax status.

# Texas Legal Entity Choices

---

## 1. Corporations

- a) For-Profit
- b) Non-Profit
- c) Professional

## 2. Partnerships

- a) General Partnership (GP)
  - i. LLP Registration (LLP)
- b) Limited Partnership (LP)
  - i. LLP Registration (LLLP)

## 3. Limited Liability Companies

- a) LLC
- b) PLLC

## 4. Associations

- a) Cooperative
- b) Professional

# Federal Taxation Types (Federal Tax Form)

---

- Corporation

- C Corporation (1120)
- S Corporation (1120S)

- REIT (1120-REIT)
- Tax Exempt (990)

- Partnership

- General (1065)
- Limited (1065)

- MLP (1065)

- Sole Proprietorship (Schedule C)

# Federal Tax Treatment of Domestic Entities

---

## Default Treatment

- a) Corporations and “Associations” = C Corporation
- b) Partnerships = Partnership (*unless partners are disregarded*)
- c) LLCs
  - i. One Member = Disregarded entity (sole proprietorship)
  - ii. Two or More Members = Partnership

Note – Rules for state tax and foreign entities are different

# Federal Tax Treatment of Domestic Entities (Continued)

---

- Check The Box Flexibility (Form 8832):  
ONLY Associations, Partnerships, and LLCs
  - a) Can only elect once every 5 years
  - b) Foreign rules are different
  - c) Corporations cannot check the box
  
- Corporations: S Corporation Elections (Form 2553)

# Taxation Type Example: LLC

---

## Single Member Texas LLC

- a) Default Tax Status: Disregarded entity
- b) Election Options: C or S Corporation
- c) Admission of Member: Keeps default taxation, but next year gets a second member. Taxation type?
  - i. Must file as a partnership.
  - ii. Partial year as disregarded entity, partial year as partnership.  
Deemed Transaction – Rev. Rul. 99-5
- d) Effect of two member LLC losing one during year  
*See Rev. Rul. 99-6*





**GRAY REED**  

---

**GRAY REED & MCGRAW, P.C.**

# OBJECTIVE TWO

Understand the main drivers for entity selection:

- Tax;
- Liability; and
- Entity Functionality

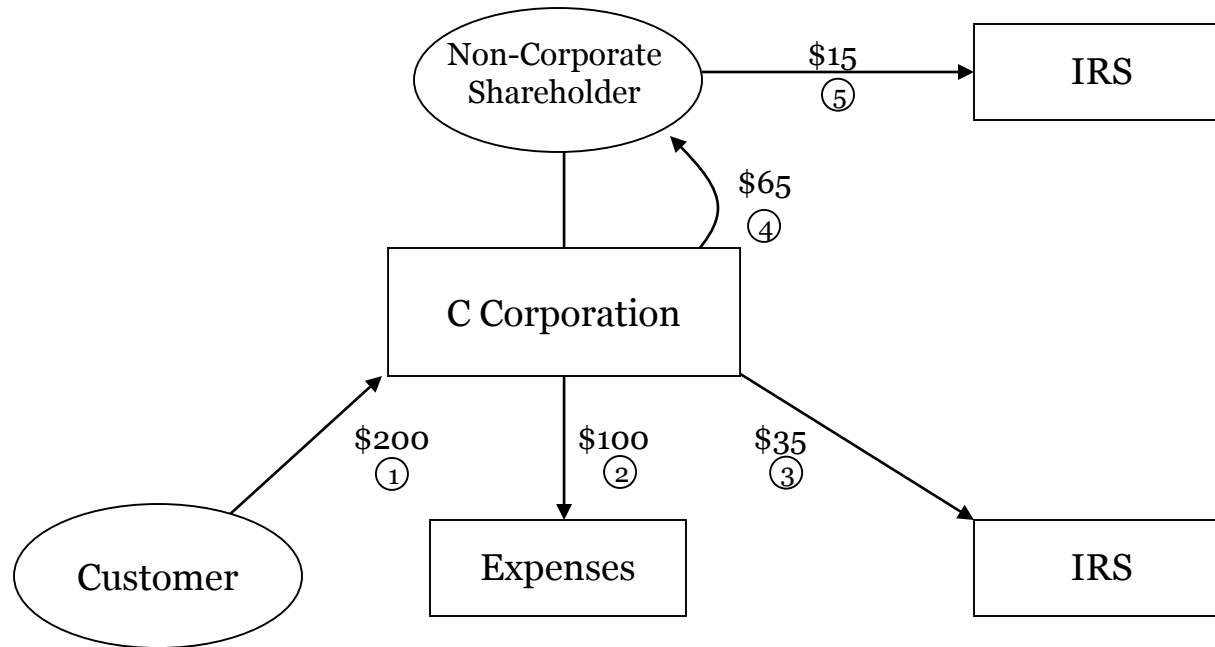
# Common Tax Drivers

---

1. Federal Taxation: Double Taxation (Entity and Owner) v. Single Taxation (Owner Only)
2. State Taxation of Entity
3. Taxation of In Kind Distributions
4. Tax-Free Merger

**To be discussed in another presentation** – international tax issues often end up being more important than most other drivers.

# Double Tax Example: Ordinary Income

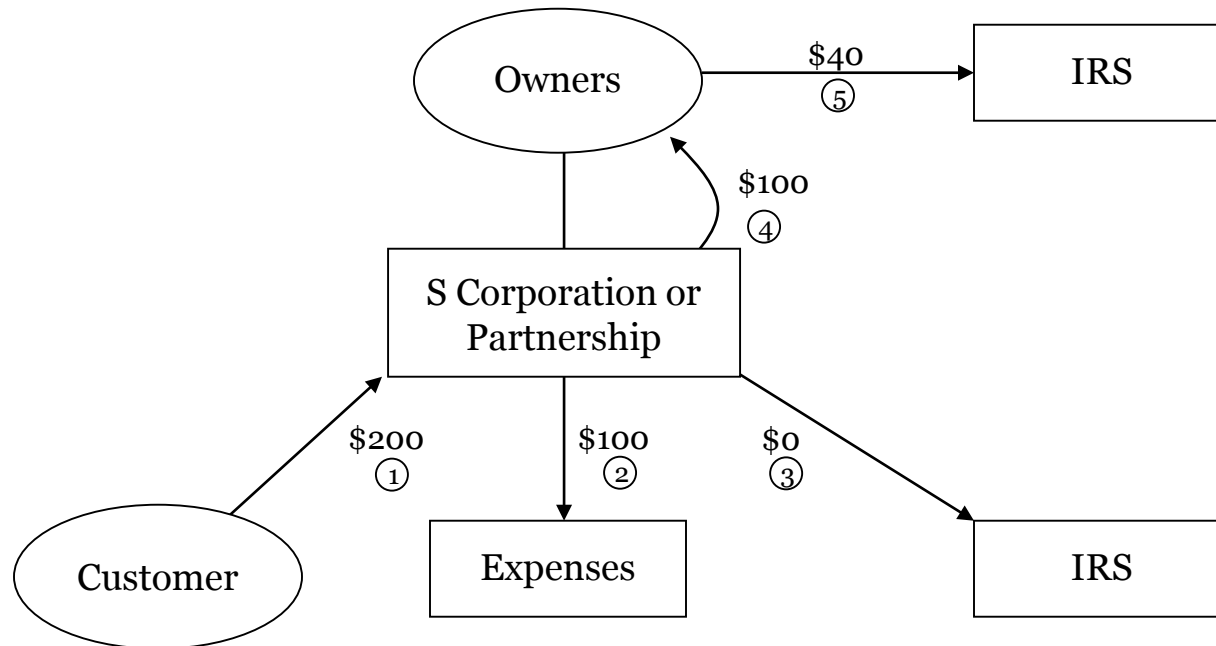


|                                |            |
|--------------------------------|------------|
| Revenue                        | 200        |
| Expenses                       | -100       |
| Net Income                     | 100        |
| Less: 35% Corporate Tax        | -35        |
| After-Tax (Corporate)          | 65         |
| Less: 23.8% Dividend Tax       | -15        |
| To Shareholder After All Taxes | 50         |
| <b>Aggregate Tax Rate</b>      | <b>50%</b> |

If the \$65 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

# Single Tax Example: Ordinary Income

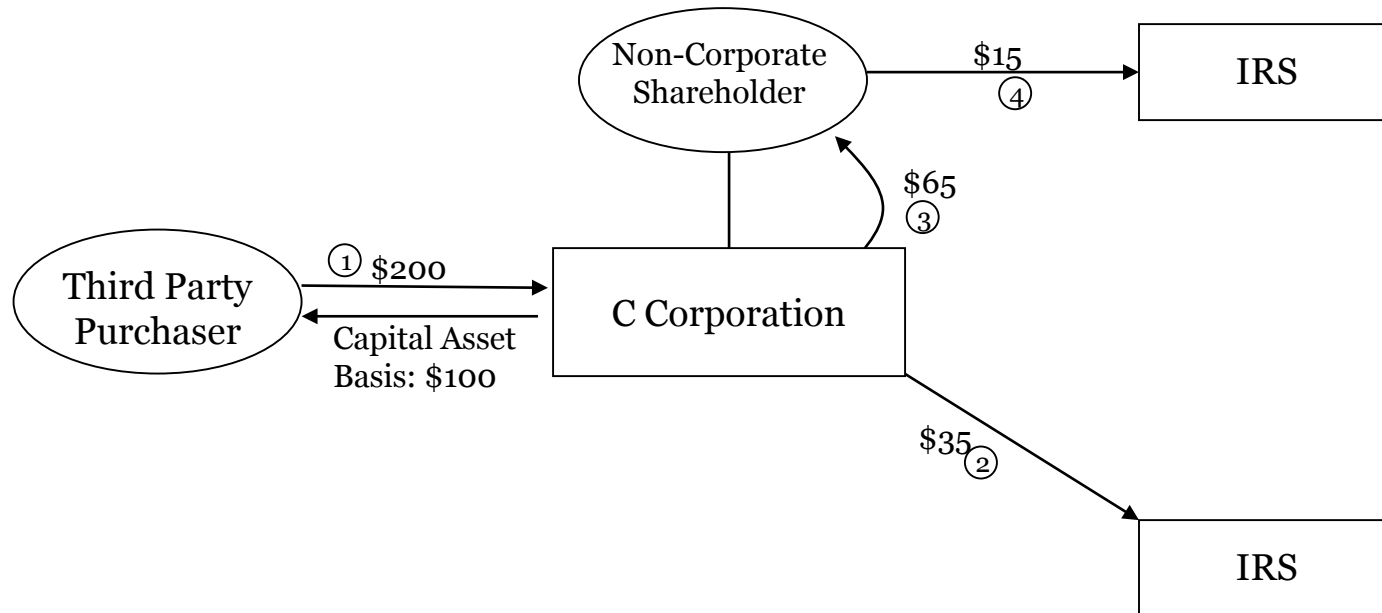


|                           |             |
|---------------------------|-------------|
| Revenue                   | 200         |
| Expenses                  | <u>-100</u> |
| Net Income                | 100         |
| Less: Corporate Tax       | <u>-0</u>   |
| After-Tax (Corporate)     | 100         |
| Less: 40% Shareholder Tax | <u>-40</u>  |
| Retained Earnings         | 60          |

Pass through entity distributes \$100 to Owners Taxes; Owners pay \$40 in tax at ordinary income rates, retains \$60.

**Aggregate Tax Rate 40%**

# Double Tax Example: Capital Gain



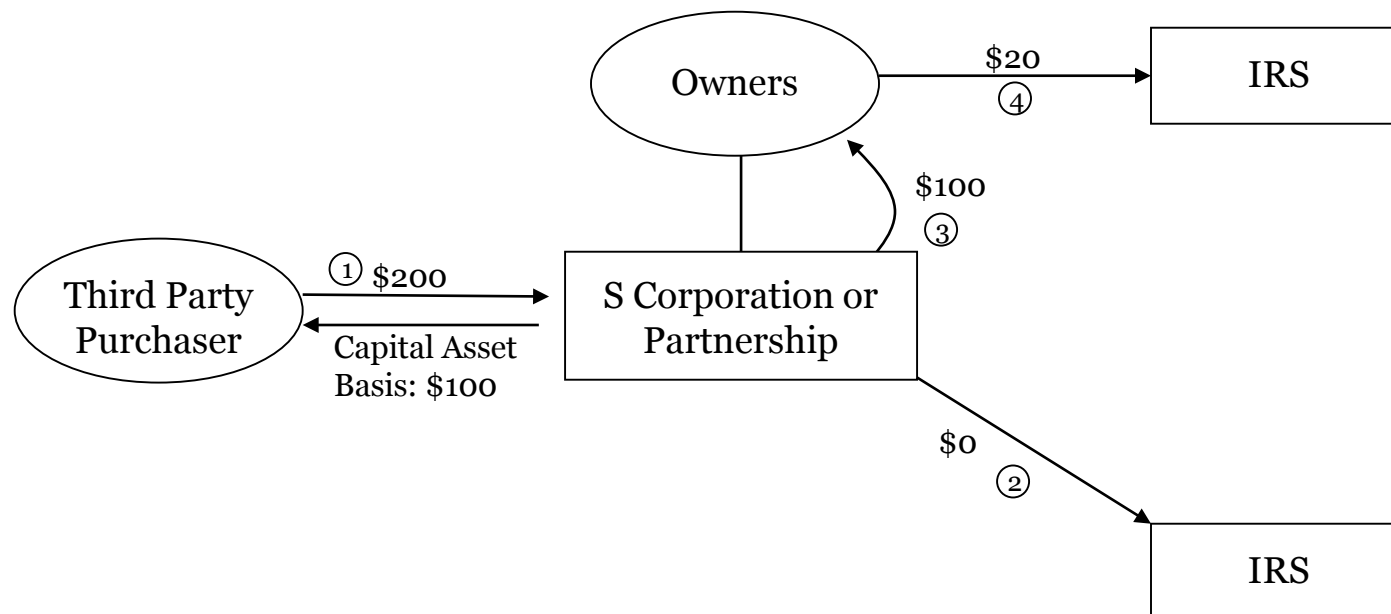
|                                |      |
|--------------------------------|------|
| Revenue                        | 200  |
| Basis in Capital Asset         | -100 |
| Net Income                     | 100  |
| Less: 35% Corporate Tax        | -35  |
| After-Tax (Corporate)          | 65   |
| Less: 23.8% Dividend Tax       | -15  |
| To Shareholder After All Taxes | 50   |

**Aggregate Tax Rate 50%**

If the \$65 of after-tax earnings are retained in the C Corporation, Shareholder's Tax Basis in the Shares does not increase.

Assuming top capital gains rate of 20% and application of 3.8% Net Investment Tax.

# Single Tax Example: Capital Gain



|                           |             |
|---------------------------|-------------|
| Revenue                   | 200         |
| Basis in Capital Asset    | <u>-100</u> |
| Net Income                | 100         |
| Less: Corporate Tax       | <u>-0</u>   |
| After-Tax (Corporate)     | 100         |
| Less: 20% Shareholder Tax | <u>-20</u>  |
| Retained Earnings         | 80          |
| <b>Aggregate Tax Rate</b> | <b>20%</b>  |

Pass through entity distributes \$100 to Owners Taxes; Owners pay \$20 in capital gain tax, retain \$80.

Assumes active participation by owners to avoid application of 3.8% Net Investment Tax.

# Tax Driver Comparison By Tax Status

## Federal Tax Status

| <u>Taxation Attribute</u>           | C Corp           | S Corp                  | Partnership | Sole Proprietorship                          | Tax Exempt                     |
|-------------------------------------|------------------|-------------------------|-------------|--|--------------------------------|
| <b>Levels of Taxation</b>           | Entity AND Owner | Owner; Sometimes Entity | Owner ONLY  | Owner ONLY                                   | Sometimes Entity               |
| <b>In-Kind Distributions Taxed</b>  | Yes              | Yes                     | No          | No   | N/A - Distributions prohibited |
| <b>Eligible for Tax-Free Merger</b> | Yes              | Yes                     | Yes         | N/A - Sole proprietor is tax owner of assets | Yes                            |

## State Entity

| <u>Taxation Attribute</u>             | Corporation | LLC | Partnerships   | Sole Propr. (No Entity) | Non-Profit Corp.                               |
|---------------------------------------|-------------|-----|--|-------------------------|--|
| <b>Subject to Texas Franchise Tax</b> | Yes         | Yes | Yes, unless liability is not limited or meets passive entity exception | No                      | No (if also tax exempt for state tax purposes) |

# Liability Drivers

---

1. Limited liability for owners. What's at stake?
2. General partnership (unless LLP registration)
3. Limited Partnership (unless LLLP registration)
4. All other entities



# Common Function Drivers

---

1. Entity Formalities Required (State Law Issue)
  - a) State formation certificate filing.
  - b) Written agreement required.
  - c) Corporate minutes.
2. Management of Entity (State Law Issue)
3. Ownership Restrictions (State Law and Tax Issue)
  - a) Professional licenses (State Law Issue)
  - b) Number of shareholders (Tax Issue)
  - c) Foreign ownership (Tax Issue)
4. Allocation of Income Restrictions (Tax Issue)
  - a) Different classes of stock
  - b) Disproportionate allocations
  - c) Profits Interests

# Common Function Driver Comparison By Entity

## *Table One: Corporate Formalities and Management*

| <i>Functional/Structural Attribute</i>                                      | <i>State Entity Type</i>   |   |   |  |   |
|---|--|---|---|--|---|
|   | <b>Corporation</b>   | <b>General Partnership</b>              | <b>Limited Partnership</b>              | <b>Limited Liability Company</b>                     | <b>Non Profit Corporation</b>   |
| <b>Formation Document must be Filed with State</b>                          | Yes  | No                                      | Yes                                     | Yes  | Yes   |
| <b>Written Organizational Agreement Required</b>                            | Yes  | No                                      | No                                      | No   | Yes   |
| <b>Corporate Formalities Required (Issued shares, minutes, resolutions)</b> | Yes  | No                                      | No                                      | No (unless required by agreement)                    | Yes   |
| <b>Governing Persons</b>  | Board of Directors; Shareholders; President & Secretary required, other Officers optional. | General Partner; Officers are optional. | General Partner; Officers are optional. | Managers (optional); Members; Officers are optional. | Directors; Members (optional); President & Secretary required, other Officers optional. |

# Common Function Driver Comparison By Entity

## *Table Two: Ownership Restrictions and Income Allocation*

| <u>Functional/Structural Attribute</u>               | <u>Federal Tax Status</u>     |             |                        |                     |                                   |
|--|-------------------------------|-------------|------------------------|---------------------|-----------------------------------|
|  | C Corp                        | S Corp      | Partnership            | Sole Proprietorship | Tax Exempt                        |
| <b>Number of Owners Allocated</b>                    | Unlimited                     | 100 or Less | Unlimited <sup>1</sup> | 1                   | N/A (in Texas may have "Members") |
| <b>Foreign Owner Allowed</b>                         | Yes                           | No          | Yes                    | Yes                 | Yes                               |
| <b>Different Classes of Stock Allowed</b>            | Yes                           | No          | N/A                    | N/A                 | N/A                               |
| <b>Disproportionate Distribution of Cash Allowed</b> | Yes (Through preferred stock) | No          | Yes                    | N/A                 | N/A - Distributions prohibited    |

<sup>1</sup>Note, however, that an established market for the purchase and sale of partnership interests may create a publicly traded partnership, which is subject to numerous special tax rules (like REITs).

# A Word of Caution on Entity Selection

---

- Business objectives should be the top priority.
- Long term flexibility and exit planning:
  - Distributions of property.
  - Adding additional owners.
  - Planning for ultimate sale of business.
- Topic for another presentation: many structures will require multiple entities.