



**GRAY REED**  

---

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

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

Austin C. Carlson

Gray Reed Transactional Section Meeting  
April 30, 2015

# 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

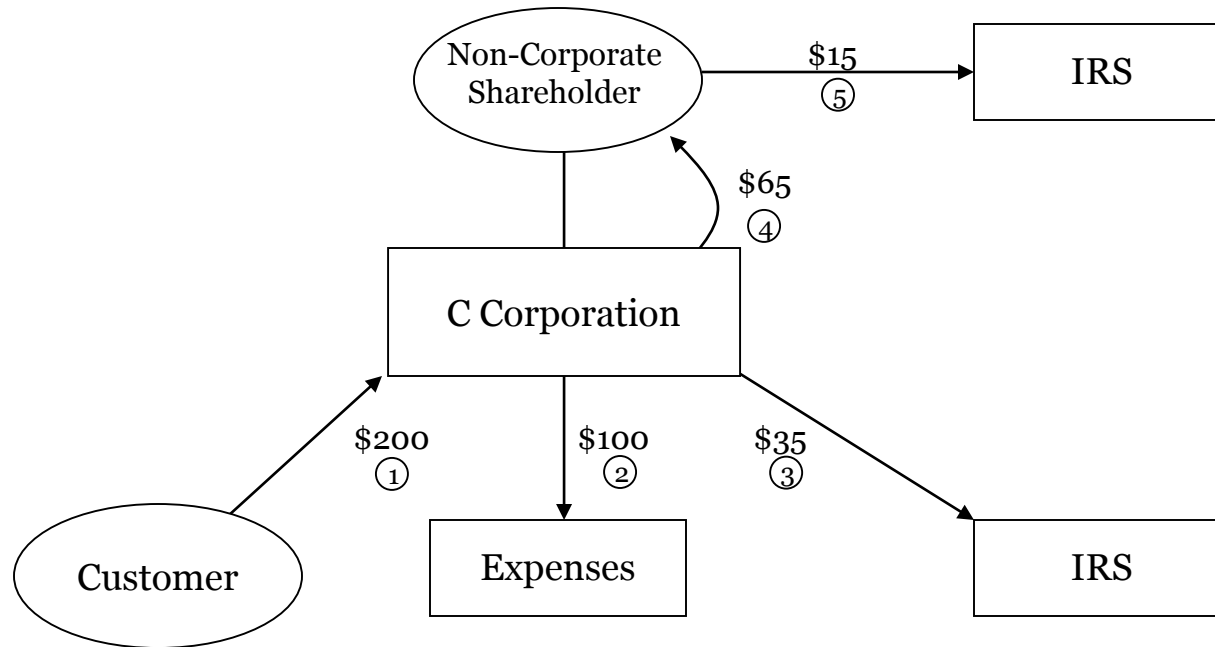
# Common Tax Drivers

---

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

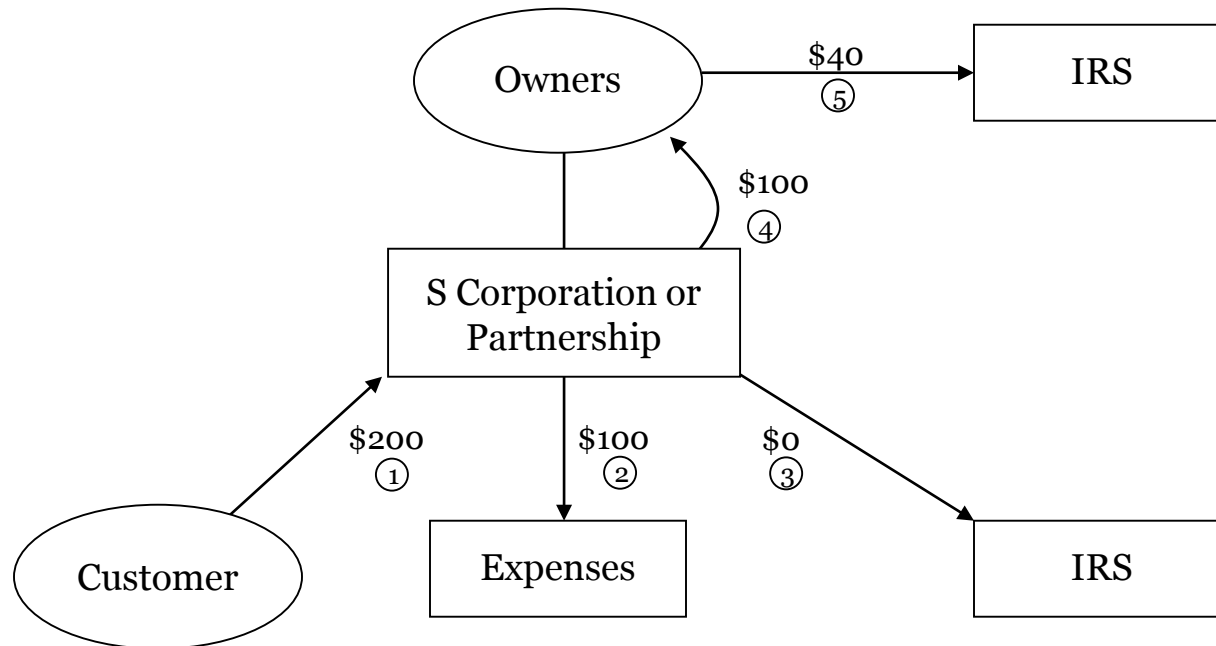


Revenue	200
Expenses	-100
Net Income	100
Less: 35% Corporate Tax	-35
After-Tax (Corporate)	65
Less: 23.8% Dividend Tax	-15
To Shareholder After All Taxes	50
<b>Aggregate Tax Rate</b>	<b>50%</b>

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

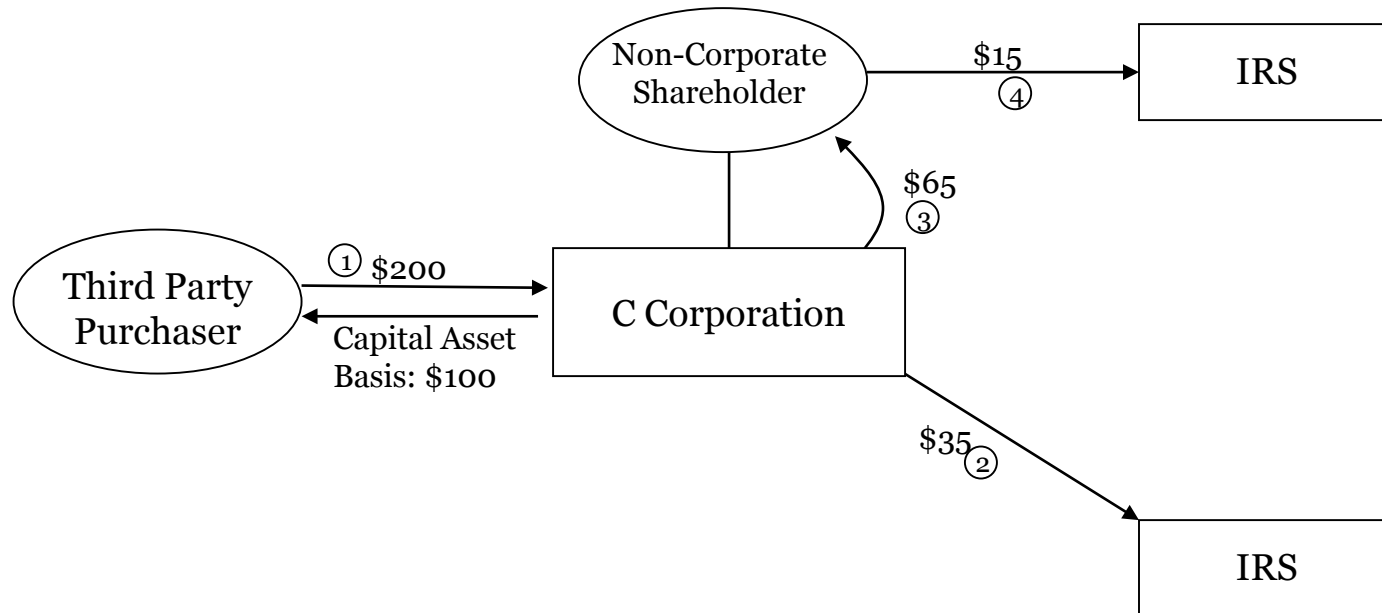


Revenue	200
Expenses	-100
Net Income	100
Less: Corporate Tax	-0
After-Tax (Corporate)	100
Less: 40% Shareholder Tax	-40
Retained Earnings	60

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



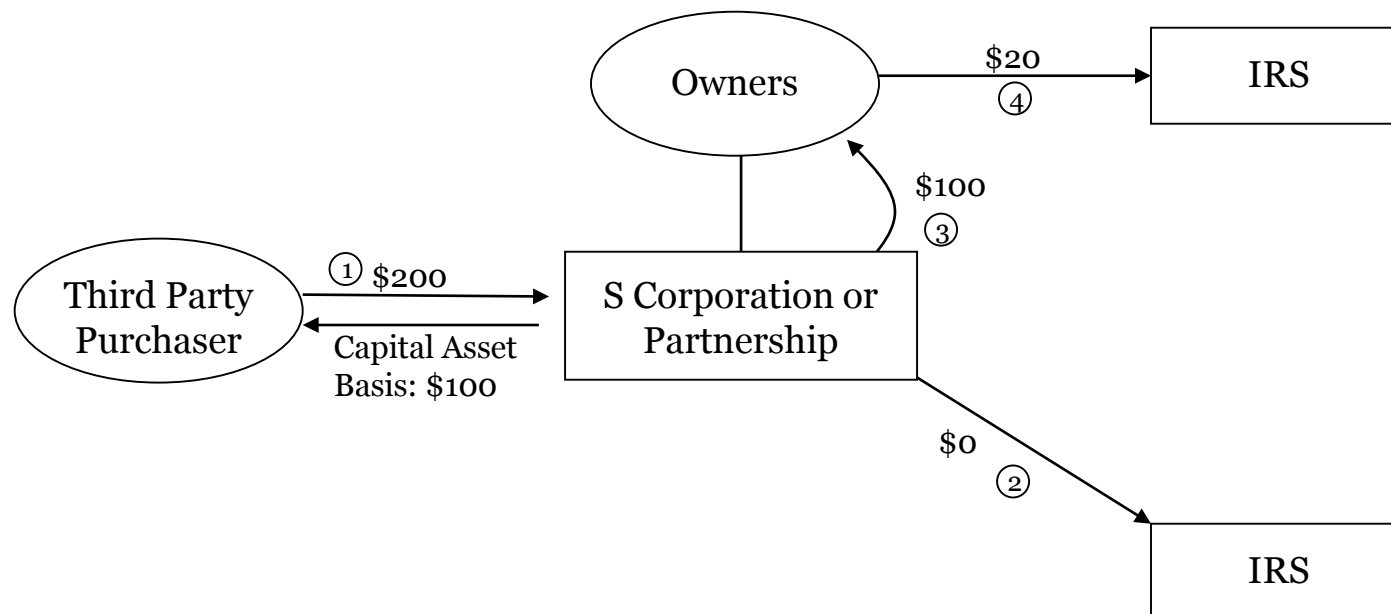
Revenue	200
Basis in Capital Asset	-100
Net Income	100
Less: 35% Corporate Tax	-35
After-Tax (Corporate)	65
Less: 23.8% Dividend Tax	-15
To Shareholder After All Taxes	50

**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

<u>Taxation Attribute</u>	<u>Federal Tax Status</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	No	No	N/A - Sole proprietor is tax owner of assets	Yes

<u>Taxation Attribute</u>	<u>State Entity</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*

Federal Tax Status

<u>Functional/Structural Attribute</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 publically 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.