
Considerations in Forming a New Company

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The Job and Growth Tax Relief Reconciliation Act of 2003

- Reduced the marginal tax rates applicable to high income taxpayers, effective in 2003 through 2010 (sunset extended by 2005 Act)
- Reduce the tax rate on “qualifying dividends” received by individuals between January 1, 2003 and December 31, 2010 to a maximum of 15%, only to return to 2002 levels as of January 1, 2011

Implications of Tax Rate Reductions

- Prior to EGTRRA-2001 and the 2003 Act, the combined corporate and individual maximum income tax rate imposed on corporate earnings of a C corporation to be distributed to shareholders was -----60.74%
- Assuming that the business owner would have qualified for long term capital gains treatment and a maximum individual rate of 20% upon sale or liquidation of the business, the aggregate corporate and individual tax rate prior to EGTRRA-2001 and the 2003 Act was -----48%
- After the 2003 Act and the maximum individual tax rate of 15% on dividends, the combined corporate and individual income tax rate is -----44.75%
- Until the 15% tax rate on dividends and capital gain sunsets after 2010, there is less incentive to distinguish between dividend and sale or exchange treatment for corporate distributions.

Taxation of Qualified Dividends

Under the 2003 Act

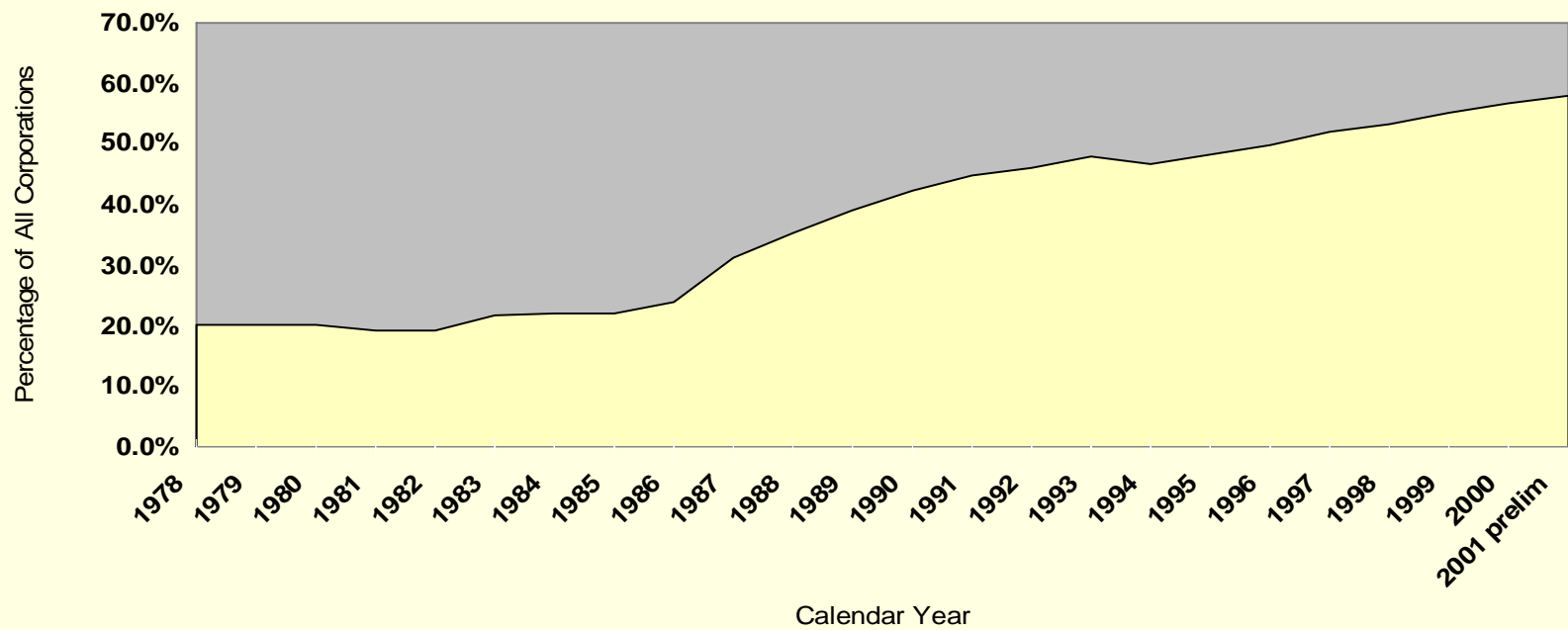
- “qualified dividend income” means dividends received during the taxable year from domestic corporations and qualified domestic foreign corporations received by a non-corporate taxpayer
- A dividend is a distribution from the corporation’s current or accumulated earnings and profits (“E&P”).
- Qualified dividends do not include: (1) Any dividend from a tax-exempt corporation; (2) any tax deductible dividend paid by mutual savings bank; (3) any deductible dividend paid by a C corporation with respect to employer securities in a qualified plan that is paid to the plan participants; (4) any dividend paid with respect to stock held by the shareholder for less than 60 days; (5) any dividend paid by a RIC or REIT to the extent deductible in computing the taxable income of such entity

Constructive Dividends

- Unreasonable Compensation
- Bargain Sales/Leases To Shareholder
- Excessive Sales/Leases to Corporation
- Shareholder's Personal Expenses
- Payment on Reclassified Debts
- Corporate Low Interest Loans
- Corporate Loans Without Payment Expectation

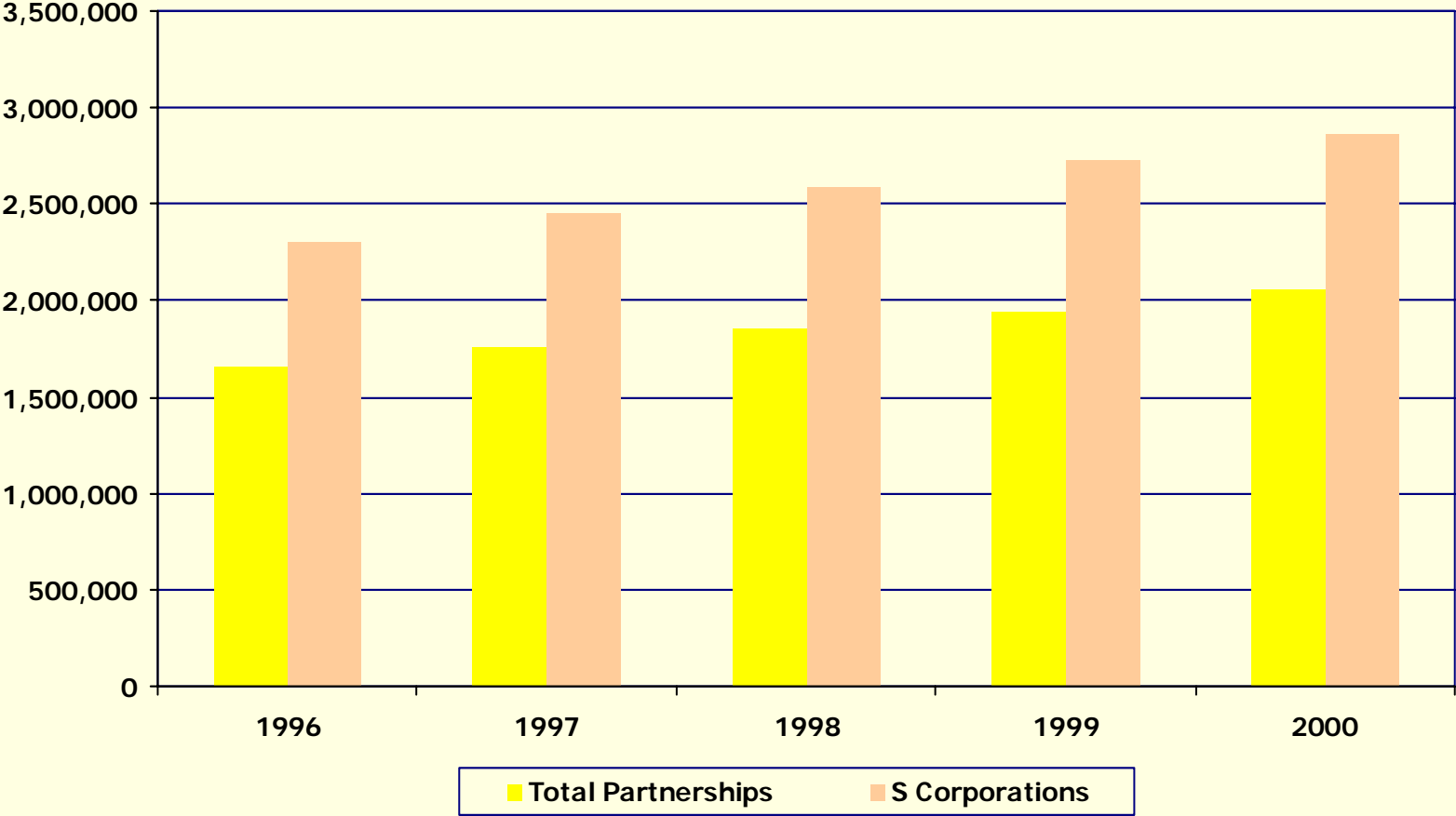
Pass-Through Entity (S Corporation, LLC) or C Corporation?

S Corporations as a Percentage of All Corporations (1978-2001)



Source: SOI Data

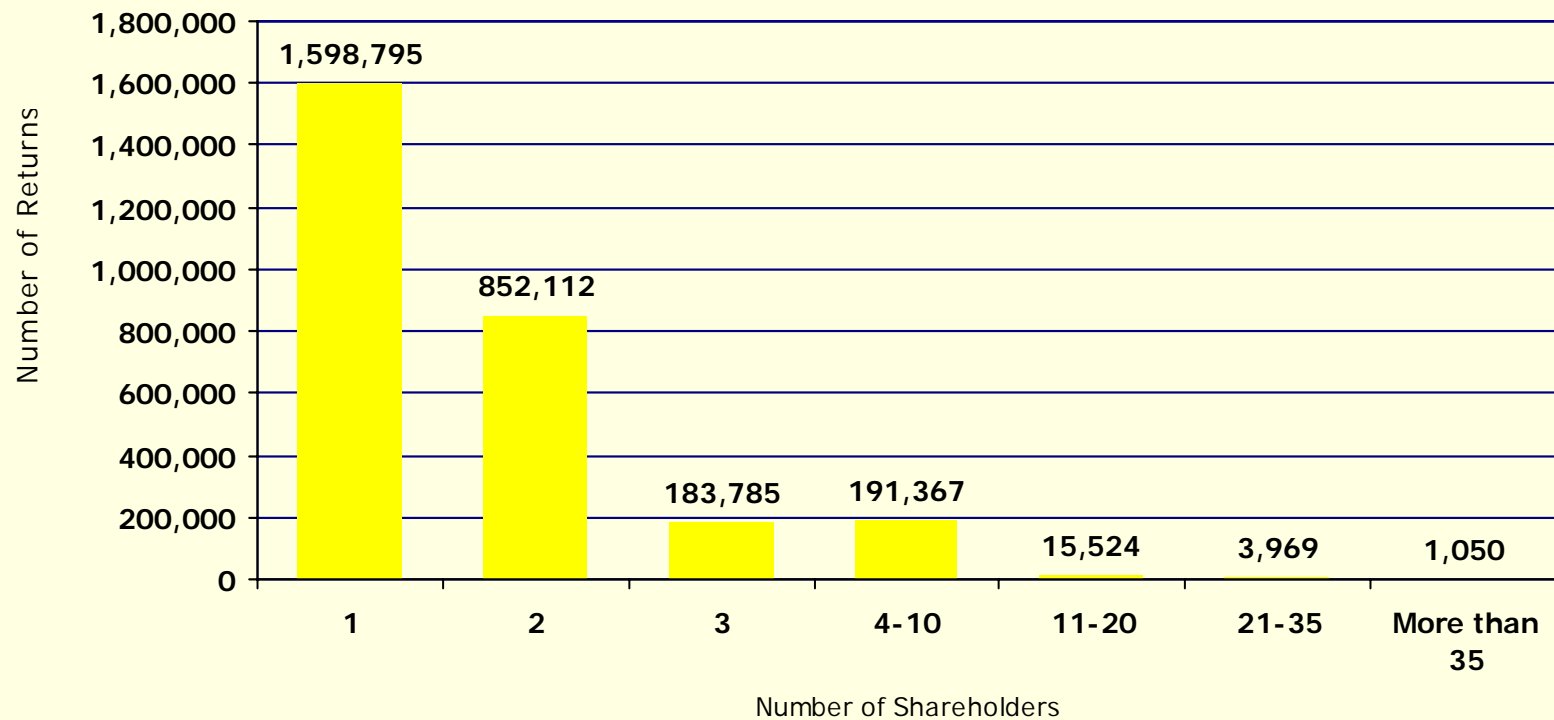
S Corporations and Partnerships



Source: SOI Data

Number of S Corporation Returns, by Number of Shareholders

Tax Year 2000



Source: SOI Data

Advantages of Operating as a Pass-Through Entity

- One Level of Tax on Earnings with Increase in Owner Basis for Undistributed Earnings
- Avoidance of Double Tax Upon Sale or Liquidation of Business
- Corporate Alternative Minimum Tax Not Applicable
- Pass-Through of Losses
- Social Security Tax Considerations

Advantages of Operating as a Pass-Through Entity (cont.)

- Avoidance of Accumulated Earnings Tax
- Avoidance of PHC Tax
- Deductibility of Interest on Debt Incurred to Purchase Interest in a Pass-Through Entity
- Avoidance of Limitations on Using Cash Method of Accounting
- State Tax Considerations

Disadvantages of Operating as a Pass-Through Entity

- No Benefit of Lower Corporate Rates
- Tax Costs of Converting from C to S
- Limitations on Filing Consolidated Returns
- Section 1202 Exclusion Not Available
- Loss of Tax-Free Employee Fringe Benefits
- Limitation on Selection of Taxable Year
- Restrictive Eligibility Requirements

The American Jobs Creation Act of 2004 (HR 4520)-S Corporation Provisions

- New deduction relating to income attributable to domestic production activities –available to S corps, LLCs
- Members of family treated as 1 shareholder
- Increase in number of shareholders to 100
- Existing IRAs eligible shareholders of bank S corps
- Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT

The American Jobs Creation Act of 2004 (HR 4520)- S Corporation Provisions

- Transfer of suspended losses incident to divorce
- QSST income beneficiaries may deduct suspended PALs and at-risk amounts when QSST disposes of S corporation stock
- Investment securities income excluded from passive income test for bank S corps

The American Jobs Creation Act of 2004 (HR 4520)- S Corporation Provisions

- Relief from inadvertently invalid QSUB elections and terminations
- Information returns for QSUBs
- Repayment of ESOP loans with distributions from qualifying employer securities

The Small Business and Work Opportunity Act of 2007 – S Corporation Provisions

- Gain from sales or exchanges of stock or securities excluded from passive investment income for purposes of Sections 1375 and 1362(d)(3)
- Qualifying bank director shares not treated as second class of stock
- Bank converting to S status may elect to charge adjustments from change from reserve method of accounting to final C year
- Termination of Qsubs protected from busted 351 treatment
- Elimination of C E&P for taxable years before 1983
- Nonresident aliens may be potential current beneficiaries of ESBTs

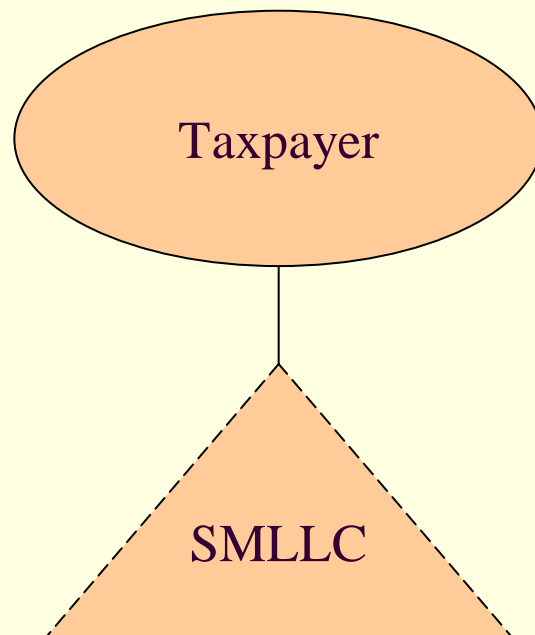
Advantages of Operating as a C Corporation

- Multiple Classes of Stock
- No Limitations on Shareholders
- Losses on Small Business Stock
- Gains on Qualified Small Business Stock
- No Shareholder-Level Tax on Undistributed Income
- Fringe Benefits
- Taxable Year
- Consolidated Returns

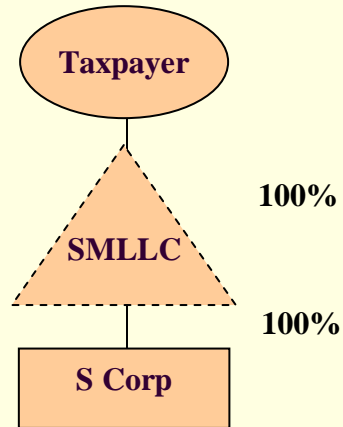
Disadvantages of Operating as a C Corporation

- Entity Level/Double Taxation
- Corporate Losses Trapped
- Method of Accounting Limitations
- Corporate AMT
- Accumulated Earnings Tax
- Personal Holding Company Tax

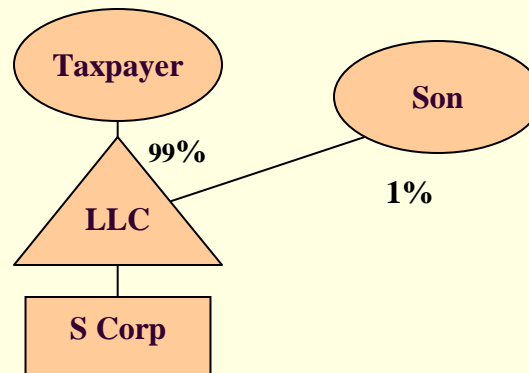
Single Member LLC - Disregarded



Single Member LLC – Disregarded Stockholder of S Corporation

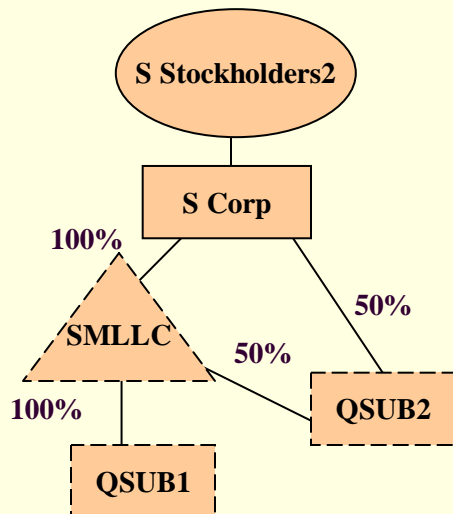
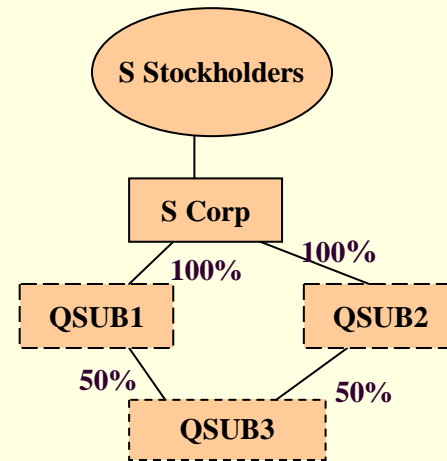
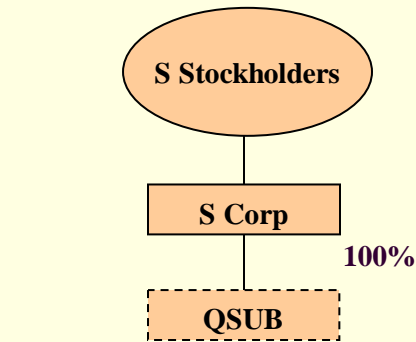


Taxpayer is a permitted S stockholder. SMLLC is disregarded. Thus, S corp. can maintain its S election.



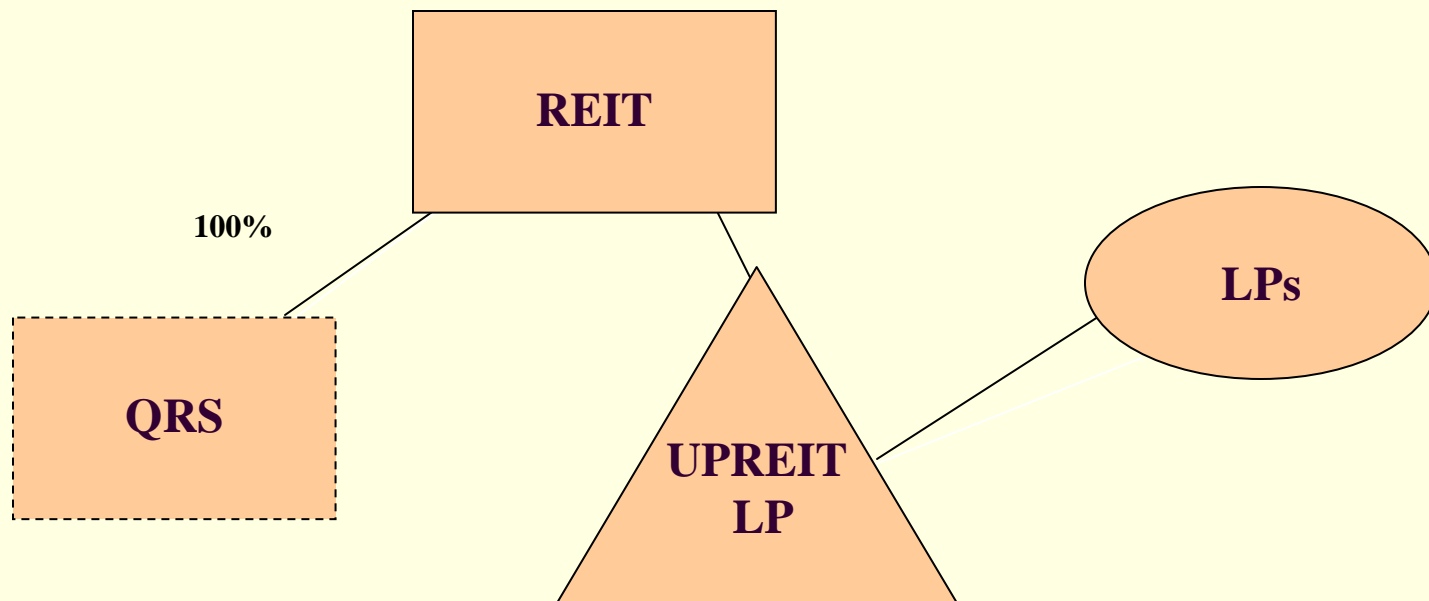
This slight variation results in the termination of the S election. A partnership is not a permitted S stockholder.

QSUB - Disregarded



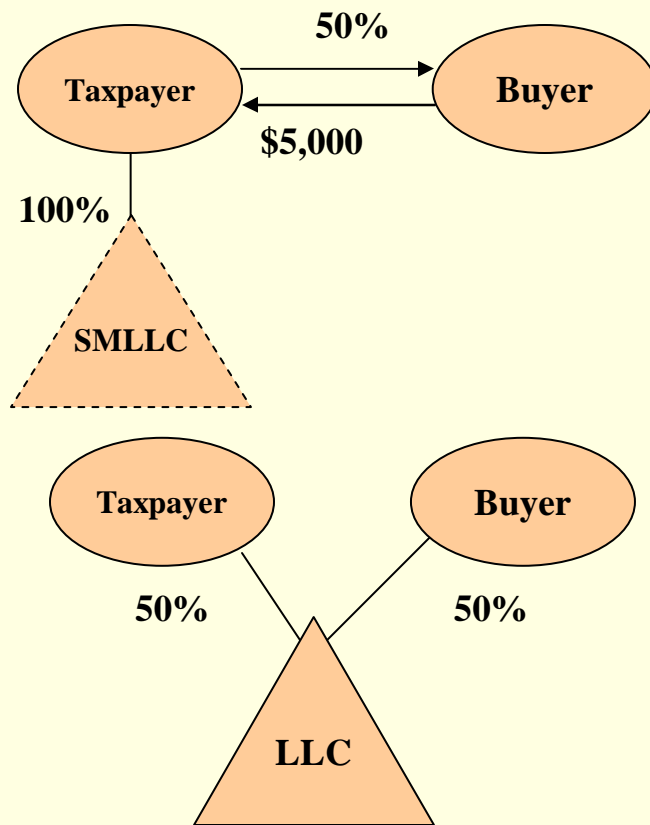
In all of these examples, the QSUBs are valid QSUBs.

QRS - Disregarded

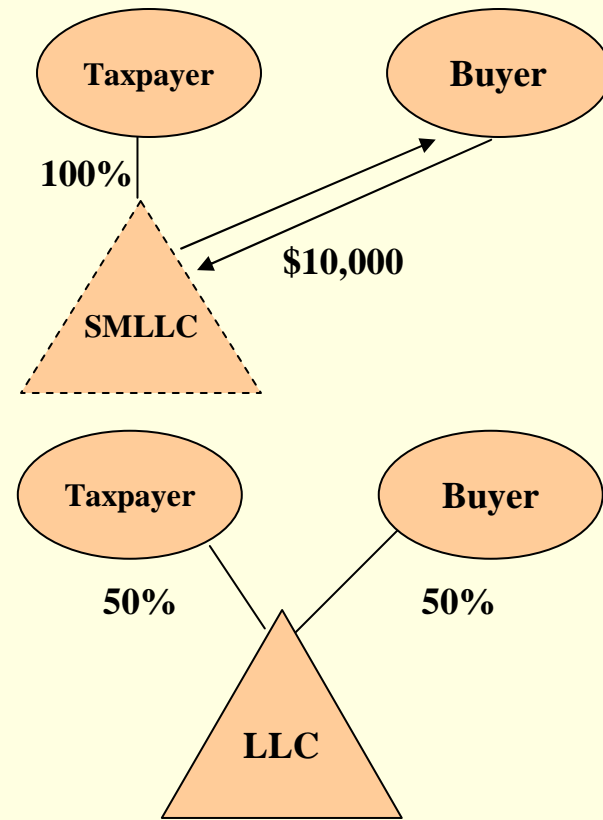


Rev. Rul 99-5

Situation 1

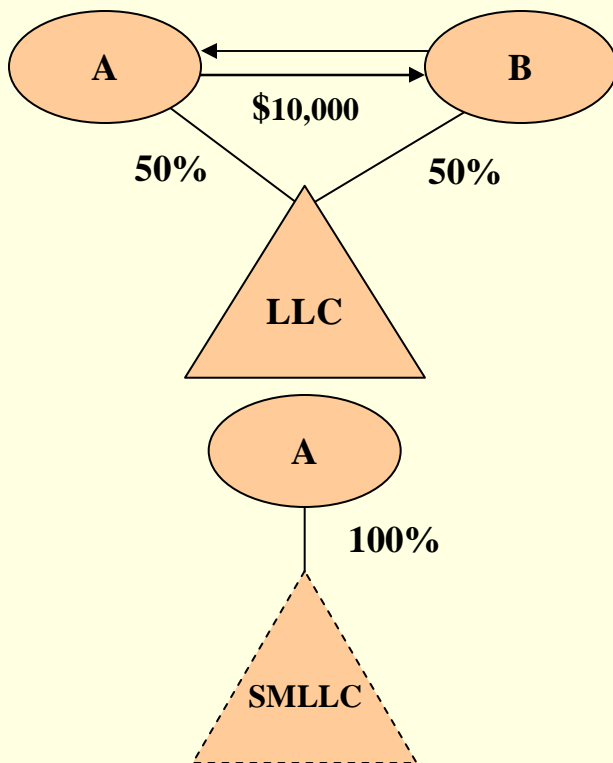


Situation 2

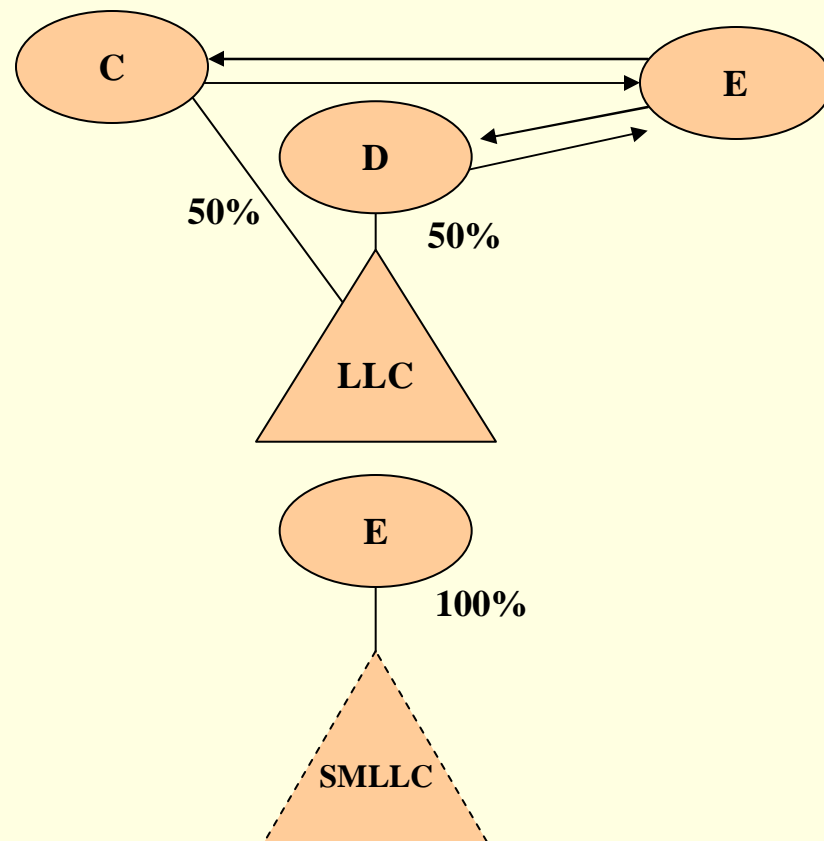


Rev. Rul 99-6

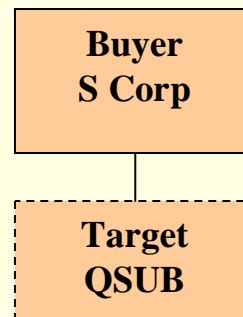
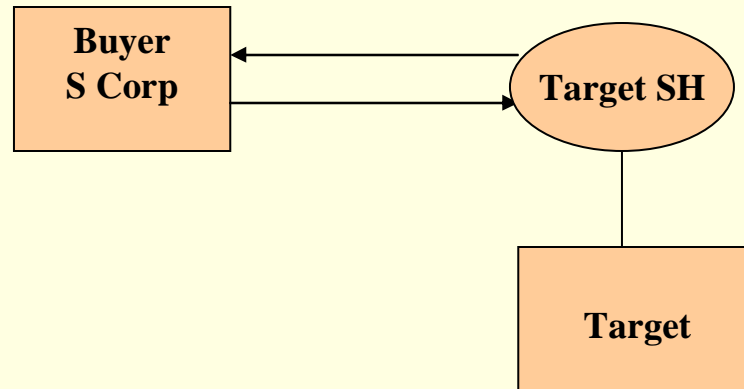
Situation 1



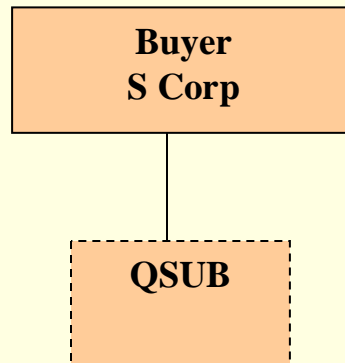
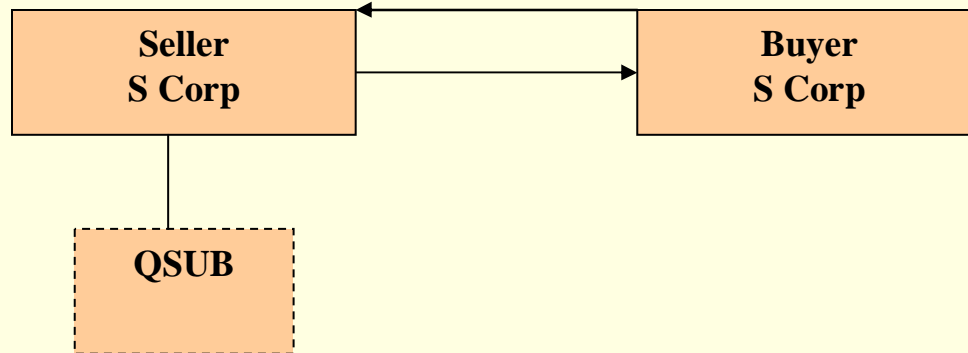
Situation 2



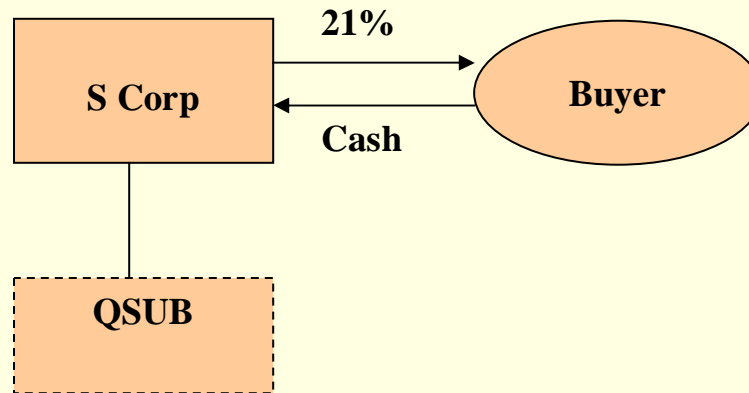
QSUB Election for Target



QSUB Sale – Buyer S Corp Continues QSUB Election

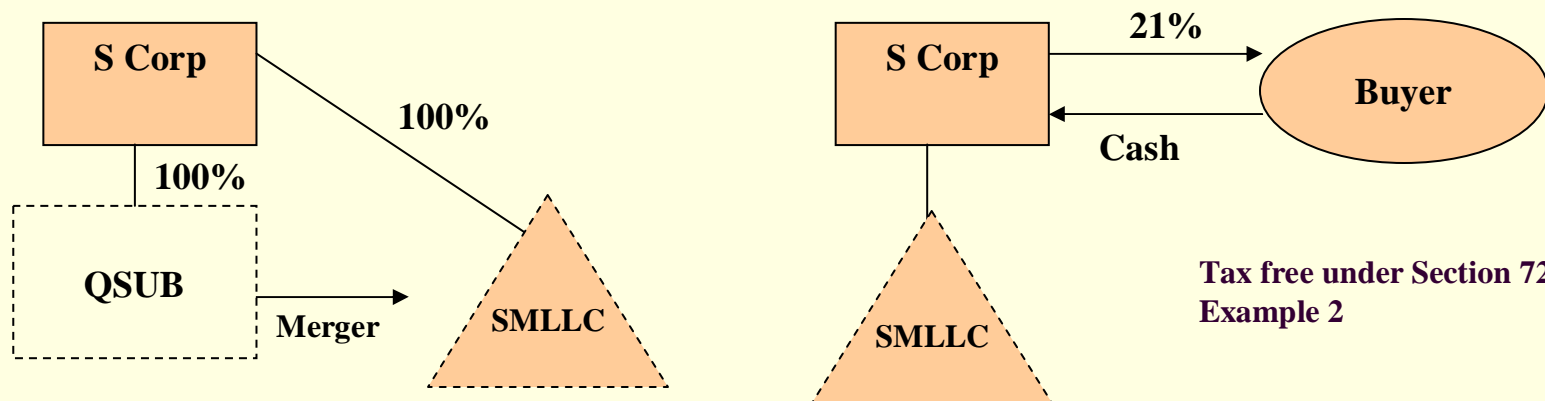


QSUB Termination – Reg. §1.1361-5(b)(3)



Busted 351 – Example 1
(changed by 2007 Act)

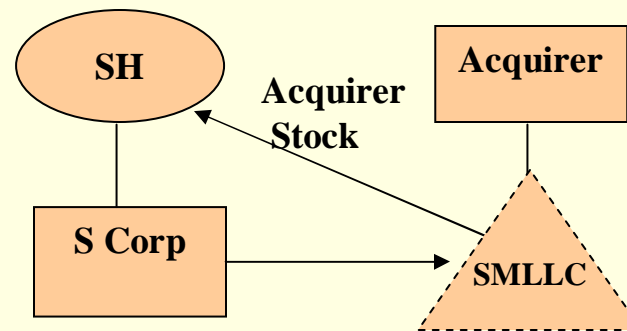
Use of SMLLC in Lieu of QSUB



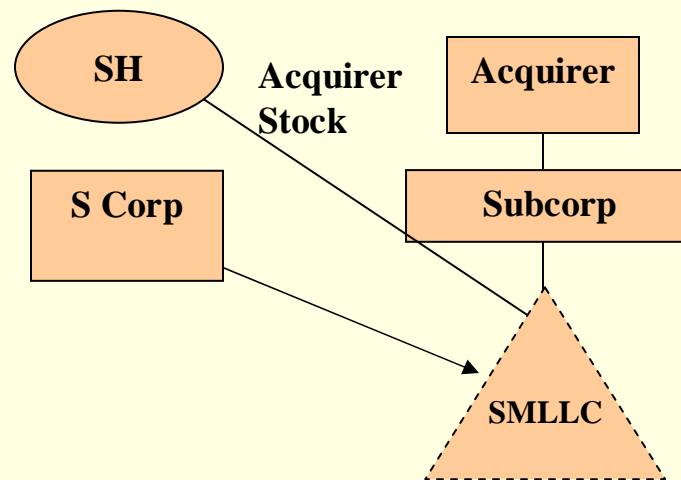
Tax free under Section 721
Example 2

Merger Using SMLLC

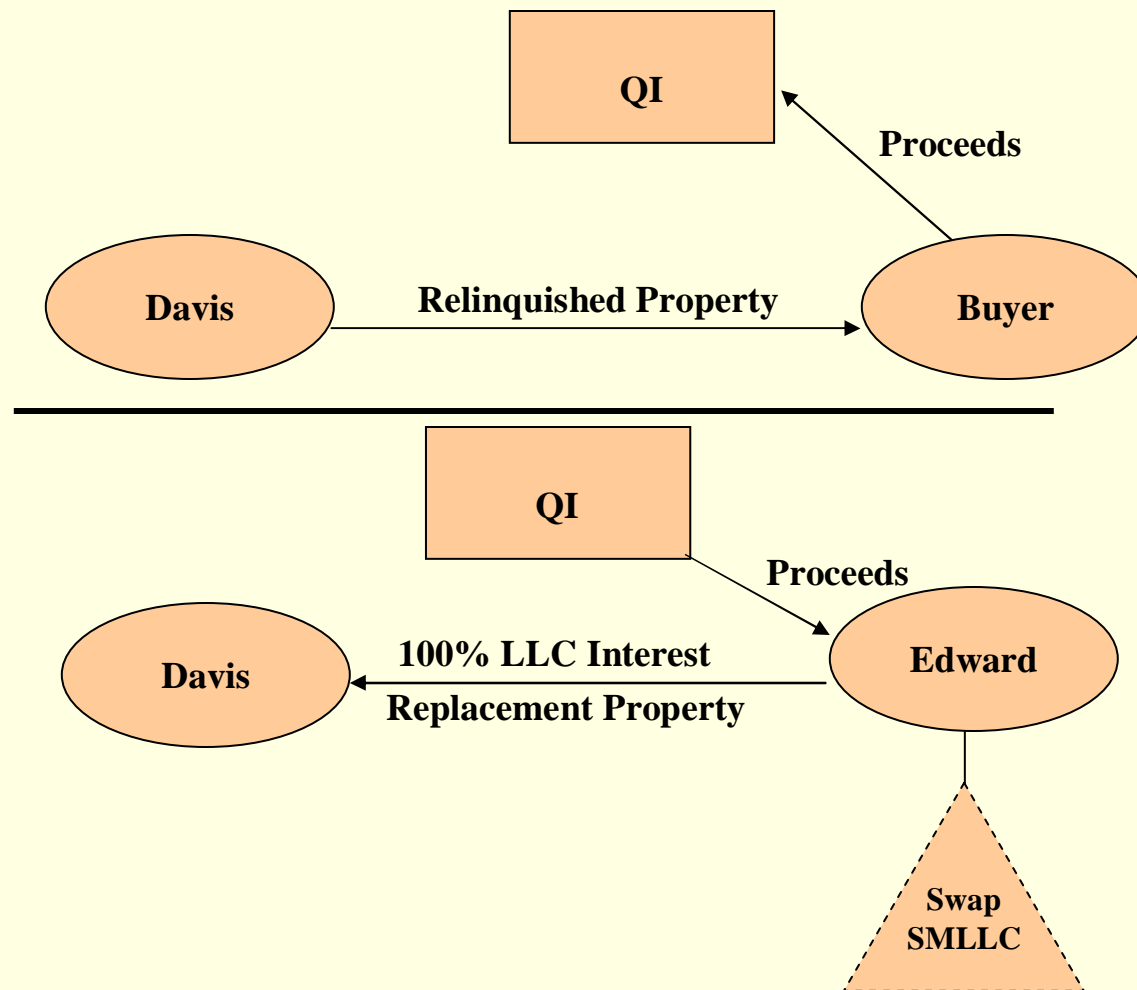
(A) Merger Using SMLLC [Example 1]



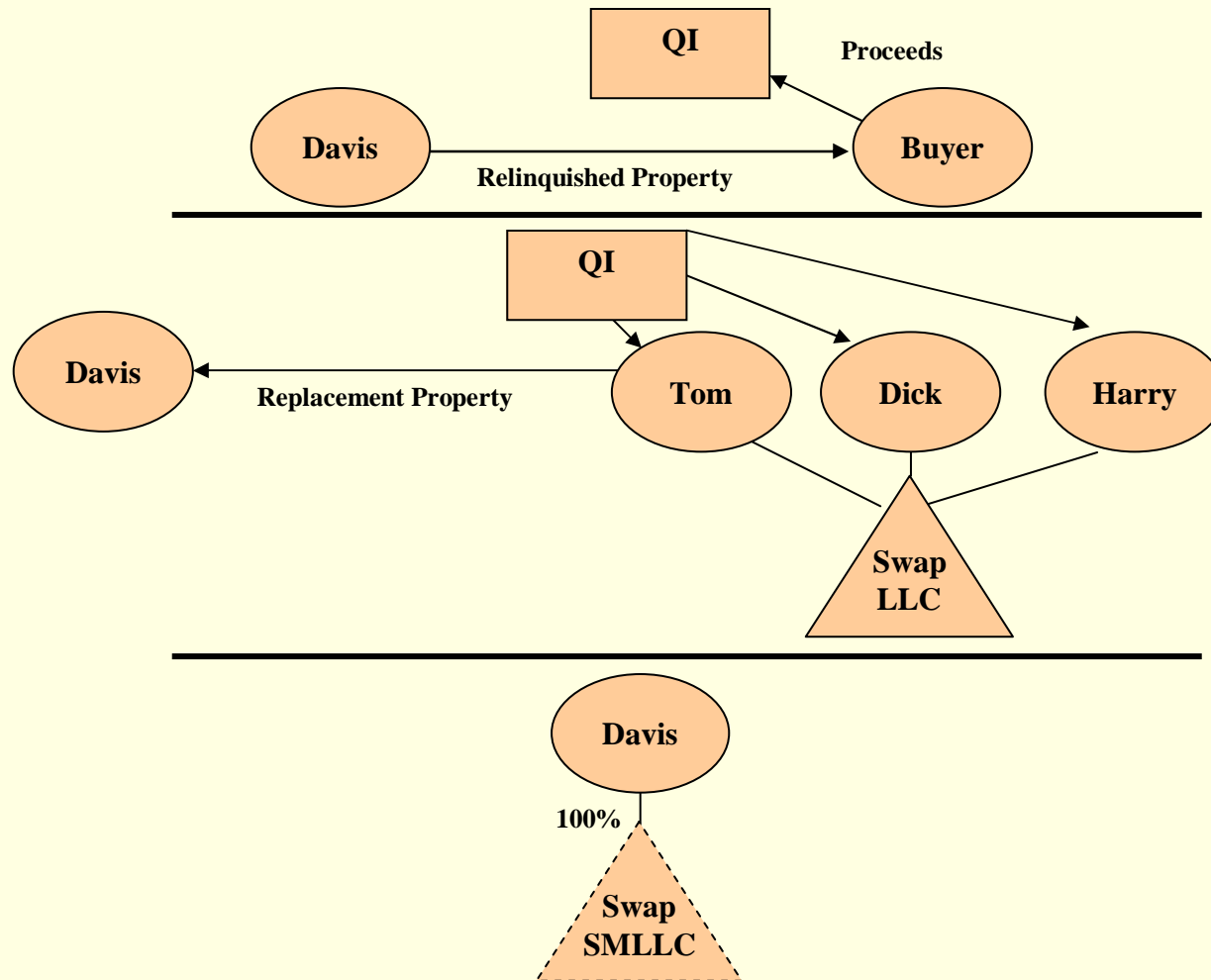
(a)(2)(D) Merger Using SMLLC [Example 2]



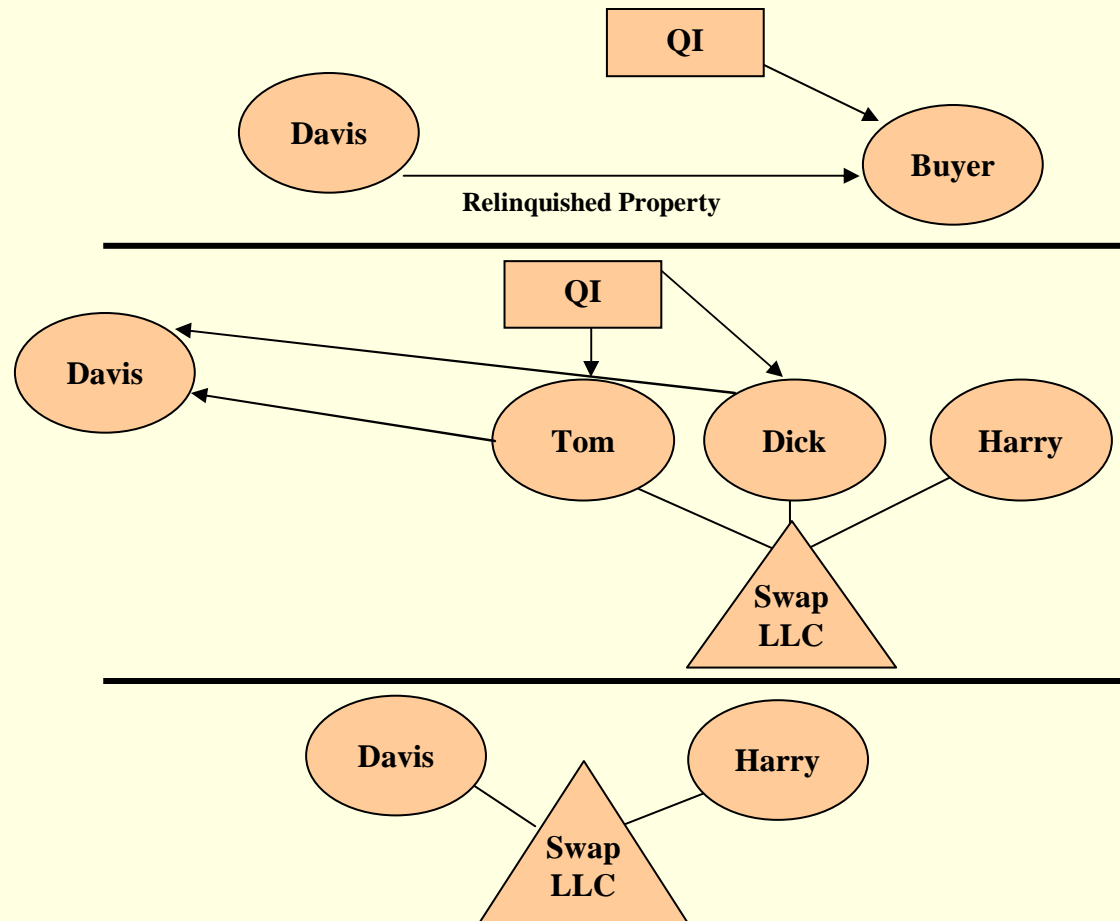
Exchange – 100% LLC Interests Of Disregarded Entity As Replacement Property [Example 7]



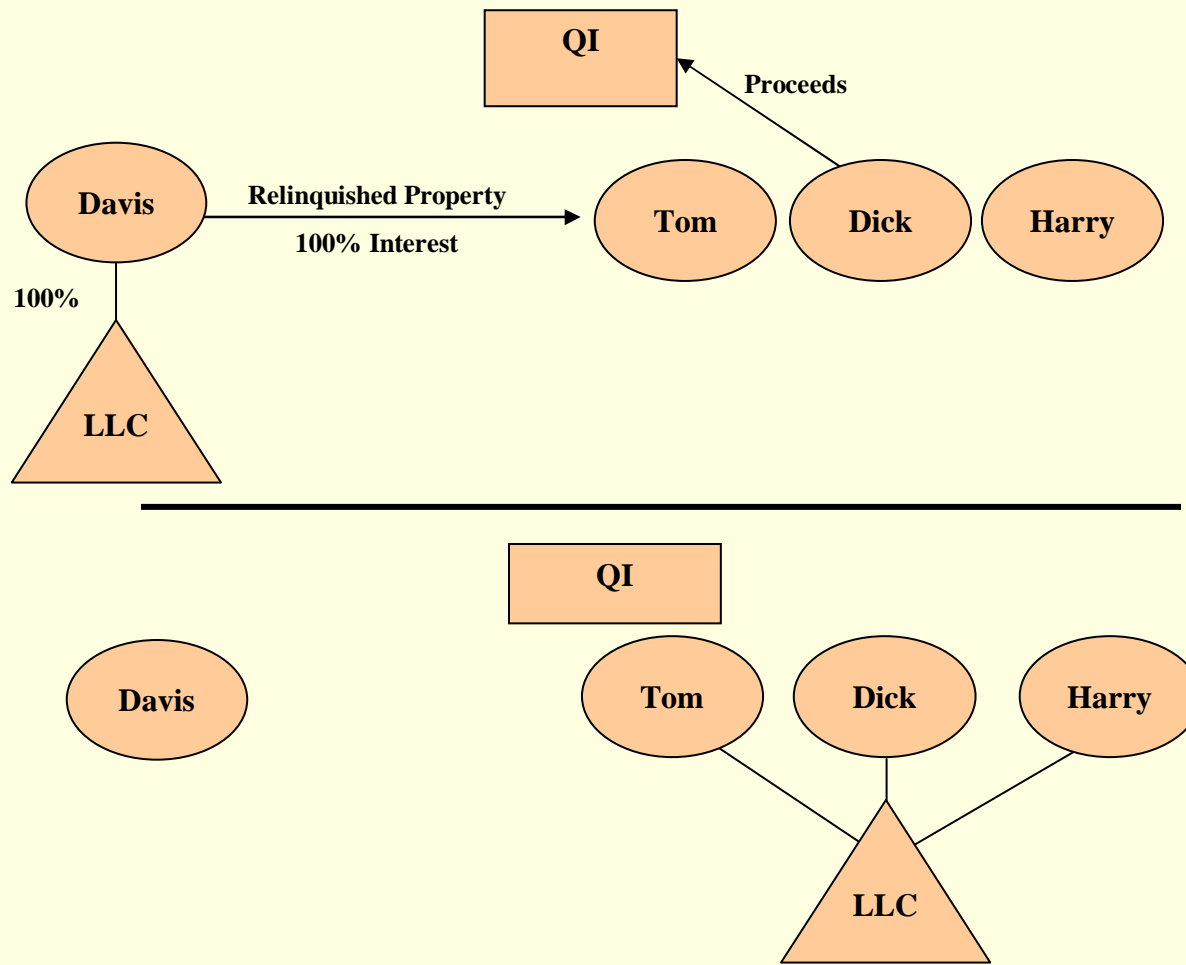
Exchange – 100% LLC Interests Of Partnership As Replacement Property [Example 8]



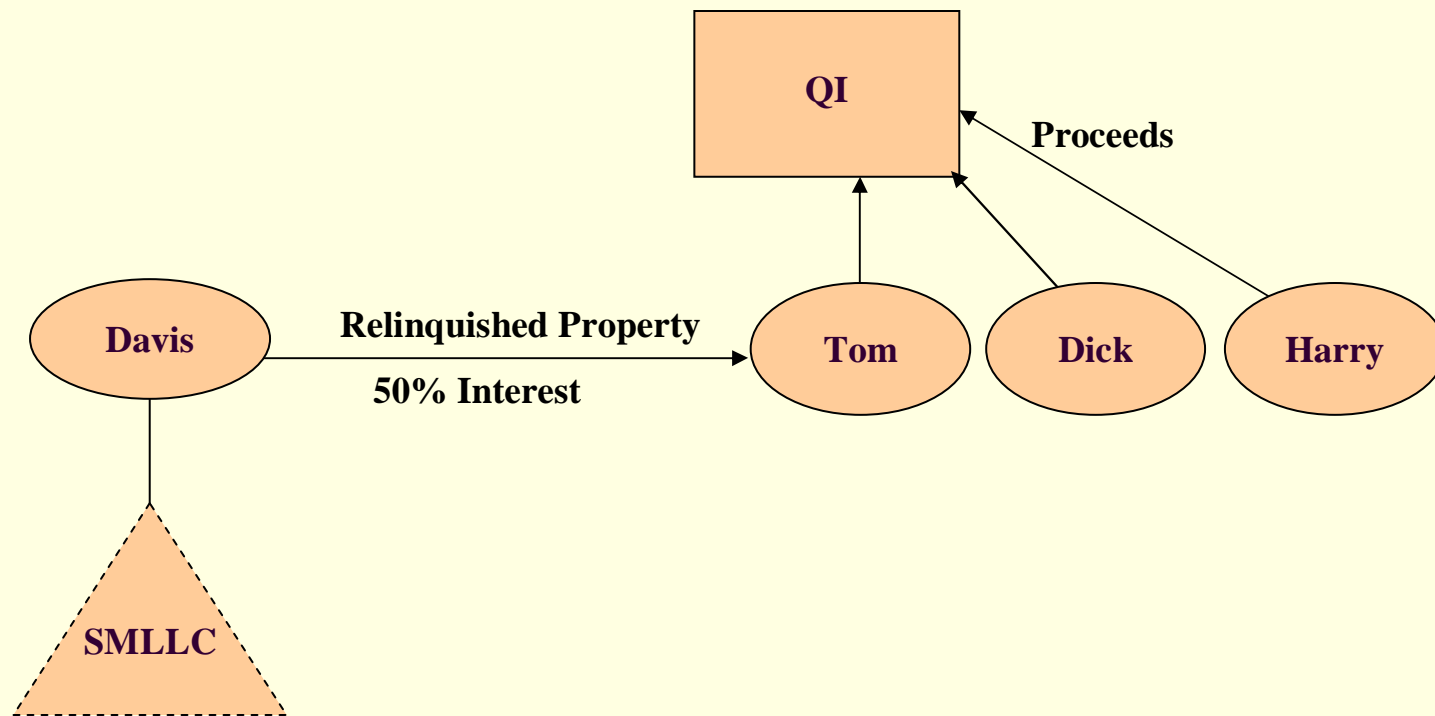
Bad Exchange – Purchase of Partnership Interests [Example 8]



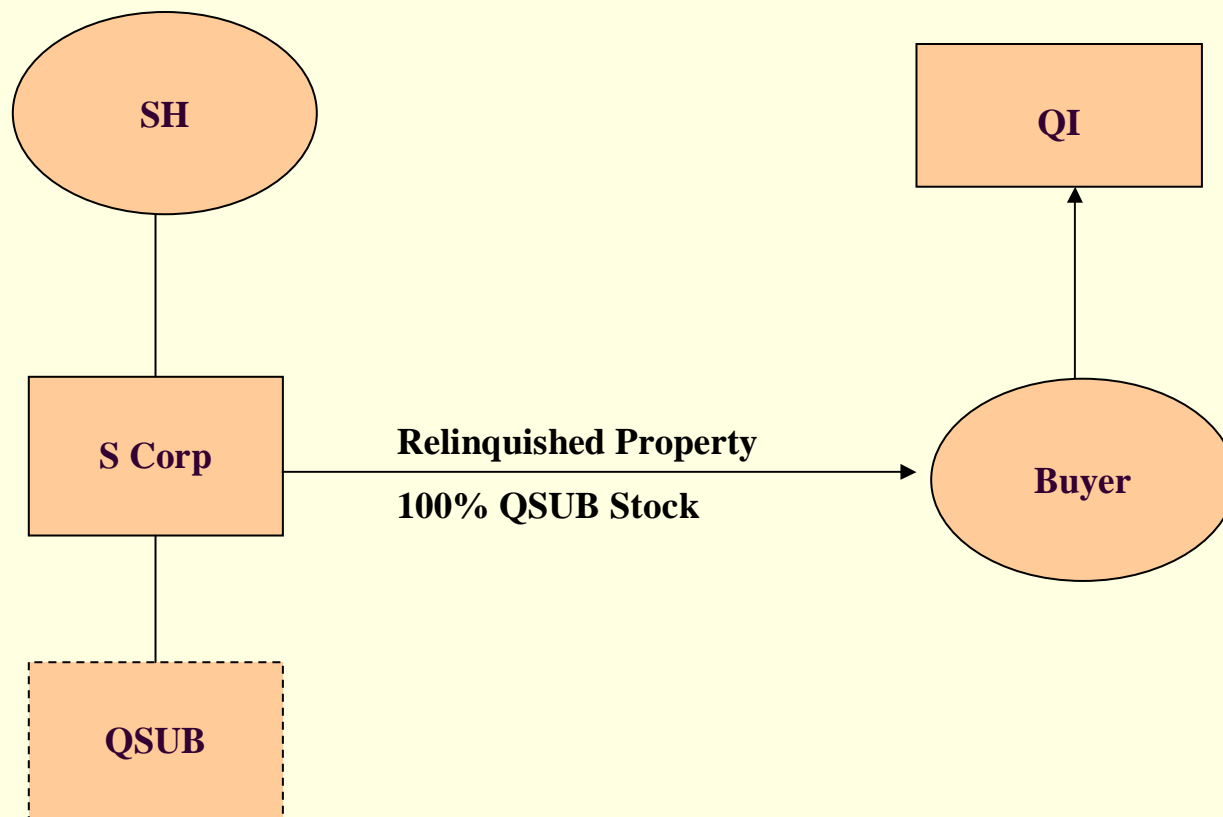
Exchange – Interest of Disregarded Entity As Relinquished Property [Example 9]



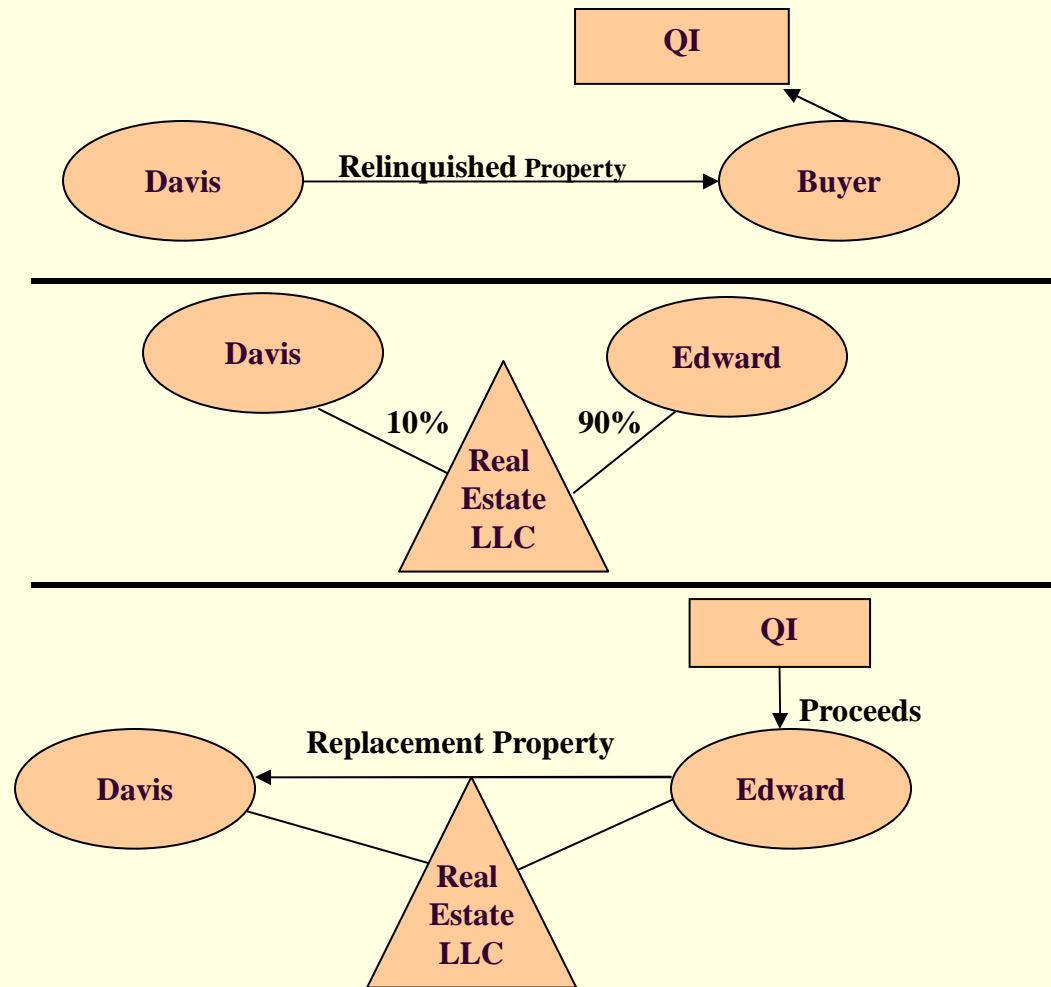
Exchange – Interest of Disregarded Entity As Relinquished Property [Example 9]



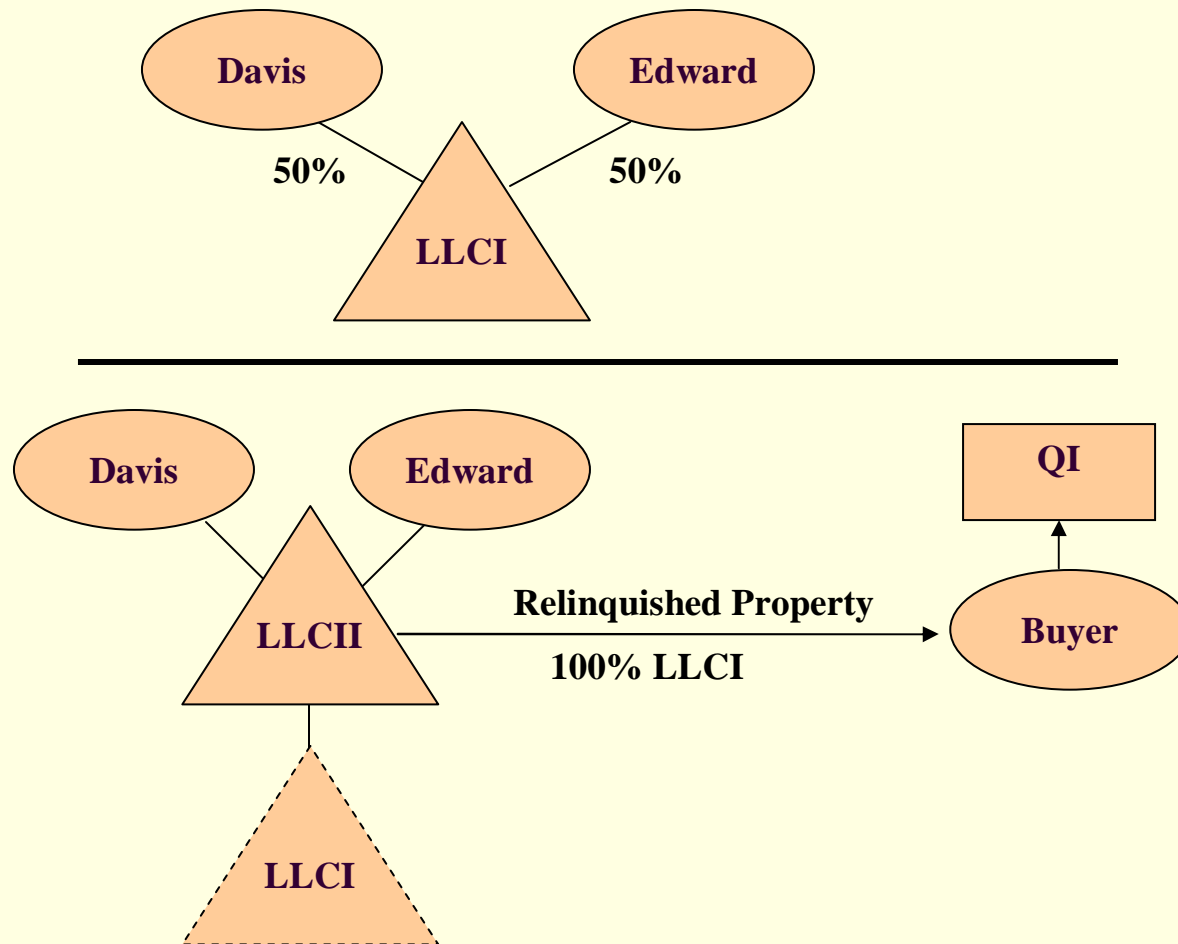
Exchange – 100% QSUB Stock As Relinquished Property [Example 10]



Exchange – Partnership Interest as Replacement Property [Example 11]

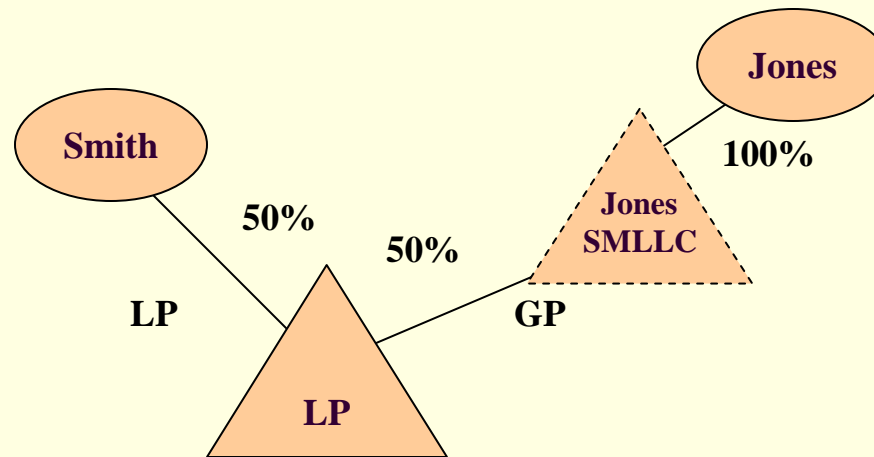
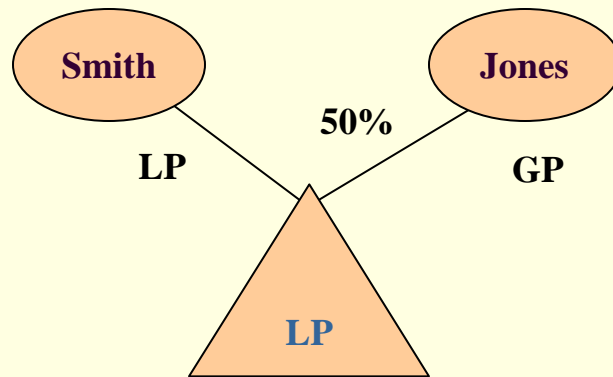


Exchange – Partnership Interests as Relinquished Property [Example 12]



Disregarded Entity as GP – Recourse Debt

Example 13



When the C Corporation is the Entity of Choice

- Use of Lower Tax Rates
- Parent Subsidiary Corporations
- Fringe Benefit – Professional Service Corporations

When the LLC is the Entity of Choice

- For Venture Capital Projects and Corporate Joint Ventures
- To Hold Real Property
- Estate Planning
- For the Professional Service Business

Special Considerations Favoring Use of LLC

- Pass through taxation without limitations on number or types of owners
- Nonrecognition of gain upon distribution of property to owners
- Outside basis available for inside debt
- Conversion to corporate classification always possible (Form 8832)
- Flexibility in allocating income, losses, deductions and credits
- When disregarded entity is desired for single member entity

When the S Corporation is the Entity of Choice

- Already an S Corporation
- Existing C Corporation Desiring to Convert to Pass Through Entity
- Entities Desiring to Participate in Tax Free Mergers and Reorganizations

Summary of Points to Remember

- Pass-through treatment still favored
- Limited liability should always be considered
- LLC versus S corporation analysis still important- SECA tax, permitted shareholders, phase of life cycle, etc.
- Conversion to C corporation status always possible either through check the box election or termination of S election (the reverse is not as simple)