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CHOICE OF ENTITY: WHEN NOT TO USE A LIMITED LIABILITY COMPANY

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I. HISTORY OF BUSINESS ENTITY CHOICES

In the 1970's, only three types of entities existed – a corporation, a limited partnership, and a general partnership. General partnerships were generally disfavored because each partner was subject to liability for the partnership's debts, as well as the acts and omissions of his or her partners. Limited partnerships offered liability protection to the limited partners, but a myriad of state laws made it easy for a limited partner to lose his or her status as such. As a result, corporations became the entity of choice during that time.

In the 1980's, the Texas legislature revised the limited partnership statutes so that it would be more difficult for limited partners to lose their liability protection. As a result, limited partnerships became more favored. However, it was unclear whether a partnership would be treated as a partnership or a corporation for income tax purposes. Generally, the Internal Revenue Service (the "IRS") applied a six-part test to determine whether any association would be treated as a corporation for income tax purposes. Two of the factors were common to both partnerships and corporations – presence of associates and objective to carry on a business for profit. The remaining four factors consisted of examining the entity's continuity of life, centralization of management, free transferability of ownership interests, and the owners' personal liability for entity debts. If three of the four factors were satisfied, the partnership would be treated as a corporation for tax purposes, regardless of its state-law classification. If only one or two of the factors were met, then the entity would be treated as a partnership for tax purposes.

During the 1990's, the limited liability company ("LLC") became more prevalent. LLCs were similar to corporations from a state-law perspective in that no owner was personally liable for the LLC's debts, but were similar to partnerships from a tax perspective. As a result, owners of an LLC could obtain the benefits of having a state-law corporation while also obtaining the benefits of having a tax partnership.

The IRS noticed that taxpayers were almost always able to achieve the tax status that they desired, but the process was very inconvenient. Consequently, the IRS implemented the "check the box" rules. As a result, any noncorporate domestic entity could elect to the be treated as a corporate entity or noncorporate entity for income tax purposes. Single-member noncorporate entities are treated as disregarded entities for income tax purposes unless they elect otherwise, while multi-member noncorporate entities are treated as partnerships for income tax purposes unless they elect otherwise.

Because taxpayers now have this easy freedom of choice, the decision of which entity is appropriate for state-law purposes is made separately from the decision of which entity is appropriate for federal tax purposes. A mental gymnastics of sorts is required to independently consider the state-law factors and income tax factors at the same time to arrive at the appropriate entity choice.

As a result, many practitioners find an entity with which they are comfortable working and tend to automatically choose that entity in almost all instances. In the past, we have often seen others use as their "default entity" a state-law corporation that makes the S election for tax purposes. However, LLCs that elect to be taxed as partnerships are gaining ground and replacing the S corporation as the default entity. With that in mind, the topic of this presentation focuses on when an LLC taxed as a partnership may not be the appropriate choice of entity.

II. BENEFITS OF LLCs TAXABLE AS PARTNERSHIPS

As stated above, LLCs are quickly becoming the most commonly chosen entity form. This is because LLCs have many benefits, the combinations of which are unique to them. A few of the benefits of LLCs are discussed below.

<u>Limited Liability</u>. The owners of an LLC are protected from the liabilities of the LLC, similar to owners of a state-law corporation. The Texas Business Organizations Code (the "TBOC") specifically limits the liability of the members of an LLC, unless the members agree otherwise.

<u>Fewer Formalities</u>. LLCs require fewer formalities than a corporation. For example, members and managers of an LLC are not statutorily required to hold annual meetings.

<u>Flexibility in Governance</u>. An LLC may be either "manager-managed" or "member-managed." In a manager-managed LLC, the managers are similar to a board of directors in a corporation. The managers make the operating decisions and can appoint officers to handle the day-to-day tasks. In a member-managed LLC, the member manages the LLC's affairs in his or her capacity as a member.

<u>Flexibility in Capital Structure</u>. Almost any conceivable economic structure that one can conceptualize can easily be built into an LLC, particularly if the LLC is taxed as a partnership. If a change in capital structure is desired, the LLC's organizational documents can be easily amended to effectuate the structural change. Specifically, the LLC has a great deal of flexibility regarding preferred payments, separation of profits percentages from capital percentages, and guaranteed payments, among other things.

The same is not true for corporations, wherein the articles of organization must be amended to reflect capital structure modifications, or for limited partnerships, where the general partner would probably be involved in the modifications and may be difficult to deal with. S corporations are even more restrictive, especially with regard to their capital structure. It is fair to say that no other entity is more flexible than the LLC.

Tax Benefits. A multi-member LLC will be taxed as a partnership, and a single-member LLC will be treated as a disregarded entity, unless it affirmatively elects otherwise. LLCs have a flexible tax structure and can elect to be taxed as a corporation or partnership. In addition, an LLC taxable as a corporation can make the S election so long as its operating agreement does not provide for more than one class of stock.

III. FACTORS INDICATING AN LLC MAY NOT BE APPROPRIATE

Even though the LLC structure has the many benefits discussed above, it is not always the appropriate entity. Some factors indicating when an entity other than the LLC may be appropriate are discussed below.

A. REGULATORY/PROFESSIONAL RESTRICTIONS

Section 2.003 of the TBOC specifically states that entities, including limited liability companies, cannot operate as banking institutions (including trust companies and savings associations), insurance companies, railroad companies, cemetery organizations, and abstract or title companies governed by Title 11 of the Insurance Code.

1. BANKING INSTITUTIONS

Banking institutions, trust companies, and savings associations must be formed under and are governed by the Texas Finance Code. The specific operating and taxation attributes of these entities are beyond the scope of this presentation.

2. INSURANCE COMPANIES

Insurance companies must be formed under and are governed by the Texas Insurance Code. The specific operating and taxation attributes of these entities are beyond the scope of this presentation.

3. CEMETERY ORGANIZATIONS

Cemetery organizations must be formed as corporations under Section 711.021 of the Texas Health & Safety Code. The specific operating and taxation attributes of these entities are beyond the scope of this presentation.

4. ABSTRACT AND TITLE INSURANCE COMPANIES

Abstract and Title Insurance Companies must be formed under and are governed by the Title 11 of the Texas Insurance Code. The specific operating and taxation attributes of these entities are beyond the scope of this presentation.

5. PROFESSIONAL ENTITIES

Certain organizations operated by "professionals" may be organized as professional entities. A "professional individual" is defined as an individual who is licensed (under Texas law or under the laws of another jurisdiction) to render the same professional service that is rendered by the professional entity. A professional service includes the types of services rendered by architects, attorneys, CPAs, dentists, physicians, and veterinarians.

A professional entity may be organized as a professional association, if all of the owners of the entity are certain medical professionals, or as a professional limited liability company or professional corporation, if all of the owners are professional individuals. If an owner, managerial official, employee, or agent of the professional entity commits an error, omission, negligent or incompetent act, or malfeasance while providing a professional service for the entity, the entity will be jointly and severally liable for any damages. However, the other owners, managers, employees, and agents of the entity will not be liable for the damages.

Professional limited liability companies may elect to be taxed as corporations or partnerships for federal tax purposes. Professional corporations and professional associations will automatically be taxed as corporations for federal tax purposes, but they can make the S election.

B. OWNERSHIP RESTRICTIONS

1. EMPLOYEE STOCK OWNERSHIP PLANS

A company that wishes to implement a defined benefit plan that qualifies as an employee stock ownership plan ("ESOP") must be organized as a corporation for state law purposes. Section 4975(e)(7) requires the ESOP to contain a stock bonus plan element. As a result, the investment under the plan will usually be made largely, if not exclusively, of the employer-company's stock. Section 4975(e)(7) does not provide for such plans to make investments in other types of ownership interests in the employer-company (such as membership interests in LLCs or limited partnership interests in limited partnerships).

A corporation that has an ESOP as a shareholder does have the ability to make the S election because Section 1361 allows qualified plan trusts and Section 501(c)(3) organizations to be shareholders of S corporations. Therefore, a corporation that intends to implement an ESOP can be taxed either as a C corporation or as an S corporation.

2. TAX EXEMPT ENTITIES

In order to be tax exempt for federal income tax purposes, an organization must be classified as a corporation, limited liability company, unincorporated organization, or trust. Texas law provides for the formation of state-law nonprofit corporations, unincorporated nonprofit associations, and charitable trusts. As a result, although the IRS would recognize an LLC as a tax-exempt organization (provided it meets all of the applicable requirements), Texas law does not contain a mechanism under which a nonprofit LLC can be formed.

3. S CORPORATIONS – OWNERSHIP LIMITATIONS

According to Section 1361(b)(1), in order for an entity to qualify as an S corporation, it must meet the following requirements:

1. It must be a domestic corporation;
2. The corporation must not have more than 100 shareholders,
3. All of its shareholders must be individuals, estates, qualified subchapter S trusts, electing small business trusts, or exempt organizations described in Section 401(a) or Section 501(c)(3) and exempt from tax under Section 501(a);
4. All individual shareholders must be U.S. residents; and
5. It must only have one class of stock.

As a result, LLCs taxable as partnerships cannot be shareholders of S corporations.

However, a single-member LLC that is disregarded for tax purposes and whose member meets the requirements to own S corporation stock can be an S corporation shareholder. That is because, for tax purposes, the single member of the LLC is treated as the owner of the stock. For state law purposes, though, the stock will be treated as being owned by the LLC.

The same is true for state-law partnerships that are treated as disregarded entities for tax purposes. For example, a limited partnership with a general-partner LLC has Joe as its sole limited partner. Joe is also the sole owner of the LLC. As a result, both the LLC and the limited partnership are treated as disregarded entities for income tax purposes. Therefore, assuming Joe is a U.S. resident, and thus qualifies to be S corporation shareholder, the limited partnership can own S corporation stock.

C. EMPLOYMENT TAX CONSIDERATIONS

In many businesses, the owner of the business is also an employee of the business. This dual role of the business owner can create interesting situations from a federal income tax standpoint. The entity's tax status determines whether an owner/employee may be treated as a W-2 wage earner or is treated as being self-employed.

The determination of whether an owner/employee's distributive share of an entity's income is wages or self-employment income is important because the self-employment tax liability may impact how much the owner/employee can fund into retirement accounts and pension plans. For example, qualified plan funding is restricted to an employee's "earned income." Also, as a practical matter, third party payroll companies may refuse to handle the payroll and withholding requirements for non-W-2 wage earners. (If this is a concern, the partnership or LLC could elect to be taxed as a corporation and make the S election.)

When the entity is taxed a corporation, the shareholder can clearly be an employee. The corporation merely treats the shareholder/employee like any other W-2 wage earner.

When the business is organized as a partnership, the rules are different. If the owner/employee is a general partner, he or she may not be considered a W-2 employee. As a result, the owner/employee must always pay self-employment taxes on his or her distributive share of the partnership's earned income. Other investment income items flow through to the partner's income tax return via a K-1.

If the owner/employee is a limited partner, he or she is not considered a W-2 employee. Rather, the owner/employee can receive guaranteed payments for services rendered to the limited partnership. The guaranteed payments will be treated as self-employment income, and self-employment taxes will be due on the payments. The owner/employee's distributive share of the partnership's profits will flow through to him or her on a K-1 without triggering self-employment taxes.

When the business is organized as an LLC, the rules are ambiguous. Section 1402 does not specifically address the treatment of LLC members. Arguably, if an LLC is organized as a manager-managed LLC (as opposed to a member-managed LLC), the members could be likened to limited partners. In that case, any guaranteed payments received by a member would be subject to self-employment taxes, but the member's distributive share of the LLC's earnings would not. In a member-managed LLC, a member who participates in the management of the LLC could be likened to the general partner of a limited partnership. In that case, all of the member-managers's distributive share of LLC earnings could be subject to self-employment taxes. Needless to say, this is a gray area of the law.

To address this conflict, the IRS promulgated proposed regulations in 1997. The regulations provided that a member of an LLC would be treated as a limited partner for purposes of Section 1402, unless one of the following applied, in which case the member would be treated as a general partner:

1. Personal Liability. The member has personal liability for the LLC's debts by virtue of the fact that he or she is a member of the LLC.

2. Contractual Authority. The member has statutory authority to enter into contracts on behalf of the LLC. Under the TBOC, if the LLC is manager-managed, members will not have statutory authority, in their capacity as members, to contractually bind the LLC. However, members of a member-managed LLC will have this statutory authority.

3. Material Participation. The member participates in the LLC's trade or business for more than 500 hours during the LLC's tax year.

4. Personal Services. The member provides more than a de minimis amount of services on behalf of an LLC, substantially all of the activities of which involve performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

To illustrate the proposed regulations, suppose Bill Gates owns and works 2,000 hours per year for Microsoft, LLC. He will be considered self-employed for his portion of Microsoft's $14 billion in annual earnings. As a result, that portion of Microsoft's earnings will be subject to self-employment taxes.

Note that the proposed regulations were never finalized. When the proposed regulations were issued, Congress prohibited the IRS from finalizing the regulations for a period of two years. Ten years have passed since Congress' pronouncement, and the regulations have been neither finalized nor withdrawn.

To create more certainty with respect to this issue, the LLC interest could be contributed to a limited partnership. Only guaranteed payments to the member/employee would trigger self-employment taxes. Alternatively, the LLC could elect to be an association taxable as a corporation and make the S election since the rules with regard to S corporations and self-employment taxes are more clear.

D. MARGIN TAX CONSIDERATIONS

1. Summary of the Margin Tax

The Texas Margin Tax applies to most liability limiting entities operating in Texas. Generally, the tax is imposed at a rate of 1% of the taxable margin, unless the entity is a retailer, in which case the applicable rate is 0.5%. The taxable margin is calculated by subtracting either the entity's cost of goods sold or compensation expense from the entity's total revenue or by deducting 30% of the entity's revenue.

The Margin Tax is imposed on the following entities:

- Limited partnerships (except "passive" entities discussed below)
- Limited liability partnerships
- Corporations
- Limited liability companies
- Savings and loan associations
- Business trusts
- Professional associations
- Joint ventures
- Holding companies

A few entities are specifically exempted from Margin Tax. These include certain partnerships, sole proprietorships, grantor trusts (discussed in more detail below), trusts that meet the passive entity definition discussed below, qualifying real estate investment trusts, real estate mortgage investment conduits, estates of natural persons, escrow accounts, and certain entities (such as nonprofit corporations) described in Sections 171.052 through 171.088 of the Texas Tax Code. In addition, entities with <u>less than $300,000</u> in revenues are not subject to Margin Tax.

In order to qualify as a grantor trust that is exempt from Margin Tax, the trust must meet the definition of a grantor trust set forth in Section 671 and Section 7701(a)(3)(E) of the Internal Revenue Code. In addition, all of the grantors and beneficiaries of the trust must be natural persons or charitable entities described in Section 501(c)(3) of the Internal Revenue Code. Business trusts described in Treasury Regulation Section 301.7701-4(b) are specifically excluded from the Margin Tax exemption and thus will be subject to the Margin Tax.

The partnerships specifically excluded from Margin Tax are passive investment partnerships and general partnerships in which all of the partners are natural persons. To qualify as a passive entity, the entity's gross income must consist of at least 90% of the following items: dividends and interest; limited liability company income; distributive shares of partnership income; gains from the sale of real property and securities; and/or royalties, bonuses, and delay rental income from mineral interests.

If more than 10% of the partnership's income is derived from an active trade or business, it will not qualify as a passive partnership. Note that rental income and working interest mineral income where the owner is also the operator (or a party to a joint venture agreement with the operator) are specifically excluded from passive treatment under the Margin Tax rules. Therefore, partnerships of which more than 10% of their income is derived from rental income and/or working interest mineral income are excluded from the definition of "passive partnerships" for Margin Tax purposes.

Note that limited liability companies and corporations, regardless of the nature of their assets (i.e., whether "passive" or "active"), will be subject to Margin Tax if their annual gross receipts are greater than $300,000.

2. Planning Under the Margin Tax

Under the Margin Tax, the most significant savings can be achieved by properly structuring the ownership of passive assets. For example, JJ Partners, LP owns rental real estate and mineral interests that generate royalty income. All of JJ Partners, LP's revenue, even that from the passive mineral interests, will be subject to the Margin Tax if the rental revenue is 10% or more of the total revenue. To prevent this from occurring, JJ Partners, LP can form a subsidiary LLC, JJ Rental, LLC. The rental real estate can be transferred to JJ Rental, LLC, where they will still be subject to Margin Tax. However, the mineral interests owned by JJ Partners, LP will no longer be subject to Margin Tax because JJ Partners, LP will qualify as a passive entity.

Alternatively, assume JJ Investments, LLC owns only stocks and bonds. If the dividends, interest, and net capital gains generated by the stocks and bonds is greater than $300,000, then all of the proceeds will be subject to Margin Tax because the entity is an LLC, which does not qualify for passive treatment. To qualify for passive treatment and avoid the Margin Tax on its earnings, the LLC could convert to a limited partnership. After the conversion, the revenue would not be subject to Margin Tax because the limited partnership would qualify for the "passive entity" exception to the imposition of the Margin Tax.

IV. CORPORATE TAXATION PITFALLS

C corporations are generally the least favorable entities tax-wise. Shareholders are subject to double taxation – once when the corporation's earnings are taxed inside the corporation and again when the earnings are distributed to the shareholders in the form of dividends. Currently, corporate income tax rates and dividend income tax rates are relatively low, but historically they have been much higher and it appears probable that they could increase in the future.

Many C corporation shareholders attempt to avoid the double taxation by taking a large amount of the corporation's earnings through salaries and bonuses. The IRS has been known to take issue with this practice and recharacterize the "excess" portion of the salary as a dividend. This recharacterization serves to reduce the compensation deduction taken by the corporation, generate a taxable dividend to the shareholder, and reduced the shareholder's compensation.

V. STATE-LAW CORPORATION ASSET PROTECTION PITFALLS

State law corporations are also generally the least favorable entities from an asset protection standpoint. If a shareholder is sued and has a judgment entered against him or her, the creditor can seize the debtor-shareholder's stock in the corporation and vote it. This allows the creditor to step into the shoes of the debtor and participate in the management of the corporation to the extent that the debtor had the ability to do so. To the extent that the stock appreciates beyond the amount of the judgment, the creditor will benefit because the debtor will no longer be treated as the owner of the stock.

If the debtor was instead a member of an LLC or a limited partner of limited partnership, the creditor would be limited to obtaining a charging order against the debtor's interest. This would allow the creditor to seize distributions made to the debtor by the LLC or limited partnership, up to the amount of the judgment. However, the creditor would not have the ability to participate in the management of the entity or to force it to make distributions. Also, if the LLC interest or partnership interest later appreciates in value, the debtor would retain the appreciation. This result makes the LLC interest and partnership interest unattractive from the creditor's perspective, making it more likely that any such creditor would be more likely to settle with the debtor.

VI. COMPARISON OF THE TAX TREATMENT OF S CORPORATIONS AND PARTNERSHIPS

Note that S corporations can be formed as corporations, partnerships, or LLCs for state-law purposes, and tax partnerships can be formed as partnerships or LLCs for state-law purposes. You will often hear the general statement that S corporations are taxed "just like" tax partnerships. While S corporations and tax partnerships are both flow-through entities, in that the entity's income is reported on its owners' tax returns, there are several differences that tax practitioners should consider when advising clients on their entity selection.

A. CONTRIBUTIONS OF PROPERTY TO THE ENTITY

Contributions of property to an S corporation are controlled by the provisions of Subchapter C of the Code (because Subchapter S does not address the issue), while contributions of property to a tax partnership are controlled by the provisions of Subchapter K. As a result, transfers of appreciated property to S corporations are treated differently from transfers of appreciated property to a partnership.

According to Section 351(a) of the Code, when appreciated or depreciated property is transferred to an S corporation that is not an investment company, the contributing transferring persons must be in "control" of the corporation immediately after the transfer in order for no gain or loss to be recognized. For this purpose, "control" means that the transferors must own at least 80% of the stock after the contribution. If the transferors do not control the corporation, they will recognize a gain, with respect to appreciated property, or a loss, with respect to depreciated property, equal to the difference between the fair market value of the property and their basis in the property.[1] The basis in the stock received in exchange for the property will be equal to the fair market value of the property contributed.

Example: Joe transfers property with a $10,000 basis and a $100,000 fair market value to JJ Corporation, an S corporation for tax purposes that has been in existence for more than one year, in exchange for 80% of JJ Corporation's stock. Because Joe will be in control of JJ Corporation after the contribution, he will not recognize a gain on the contribution of the property. His basis in the stock will be $10,000.

If, instead, Joe transfers the property to JJ Corporation in exchange for only 20% of the stock, Joe will be required to recognize a gain of $90,000 ($100,000 fair market value, less the $10,000 basis). Joe's basis in the stock he receives will be $100,000.

When the same property is contributed to a tax partnership, the lack of control by the transferors will not cause them to recognize gain or loss under Section 721. Therefore, a person may generally contribute an appreciated asset to a partnership, even if the interest taken back is very small, without recognizing a gain or loss.

Example: Joe transfers property with a $10,000 basis and a $100,000 fair market value to JJ Partnership in exchange for an 80% partnership interest. Joe will not be required to recognize gain on the contribution, and his basis in the partnership interest will be $10,000. The same result occurs if the property is transferred to JJ Partnership in exchange for a 20% partnership interest.

B. CONTRIBUTIONS OF SERVICES TO THE ENTITY

If a person receives S corporation stock in exchange for rendering services, the recipient will be required to recognize ordinary income equal to the value of the services rendered. The recipient's basis in the stock would be equal to the income that was recognized, and the holding period would begin on the date the stock was received.

Example: Joe renders services to JJ Corporation in exchange for stock. Joe will recognize ordinary income equal to the value of the stock received ($50,000). His basis in the stock will be $50,000, and his holding period will begin on the day he receives the stock.

Similarly, if partnership capital interests are received from a tax partnership in exchange for services, the recipient will recognize income equal to the value of the capital interest received. The transferor will also receive a capital account credit and an outside basis in the partnership interests equal to the value of the capital interest received.

[1] Note that the loss may be disallowed under Section 267 of the Code if the shareholder owns more than 50% of the corporation prior to the transfer.

Example: Joe renders services to JJ Partnership in exchange for a capital interest worth $50,000. Joe will recognize ordinary income in the amount of $50,000. His outside basis in the partnership will be equal to $50,000.

On the other hand, if the transferor receives only a profits interest (as opposed to a capital interest) in the partnership, the transferor would not be taxed on the receipt of the interest. Whether or not an interest in a partnership qualifies as a "profits interest" is determined under the liquidation value approach. A "profits interest" is defined as an interest that would not give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership at the time of the receipt of the partnership interest.

Note that the option of granting a profits interest in exchange for the contribution of services to the entity would not be available in an S corporation. This is because the existence of the profits interest would violate the "single class of stock" requirement.

Example: Joe renders services to JJ Partnership in exchange for a profits interest. Joe will not recognize income on the receipt of the profits interest. He will not receive a partnership capital account, and his outside basis in the profits interest will be equal to $0.

Proposed Treasury Regulations regarding grants of partnership equity for services were issued in 2005. If the proposed Regulations are finalized, valuation methods regarding grants of capital interests and profits interests will have to be harmonized. Under the proposed Regulations, grants of profits interests will not be nontaxable unless a liquidation value election is made. That valuation approach will generally result in greater income recognition to capital interest recipients.

C. ALLOCATION OF INCOME

The S corporation rules require all income to be allocated among the shareholders on a pro-rata basis. As a result, S corporations do not have the same flexibility in allocating profits and losses as tax partnerships governed by Subchapter K of the Code. Tax partnerships generally have a great amount of flexibility when it comes to allocating profits and losses so long as the allocations have substantial economic effect.

For example, we have a client that formed an irrevocable trust to own life insurance on his life. The client also formed a limited partnership to own investment assets. The trust subsequently contributed the life insurance to the partnership as a "special investment." Two classes of partnership interests were created – Class A interests represented all of the partnership assets other than the special investment while Class B interests represented only the special investment. The client only owned Class A interests, while the other partners owned both Class A and Class B interests. The purpose of this equity structure was to prevent the client from having any incidents of ownership in the special investment life insurance.

We have a second client who owned interests in a partnership that owned mineral interests and other investment assets. The client wanted to gift the mineral interests to his children. While one option would have been to distribute the mineral interests to the client, which he could then gift directly to his children, accomplishing the transfers would be very difficult from an administrative standpoint. To achieve the client's goals in the most efficient way possible, we amended the partnership agreement to create two classes of partnership interests. Class A interests represented all of the partnership assets other than the mineral interests, and Class B interests represented only the mineral interests. The client then gifted all of the Class B interest to his children. As a result, the children effectively own the mineral interests, but they never had to be distributed out of the partnership.

A third situation arose in which the client owned a partnership with assets consisting of marketable securities and stock options. The partnership was going to make a non-pro rata distribution to the client, but valuing the stock options proved difficult. As a result, the partnership agreement was amended to provide for two classes of partnership interests. The Class A interests represented the easy-to-value marketable securities and the Class B interests represented the hard-to-value stock options. When the non-pro rata distribution was made to our client, the Class A interests were recalculated, while the Class B interests remained unchanged. If any non-pro rata distributions are made in the future, the same methodology can be used until the stock options mature.

Another difference between partnerships and S corporations related to allocation of income concerns Section 704(c) of the Code. With respect to contributions of property with a built-in gain or loss, the partnership must allocate all items of income, deduction, gain, or loss attributable to the property among its partners in a way that allocates the burdens and benefits of the built-in gain or loss to the partner who contributed the property. If that same property were contributed to an S corporation with the same ownership structure, the gain or loss would be required to be allocated pro rata among all of the shareholders.

Example: Joe owns a building with a Fair Market Value of $100,000 and a basis of $25,000. He wants to enter into an entity on a 50% -50% basis with Jennifer who will contribute $100,000 for working capital and building improvements. Joe and Jennifer come to you for advice. You are considering an LLC taxable either as a partnership or an S corporation. The choice of tax classification will alter the after tax economic deal between Joe and Jennifer. The building will have a $25,000 basis. If a partnership is selected, all of the depreciation will be allocated to Jennifer. Additionally, if the building is sold, all of the pretax gain will be allocated to Joe on the other hand, if an S corporation is selected, depreciation would be allocated equally between Joe and Jennifer. Gain or loss on the sale of the building will also be allocated equally. Obviously, these differing tax results should be discussed with Joe and Jennifer before an entity is selected.

D. DISTRIBUTIONS FROM THE ENTITY

Assuming that the S corporation has never been a C corporation, distributions of cash are treated the same regardless of whether the cash is distributed from an S corporation or a tax partnership. This is because the basis in cash is equal to its fair market value. Distributions of property other than cash from S corporations are treated much differently than distributions of property from tax partnerships.

When an S corporation distributes appreciated property to one or more of its shareholders, it must recognize gain equal to the difference between the fair market value of the property distributed and the S corporation's adjusted basis in the property.

Example: JJ Corporation distributes property with a basis of $10,000 and a fair market value of $100,000 to its sole shareholder, Joe. Upon making the distribution, JJ Corporation will be required to recognize a gain in the amount of $90,000 ($100,000 fair market value, minus $10,000 basis). Joe's basis in the property will be $100,000.

If, instead, a tax partnership distributes appreciated property, the partnership would not generally recognize a gain. The capital account of the partner receiving the property would be reduced by the amount of gain inherent in the property while the partner's outside basis would be reduced by an amount equal to the partnership's adjusted basis in the property. There are specific exceptions to this nonrecognition rule that are discussed in Section VI.G.2.c of this outline.

Example: JJ Partnership distributes property with a basis of $10,000 and a fair market value of $100,000 to Joe, one of its partners. JJ Partnership will not recognize gain on the distribution. Joe's capital account will be reduced by $90,000, the amount of built-in gain, and his outside basis will be reduced by $10,000, JJ Partnership's basis in the property. Joe's basis in the property will be $10,000.

If the property distributed by the S corporation is loss property, the S corporation will not recognize a loss on the distribution. Instead, the stockholder receiving the distribution will reduce the basis in his stock by the fair market value of the property distributed, and his basis in the property will be equal to the fair market value of the property. As a result, the loss inherent in the property prior to its distribution would be lost. This result may be avoided by timely planning, but is a trap for the unwary that does not apply to partnerships.

Example: JJ Corporation distributes property with a basis of $50,000 and a fair market value of $40,000 to its sole shareholder, Joe. JJ Corporation will not recognize a loss on the distribution. Joe's basis in his stock will be reduced by $40,000, the fair market value of the property. Joe's basis in the property will be equal to $40,000, its fair market value. As a result, the $10,000 built-in loss is lost.

When a tax partnership distributes loss property, the loss is not recognized by the partnership. However, the partner will reduce his outside basis by an amount equal to the partnership's basis in the property and will have a carry-over basis in the property. As a result, when the partner later sells the property, he can fully utilize the loss inherent in the property when he receives it.

Example: JJ Partnership distributes property with a basis of $50,000 and a fair market value of $40,000 to its partner, Joe. JJ Partnership will not recognize a loss on the distribution. Joe's basis in the property will be $50,000. If Joe later sells the property for $40,000, he will be able to fully utilize the $10,000 built-in loss.

E. ENTITY DEBT IMPACT ON OWNER BASIS

With respect to an S corporation, when the entity's debt is increased, the shareholders' bases in the stock is not affected. Therefore, if an S corporation borrows against an appreciated asset and distributes the proceeds, a capital gain will result if the shareholders do not have sufficient outside basis to absorb the distribution.

Example: JJ Corporation borrows $50,000, which it subsequently distributes to Joe. Assuming Joe's basis in the stock is $50,000 or more, he will not recognize gain on the distribution and his basis will be reduced by $50,000. If instead Joe's basis in the stock is $40,000, he will recognize a $10,000 gain ($50,000 distribution, minus $40,000 basis), and his basis in the stock will be reduced to $0.

Conversely, when a tax partnership's debt is increased, each partner is generally treated as if he or she had contributed an amount of cash equal to the partner's allocable share of the debt (unless the debt is recourse to one or more partners, in which case the debt will be allocated among the at-risk partners). As result, each partner's outside basis is increased by that amount. Consequently, a partnership may generally borrow against its appreciated assets and distribute the proceeds without triggering a capital gain.

Example: JJ Partnership borrows $50,000. Joe, who owns 50% of the partnership interests, is treated as if he contributed cash equal to 50% of the debt, or $25,000. As a result, his outside basis increases by $25,000. If JJ Partnership subsequently distributes the cash that was borrowed to its partners pro-rata, Joe will receive $25,000, which will be fully absorbed by his outside basis, resulting in no gain to Joe.

F. TRANSFERS OF EQUITY INTERESTS

S corporation stock is treated as a capital asset, and the transfer of such stock will generally result in a capital gain or loss. While a partnership interest is generally treated as a capital asset, there are circumstances under which the transfer of a partnership interest will trigger ordinary income.

Section 751(a) generally requires a partner to recognize ordinary income or loss on the transfer of a partnership interest to the extent that the partner receives consideration that is attributable to his share of inventory and unrealized receivables ("hot assets"). Thus, if a partner who has been holding his partnership interest for more than a year sells the partnership interest, he will recognize ordinary income to the extent of his share of the partnership's inventory and unrealized receivables. The remainder of his gain will be taxed at the capital gain tax rates.

Section 752(d) also impacts the transfer of equity interests. Section 752(d) provides that in the case of a sale or exchange of a partnership interest, liabilities will be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

Example: Joe owns an asset with a basis of $500,000, which he contributes to JJ Partnership. Joe will have a $500,000 basis in his partnership interest. The asset subsequently appreciates to $1.5 million. In addition, JJ Partnership borrows $1 million, causing Joe's basis to increase to $1.5 million. JJ Partnership then distributes the $1 million to Joe, reducing his basis to $500,000. Joe then sells his partnership interest to a third party for $500,000 and is relieved of any liability for the $1 million loan. As a result, Joe will recognize gain equal to $1 million upon the sale of his partnership interest.

G. ENTITY LIQUIDATIONS

1. GENERAL RULES

Subchapter S is silent with regard to liquidating distributions from an S corporation. As a result, the Subchapter C rules control. When making liquidating distributions, the corporation will recognize gain or loss on the distribution of the assets as if it had sold the assets to the stockholders at fair market value. The stockholders will be treated as if they received full payment for their stock, resulting in capital gain or loss.

<u>Example</u>: JJ Corporation makes a liquidating distribution of cash in the amount of $20,000 and property with a basis of $10,000 and a fair market value of $100,000. Upon making the distribution, JJ Corporation will recognize a gain of $90,000 ($100,000 – $10,000). Joe, the sole shareholder, has a basis in his stock equal to $50,000. Upon receiving the liquidating distribution, he will recognize a gain of $70,000 [($100,000 + $20,000) – $50,000].

With respect to a tax partnership, it will not recognize gain or loss on the liquidating distribution. A partner will not recognize gain if the amount of money received is less than the partner's outside basis. Gain will be recognized if the amount of money received is greater than the partner's outside basis. The partner will recognize a loss if the amount of money received, plus the basis of unrealized receivables and inventory received by the partner, is less than his outside basis <u>and</u> the partner receives no other assets.

<u>Example</u>: JJ Partnership makes a liquidating distribution of cash in the amount of $20,000 and property with a basis of $10,000 and a fair market value of $100,000. Upon making the distribution, JJ Partnership will not recognize gain or loss. Joe's outside basis in his partnership interest is $50,000. The cash distribution of $20,000 will reduce his basis to $30,000. Upon receiving the property distribution, Joe will not recognize a gain, but his basis in the partnership will be reduced to $0 and his basis in the property will be equal to $30,000 (the amount of his remaining basis).

If, instead, Joe's basis in his partnership interest was equal to $10,000, he would recognize a gain of $10,000 ($20,000 cash, minus $10,000 basis) upon receiving the cash distribution. His basis in the property he subsequently receives would be zero.

Alternatively, assume JJ Partnership makes a liquidating distribution of cash in the amount of $20,000 and no other property is distributed. Joe's basis in his partnership interest is $50,000. When Joe receives the cash distribution, he will recognize a loss of $30,000 ($50,000 basis in partnership interest, minus $20,000 cash distribution).

2. SPECIAL RULES APPLICABLE TO PARTNERSHIPS

a. Section 704(c) Considerations

Generally, under Section 704(c)(1)(B), when a partner contributes appreciated property to a partnership and that property is distributed to another partner within seven years, the contributing partner must recognize gain, in an amount equal to the difference between the partner's basis in the property and the fair market value of the property on the date of the contribution, upon the distribution. Essentially, the contributing partner is treated as selling the property to the distributee partner.

Example: Joe transfers property with a fair market value of $15,000 and a basis of $3,000 to JJ Partnership on January 1, 2008. On January 31, 2013 (5 years later), JJ Partnership distributes the property to another partner, Jan. Upon this distribution to Jan, Joe must recognize a gain of $12,000. Joe's outside basis will increase to $15,000. However, if JJ Partnership distributes the property to Jan on January 31, 2015 (over 7 years later), Joe will not be required to recognize a gain.

Section 704(c) also impacts the allocation of depreciation. Section 704(c) gain or loss must be taken into account when allocating depreciation expense among the partnerships of a partnership. In an S corporation (as previously discussed), depreciation related to assets contributed with a built-in gain or loss is allocated pro rata among the shareholders.

b. Section 707 Disguised Sale Rules

Once section of the Code unique to partnerships is the disguised sale rules. These rules prevent a person from contributing an asset to a partnership and taking back cash without presuming a sale. The single class of stock rules that apply to S corporations would generally prevent the same from occurring in an S corporation. This is because the single class of stock rules restrict the flexibility of the corporation's capital structure.

Generally, under Section 707, if a partner transfers property to a partnership and receives a distribution of money or other property from the partnership in the two-year period following the transfer, the transfer will be presumed to be a disguised sale. This will be the result unless the facts and circumstances clearly indicate otherwise.

There are certain specific exceptions to the Section 707 disguised sale rules. The following distributions will not be presumed to be part of a disguised sale:

1. A "reasonable" guaranteed payment made to the partner for the use of the partner's capital. The payment will be presumed reasonable if it is determined without regard to the partnership's income, is made pursuant to a written provision in the partnership agreement, and does not exceed 150% of the AFR.

   Example: Joe contributes property worth $400,000 to JJ Partnership. He may receive a guaranteed payment (assuming a 5% AFR) each year of up to $30,000 [$400,000 x (5% x 150%)].

2. A distribution from the partnership's operating cash flow. This is essentially a payment representing the partner's share of the partnership profits.

Example: Joe owns a 20% limited partnership interest in JJ Partnership, which decides to distribute $100,000 of its operating cash flow to its partners. Joe can receive his $20,000 distribution without the distribution being presumed to be a disguised sale.

3. Reimbursement for preformation expenditures that were incurred during the two-year period preceding the formation of the partnership. Preformation costs include the partnership formation costs and capital improvements made on the property. However, the reimbursed amount cannot exceed 20% of the fair market value of the contributed property.

Example: Joe contributes property worth $400,000 to JJ Partnership. Joe can receive reimbursement of his preformation costs up to $80,000.

4. Contributing property subject to qualified indebtedness, which the partnership assumes. In order for this exception to apply, the transaction must not otherwise be classified as a disguised sale. In order for indebtedness to be "qualified," it must meet the following requirements:

a. The liability meets at least one of the following:

i. The liability has encumbered the transferred property throughout the previous two-year period and the liability was incurred by the partner more than two years before the earlier of: (1) the date the partner agrees in writing to contribute the property to the partnership, or (2) the date the partner actually contributes the property;

ii. The liability was incurred during the two-year period preceding the transfer, but was not incurred in anticipation of the transfer;

iii. The liability is allocable to capital expenditures relating to the property under Treasury Regulation § 1.163-8T; or

iv. The liability was incurred in the ordinary course of the trade or business (certain other requirements must be met for this exception to apply).

b. If the liability is recourse, the amount of the liability must not exceed the fair market value of the transferred property.

By contributing property subject to qualified indebtedness, the partner can defer recognizing gain on the "sale" of the business assets. Should he liquidate or sell his partnership interest, he will be required to recognize gain on the amount by which his amount realized exceeds his basis in his partnership interest. However, should the partner die holding his partnership interest, it will receive a step-up in basis and can then be sold without recognizing gain. This serves to permanently defer the tax.

c. Section 708 Technical Terminations

Section 708 provides that, if more than 50% of the interests in a partnership are transferred in one year, the partnership will be deemed to have terminated and all of the assets distributed to its partners and then reconstituted and the assets recontributed by its partners. This effect depreciation, in that the partnership must treat each asset as if it just acquired each asset at an amount equal to its adjusted basis immediately before the technical termination, and depreciate the asset over the appropriate number of years starting on the date of the reconstitution.

d. Section 731 Distributions

The treatment of distributions made by an S corporation, which are fairly straightforward are discussed in Section VI.D of this outline.

Section 731 provides that a partner will recognize gain to the extent he receives distributions of money in excess of the adjusted basis of the Partner's interest in the partnership immediately before the distribution. There are two easy ways that this position may be overlooked. First, it is easy to forget that, with some exceptions, the term "money" includes the fair market value of any marketable securities that are distributed to the Partner. Secondly, in some cases, the order in which assets are distributed causes taxation.

Example: JJ partnership plans to redeem Joe's partnership interest in a series of transactions. The fair market value and basis information is as follows:

	Total Assets	**Marketable Securities**	**Oil & Gas**
FMV of Assets	$4,500,000	$1,500,000	$3,000,000
P'ship Inside Basis	3,000,000	800,000	2,200,000
Partner's Outside Basis	3,000,000		

If marketable securities are distributed first:

Outside Basis	$3,000,000
Fair Market Value of distributed securities	1,500,000
Remaining O/S Basis	1,500,000

Upon the subsequent distribution of the oil and gas properties, there is no gain or loss. The basis of the oil and gas properties is reduced to $1,500,000.

If the oil and gas assets are distributed first:

Outside Basis	$3,000,000
Basis of Oil & Gas Properties	2,200,000
Remaining Basis	800,000
FMV of Securities	1,500,000
Taxable Gain	700,000

e. Section 737 Distributions

Generally, distributions of assets other than cash by a partnership do not cause the partners to recognize gain. However, Section 737 may cause a partner to recognize gain when a partnership distributes certain assets. It is important to note that, in some cases, the gain on the distribution that the partner is required to recognize could be higher than the built-in-gain inherent in the property distributed.

Section 737 requires a partner to recognize gain when the partner receives certain distributions within seven years of making a contribution to the partnership. The gain that must be recognized is determined with reference to the "net precontribution gain" and the "excess distribution."

The net precontribution gain is the net gain that would have been recognized by the distributee partner under section 704(c)(1)(B) if the property had been distributed to another partner within seven years. Therefore, the net precontribution gain is essentially the difference between the partner's basis in and the fair market value of the property on the date it is contributed to the partnership. It only applies, however, to contributed property that is still owned by the partnership.

The excess distribution is the excess of the fair market value of property, other than money, received by the partner in the distribution over the partner's adjusted basis in the partnership immediately before the distribution, reduced by the amount of money received by the partner in the distribution.

The partner must recognize gain in an amount equal to the lesser of the net precontribution gain or the excess distribution.

<u>Example</u>: Joe transfers property with a fair market value of $15,000 and a basis of $3,000 to JJ Partnership on January 1, 2008. Under these facts, Joe's net precontribution gain is $12,000. On January 31, 2013, JJ Partnership distributes land with a fair market value of $5,000 to Joe. Immediately before the distribution, Joe's basis in the partnership is $3,000. The excess distribution is $2,000, which is the difference between the fair market value of the property ($5,000) and the basis of Joe's partnership interest ($3,000). The excess distribution of $2,000 is less than the net precontribution gain of $12,000, so Joe must recognize a gain of $2,000.

Alternatively, on January 31, 2013, JJ Partnership distributes land with a fair market value of $20,000 and a basis of $10,000 to Joe. Immediately before the distribution, Joe's basis in the partnership is $3,000. The excess distribution is $17,000, which is the difference between the fair market value of the property ($20,000) and the basis of Joe's partnership interest ($3,000). Since the net precontribution gain is less than the excess distribution, Joe must recognize a gain of $12,000. Note that this situation creates a counterintuitive result in that Joe's gain of $12,000 exceeds the $10,000 built-in gain on the distributed property.

f. Exceptions to Section 737

The following are a few of the exceptions to Section 737, which can be found in Treasury Regulation § 1.737-2:

i. Technical terminations under Section 708(b)(1)(B);

ii. A transfer of all of a partnership's assets and liabilities to a second partnership, followed by a distribution of the partnership interest held in the second partnership in liquidation of the first partnership as part of the same plan or arrangement;

iii. A transfer of all of a partnership's Section 704(c) property previously contributed by a partner to a second partnership in an exchange described in Section 721, followed by a distribution as part of the same plan or arrangement of a partnership interest in the second partnership in complete liquidation of the interest of the contributing partner's interest in the first partnership; and

iv. The incorporation of a partnership provided that the partnership is liquidated and that partnership assets are not distributed to the partners as part of the incorporation.

H. SECTION 754 ELECTIONS

Upon the death of a partner, a partnership can make an election under Section 754 of the Code to increase (or decrease, as the case may be) the partnership's basis in all of its property so that the basis is equal to the property's fair market value on the date of the partner's death.

The Section 754 election is not available to S corporations. However, if the S corporation is liquidated soon after the shareholder's death, the result may be the same with respect to the deceased shareholder's stock. This is because the shareholder's estate will receive a step-up in the S corporation stock basis upon the shareholder's death. If the S corporation liquidates soon thereafter, the S corporation will recognize gain equal to the difference between the fair market value of the assets on the date of the liquidation and its basis in the assets. That gain will flow through to the shareholder's estate and increase its outside basis.

Upon the shareholder's estate receiving the assets, it will be treated as if received payment for all of its stock equal to the value of the assets it receives, resulting in a loss to the shareholder's estate. This loss can be used to offset the gain flowing through to the shareholder's estate from the S corporation.

BUSINESS START-UP CHECKLIST

I. Choice of Entity

A. Options: C Corporation, S Corporation, Limited Liability Company, Limited Partnership, General Partnership.

B. Who will the initial owners be? In the future?

C. What is the nature of each anticipated owner (individual, entity, trust)?

D. Will there be separate classes of stock/ownership interest (e.g., preferred stock)?

E. Will there be outside investors?

F. How many owners do you anticipate?

G. Should interests be easily transferable?

H. Will the entity have a limited duration?

I. What is your exit strategy?

J. Sale to a third party?

K. Initial public offering?

L. Gifting to family members?

M. Will there be employees other than the owners?

N. Is benefit planning a major objective of the owners?

O. Do you expect to have special allocations between the owners (e.g., losses, profits, taxes, debts, etc.)?

II. Management & Control

A. Should management be delegated to a management group (Board of Directors/Managing Members), or retained by all owners?

B. If management is delegated to a management group, must members of the management group also be owners?

C. What type of owner and/or management group voting requirements will exist for the following actions, if any?

1. Day-to-day operations?

2. Approval of leases?

3. Sale of substantially all of the assets?

4. Dissolution?

5. Contracts of the entity in excess of a certain, stated dollar amount? If so, what amount (e.g., $10,000, $50,000)?

6. Removal of a manager?

7. Removal of an owner?

8. Addition of new members?

9. Other?

D. Who will manage the day-to-day operations? How much time will such manager be expected to devote to these duties?

E. How do owners vote?

1. Equally?

2. Based on percentage ownership?

3. Based on the profit/loss distribution percentages?

4. Will formal voting trusts/agreements between owners be permitted?

F. How many signatures are required on checks, contracts, etc.? Who is authorized to sign?

III. Capitalization

A. What is the estimated amount of funds necessary for start-up? First year of operations? Second year? Etc.?

B. What sources of funds will be utilized?

1. Equal contribution by each owner?

2. Disproportionate contribution by each owner?

3. Loans from owners?

4. Loans from third parties/banks?

5. Outside investors?

C. What uses of funds can be forecasted (estimated expenses such as rent, phones, computers, utilities, insurance, travel, advertising, and other expenses particular to your business)? Have proforma financials been prepared?

D. If owners contribute capital, will 100% of infusion be structured as equity, or will some of it be structured as a loan?

IV. Compensation

A. How will owners be compensated?

1. Distribution of profits only?

2. Salary only?

3. Salary plus commission?

4. Salary plus a distribution of profits?

5. Advances plus distribution of profits?

B. Will the managers receive additional salary for their roles as managers? How much?

V. Distributions

A. How will profits and losses be distributed among the owners?

1. Equal split of profits?

2. Profits distributed based on capital contribution?

3. Establish separate profit-sharing interests?

4. Preferred return?

5. Other?

B. When will distributions be made (monthly, quarterly, annually)?

C. Will earnings/profits be retained in the business during the beginning years? If so, who may approve such retention and the amount retained (management group, vote of owners)? What percentage approval is required?

D. Will the entity make mandatory distributions sufficient to meet each owner's tax liability resulting from such equity participation for the prior year?

E. Will advances be permitted?

VI. <u>Transferability of Interests</u>

A. Will equity interests be freely transferable? If not, what type of transfer limitations will be imposed?

1. Right of first refusal granted to the entity?

2. Right of first refusal granted to the other owners?

B. Will there be mandatory buyout provisions for the following events?

1. Death?

2. Permanent and total disability?

3. Incompetency?

4. Other disability?

5. Resignation (at retirement age)?

6. Voluntary withdrawal (prior to retirement age)?

7. Involuntary withdrawal (e.g., termination)?

8. Operation of law (e.g., divorce, bankruptcy)?

9. Engaging in competitive activities?

10. Conviction of a crime or misconduct?

11. Creditor attempting levy?

12. Other?

C. If transfer of interests is restricted, will there be a class of permitted transferees to whom transfers are allowed (spouse, other family members, entity controlled by the transferee, trust, etc.?

D. If interests may be sold to third parties or transferred to permitted transferees, what rights does the new equity owner obtain (rights to distributions of profits/losses that were vested in the interest purchased, voting rights, all the rights inherent in the equity interest that were held by the selling owner prior to the sale)?

E. May owners pledge their interests as security for a loan?

F. If shareholder or buy-sell agreements are in place, mandating the purchase of an equity interest upon dissociation of an owner, will the obligation to purchase be funded with insurance or a sinking fund?

G. If buyouts are mandatory upon dissociation of an owner, how will the purchase price be determined (fixed amount updated annually by agreement, based upon a formula, based upon a business appraisal at the time of the buyout)? Will the amounts be payable immediately, or over time in installments? Do you want the valuation to differ based on the particular withdrawal event (e.g., death vs. competitive activities)?

H. What is an owner entitled to if he or she wants to voluntarily withdraw from the entity? When may a request to dissociate be declared?

VII. <u>Benefits</u>

A. What types of employee benefits, if any, will be provided by the new entity to the owners and other employees (medical, dental, disability, retirement, automobile allowances, etc…)?

B. Will the participants in the benefit plans be required to contribute their own funds toward benefit premium payments?

C. Do you want to benefit the owners primarily, or all employees?

VIII. <u>Insurance</u>

A. What types of insurance will be maintained by the new entity?

1. Automobile?

2. Valuable papers?

3. Office contents?

4. Workers' compensation?

5. Group life?

6. Group health?

7. Accident?

8. Business interruption?

9. General liability?

10. Errors and omissions for directors and officers?

11. Other?

IX. Employment

A. Will additional employees be hired by the new entity, who are not owners?

B. How many additional employees will be needed?

C. Will the employees be full-time or part-time?

D. How will additional employees be compensated (hourly, salary, salary plus commission, salary plus bonus)?

E. Will benefits be provided for such additional employees?

F. May additional employees be related to the owners, or will the entity maintain a strict policy against nepotism?

X. Location

A. Will the new entity lease office space?

B. For what duration will a lease be sought?

C. Will more than one office be required?

D. Where will the office(s) be located?

E. Will the company be segregated into separate regions, operations, product lines, etc.? Should separate companies be formed for each location to limit liability?

XI. Conflict of Interest

A. May owners be involved in other business ventures, or are they required to devote 100% of their efforts to the new entity?

B. If permitted to be involved in other business ventures, may the ventures be in the same line of business as the new entity? Same industry as the new entity?

C. Will you require noncompetition covenants between owners, employees, etc.

XII. Name – What will be the name of the new entity?

XIII. Strategic Planning

A. Has a comprehensive, written, mutually agreeable business plan been established?

B. What are the business strategies of the entity?

C. What contacts, resources will each owner be bringing to the new entity (suppliers, buyers, etc.)? Are the respective contributions to be valued equally, or will different valuations be applied?

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CHOICE OF ENTITY: WHEN NOT TO USE A LIMITED LIABILITY COMPANY

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