


# Choice Of Entity For The Family Business

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## ABSTRACT

*Choice of entity has long been one of the central issues in applied business planning. The family business often has special characteristics and needs that may differ from other businesses. These different characteristics and needs will affect the determination of which entity is best for a particular business enterprise. To give some examples, the owners of a family business may want to maintain long-term control in the hands of one or two family members while still providing fairness for minority owners, may need to deal with attribution rules and other statutory provisions that make income tax planning more complicated, and may have the desire to take estate taxes into account as well as income taxes. Tax legislation enacted in the years 2003 through 2006, as well as evolving case law, have made choice of entity for the family business more complicated than before, warranting a new look at this special topic.*

## INTRODUCTION

very business, except perhaps for the most rudimentary sole proprietorship, is conducted through a business entity. The decision as to what type of business entity best meets the needs of the business is one that must be made at the inception of the business. In some cases, the decision may be revisited at a later time. It is one of the central issues in applied business planning.

The basic categories of business entities are the corporation, the limited liability company, and the partnership, and each of these categories has subcategories. A corporation may elect to be an “S corporation,” where the income is taxed directly to the shareholders; otherwise it is a “C corporation.” A limited liability company may be “member-managed” or “manager-managed.” A partnership may be a general partnership, limited partnership, limited liability partnership, and, in some states, limited liability limited partnership.

It is sometimes tempting to think in terms of choosing a C corporation for a business that will be publicly-held, and an LLC for a business that will be closely-held. Although the first of these makes sense for tax, securities, underwriting, and marketing reasons, it may be a mistake to think of LLC as the default decision for the closely-held business. Even when an LLC is the optimal entity for a particular business, it may be a mistake not to understand the distinction between the member-managed LLC and the manager-managed LLC. There are numerous factors involved in the choice of entity for any closely-held business, as the needs and the goals of each may be best addressed by a particular business entity.

This is especially true where there is a family business, a closely-held business owned primarily by members of the same family. Family businesses have their own special characteristics and needs, and these will affect the choice of entity determination.

Choosing the optimal entity for a family business is not something that can be done by a checklist or by a chart. This is all the more true in light of significant changes to the Internal Revenue Code (the “Code”) in the years 2003 through 2006, as well as evolving case law. However, the best choice can be made by appreciating the current legal and practical issues affecting choice of entity decisions, understanding the unique ways to which they relate to the family business, and then weighing those factors and applying them to the particular family business involved.

## **GENERAL CHOICE OF ENTITY PRINCIPLES AND THE FAMILY BUSINESS**

### **Limited Liability**

In the days before the limited liability company (LLC) and the limited liability partnership (LLP), a business entity whose owners wanted protection from personal liability had to make some difficult choices. A regular corporation (now called a C corporation) was the easiest route to limited liability, but it could result in double taxation if the company's profits were more than it could reasonably pay out in compensation to the owners.<sup>1</sup> An S corporation could avoid most instances of double taxation, but then it had technical rules to comply with, and treacherous qualifications such as the requirement that there be only one share of stock.<sup>2</sup> A limited partnership could provide limited liability to limited partners, but these had to be passive investors. What is more, there always remained the question of how to protect the general partner from unlimited liability, and often this meant just forming another corporation to be general partner.

Now that we have LLCs and LLPs (and in some states, even LLLPs, limited liability limited partnerships), a business will no longer have to make sacrifices in order to get limited liability. Given a choice among C corporation, S corporation, or one of the new limited liability entities, it is difficult to imagine any business having to make a trade-off or sacrifice of any kind in order for its owners to have limited liability. This would mean that in most situations any kind of business should rule out any form of business that might subject an owner to unlimited personal liability.

Are there any reasons remaining why any business would operate in a form that would subject one or more of its owners to unlimited liability? Other than the possibility that the business may be getting inadequate professional advice, there still are some reasons an individual business owner may sensibly want to be a sole proprietor or general partner, despite the unlimited personal liability that results. First, there are businesses that are so small and uncomplicated that the owner(s) may feel there is no possible liability against which protection is needed. Second, there may be some other way that the business is addressing liability, for instance, if all the general partners of a partnership are corporations, or if the liabilities are adequately covered by insurance. Third, if the only possible liability of the corporation would be from the tortious acts of a sole owner (e.g., a professional malpractice claim against a one-person professional practice), which liability cannot be shielded by an entity in any event, it may be that a limited liability entity would provide no benefit.

For the most part, however, these reasons are not likely to apply to a family business, which will likely need an entity that provides limited liability. Thus, this article will focus on the "limited liability entities" -- the C or S corporation, the limited liability company, and the limited liability partnership -- as well as the limited partnership that has a limited liability entity as its general partner, as these entities will protect individual owners from personal liability.<sup>3</sup>

### **Pass-Through Entities Vs. The Non-Integrated Tax System**

It is said that the net income of a C corporation is subject to "double taxation," meaning that the income is taxed first to the corporation when earned, and again to the shareholder when paid out as a dividend. This characterization is not entirely correct, as compensation is deductible. As long as payment is reasonable, and paid as compensation for services, the owner of a C corporation can have most or all of the net income taxed only once. The strategy of using compensation to owners to diminish taxable corporate net income to zero, or to a minimum amount, is sometimes referred to colloquially as "zeroing out."

As has been noted: "One of the key ways to minimize the corporate income tax has always been the payment of compensation to owners. The Internal Revenue Code has long sanctioned deductibility of 'a reasonable allowance

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<sup>1</sup> Internal Revenue Code ("Code") §162(a)(1)

<sup>2</sup> Code §1361(b)

<sup>3</sup> It is beyond the scope of this article, but worth mentioning at this point, that there are exceptions to this protection, such as when an owner personally guarantees an obligation of the business, or when the business entity is disregarded by the owners and used as an agent of deception.

for salaries or other compensation for personal services actually rendered,' Code §162(a) (1). While the Code's formulation appears to be a single test, the regulations break it into two parts. To be deductible, it's not enough for compensation to be reasonable in amount; it must also be 'purely for services.' Treas. Reg. 1.162-7(a). This 'purely for services' test has been referred to as the 'second prong' of the deductibility test."<sup>4</sup>

Although earlier cases seemed to assume that if the amount of the payment was reasonable for compensation for the services rendered, they it would be treated as paid for the services. More recent cases have held otherwise, citing factors to determine when a payment would be treated as a non-deductible dividend, despite being a reasonable amount to pay for services rendered.<sup>5</sup> The factors include:

1. Payments made in lump sums rather than as the work was performed.
2. Absence of formal dividend distributions.
3. Payments made only to stockholders, and in proportion to stockholdings.
4. Amount of distributions based on funds available rather than on services rendered.
5. Evidence that the source of the profits of the business derived from the efforts of individuals other than the recipients of the payments.<sup>6</sup>

Many of the problems raised by the recent cases could be avoided merely by caution, that is, making periodic rather than lump-sum payments, and documenting the value of all the services performed by the family member-stockholder. But that kind of caution only takes the business part of the way towards defending the deductibility of compensation.

One of the biggest of the indicia that amounts have not been paid for services is proportionality. That is, when amounts are paid in proportion to stock ownership, there is the appearance that the payments, even if reasonable in amount, are not payment for services. In a family setting, the parents may want their children to receive an equal percentage of the business, and an equal percentage of the profits. Such an arrangement is highly vulnerable, and a family business that plans to do this will need to be able to produce evidence of the value of services.

"Zeroing out" will not always be a satisfactory solution to the owners of a family business. It may be that some or all of the owners do not provide services whose value is commensurate with their share of the profits. In a family business, there could be some owners in a nursing home, and others in a nursery. Defending substantial compensation for such individuals may be a challenge in any examination by the Internal Revenue Service.

When it is not practical to use compensation to deplete the taxable income of a corporation, there will be both tax at the corporate level as the income is earned, and then again at the shareholder level as dividends are paid out. This is referred to as a "non-integrated" tax system, because the corporate tax and the shareholder tax are calculated independently.

In Part III of this article, there is a discussion of the temporary lower tax rate applicable to dividends received in the years 2003 through 2010. This political compromise partially mitigates the double taxation inherent in the non-integrated tax system. Whether this is a satisfactory solution to the problem will depend on the facts and circumstances of each individual business. In the event that this temporary lower tax rate does not address the problem for a particular family business, then the business will want to consider an entity other than the C corporation, that is, the business will want to consider using a pass-through entity.

A pass-through entity is one where the taxable income of the business (and often, but not always, the losses) are passed through directly to the owners. This is a type of integrated tax system, because the taxable income of the

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<sup>4</sup> Martin A. Goldberg, "Corporate Deductions for Compensation Under Recent Cases," *Connecticut Lawyer*, Vol. 12, No. 4, December 2001/January 2002, p. 20.

<sup>5</sup> *Id.*, page 21.

<sup>6</sup> *Id.*, pages 21-22; citing, e.g., *O.S.C. & Associates, Inc. v. Comm'r*, 187 F.3d 1116 (9th Cir. 1999), *aff'g* T.C. Memo 1997-300, cert. den. 529 U.S. 1097 (2000) and *Pediatric Surgical Associates, P.C. v. Comm'r*, TC Memo. 2001-81.

entity and the taxable income of the owners are calculated in a single procedure. Except in rare circumstances, the entity itself does not pay any taxes, so there is no double taxation. The pass-through entities are the S corporation, whose particular characteristics are discussed in more detail in Part IV, below, as well as the LLC and all varieties of the partnership.

### **Centralized Vs. Non-Centralized Management**

A corporation, whether a C corporation or an S corporation, is the classic example of a business entity with centralized management. The owners, the shareholders, do not manage the corporation, rather the corporation is managed by officers appointed by the board of directors. A general partnership is the classic example of a business entity with non-centralized management. All of the owners, the partners, participate in the management of the business. All decisions as to choice of entity need to take account of the difference between centralized and non-centralized management.

In a business other than a family business, the question of centralized management is decided at the outset, and will rarely change. An investor who buys stock in Microsoft or General Motors is not expecting to provide any input into the management of the company. An investor who buys a limited partnership interest in a business venture similarly knows he or she is not going to have any input in the operation of the business. In contrast, if a small number of auto mechanics (or architects, doctors, dog groomers, or whatever) decide to be co-owners of a business, the chances are good that each will expect to have some voice in the management of the business. In all cases, the expectations at the outset will rarely change, and the managers of the business will feel little obligation to the non-managers other than what is required by contract or law.

Management issues in a family business are different in several significant ways.

First, a member of a family may start out as not manager material, but then mature into someone who will be able to manage the business.

Second, within a family there could be equally-situated individuals (e.g., the children of the company founders) who differ in their ability to manage the company.

Third, if some members of the family are permanently relegated to non-manager status, the founders of the company are likely to want to give them more than just bare-bones protection, i.e., to ensure that they receive their proportion of the economic benefit of the company. This would especially be the case if the company were a large portion of the founders' wealth.

Fourth, the amount of control that an individual has over a business may affect how that business is valued for estate tax purposes, so estate planning goals may need to be taken into account when determining which entity has the optimal management structure.

In short, a family business will generally need greater flexibility in management structure, and greater protection for non-management owners, than a business that is owned by unrelated individuals. With that in mind, we can review the different entities in terms of which kind of family might opt for which management structure.

#### *Limited Liability Partnership Or Member-Managed Limited Liability Company*

In the event that the family wants to give all the owners a voice in the management of the business, whether an equal vote or otherwise in proportion to ownership percentages, these entities will provide that.

#### *Corporation*

The management of a corporation is by the board of directors, whether or not the corporation is a C corporation or an S corporation, and the members of the board of directors are elected by the shareholders. Although

an S corporation is only permitted one class of stock, this prohibition is not violated by the issuance of voting and non-voting shares.<sup>7</sup> Thus, if there is a family business where the founders wish to retain flexibility over control, they can form a corporation, issue voting and non-voting shares, make gifts of non-voting shares to their children, and make gifts of voting shares over time as they determine who are the best candidates for running the business.

*Manager-Managed Limited Liability Company*

In a manager-managed limited liability company, the members may vote on who will be the manager(s). In this regard, the management appears to be a form of centralized management similar to that of a corporation. However, there is *no requirement* that the manager be elected by owners. An LLC is governed by its operating agreement, and the operating agreement is not restricted as to how the manager may be selected. Thus, the founders may retain a right to be or designate managers long after they have transferred most of the ownership of the business to their children. Whether or not this is an important factor depends on the specific individuals involved.

*Limited Partnership Or, Where Available, Limited Liability Limited Partnership*

As we have seen, not all forms of centralized management are the same. The corporation is essentially democratic, where management (the board) is elected. The manager-managed LLC may be democratic, but it need not be. With the limited partnership, management rights are inseparable from the ownership of the general partnership interests and, as such, are inalienable without the consent of the owner. Although the limited partnership is not generally thought of as the entity of choice for family businesses, the founders of a business who want to retain the greatest possible control over the business, with the least likely chance of interference by members of the family who have been given a non-managerial investment in the business, may want to consider the strict management benefits of the limited partnership. The only qualification is that if the business is in a state that does not authorize the limited liability limited partnership, the owners of the general partnership interest may choose instead to have that interest owned by a corporation owned by them.

Although estate planning factors are discussed below, it is important at this point to note a relationship between management and estate planning considerations. For estate tax purposes, each of a decedent's assets will be valued at "fair market value," defined as "...the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."<sup>8</sup> Where there is a fractional interest in a business entity, the value of that interest may often be discounted for tax purposes, because buyers are willing to pay less money for a fractional interest. That is, a buyer will pay less for one-quarter of a company worth \$1million, than for all of a company worth \$250,000. The two reasons commonly given for this discount are lack of marketability and lack of control.

On the one hand, a parent who wishes to retain absolute control will retain the general partnership interests while giving limited partnership interests to his or her children. On the other hand, a parent who does not need control (such as one with grown children capable of managing the business) will retain limited partnership interests and give away general partnership interests to his or her children. Since owners of limited partnership interests have so little control over the limited partnership, the estate can claim a greater discount in the value of the interests retained by the parent. Thus, the management structure of the limited partnership may result in estate tax savings. Although any fractional business interest in a decedent's estate may be discounted for valuation purposes, the discount may arguably be greatest where the retained interest in a limited partnership interest in a limited partnership because of the absolute lack of control.

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<sup>7</sup> Code §1361(c)(3).

<sup>8</sup> Treas. Reg. § 20.2031-1(b).

## INCOME TAX ISSUES

### Income Deferral And Shifting

No choice of entity discussion is complete without mention of Code §1(h)(11), added in 2003 by the Jobs and Growth Tax Relief Reconciliation Act of 2003,<sup>9</sup> and amended in 2006 by the Tax Increase Prevention and Reconciliation Act of 2005.<sup>10</sup> Under Code §1(h)(11), qualifying dividends received between January 1, 2003, and December 31, 2010, are taxed at the same rate as long-term capital gains. This means:

1. Qualifying dividends will be subject to a maximum rate of 15 percent.
2. Qualifying dividends received by individuals in the 10- or 15-percent marginal bracket will be subject to a maximum tax of 5 percent through the end of 2007, and zero percent for the years 2008 through 2010.

On January 1, 2011, taxation of dividends will revert to the rules previously in effect, and dividends will be taxed at the same rate as other ordinary income.

As a result of this new, although temporary, provision, the owner-employee of a C corporation will want to consider whether a portion of his or her income should be paid as a dividend rather than compensation. This would be the case to the extent that corporate income is taxed at a rate of 15 percent or less (the first \$50,000 of taxable income for a C corporation other than a “qualified personal service corporation”),<sup>11</sup> if the person receiving the income would otherwise be paying income taxes at a rate of more than 30 percent (the combined corporate tax on profit and individual tax on dividends). It will generally be beneficial for a corporation to pay out the first \$50,000 of its profits in the form of dividends, since compensation below the 31 percent tax bracket is within the Social Security wage base, and even workers nominally at the 28 percent marginal bracket will be paying an actual rate of well over 30 percent on compensation for services.

This is similar to the situation of the S corporation owner-employee who tries to peg his or her compensation below the Social Security wage base in order to reduce F.I.C.A. and similar payroll taxes. The difference is that the S corporation owner’s sole benefit is to reduce the payroll taxes, while the C corporation owner may also be subjecting income to a lower combined corporate and individual tax rate.

There’s another respect in which the C corporation owner is different from the S corporation owner. The S corporation owner reports corporate profits on his or her return in the year earned. The C corporation only pays corporate taxes in the year the profits are earned, and the second 15 percent, the individual tax, is not due until the year that the owner actually receives the dividend. As long as the corporation steers clear of the accumulated earnings tax,<sup>12</sup> there is no tax incentive not to delay the payment of the dividend as long as possible. This would mean waiting until the end of 2010, in order to see whether Congress extends the special dividend tax rate further.

The ability to pay taxes at a lower rate, and to defer half that tax at will, is an option that is not limited to the family business. But the family business has an additional reason to utilize this technique. The family business may be co-owned by a range of generations, including a retired generation in a low bracket, or a younger generation in an even lower bracket. To the extent that any of these shareholders is in a marginal bracket of 15 percent or lower, then they would qualify for the tax-free dividend payout in the years 2008 through 2010.

Assuming that Congress does not extend the special capital-gains rate for dividends, this short-term benefit may still be taken into account when choosing an entity for a family business, and should be added to the list of factors favoring C corporation. Even if the company begins this strategy in 2007, at a rate of \$50,000 a year between 2007 and 2010 the company will end up paying taxes at a lower rate on \$200,000 of income. The amount of the savings will depend on who the recipients of the dividends are (their marginal brackets, including payroll taxes), but

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<sup>9</sup> P.L. 108-27, May 28, 2003.

<sup>10</sup> P.L. 109-222, May 17, 2006.

<sup>11</sup> Code §§11(b)(2), 448(d)(2).

<sup>12</sup> Code §531 *et seq.*

the amount of income to which the savings would apply can be calculated by direct reference to the 15 percent marginal corporate bracket.

Two caveats are in order here:

First, the Tax Increase Prevention and Reconciliation Act of 2005 contained another provision relevant to a business owned by different generations in a family. Retroactive (because the law was actually enacted in 2006) to the beginning of the year 2006, the law changed the age at which the so-called “kiddie tax” would be applicable. Under prior law, investment income of a child in any year prior to the year he or she reached the age of 14 would, after some minor exemptions, be taxed at the bracket of the child’s parents. The new law increases this to age 18, so that a child does not have full advantage of his or her lower brackets until the year that includes his or her 18th birthday.<sup>13</sup> Each case will be different, but since the corporation may make a distribution in 2008, 2009, and 2010, it should delay the distribution if doing so will push it to or past the year the recipient turns 18.

Second, the tax advantages described in this section of this article will be significantly less, and there may even be a higher tax cost, if the corporation is a “qualified personal service corporation.” This is a C corporation “...substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting...”<sup>14</sup> The consequences of being a qualified personal service corporation include a flat 35% tax on corporate taxable income, that is, without the benefit of lower tax brackets,<sup>15</sup> and the fact that the corporation is eligible for only \$150,000 of accumulated earnings credit, instead of the regular \$250,000,<sup>16</sup> meaning that a surtax would apply in the example above.

These caveats will need to be taken into account when choosing a business entity for a family business. However, in most cases, they will not affect the overall advice, which is that a C corporation may be used to accumulate income at its 15-percent bracket, and then be paid out as dividends before the end of 2010 at rates ranging from zero to 15 percent, and not subject to payroll taxes.

### **Owners’ Agreements Among Family Members**

Owners of closely-held businesses will often have some kind of buyout arrangements among themselves. In a partnership the terms of these arrangements will often be included in the provisions of the partnership interest, in an LLC these will often be included in the provisions of the operating agreement, and in a corporation these will often be included in the provisions of a shareholders’ (or stockholders’) agreement. In fact, sometimes the partnership agreement, the LLC operating agreement, or the shareholders’ agreement will be little more than a collection of buyout provisions.

In the closely-held business owned by unrelated individuals, one of the main functions of the buy-out agreement is to keep outsiders from owning an interest in the business. Typically, if an owner of an interest in the business dies (or, in some cases, just retires from active participation in the business), the owner or his or her estate will be compelled to sell the business interest back to the entity or the other owners, at a price or upon terms determined by the buyout agreement. Similarly, if an owner wishes to sell his or her interest to outsiders, the entity or other owners will usually have some kind of option or right of first refusal to keep that from happening

Where the business is owned by members of a family, there is a somewhat different dynamic at play. Now the goal is no longer to keep out all outsiders, only specified outsiders. A family business will often be created with the expectation that business interests will eventually be passed on to children, perhaps even grandchildren. Rather than prohibit all transfers to non-owners, a buyout agreement among family members will often have specified transfers that are permitted, such as to lineal descendants. This means that the death of an owner of a family business is less likely to trigger a sale of the owner’s interest than the death of an owner of a non-family business.

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<sup>13</sup> Code §1(g).

<sup>14</sup> Code §448(d)(2).

<sup>15</sup> Code §11(b)(2).

<sup>16</sup> Code §535(c)(2).

Still, there are some situations where the death of an owner will trigger a sale, even if it is just among family members. This would happen if one or more of the family members might be expected to succeed to the owner's interest, but other family members are not. In such a case, the individual(s) succeeding to the owner's interest would be expected to pay for that interest, so that there is not an unfair benefit perceived as conferred on one family member over another similarly-situated family member.

Once we are talking about a purchase on death, the next natural topic is life insurance.

For example, assume that a family business is owned by Father, Mother, and Junior. Junior is one of Father's and Mother's three children, the only one actively involved in the business. Father and Mother do not want their business interests to go directly to Junior, without payment, for two reasons: (1) If either Father or Mother is still alive, he or she wants to get the economic value of anything transferred to Junior. (2) Father and Mother want to make sure that there's some mechanism by which their other children will have something of similar economic value.

They buy life insurance policies. Father buys policies on the life of Mother and Son, Mother buys policies on the life of Father and Son, and Son buys policies on the life of Mother and Father. The way this is set up, when any individual business owner dies, the two remaining will have life insurance proceeds that can be used to purchase the interest of that business owner.

Let's say that Father dies first. Mother and son each collect life insurance proceeds, and use that money to buy out Father's interest in the business from his estate. That part is the easy part. More complicated is the fact that Father's estate also includes a life insurance policy on Mother as well as a life insurance policy on Junior. The estate can distribute Mother's life insurance policy to her, and Junior's life insurance policy to him, but they will want to exchange these policies. This way each of them has the insurance on each other's life, which will provide funds to make another purchase when the next one dies. It's that exchange of insurance policies that will create special income tax problems.

The tax treatment of life insurance proceeds can be summarized by reference to four provisions in the Internal Revenue Code.

Code §61(a)(10) states that income from life insurance contracts will be included in gross income.

Code §101(a)(1) excludes from gross income amounts received from a qualifying life insurance contract by reason of the death of the insured. This provision makes most life insurance policy proceeds income tax-free.

Code §101(a)(2) creates an exception to the Code §101(a)(1) exclusion when the life insurance contract has been transferred for valuable consideration. This provision says, essentially, someone who buys an insurance policy as an investment will be taxed on the net proceeds as though the policy were just like any other investment.

Code §101(a)(2)(A) and (B) are exceptions to the exception (again, to the exception, if one considers Code §61(a)(10) to be the general rule). Under certain circumstances, the proceeds of a life insurance policy will still be income tax-free, even if transferred for valuable consideration. Code §101(a)(2)(A) restores tax-free treatment where there is a carryover basis transaction, such as a corporate reorganization. More importantly in the closely-held business context, Code §101(a)(2)(B) restores tax-free treatment when the transfer is to one of several specified persons:

1. The insured
2. A partner of the insured
3. A partnership of which the insured is a partner
4. A corporation of which the insured is a shareholder or officer



Let's go back to our example of Father, Mother, and Junior. Father dies, and Mother and Junior wish to exchange their life insurance policies so that each has a policy on the life of the other. This is a transfer for valuable consideration, which will result in the inclusion of insurance proceeds in gross income unless an exception applies. The tax consequences of this will depend on the choice of entity that the family has used for its business. If the business is a partnership or LLC, then exception #2 applies. The exchange is a "transfer to a partner of the insured," and the insurance proceeds will be excluded from gross income. On the other hand, if the business is a corporation (and it doesn't matter whether C or S corporation here), then there is no exception that applies. The exchange is a transfer for valuable consideration, and the net proceeds will be included in the gross income of the recipient.

As we have seen, it is not every family business that will have a buyout at the death of a shareholder. However, if there are buyouts contemplated, and they are funded by insurance policies, the chances are good that the insurance policies may be transferred among the family members, such as at the death of the first shareholder. By using a partnership or LLC rather than a corporation, the family can avoid an unexpected income tax levy on the insurance proceeds.

There is one interesting quirk in that rule. The requirement for exception is that the transfer be between partners. There could be a partnership that is separate from the business interest the insurance was acquired to purchase. If the family members have a separate partnership or LLC (e.g., to hold real estate or other investments), then they can exchange insurance policies among themselves and still qualify for exception #2.

One final point: When Father's estate sells its stock, it will hope to get capital gain treatment. Aside from the lower tax rate, assets in an individual's estate are eligible for "stepped-up basis,"<sup>17</sup> meaning that to the extent the stock is sold for its fair market value there will be no taxable income to the estate. In some cases a stock redemption by the corporation will result in dividend rather than capital gain treatment, where the remaining owners are family members.<sup>18</sup> Although this result can be avoided with expert tax law planning, it is generally easier to provide that the purchase is made by the remaining shareholders (as in the above example) rather than by the corporation. This, too, is something that would not be a concern where there is an entity other than a corporation.

## **THE S CORPORATION OPTION**

It is tempting to regard the S Corporation as quaintly passé, a throwback to the days before the limited liability company and the limited liability partnership. And yet, the S corporation refuses to be relegated to tax history's dustbin. It just has too many unique advantages, ranging from the ability of an owner to reduce his or her compensation, within reason, in order to minimize payroll taxes,<sup>19</sup> to the relative simplicity of a world free of the Kafkaesque partnership taxation rules of Subchapter K.

The S Corporation has always been a viable option as an entity for a family-owned business. Subject to some special caveats in IV.B., below, the situations which would tend to favor an S corporation for a non-family business apply with equal strength to a family business. In addition, there are special factors that can be taken into account when considering the S corporation for a family business.

### **Recent Family-Friendly Legislative Changes**

The American Jobs Creation Act of 2004<sup>20</sup> made several changes to subchapter S that could have an impact on choice of entity for a family business, effective January 1, 2005.

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<sup>17</sup> Code §1014.

<sup>18</sup> Code §302.

<sup>19</sup> Cases re-characterizing distributions of S corporation profits as wages subject to payroll taxes include *Radtke v. U.S.*, 712 F.Supp. 143 (E.D.Wisc. 1989), aff'd 895 F.2d 1196 (7th Cir. 1990), *Esser v. U.S.*, 750 F. Supp. 421 (D.Ariz.1990), *Dunn & Clark v. Comm'r*, 57 F.3d 1076 (9th Cir. 1995), and *Spicer Accounting v. U.S.*, 918 F.2d 90 (9th Cir. 1990).

<sup>20</sup> P. L. 108-357, October 22, 2004.

In addition to the fact that the maximum number of shareholders was increased from 75 to 100, the law redefined the family members that could count as a single shareholder. Previously only a husband and wife (including their estates) could count as a single shareholder. The new law permits a family group to count as a single shareholder, a group that includes lineal descendants, as well as current and former spouses of lineal descendants, of a common ancestor within six generations. For this more liberal rule to apply, there only needs to be an election by any member of the group. Since this definition includes siblings, cousins as remote as fifth cousin, and any of their spouses, it is a fairly generous definition of family.

### **Special Considerations**

Eligibility for S corporation status is dependent on a corporation's being a "small business corporation." One of the requirements for meeting the definition of a small business corporation is that stock cannot be owned by a trust, unless it is one of several specially designated trusts.<sup>21</sup> Code §1361(c)-(e) describe the kind of trusts that are permitted to be shareholders of a small business corporation. Included in the list of trusts to be permitted as shareholders are:

1. Grantor trusts
2. Grantor trusts after the death of the grantor, for a period of two years.
3. A pour over trust, for a period of two years after the death of the grantor.
4. A voting trust
5. An "electing small business trust"
6. A "qualified subchapter S trust"

At first, this seems like a wide array of options. The problem is, with the exception of the voting trust, all of these require some affirmative act on the part of the trust or its beneficiaries in order to retain its status as a qualified shareholder. In the case of the first three trusts, the S corporation stock must be distributed from the trust within two years after the death of the grantor. While most estates are settled within two years, the owner of a closely-held business is a prime candidate for someone whose estate might be kept open longer than that. The family that owns an S corporation relying on the first three trusts needs to be vigilant to be sure that the stock is either distributed or sold out of the trust, or make sure that the trust qualifies under one of the remaining categories, within that two-year window. Otherwise, the S corporation election is in jeopardy.

Of greater interest to the family business are the last two trusts. The qualified subchapter S trust is essentially a trust for the benefit of one person, who is the recipient of all income. From a practical point of view, this is more likely to be used as a QTIP trust for the benefit of a surviving spouse than as a trust for someone's lineal descendants. The electing small business trust has more flexibility in the context of a family-owned business, in that there may be multiple beneficiaries of such a trust.

What both of these have in common is the requirement that there be an affirmative election to qualify as the shareholder of an S corporation. In the case of the qualified subchapter S trust the election must be by the beneficiary. In the case of the electing small business trust, the election must be made by the trustee. Although these are administrative acts that can be handled uneventfully, the S corporation status should not be chosen unless the members of the family can be relied upon to notify their professional advisors when a transfer of stock occurs, so that these elections may be done properly. Finally, electing small business trust status is only available where the interest in the trust is not acquired by purchase. While this suggests that the trust is designed to be used in the family context, where transfers are often gratuitous, it also creates a potential trap that may trip up the unwary.

Although none of these rules are, by themselves, reasons for a family business not to choose an S corporation, they do raise red flags. Unless the family can be relied on to be aware of the rules and refer to professional assistance, the family should probably not think in terms of the S corporation as the entity of choice for its business.

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<sup>21</sup> Code §1361(b)(1).

### **One-Class-Of-Stock Requirement And Business Succession**

Another requirement for an S corporation is that there can only be one class of stock. This may be problematic in the context of a family-owned business, when looking at the anticipated phasing out of an older generation family member. The problem arises in two contexts.

First, an older generation family member may want a “preferred” interest in the business, that is, an interest that has priority as to income but without any share of future growth. A C corporation could easily issue preferred shares to accomplish this. A partnership or LLC can create partnership rights that mimic the rights of a preferred shareholder. Unfortunately, neither of these alternatives is available for an S corporation that wishes to continue qualifying as such. The only variation allowable in the one-class-of-stock rule is that there can be a class of nonvoting stock, but this does not address the needs of the senior family member who wants to have a preferred interest.

Second, the buyout of a senior family member may sometimes be done by a combination of stock purchase and incentive compensation or severance pay. An issue quietly lurking is whether that incentive compensation or severance pay will in fact be re-characterized as a second class of stock. Treas. Reg. §1.1361-1(b)(4) creates a safe harbor to assure that deferred compensation will not be treated as a second class of stock under certain circumstances:

- (4) Treatment of deferred compensation plans. For purposes of subchapter S, an instrument, obligation, or arrangement is not outstanding stock if it --
  - (i) Does not convey the right to vote;
  - (ii) Is an unfunded and unsecured promise to pay money or property in the future;
  - (iii) Is issued to an individual who is an employee in connection with the performance of services for the corporation or to an individual who is an independent contractor in connection with the performance of services for the corporation (and is not excessive by reference to the services performed); and
  - (iv) Is issued pursuant to a plan with respect to which the employee or independent contractor is not taxed currently on income.

A deferred compensation plan that has a current payment feature (e.g., payment of dividend equivalent amounts that are taxed currently as compensation) is not for that reason excluded from this paragraph (b)(4).

Although this safe harbor does not indicate that failure to comply with its terms will automatically result in the re-characterization of a deferred payment arrangement as a second class of stock, it may be advisable to comply with the terms of this regulation absent a compelling reason otherwise.

None of these second-class-of-stock issues will arise with any business entity other than the S corporation. Accordingly, unless a corporation is prepared to steer clear of any of these potential problems, the family business might be better off choosing an entity other than an S corporation.

### **ESTATE PLANNING CONSIDERATIONS**

Estate planning considerations rarely enter into the choice of entity equation for a closely-held business owned by unrelated individuals. Once the entity is chosen, there may be estate planning factors considered in structuring the buy-out agreement, but these estate planning factors enter into the picture at a relatively late stage. With a family business, estate planning considerations are present from the start.

## **Estate Valuation**

In any family-based economic activity, the impact on estate planning will routinely be considered. One of the key issues in estate planning is reducing the size of the gross estate for tax purposes. Where there are closely-held business interests owned by family members, the value of those business interests in the estate of one of them should always be considered.

The subject of valuation of family-owned business interests is governed primarily by Chapter 14 of the Internal Revenue Code, Special Valuation Rules, mainly Code §2703. Prior to the enactment of this section, the shareholders in a family-owned business might be tempted to write an intrafamily buyout agreement with a deliberately understated value for the business. Thus, when one member of the family died (typically a member of the older generation), the value of the business interest in the decedent's estate would appear lower than its actual value. Code §2703 effectively prohibits this, by stating that an agreement among family members that restricted transfer of any property would be disregarded for purposes of determining valuation, unless it is a bona fide business arrangement, an arm's length agreement that is not a device, and not a device to transfer property to family members for less than full value.

Code §2703 addresses specifically the impact of restrictions created by agreement. It does not apply to restrictions inherent in the nature of the property. In this regard, corporate stock is different from partnership interests, and membership interests in an LLC. Corporate stock, absent an agreement otherwise, can be freely transferred, while partnership and LLC interests cannot. Thus, if a family is looking for a discount in valuation for federal estate tax purposes, it is more likely to be available with the partnership and LLC than with a corporation. As previously noted, a limited partnership interest in a limited partnership is even more likely than a general partnership interest to be eligible for a discount in valuation for estate tax purposes.

## **Gross Estate Inclusion Under Code §2036**

Code §2036 provides that, for estate tax purposes, the gross estate of a decedent includes the value of property transferred by the decedent during his or her lifetime, if the decedent retained possession or enjoyment of the property, the right to income from the property, or the right to designate the persons entitled to possession or enjoyment of the property, or income from it. In its simplest form this Code section would apply if a person transferred his or her home but retained a life estate, or if a person set up a trust and either received an income stream from it or retained the right to change the beneficiaries. In recent years, Code §2036 has been invoked by the IRS, with varying degrees of success, in the context of family-owned businesses.

A slight digression is in order here. As an estate planning device that has had increasing popularity since the early 1990's is the family limited partnership, the FLP (pronounced "flip") and variations including the family general partnership and family limited liability company. The theory behind the estate planning device was that if a parent put property into this business entity, and gave away some of it during his or her lifetime, then each lifetime gift would be discounted for valuation purposes as a fractional interest, and the share remaining in the parent's estate at death would also be eligible for a discount.

Because this appeared to be a loophole in the general rule that the assets in a decedent's estate should be valued at fair market value, the Internal Revenue Service challenged these discounts. Originally the Service took the position that a fractional discount should never be available when all the interests are owned by members of the same family. After losing this argument in several cases, the Service abandoned the position. Then it made the argument that the act of selecting a business entity was itself an agreement that should be disregarded for purposes of Code §2703, and thus there should be no valuation discount. Again, the Service lost. Another argument came along that the lifetime gifts should be aggregated with the bequests and treated as a single testamentary transaction, and again the Service got no traction in the courts.

Finally, when challenging these valuation discounts, the Service came upon a strategy that did in fact work – sometimes. The newest argument was that if a parent gave a partial interest in a business entity, it was a transfer with

a retained life interest under Code §2036, and the result of this would be that the entire business should be included in the parent's estate. There would be no fractional discount because 100% of the business was treated as being owned by the estate.

This argument did not work in every case, but it worked in some cases. The most recent high-profile case in this regard was *Strangi v. Commissioner*, 417 F.3d 468 (5th Cir., 2005). In this case the Fifth Circuit said that Code §2036 would apply, and the business interest transferred during the lifetime of the decedent would be included in the decedent's estate at full value, unless there could be demonstrated a business purpose for the transfer. Although the *Strangi* case was extreme, in that it appeared to be a transaction set up primarily for tax avoidance purposes, it creates a dire warning for anyone with a business entity co-owned by different members of the same family. The warning is that there needs to be clear documentation showing that the transferred business interests were in fact transferred in substance as well as in form. Since a partnership is by nature more informal than a corporation, the risk is greater with a partnership that Code §2036 will be invoked by the Service to bring a transferred business interest back into the estate of a deceased transferor. If the owners of the family entity are not prepared to maintain and provide this kind of evidence, then the corporation may be a better choice of entity for them.

One final word: Code §2036(b)(1) provides that a decedent's gross estate will include stock in a controlled corporation (a specially-defined closely-held or family-held corporation) that was transferred by the decedent during his or her lifetime, if the decedent retained a lifetime right to vote the shares. This provision applies only to stock in a corporation, and would not apply to partnership or LLC interests. Thus, a parent who wished to give a partnership or LLC interest to a child, but wished to retain the right to vote those interests, could do so without risking estate inclusion under Code §2036(b)(1). In terms of choice of entity, this would appear to suggest that a parent with such a plan should choose a partnership or LLC over a corporation. While this is literally true, there are two other considerations this parent might wish to take into account. First, even if such a gift does not create any problems under Code §2036(b)(1), it still looks shaky under Code §2036(a), especially after the recent cases. Second, even in the corporate context, Code §2036(b)(1) only applies to the transfer of voting stock where the right to vote is retained. It does not apply to the issuance and gifting of new non-voting stock, which will often have the exact same result. This is the proverbial loophole you could drive a truck through, which renders Code §2036(b)(1) more of a yellow light than a red light.

### **Asset Protection**

When we speak of the protection from liabilities that many entities afford, we are generally speaking in terms of the fact that owners are protected against personal liability for the obligations of the entity. There is a converse liability to be concerned with, and that is where the entity might be liable for the obligations of the individual owner. In the case of an entity among non-family members, the solution is simple: Buy the owner out. In the case of a family member, there may be less desire to buy out the owner with liability problems, and instead look for ways to ward off the creditor.

Most states provide that a creditor may not make a claim against a limited partnership interest or an LLC interest. That is, a creditor may end up taking corporate stock owned by a debtor, but the creditor cannot take a limited partnership interest or an LLC membership interest. The creditor's rights in these interests is limited to a "charging order." This is an order saying that the creditor has the right to have income distributions which are actually paid out, but no other rights. This means no rights to vote, or otherwise manage the partnership or LLC, and this, in turn, means no rights to compel the distribution of any income.

The right to receive partnership income actually paid, without the right to compel such payment, is more of a negative than a positive. Under basic partnership taxation law, the creditor with the charging order has to report its share of partnership or LLC income, and pay income taxes on such share, regardless of whether there has been any distribution of such share. The creditor may be entitled to accumulated income eventually, but the cost of that is year-to-year tax liability that many creditors will not want to sustain. Accordingly, the partnership or LLC contain a disincentive to creditors that, indirectly, creates an asset protection benefit. All but the most solvent or cash-rich creditors will avoid getting the charging order and the ongoing liability that it entails.

## **CONCLUSION**

Choice of entity decisions have long been an essential part of the applied business planning process. The advent of new limited liability entities made the decision far more complicated. In the case of a closely-held business owned primarily by members of a family, the decisions are even more complicated, in particular in light of multiple developments in the law. This is a decision that can only be made in a manner to meet the needs of the particular business and family, after consideration of multiple complex factors.

## **NOTES**