# Chapter 1: Entity Selection



Corrections were made to this workbook through January of 2015. No subsequent modifications were made.

A taxpayer launching or acquiring a new business has several forms of business to choose from, including the following.

- Sole proprietorship
- C corporation
- S corporation
- General partnership
- Limited partnership (LP)
- Limited liability company (LLC)

There are other types of entities — such as a limited liability partnership (LLP), limited liability limited partnership (LLLP), and series LLC — that may be available in some states. However, this chapter focuses on the six types of entities listed, comparing and contrasting these entities in the following areas.

- Initial formation
- Taxation of business entities
- Liability protection
- Entity choice and family business considerations
- Other taxation considerations

## INITIAL FORMATION

Although statutory requirements vary between states, the following table represents a simple comparison of typical formation issues for various types of business entities.

| Entity | State Filing Required | Legal Documents Necessary | Annual Meeting Required | Treatment of Taxable Income | Ease of Formation |
|---|---|---|---|---|---|
| Sole proprietorship | No | None | No | Entity level | Easy |
| C corporation | Yes | Articles, bylaws, share certificates | Yes | Entity level | Complex |
| S corporation | Yes | Articles, bylaws, share certificates | Yes | Passthrough | Complex |
| General partnership | No | Partnership agreement | No | Passthrough | Easy |
| LP | Yes | Partnership agreement | Yes | Passthrough | Complex |
| LLC | Yes | Operating agreement | No | By election | Complex |

**Note.** When the entity choice requires drafting legal documents (articles of incorporation, partnership agreements), organizational costs increase. The specific laws and requirements of the state in which the taxpayer desires to form an entity must be considered. The preceding table should be regarded as only a general reflection of typical state law.

The easiest type of business entity to establish is the **sole proprietorship.** Paperwork does not generally need to be filed with a state agency, because establishing a sole proprietorship does not serve to create a separate legal entity. However, as with all other types of business entities, it may be necessary to register as an active business, register a business name, obtain any regulatory licenses needed for the business, and meet other state-level legal requirements. These requirements vary between states.

Establishing a **C corporation** always involves completing and filing forms with a state agency to create the corporation, which is a separate legal entity. Typical state statutes outline the rights and obligations of shareholders, officers, and directors. Rigorous recordkeeping and at least an annual shareholders' meeting (to elect directors for the year) and an annual directors' meeting (to appoint officers for the year) are also required. Meeting these requirements can impact initial costs at start-up as well as some ongoing annual costs.

Creation of an **S corporation** typically begins by establishing a corporation under state law. The corporation's tax status is subsequently changed to that of an S corporation by making the appropriate S election. The federal election is made using Form 2553, *Election by a Small Business Corporation.*

**Note.** Most states accept the federal S corporation tax election, but some states also require a separate state-level S corporation tax election or an annual notice to the state taxation authority in order to ensure that the corporation is treated as an S corporation for state tax purposes.

A **general partnership** can be formed by a simple agreement between two or more taxpayers without filing any state forms. However, it is preferable to form a partnership with a partnership agreement that addresses items such as the following.

- Ownership interests of each partner
- Decision-making authority of each partner
- Contribution of money or property by each partner
- Compensation of each partner
- Allocation of profit and loss
- Terms under which a partner must withdraw from the partnership
- Procedures for admission of a new partner

States generally have statutory "default" rules regarding arrangements between partners; such rules prevail unless a partnership agreement specifies other arrangements. Conflicting interests or objectives among the partners — and the fact that some partners may contribute money while others contribute assets or services — frequently make it prudent to ensure that each partner obtains independent legal advice in connection with the drafting of the partnership agreement.

An **LP** usually has more rigorous state filing requirements because it is necessary to establish those who are general partners (who have unlimited personal liability in connection with partnership business) and those who are limited partners (who have limited liability).

An **LLC** typically requires filing state-level forms to indicate aspects of the LLC's structure, including who will be the LLC's managers and members.

**Observation.** Filing fees associated with state forms for business organizations generally range from about $45 to over $500, depending on the type of business organization and the state. Accordingly, both the type of business organization and the particular state in which it is established determines some of the initial start-up costs. There may also be annual filing requirements and fees.

## TAXATION OF BUSINESS ENTITIES

The federal tax treatment of an entity depends on how applicable federal tax regulations categorize that entity for tax purposes. The question of whether a separate entity exists is a matter of federal tax law,[1] but the federal tax regulations refer to state law in their application.

Federal tax regulations that provide basic rules for entity tax classification are summarized as follows.

| Reference | Title |
|---|---|
| Treas. Reg. §301.7701-1 | Classification of organizations for federal tax purposes |
| Treas. Reg. §301.7701-2 | Business entities; definitions |
| Treas. Reg. §301.7701-3 | Classification of certain business entities |

1. Treas. Reg. §301.7701-1(a)(1).

## BASIC CLASSIFICATION RULES

Generally, although the regulations provide default rules for entity classification, an entity may be allowed to make an election regarding tax treatment in some cases.

### Entities Classified as Corporations

Under the classification regulations, the definition of a corporation includes the following.

- A business entity organized under a federal or state statute that refers to the entity as a "corporation" or that refers to the entity as "incorporated"
- A business entity organized under a state statute that refers to the entity as a "joint-stock company" or "joint-stock association"

These organizations are classified under the regulations as corporations and are therefore taxed as corporations.

> **Note.** Corporations are generally taxed under subchapter C of the Code. Taxation under subchapter C may lead to "double taxation" of income (discussed later).

### Noncorporate Entities

An **eligible entity** is any business entity that is not automatically classified as a corporation (as discussed previously).[2] An eligible entity with two or more members or owners is normally taxed as a partnership but can be taxed as a corporation by filing an appropriate election. Under the terms of the regulations, filing the election classifies the eligible entity with at least two members or owners as an association that is taxed as a corporation.[3] Eligible entities with only one member or owner are treated as a disregarded entity for federal tax purposes unless an appropriate election is filed to be classified as an association and taxed as a corporation.[4]

**Example 1.** Gregorio wants to start a new auto mechanic business. After careful consideration, he completes and files the necessary forms under his state's business corporations act to form a new corporation. Gregorio is the sole shareholder. Under federal tax classification rules, his entity is classified and taxed as a corporation under subchapter C of the Code.

**Example 2.** Use the same facts as **Example 1,** except Gregorio, Hillary, and Ignatius are all shareholders in the new corporation. Because the entity formed was a corporation under state law, the entity is classified as a corporation and taxed under subchapter C.

**Example 3.** Use the same facts as **Example 1,** except instead of forming a corporation under the state's incorporation statute, Gregorio forms an LLC under his state's LLC statute. The LLC is an eligible entity under the federal classification rules and is subject to the default rule of being treated as a disregarded entity. The LLC is not recognized as an entity separate from its owner for federal income tax purposes and Gregorio is taxed as a sole proprietor. Gregorio therefore reports business income and expenses for the new auto mechanic business on Schedule C, *Profit or Loss From Business*. No entity-level federal income tax return is required in connection with the LLC.

**Example 4.** Use the same facts as **Example 2,** except instead of forming a corporation under the state's incorporation statute, Gregorio forms an LLC under his state's LLC statute. Gregorio, Hillary, and Ignatius become members of the new LLC. Under the federal tax classification rules, the LLC is an eligible entity that is subject to the default rule for partnership tax treatment because of the existence of two or more members.

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2. Treas. Reg. §301.7701-3(a).
3. Treas. Reg. §§301.7701-3(a) and 301.7701-2(b)(2).
4. Treas. Reg. §301.7701-3(a), (b).

**Required Election.** The required election used by eligible entities to determine how they will be classified for federal tax purposes generally consists of filing Form 8832, *Entity Classification Election.* Generally, Form 8832 must be filed by an eligible entity in the following circumstances.

- The entity has two or more members or owners and wishes to avoid the default classification for partnership tax treatment and instead elects to be taxed as a corporation.
- The entity has one member or owner and wishes to avoid the default classification rule for disregarded entity tax treatment and instead elects to be taxed as a corporation.
- The eligible entity wishes to change its tax classification (whether it previously elected out of the applicable default rule or was subject to it).[5]

The desired effective date of the election is indicated on Form 8832. If no date is indicated, the date the election is filed is used as the effective date.[6]

**Election Filing Procedure.** Once completed, Form 8832 is filed with the IRS (either the Cincinnati, Ohio, or Ogden, Utah service center, depending on the state in which the entity's principal place of business or office is located).[7]

In addition to filing the form with the appropriate IRS office, **a copy of Form 8832 is also filed with the business entity's return for the tax year in which the election is made.** If the entity is not required to file a return for that year, a direct or indirect owner is generally required to file a copy of Form 8832 with their own individual return. If an individual owns an entity that has an ownership interest in a second entity for which the election is being made, the individual is an "indirect owner" of that second entity.[8] An indirect owner does not need to file a copy of Form 8832 with their individual return if the entity in which it has an ownership interest is filing a copy with its entity-level return.[9] Failure to attach the required copies of Form 8832 with the returns does not invalidate an election, but penalties may be assessed.[10]

5. Instructions for Form 8832.
6. Treas. Reg. §301.7701-3(c)(1)(iii).
7. For further details on which of the two IRS offices apply to an entity, see the instructions for Form 8832.
8. Instructions for Form 8832.
9. Ibid.
10. Ibid.

**Example 5.** Use the same facts as **Example 3,** except Gregorio does not want the LLC's tax treatment to be subject to the disregarded entity default rule. Instead, he wishes to file the appropriate election to obtain corporate tax treatment for the LLC that was formed on May 1, 2014. He does so by filing Form 8832 as follows.

Form **8832**
(Rev. December 2013)
Department of the Treasury
Internal Revenue Service

**Entity Classification Election**

▶ **Information about Form 8832 and its instructions is at *www.irs.gov/form8832*.**

OMB No. 1545-1516

**Type or Print**

| Name of eligible entity making election | **Employer identification number** |
|---|---|
| **Gregorio's Auto Shop LLC** | **37-1234567** |

Number, street, and room or suite no. If a P.O. box, see instructions.
**163 Salem Street**

City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.
**Boston, MA 02113**

▶Check if: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32

**Part I** **Election Information**

**1** **Type of election** (see instructions):

**a** ☒ Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
**b** ☐ Change in current classification. Go to line 2a.

**2a** Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

☐ **Yes.** Go to line 2b.
☐ **No.** Skip line 2b and go to line 3.

**2b** Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

☐ **Yes.** Go to line 3.
☐ **No.** Stop here. You generally are not currently eligible to make the election (see instructions).

**3** Does the eligible entity have more than one owner?

☐ **Yes.** You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
☒ **No.** You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

**4** If the eligible entity has only one owner, provide the following information:

**a** Name of owner ▶ **Gregorio Domenico Veluzzo**
**b** Identifying number of owner ▶ **999-99-9999**

**5** If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

**a** Name of parent corporation ▶
**b** Employer identification number ▶

**For Paperwork Reduction Act Notice, see instructions.** Cat. No. 22598R Form **8832** (Rev. 12-2013)

## For Example 5

Form 8832 (Rev. 12-2013) Page **2**

**Part I** **Election Information** (Continued)

**6** **Type of entity** (see instructions):

- **a** ☒ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- **b** ☐ A domestic eligible entity electing to be classified as a partnership.
- **c** ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- **d** ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- **e** ☐ A foreign eligible entity electing to be classified as a partnership.
- **f** ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

**7** If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶ ----------

**8** Election is to be effective beginning (month, day, year) (see instructions) . . . . . . . . . . . . ▶ **05/01/14**

**9** Name and title of contact person whom the IRS may call for more information

**Gregorio Domenico Veluzzo**

**10** Contact person's telephone number

**617-123-4567**

**Consent Statement and Signature(s) (see instructions)**

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

| Signature(s) | Date | Title |
|---|---|---|
| | | **Manager** |
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Form **8832** (Rev. 12-2013)

**Timing of the Election.** The election cannot become effective any earlier than 75 days before filing the election or any later than 12 months after the election is filed. Generally, within 60 days of filing, the IRS provides a notification of whether the election was accepted. If Form 8832 is filed requesting an effective date that is more than 75 days before the date the form is filed, the effective date of the election is 75 days before the filing date. If Form 8832 is filed requesting an effective date that is more than 12 months after the filing date, the effective date is 12 months after the filing date.[11] The election is deemed effective at the start of the day for which the election becomes effective.[12]

> **Example 6.** Use the same facts as **Example 5,** except Gregorio was unaware of the need to timely file the Form 8832 election and does not file the form until September 14, 2014. The effective date he indicates on the form is May 1, 2014, which is more than 75 days before the September 14 filing date. The effective date of the election is therefore 75 days prior to the September 14 filing date, which is July 1, 2014.
>
> Gregorio's business is treated as a disregarded entity for tax purposes from the May 1, 2014, formation date to June 30, 2014 (the date immediately prior to the effective date of his election to be taxed as a corporation). Beginning July 1, 2014, Gregorio's business is classified as a corporation for tax purposes.

**Limitation on Subsequent Elections.** After an eligible entity makes an election to change its classification for tax purposes under these rules, a subsequent election to change the classification again cannot be made during the 60-month period following the effective date of the previous election.[13] However, the IRS may permit a subsequent change within this 60-month period if more than 50% of the ownership interest in the entity was transferred to new owners who did not own any interest in the entity at the time of the previous election's effective date.[14]

**Deemed Transactions upon Election.** The following table summarizes transactions deemed to take place for tax purposes once an election is made.[15] All relevant Code provisions and general principles of tax law apply to these deemed transactions[16] and, accordingly, substantial tax liability may arise from making an election that changes the tax classification of an eligible entity.

| Type of Election | Deemed Transaction |
|---|---|
| Partnership to corporation | The partnership is deemed to contribute all assets and liabilities to the corporation in exchange for corporate stock. The partnership is deemed to immediately liquidate thereafter and distribute the corporate stock to the partners, who become the shareholders in the corporation. |
| Corporation to partnership | The corporation is deemed to distribute all assets and liabilities to shareholders in a liquidating distribution. After the liquidation, the shareholders immediately contribute the assets and liabilities to the newly formed partnership. |
| Corporation to disregarded entity | The corporation is deemed to distribute all assets and liabilities in a liquidating distribution to the single owner. |
| Disregarded entity to corporation | The owner is deemed to contribute all assets and liabilities to the new corporation in exchange for stock. |

11. Treas. Reg. §301.7701-3(c)(1)(iii).
12. Treas. Reg. §301.7701-3(g)(3)(i).
13. Treas. Reg. §301.7701-3(c)(1)(iv).
14. Ibid.
15. Treas. Reg. §301.7701-3(g)(1).
16. Treas. Reg. §301.7701-3(g)(2)(i).

**Example 7.** Use the same facts as **Example 6.** On July 1, 2014, the effective date of the election, Gregorio is deemed to contribute all business assets and liabilities used in his disregarded entity to the corporation. All relevant Code rules and general tax principles associated with contributions of assets and liabilities to a corporation, including IRC §§351 and 357, apply to this transaction.

**Inadvertent Classification Changes.** It is possible for a change in the number of owners to trigger an automatic tax classification change under these rules.

**Example 8.** Emily is the sole owner of Emily's Interior Design and Décor, LLC. The LLC is treated as a disregarded entity under the "check-the-box" tax classification rules (Treas. Reg. §301.7701-3). She formed the LLC on April 1, 2011.

On July 1, 2014, Emily decides that she and her friend Annie should run the business as partners. The LLC issues units to Annie. Starting July 1, 2014, Emily and Annie each own 50% of the LLC. On July 1, 2014, the LLC is no longer a disregarded entity for tax purposes under the check-the-box rules because of the LLC ownership interest given to Annie. Instead, the entity becomes a partnership (assuming Emily and Annie do not file a Form 8832 to elect to become an association and therefore invoke tax treatment as a corporation under those rules).[17]

**Example 9.** Norris and Nick each own a 50% interest in N&N Consulting, which has been classified as a partnership for federal tax purposes since they first started the business in 2001. However, during 2014, the two partners decided that Norris would purchase Nick's interest in the partnership to become sole owner of the company. Because of Norris's sole ownership, the business becomes classified as a disregarded entity (assuming Norris does not file a Form 8832 to elect corporate tax classification).[18]

> **Observation.** When a taxpayer's entity classification changes, they need to determine if a new employer ID number is required. Guidance can be found in IRS Pub 1635, *Employer Identification Number.*

**Relief for Late Election.** Unwary business owners filing a late election may face severe adverse consequences because of the deemed transactions that take place on the effective date of the election, particularly if a liquidating transaction is deemed to occur. However, it may be possible to obtain relief from the consequences of a late election.[19] Late relief is available under Rev. Proc. 2009-41[20] for an eligible entity that satisfies the following conditions.

- Did not obtain the desired classification as of its formation date (or date that it became relevant for tax purposes) solely because it failed to file Form 8832 on a timely basis
- Had reasonable cause for failure to timely file
- Is making the relief request no later than three years and 75 days after the date of the desired effective election date

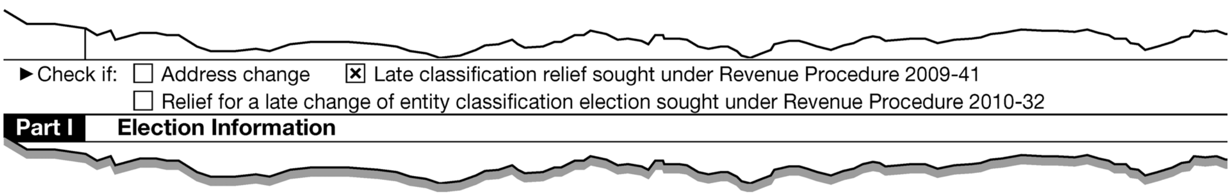
17. This example is based on the facts found in Rev. Rul. 99-5, 1999-1 CB 434.
18. See Rev. Rul. 99-6, 1999-1 CB 432.
19. Instructions for Form 8832.
20. Rev. Proc. 2009-41, 2009-39 IRB 439.

In addition to these three conditions, **one** of the following must apply in order to qualify for late relief under Rev. Proc. 2009-41.

- The eligible entity has not filed a federal tax or information return for the first year for which the election was intended to apply because the due date for that return has not yet passed**.**
- The eligible entity has timely filed all necessary federal tax and information returns (or has filed them within six months of any due date, excluding extensions) in a manner consistent with the tax classification it is requesting. This includes all entity-level and individual tax returns and information required for the business owner or owners. No tax information or filing inconsistent with the desired tax classification was filed for any tax year for the eligible entity or business owner or owners. This includes the proper filing of information returns in connection with any applicable deemed transaction (mentioned earlier).[21]

> **Note.** For further details on the late election procedure, see Rev. Proc. 2009-41.

If the late election relief provision of Rev. Proc. 2009-41 is used, the appropriate box on Form 8832, page 1, is checked. The relevant box referring to Rev. Proc. 2009-41 follows.


▶ Check if: ☐ Address change ☒ Late classification relief sought under Revenue Procedure 2009-41
☐ Relief for a late change of entity classification election sought under Revenue Procedure 2010-32
**Part I** **Election Information**

> **Note.** The other box in this illustration, referring to late election relief under Rev. Proc. 2010-32, applies to foreign (non-U.S.) entities. Discussion of this item is beyond the scope of this chapter. See Rev. Proc. 2010-32[22] for further information.

> **Note.** If the late election relief requirements of Rev. Proc. 2009-41 are not met, late relief may still be obtained through a letter ruling. However, the applicable user fee must be paid in connection with obtaining the letter ruling. See Rev. Proc. 2013-1[23] for further details.

21. See Rev. Proc. 2009-41, 2009-39 IRB 439.
22. Rev. Proc. 2010-32, 2010-36 IRB 320.
23. Rev. Proc. 2013-1, 2013-1 IRB 1.

## ELECTION RULE FOR S CORPORATIONS

One reason an eligible entity may desire to file an election for corporate tax treatment is to classify itself as a corporation for tax purposes before making an election under subchapter S to obtain the pass-through tax treatment of an S corporation. However, a corporation that makes the required S election using Form 2553, *Election by a Small Business Corporation,* is **automatically** deemed to make any election necessary to be taxed as a corporation under the classification rules. It is therefore not necessary to file Form 8832 prior to, or simultaneously with, the S election as long as the corporation actually meets all of the requirements necessary to qualify as an S corporation. The effective date of the classification election is the same as the effective date of the S election.

> **Note.** For the requirements that must be met to qualify as an S corporation, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: S Corporation. This can be found at **www.taxschool.illinois.edu/taxbookarchive.** For further information, see IRC §1361(b) and the underlying regulations.

> **Observation.** If an S corporation subsequently loses its pass-through tax status, it is taxed as a C corporation because it is considered a corporation for federal tax purposes under the automatic classification rule.

### Recent Guidance on Late S Elections

The IRS provided updated guidance regarding the late filing of an S election. Rev. Proc. 2013-30[24] provides comprehensive guidance on extended deadlines for corporations that file a late S election, which generally may be as late as three years and 75 days from the desired effective date of the election. In the case of an entity already classified as a corporation, there is no time limit if certain conditions are met. The qualifications for the extended deadline and details on how the election must be submitted are provided in the revenue procedure.

> **Note.** Rev. Proc. 2013-30 modifies and supersedes previous guidance on this subject.[25] Further details on the relief for late S elections can be found in the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

## LLC FLEXIBILITY WITH TAX CLASSIFICATION

LLC entities have a substantial amount of flexibility under the federal tax classification rules. A single-member LLC (SMLLC) is treated as a disregarded entity under the default rules of Treas. Reg. §301.7701-3(b)(1). In addition, an LLC with two or more owners receives partnership tax classification under the default rules. However, if the owner files Form 8832 and elects to be treated as an association under the tax classification rules, the entity is then treated as a C corporation for federal tax purposes. To obtain S corporation tax treatment, Form 2553 can be filed instead of Form 8832.

**Example 10.** Clark is the sole owner of CLT Engine Tuning and Blueprinting, LLC. Under the default rules of Treas. Reg. §301.7701-3(b), Clark's LLC is classified as a disregarded entity because he is the sole owner. However, he can file Form 8832 in order to become an association under Treas. Reg. §301.7701-3(c)(1), which invokes C corporation tax status. Clark could also file a Form 2553 to obtain pass-through tax treatment under subchapter S. If Clark files Form 2553 to elect S corporation tax treatment, Form 8832 is not required to first invoke corporate tax classification because Form 2553 also serves this purpose.[26]

24. Rev. Proc. 2013-30, 2013-36 IRB 173.

25. Rev. Procs. 2003-43, 2003-1 CB 998; 2004-48, 2004-2 CB 172; and 2007-62, 2007-2 CB 786.

26. Treas. Reg. §301.7701-3(c)(1)(v)(C).

**Example 11.** Use the same facts as **Example 10,** except there are three members of CLT Engine Tuning and Blueprinting, LLC. Clark, Lisette, and Travis own interests in the LLC. Under the default rules of Treas. Reg. §301.7701-3(b), the LLC is automatically classified as a partnership for federal tax purposes because there is more than one member. However, the three LLC members can file Form 8832 in order to become an association under Treas. Reg. §301.7701-3(c)(1), which invokes C corporation tax status for the LLC. The three members also have the option of filing Form 2553 to obtain pass-through tax treatment under subchapter S. If the members file Form 2553 to elect S corporation tax treatment, Form 8832 is not required to first invoke corporate tax classification because Form 2553 also serves this purpose.[27]

## LIABILITY PROTECTION

**Caution.** Competent legal advice should be sought regarding liability issues.

Even with businesses that do not involve high-risk activity, it is prudent to select a business entity that provides the business owner or owners with personal liability protection. This is especially true if the risks inherent in the business cannot be appropriately addressed by insurance or if insurance is prohibitively expensive. **Liability protection is one of the most important considerations in selecting the appropriate type of entity for a new business or when restructuring an existing business to minimize the personal liability of the owners.**

The following table summarizes the personal liability protection **generally** available from the various types of business entities.

| Entity | Owner Liability Protection |
|---|---|
| Sole proprietorship | No |
| C corporation | Yes |
| S corporation | Yes |
| General partnership | No |
| LP | Yes, for limited partners; general partners have no liability protection |
| LLC | Yes |

The use of a business entity that provides owners with personal liability protection can encourage risk-taking in order to develop and build a business. However, the personal liability protection provided by a business entity is not absolute. State law generally places some limits on the degree of personal liability protection. Two important areas of liability consideration follow.

- Misuse or fraudulent use of the business entity by its owners
- Business liability for the personal actions of owners

27. Ibid.

## MISUSE OR FRAUDULENT USE OF THE BUSINESS ENTITY

A business owner who misuses a corporation may find that a court disregards the corporation's liability protection and holds the business owner personally liable for corporate obligations by **piercing the corporate veil.** However, convincing a court to pierce the corporate veil and hold a business owner personally liable for an obligation requires proof that the corporation's status as a separate legal entity should be disregarded for liability purposes. The decision to hold a business owner personally liable begins with a fact-intensive inquiry, and each case has different relevant circumstances for a court to consider.[28] Examples include circumstances when the business owner does one of the following.[29]

- Fails to adhere to corporate formalities required by state law (such as maintaining a corporate minute book or other corporate records required by the state's corporate statute)
- Misrepresents or conceals who manages the corporation
- Intermingles personal and corporate assets and/or uses corporate assets as personal assets
- Undercapitalizes the corporation
- Uses the corporation as an "alter ego"
- Fails to maintain arm's-length relationships with related entities

**Note.** Although there are strong similarities between the states in this area of law, each state articulates its own veil-piercing law differently. Some states have factors that differ from those listed, and some states have modified judicially developed veil-piercing laws by statute.

### Corporate Veil Piercing

Generally, courts are hesitant to pierce the corporate veil without an adequate showing by an injured party that there is good reason to do so.[30] Courts generally pierce the corporate veil to prevent fraud or injustice,[31] but the applicable law varies from state to state. Federal courts rendering veil-piercing decisions look to the applicable state law in arriving at a holding.

**Example 12.** Andrew is the sole shareholder of LightningBolt Shipping and Fulfillment Services, Inc. (LSFS). He is also the sole director and president of the corporation. Over several years of operations, Andrew made a series of loans to the corporation to provide additional working capital and for major purchases.

Many LSFS employees are covered by a collective bargaining agreement (CBA). The CBA requires LSFS to make regular, periodic contributions to an employee's qualified retirement plan covered by the Employee Retirement Income Security Act (ERISA).

During the past four years, LSFS has experienced financial difficulty and Andrew had the corporation pay off all loans owed to him. These loan payments to Andrew were made during a time when LSFS was not making any qualified retirement plan payments in accordance with the CBA. During this time period, Andrew also continued to pay salaries and benefits to himself and other family members.

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28. *Vitol, S.A. v. Primerose Shipping Company Ltd., et al.*, 708 F.3d 527 (4th Cir. 2013).

29. *Kaycee Land and Livestock v. Roger Flahive*, 46 P.3d 323 (Wyo. 2002).

30. *In re KZH Livestock, Inc.*, 221 B.R. 471 (Bankr. C. D. Ill. 1998).

31. See *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986).

The trustees and the union sued Andrew personally, asking the court to pierce the corporate veil and hold Andrew personally liable for the unpaid retirement plan contributions. The court noted that, although the payment of family members and the continuation of their benefits were likely ordinary and necessary business expenses, Andrew's loan repayments to himself constituted the siphoning of funds from the company, causing it to be undercapitalized and unable to make the required payments to the qualified retirement plan. As a result, the court ruled that the corporate veil can be pierced and Andrew can be held liable for the payment amount in arrears to the employyes' qualified retirement plan in accordance with the CBA.[32]

**Example 13.** Franco and Giordana are experiencing financial difficulty and need to restore their credit rating. They contact the Credit Repair Shop, Inc. (CRS), which advertises itself as a federally funded service that does not charge fees to customers. CRS is incorporated and Gustavo is the sole shareholder, director, and officer.

Franco and Giordana arrange to make monthly payments to their creditors through CRS. CRS personnel indicate to Franco and Giordana that the company will contact each of their creditors and reach an agreement with them to accept less than the full amount currently owed by Franco and Giordana. CRS is to use each monthly payment from Franco and Giordana to make the various required payments to creditors until the reduced amount of debts have been paid.

CRS makes the payments to creditors, but retains 20% of each payment as a commission. It does **not** operate as a nonprofit entity and receives no federal funding. Gustavo used CRS to commit fraud. If Franco and Giordana sue Gustavo personally to recover the 20% fee portion of their payments, it is very likely the court will not allow Gustavo to benefit from corporate liability protection, because he committed fraud. It is extremely likely that the corporate veil will be pierced and Gustavo will be held personally liable for the repayment of the fraudulently retained commission amounts.

**Note.** Some state laws, including Illinois, indicate that veil piercing may occur if there is:

- A unity of interest and ownership such that the separate personalities of the corporation and individual owner no longer exist, and
- There are circumstances in which providing the owner with the corporate liability shield would promote a fraud or injustice.[33]

These corporate veil-piercing principles apply to both C corporations and S corporations. The S election that a corporation makes is an election for tax purposes and generally has no impact on veil-piercing rules that may apply within a state.

32. This example is based on the facts of *Trustees of the National Elevator Industry Pension, Health Benefit and Education Funds v. Andrew Lutyk*, 140 F.Supp. 2d 407 (E.D.Penn. 2001).

33. *Wachovia Securities, LLC v. Banco Panamericano, Inc*., 674 F.3d 743 (7th Cir. 2010).

### Partnerships and Veil Piercing

The concept of piercing the corporate veil is generally inapplicable to partnerships, because **partners are personally liable for obligations of the partnership.** The Uniform Partnership Act (UPA) indicates that partners are jointly liable for all debts and obligations of the partnership.[34] The UPA was revised in 1997. Section 306(a) of the Revised Uniform Partnership Act (RUPA) indicates that "all partners are liable, jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law."[35] All states except Louisiana have adopted either the UPA or the RUPA; this is reflected in current law regarding partner liability in these states.

> **Note.** The **National Conference of Commissioners on Uniform State Laws** (NCCUSL) drafted several uniform laws in various areas, including laws for business entities such as partnerships, limited partnerships, corporations, and LLCs. These uniform laws were drafted for adoption by individual states. Individual states can adopt such a statute either exactly in the form drafted by the NCCUSL or in a form modified as desired by the state legislature. See **www.uniformlaws.org** for additional details.

### Limited Partnerships and Veil Piercing

Unlike traditional partnerships, LPs provide a personal liability shield for limited partners. Accordingly, the veil-piercing concept has been applied to limited partners.

States vary in the degree of protection from veil piercing provided to limited partners. In some states, the limited partners remain protected by the LP liability shield as long as they do not act like general partners in controlling the business. For example, under New Jersey law, a limited partner is not liable for the obligations of an LP unless:

- The limited partner is also a general partner, or
- The limited partner takes part in the control of the business in addition to exercising the limited partner rights available.[36]

However, under this New Jersey provision, a limited partner may control the business in a manner that is **not** substantially similar to how a general partner would exercise that control. In this case, the limited partner is only liable to a third party who has actual knowledge of the limited partner's control and also relies on that control. In addition, this statutory provision provides the limited partner with some **safe harbors** regarding conduct that does not constitute participation in the control of the business that might lead to personal liability. Conduct that is not considered control of the LP includes the following.[37]

- Being a contractor, agent, employee, corporate officer, director, or shareholder of a general partner
- Acting as surety or guarantor for the LP
- Attending or participating at partner meetings or serving on an LP committee

Other states provide the limited partner with protection even if that limited partner acts in a manner that controls the business of the LP.[38]

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34. National Conference of Commissioners on Uniform State Laws, Uniform Partnership Act (1914), §15(b).
35. National Conference of Commissioners on Uniform State Laws, Revised Uniform Partnership Act (1997).
36. NJSA 42:2A-27a.
37. NJSA 42:2A-27b.
38. See 805 ILCS 215/303.

> **Note.** Generally, each state's laws in connection with LPs and the potential liability of a limited partner may be found in the state's version of the **Uniform Limited Partnership Act (ULPA) or Revised ULPA (RULPA).** States adopting either of these may make some changes to select provisions before adopting it as legislation. Accordingly, in order to determine the scope of potential limited partner liability in a particular state, the state's applicable provisions on this subject must be reviewed. The Illinois provision mirrors the provision in the ULPA without any changes[39] while the New Jersey provision reflects a substantial change to the limited partner liability.

The first state case applying equitable principles to veil piercing in the context of an LP[40] is the New Jersey case *Canter v. Lakewood of Voorhees, et al*.[41] Lakewood of Voorhees (LV) was an LP that owned a nursing home in which a resident was injured due to negligence by the nursing home staff. A corporation, Seniors Health Care, Inc. (SHI), was a limited partner that owned 84.12% of the LP. In addition, SHI and the LP shared several employees and shared involvement of officers. Applying the limited partner safe harbors of conduct under New Jersey law, the court noted that share ownership of a limited partner alone is not sufficient to expose the limited partner to liability. In addition, sharing employees or officers did not constitute conduct outside the permissible scope of limited partner conduct under New Jersey law. There was no evidence of undercapitalization by the limited partner, commingling of funds between the LP and SHI, nor SHI's dominance in day-to-day operation of the nursing home. Moreover, the court noted that evidence of any use of the LP by SHI for fraud or wrongdoing was absent. Accordingly, the court held that, on these facts, the limited partner SHI would not be held liable. However, the court also held that the veil-piercing concept could be applied to an LP.

> **Observation.** The *Canter* decision is only applicable in New Jersey. Courts in other states generally apply ordinary partnership principles to veil-piercing issues. However, *Canter* may be used as a persuasive case in other states in circumstances that warrant veil piercing of an LP.

An earlier bankruptcy case[42] indicated that if a limited partner acts outside a state statute's safe harbors for limited partner conduct, the limited partner becomes a general partner and may become exposed to liability. The bankruptcy court noted that there was nothing about the nature of an LP that would prevent veil-piercing principles from being applied to an LP in the same way they are applied to a corporation. The *Canter* court in New Jersey referred to this bankruptcy case in its decision.

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39. See ULPA §303 and 805 ILCS 215/303.

40. *Limited Partners Now Vulnerable to Liability under Corporate Veil Piercing Principles*. Teji, Upneet S. Jul. 22, 2011. [www.martindale.com/corporate-law/article_Harwood-Lloyd-LLC_1319038.htm] Accessed on Nov. 20, 2013.

41. *Canter v. Lakewood of Voorhees, et al*., 420 N.J. Super. 508 (Jun. 28, 2011).

42. *In re Adelphia Communications Corp*., 376 B.R. 87 (Bankr. S.D.N.Y. 2007).

### LLCs and Veil Piercing

The corporate concept of veil piercing also applies to an LLC.[43] Wyoming was the first state to adopt an LLC statute. In 2002, the Wyoming Supreme Court faced the question of whether the concept of corporate veil piercing applied to an LLC in *Kaycee Land and Livestock v. Roger Flahive*.[44] Roger Flahive owned an LLC involved in oil exploration and drilling. Mr. Flahive's LLC reached an agreement with Kaycee Land and Livestock (Kaycee) to do oil exploration work on Kaycee's property. After the work was completed, Kaycee discovered contamination on the property. Kaycee sued Roger Flahive personally because there were no assets in Mr. Flahive's LLC from which damages could be paid. Kaycee asked the Court to pierce the LLC veil to make Mr. Flahive personally liable for the contamination clean-up costs. The Wyoming Supreme Court held that the same types of circumstances that call for corporate veil piercing — such as failure to adhere to formalities, misrepresentation of managers, undercapitalization, or use of the entity for fraud — can exist with an LLC. Therefore, there is no reason to treat an LLC any differently than a corporation for veil-piercing purposes.

In 2008, the 2nd Circuit Court stated that "given the similar liability shields that are provided by corporations and LLCs to their respective owners, emerging case law illustrates that situations that result in a piercing of the [LLC] veil are similar to those [that warrant] piercing the corporate veil."[45] In addition, the 2nd Circuit Court noted that "every state that enacted LLC piercing legislation has chosen to follow corporate law standards and not develop a separate LLC standard."[46]

As LLC veil-piercing law continues to evolve among states, this adherence to corporate veil-piercing standards within an LLC environment seems to be the norm. For example, in a recent Maryland case, the court noted the need for a showing of actual fraud to pierce a corporate veil in Maryland and adhered to this same high standard in connection with the piercing of an LLC veil.[47]

## BUSINESS LIABILITY FOR PERSONAL ACTS OF OWNERS

The 5th Circuit Court recognized a reverse piercing of the corporate veil in which a corporation's assets were called upon to satisfy a personal liability of a business owner who treated the corporation as his alter ego.[48] According to the Court, proof of an ownership interest in the corporation was essential to a finding of alter-ego treatment necessary for reverse piercing. This was true even though the individual taxpayers lived in a home owned by the corporate entity without any lease agreement or rent payments, intermingled personal and corporate funds, and had the corporation pay for personal liabilities using signature authority over corporate accounts.

As with piercing the entity veil, the law of reverse piercing has evolved with differing standards and applicability among the states. The Virginia Supreme Court, for example, held that reverse veil piercing is applicable to a limited partnership using the same standard required under Virginia law for piercing an entity's veil. With regard to the standard used for piercing and reverse piercing, the Virginia Supreme Court noted that although no single rule or criterion is dispositive, it must be shown that the individual and entity have a unity of interest and ownership, such that separate personalities of the individual and entity no longer exist and the entity is being used to commit an injustice or gain an unfair advantage.[49] The Colorado Supreme Court reached an arguably broader interpretation, holding that Colorado law permits outside reverse piercing "when justice so requires."[50]

> **Note. Outside piercing** refers to a court's piercing (or reverse piercing) of an entity's veil of liability protection at the request of a party that is an outsider to the entity, such as a creditor. **Inside veil piercing** refers to piercing at the request of a corporate insider, such as a shareholder or subsidiary.

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43. *Netjets Aviation Inc. v. LHC Communications LLC,* 537 F.3d 168 (2nd Cir. 2008).

44. *Kaycee Land and Livestock v. Roger Flahive,* 46 P.3d 323 (Wyo. 2002).

45. *Netjets Aviation Inc. v. LHC Communications LLC,* 537 F.3d 168 (2nd Cir. 2008).

46. Ibid.

47. *Serio v. Baystate Properties, LLC*, 60 A.3d 475 (Md. Ct. Spec. App., Jan. 25, 2013).

48. *Zahra Spiritual Trust v. U.S.*, 910 F.2d 240 (5th Cir. 1990).

49. *C.F. Trust, Inc., et al. v. First Flight Limited Partnership, et al.*, 338 F.3d 316 (4th Cir. 2003).

50. *In re: Debtor: Phillip Eugene Phillips v. Englewood Post No. 322 Veterans of Foreign Wars of the United States, Inc.*, 139 P.3d 639 (Colo. 2006).

### Federal Court Application of State Law

A federal court looks to state law to determine whether the state's standards warrant veil piercing. Accordingly, the federal court also looks to state law to determine whether an individual has treated an entity as an alter ego or has an ownership interest in the entity.[51] Federal application of state law can result in some inconsistent treatment of state law by various federal courts, particularly if state law is unclear.

Delaware law is currently silent on the subject of reverse piercing. In the absence of any guidance from Delaware courts or statutes, a federal bankruptcy court in Texas was compelled to predict whether Delaware would permit reverse piercing.[52] The federal bankruptcy court predicted that Delaware law would permit reverse veil piercing, "although only in exceptional cases, as equitable relief to avoid injustice."[53] However, a federal bankruptcy court in Illinois faced with the same challenge of predicting Delaware reverse-piercing law reached an opposite conclusion, based in part on the grounds that a federal court should not create state law.[54] Until the Delaware legislature or courts provide some guidance on reverse-piercing law, treatment of reverse-piercing cases by various federal courts will continue to be inconsistent.

## CHARGING ORDER PROTECTION

**Charging order protection** refers to liability that is limited to a charging order, which is a court order to charge a partner's transferable interest in the partnership to satisfy a debt. The charging order remedy for a creditor of a general or limited partnership originated with the drafting of the ULPA in 2001.[55] Prior to the development of the charging order remedy, a creditor with a judgment against a partner had the power to seize partnership assets and sell those assets to satisfy the judgment. The charging order was developed as a means to allow the creditor to obtain satisfaction of such a judgment without the adverse disruption or destruction of the general or limited partnership's business frequently caused by an asset seizure and sale.

Generally, the charging order provisions for general partnerships, limited partnerships, and LLCs are similar. A typical charging order provision is found in the RULPA,[56] which states that the following rules apply when a partner is a debtor against whom a creditor has an unsatisfied judgment.

- The creditor can apply to the proper state court to **charge** the limited or general partner's **transferable interest** in the partnership to satisfy the unpaid amount of the judgment.

> **Note. Transferable interest** is generally defined as the right to receive **distributions** from the partnership, LP, or LLC as provided by the partnership or operating agreement.[57] This interest is also referred to as a **distributional interest** and does not constitute the partner's or member's full ownership interest in the entity. It also does not include managerial or voting rights.

- The court can **appoint a receiver** to administer the share of the partner's distributions that are owed to the debtor and administer other aspects of the charging order.
- The charging order constitutes a **lien** against the partner's transferable interest in the LP.
- Upon request by the creditor, the court may order **foreclosure** upon the transferable interest that is the subject of the charging order.
- The charging order and the option to foreclose provide the **only remedies** available for the creditor against the partner. (This is often referred to as the **exclusive remedy provision.)**

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51. Ibid.
52. *ASARCO LLC v. Americas Mining Corp*., 382 B.R. 49 (S.D. Tex. 2007).
53. Ibid.
54. *ALT Hotel LLC v. DiamondRock Allerton Owner*, 479 B.R. 781 (Bankr. N.D. Ill. 2012).
55. Forsberg, W. S. (2009, Nov./Dec.). Asset Protection and the Limited Liability Company. *American Bar Association, Probate & Property.*
56. See Revised Uniform Limited Partnership Act, §703.
57. For example, see the Uniform Limited Liability Company Act, §102(21).

The appointment of a receiver, the availability of a foreclosure option for the creditor, and the exclusive remedy provision to maximize charging order protection for a partner or LLC member are provisions that a state may or may not have enacted in its partnership, LP, or LLC statutes.

**Observation.** In order to obtain a charging order, the creditor must generally first obtain a judgment against the partner or member in connection with the debt owed. Subsequently, the creditor can apply to the court for the charging order as a means to obtain payment of the debt.

### Rights of a Creditor with a Charging Order

A judgment creditor with a charging order receives payments from the debtor partner's distributions for the partnership interest or LLC member's interest that is the subject of that charging order. The charging order does not entitle the creditor to become the owner of the partner or member's interest in the business and does not entitle the creditor to voting rights or any right to participate in the decision making or activity of the business operations. The charging order does not provide the creditor with any ownership interest in the assets of the business. The creditor is only entitled to distributions to satisfy the unpaid amount of the judgment against the partner or member if the partners or members choose to make such distributions.

In addition, a court held that a creditor holding a charging order does not have the right to obligate an LLC to disclose books and records.[58] The court confirmed that even after entry of the charging order against the debtor, the debtor retained management power and information rights.

**Foreclosure and Exclusivity.** By statute, a charging order is generally considered a lien against the debtor's distributional interest in the partnership, limited partnership, or LLC. A creditor with a charging order may find that there were no distributions made to pay the debt. If the applicable state statute allows, the creditor may **foreclose** on the partner's or member's interest, thereby obtaining ownership of that distributional interest. Although this divests the partner or member of the economic benefit of their interest (because the creditor becomes owner of any distribution rights), it does not confer any rights to the creditor to manage, vote, or own assets in the partnership or LLC.[59] Although the affected partner or member loses the right to distributions, the business entity itself and its day-to-day management are protected from the creditor. This is especially true if the charging order is the exclusive remedy available to the creditor by statute, even in states that permit foreclosure. As a practical matter, foreclosure on the lien created by the charging order has only limited value to the creditor but may put the creditor in a much better bargaining position to negotiate settlement of the debt.[60]

Law relating to foreclosure on a distributional interest lien is developing in the states. *Kriti Ripley, LLC v. Emerald Investments, LLC,*[61] a 2013 South Carolina Supreme Court case, is an example of the current development of law on charging order foreclosure. In this case, Kriti and Emerald formed Ashley River Properties, LLC, of which they were members with 30% and 70% ownership interests, respectively. Ashley River Properties was intended to develop waterfront property. Kriti contributed $1.25 million in cash and Emerald contributed the real estate and related construction permits. Emerald, with its majority interest, immediately misappropriated the funds contributed by Kriti after they were contributed to Ashley River Properties, LLC. Kriti obtained a judgment award against Emerald and subsequently obtained a charging order in 2008 for Emerald's distributional interest in Ashley River Properties.

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58. *Wells Fargo Bank, N.A. v. Continuous Control Solutions, Inc*., No. 2-431/11-1285 (Iowa Ct. App. Aug. 8, 2012).

59. Schurig, E. M. & Jetel, A. P. (2006, May/June ).The Alarming Potential for Foreclosure and Dissolution by an LLC Member's Personal Creditors. *American Bar Association, Probate & Property,* 42–48.

60. Ibid.

61. *Kriti Ripley, LLC v. Emerald Investments, LLC,* Op. No. 27277 (S.C. Sup. Ct. Jun. 26, 2013).

In 2011, Ashley River Properties did not provide any distributions that could be applied in satisfaction of the judgment. Kriti filed a motion in trial court to foreclose. However, the trial court refused to allow Kriti to do so because it viewed foreclosure to be a drastic remedy only to be used in extreme circumstances. The trial court also believed foreclosure on a charging order was unnecessary because South Carolina's LLC statute made other alternative remedies, such as dissolution of the LLC, available to Kriti.

On appeal, the South Carolina Supreme Court indicated that alternative remedies were not a factor to be considered in a charging interest foreclosure setting. Dissolution was not relevant as an alternative because Kriti sought foreclosure in the capacity of a creditor, not as an LLC member. In addition, the Supreme Court disagreed with the trial court's assertion that foreclosure is a drastic remedy only used in extreme circumstances. Rather, the Supreme Court determined that the primary factor to consider is whether the judgment creditor would be paid within a reasonable time through distributions obtained with the charging order. The Supreme Court pointed out that Kriti had not received any payment since it obtained the charging order against Emerald in 2008. It also noted that Emerald had acted inequitably, whereas Kriti's actions with Ashley River Properties were appropriate. The Supreme Court reversed the trial court and ordered foreclosure on Emerald's distributional interest in Ashley River Properties.

**Observation.** Charging order protection generally does not exist for shareholders of corporations. Creditors of shareholders generally have a wide variety of remedies available to use against shareholders, including the means to seize and sell the debtor shareholder's shares in order to pay a debt. The remedies available vary among the states. In many states, the creditor can obtain a writ of execution from the court upon which the sheriff will seize and sell assets belonging to the debtor that are not exempt under bankruptcy law. Bankruptcy law does not exempt shares in either a C or S corporation.

**Example 14.** Alicia, Penny, Todd, and Kelly are equal partners of BluSky Design & Décor (BDD). They formed their partnership entity under the partnership act in their state, which adopted the UPA. In enacting the UPA, the state retained the UPA's charging order protection for partnerships and also retained the provision that the charging order is the exclusive remedy available against a partner in connection with the partner's interest in the partnership. The state also retained the provision allowing the holder of the charging order to foreclose on the distributional interest of the partner. Each year, BDD typically pays substantial guaranteed payments to all four partners, leaving little or no profit left to be distributed.

During 2012, Alicia was vacationing when she was involved in a severe auto accident. The other driver, Clark, eventually won a negligence suit personally against Alicia in state court. Because this was a personal act by Alicia, the other partner's interests are not at risk. Clark applied to the court for a charging order to obtain a lien against Alicia's distributional interest in BDD. The charging order was granted. It provided Clark with the right to receive Alicia's distributions from BDD up to the amount of his negligence judgment against her. This is Clark's sole remedy against Alicia for her partnership interest. Clark cannot obtain a court order and foreclose on Alicia's entire partnership interest or any partnership assets or use any other state court or process to obtain rights to Alicia's interest in BDD.

Although Clark could foreclose on Alicia's distributional interest in BDD, Clark's attorney advises him that foreclosure would have limited value. However, because it would entirely divest Alicia of her distributional interest rights in BDD, foreclosure may encourage negotiation and eventual settlement.

**Example 15.** Use the same facts as **Example 14,** except Alicia, Penny, Todd, and Kelly are equal shareholders in BDD, which is an S corporation. Clark can obtain a writ of execution in state court and have the sheriff seize Alicia's shares. The shares could be sold to satisfy the negligence judgment. Clark would obtain Alicia's 25% interest in the S corporation, which could prove highly problematic for the other three shareholders and the day-to-day operation of BDD. Clark's acquisition of Alicia's shares would also give him Alicia's voting rights and ownership rights and could lead to the forced liquidation of corporate assets to pay the negligence judgment.

**Note.** In June 2011, Nevada became the first state to amend its corporation statute to provide charging order protection to certain corporations, including corporations with only one shareholder.[62] Only corporations with less than 100 shareholders may qualify. This may reflect the beginning of a trend among states that wish to make their business environment more attractive by providing more powerful charging order protection to traditional corporations.

**Charging Orders and Tax Issues.** Laws governing tax treatment of the holder of a charging order are gradually developing. Conflicting guidance has created two different theories on the tax status of the holder of a charging order.

One theory is that the holder of the charging order becomes liable for any tax liability associated with the distributional share of income generated by the partnership or LLC. This may deter creditors from applying for a charging order which may provide greater protection for the partner or member who is a debtor. This is because the holder of a charging order may become liable for the tax liability on phantom income if there is a distributive share allocated to the interest subject to the charging order without any actual cash distribution.

**Example 16.** Moira is a member with a 25% interest in Triple M Enterprises, LLC (Triple M). Carl loaned Moira money three years ago. He has not received any payments from Moira. Carl obtains a judgment against Moira in connection with the unpaid debt that Moira has refused to pay. Carl obtains a charging order and becomes entitled to any distributions Moira is entitled to receive from Triple M.

Triple M finishes 2014 with a profit of $100,000. Moira's 25% interest entitles her to $25,000 of the LLC profits, which is her distributive share. Carl holds a charging order that entitles him to receive this $25,000. However, Triple M members decide that the profits will be retained in the business rather than distributed. As a result, Carl is liable for income tax on $25,000 of phantom income. He will receive a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.,* in connection with the $25,000 distributive share, which must be reported on his return.

Support for this theory is provided by Rev. Rul. 77-137.[63] In this ruling, party A is a limited partner in an LP. Under the LP's partnership agreement, assignees of interests do not become limited partners unless all general partners provide written consent. The agreement also states that a limited partner may assign their right to profits and losses, as well as the right to receive distributions for their limited partnership interest, to another party without the consent of the general partners. Party A assigned his limited partnership interest to party B. The revenue ruling held that because party B acquired substantially the same dominion and control over the LP interest as the assignee, he is treated as a substitute limited partner for federal tax purposes, even if the general partners do not admit him as a limited partner under the terms of the agreement.

**Note.** This theory is frequently referred to as the "K-O'd by the K-1" theory because the potential tax liability on an undistributed amount (reported on Schedule K-1) may make it unlikely that the creditor would risk incurring that tax liability by pursuing a charging order against the interest of the partner or member.

62. See Nevada Revised Statutes, Chapter 78, Private Corporations, §746.

63. Rev. Rul. 77-137, 1977-1 CB 178.

The other theory regarding taxing the holder of a charging order suggests that the holder only has a lien on the distributional interest and does not hold the entire partnership or member interest. Proponents of this view indicate that Rev. Rul. 77-137 itself should be interpreted to distinguish the very limited lien interest that a charging order holder possesses from other types of transfers that result in "substantially all of the dominion and control" with rights beyond those provided by a charging order.

**Observation.** This alternate view is significant because even with the existence of a charging order, the debtor partner or member still remains a partner or member of the entity. The debtor partner or member should still be primarily entitled to the distributions and should receive the Schedule K-1 in connection with such distributions. This is consistent with the notion that the debtor partner or member should satisfy the debt owed to the creditor with after-tax dollars (instead of pre-tax dollars, which would be the case if the creditor holding a charging order received the distributions along with a corresponding Schedule K-1, as the proponents of the "K-O'd by the K-1" theory believe).

**Single-Member LLC Entities.** Although many state statutes provide charging order protection to partnerships, LPs, and LLCs, substantial authority has developed that indicates charging order protection may not exist with SMLLCs, at least in some jurisdictions.

One case indicating that SMLLCs may not have charging order protection is *Olmstead.*[64] Shaun Olmstead and Julie Connell had substantial assets within several Florida SMLLCs that they respectively owned. The Federal Trade Commission (FTC) determined that Olmstead and Connell were operating an advance-fee credit card scam and subsequently obtained a judgment against them at a hearing for deceptive trade practices.[65] The FTC filed suit in Florida to obtain the assets in the SMLLCs in restitution and obtained a court order compelling Olmstead and Connell to surrender their assets in their respective Florida SMLLCs. This court order was the subject of *Olmstead*. Olmstead and Connell argued that their SMLLCs provided charging order protection and the FTC, in the capacity of judgment creditor, would have to use a charging order under Florida law as a remedy, instead of the court order the FTC obtained. The FTC argued that it could pursue its court order and compel the surrender of assets.

The Supreme Court of Florida reviewed applicable Florida law and observed that although a charging order was the "sole and exclusive remedy" for a judgment creditor under Florida's partnership and limited partnership acts, such a provision was notably absent in Florida's LLC statute. The court therefore concluded that other remedies, such as the FTC's court order, were available to judgment creditors seeking to obtain redress from Florida LLC entities. In addition, the court noted that the notion of charging order protection, which originated in partnership law before becoming applicable to LLCs, was designed to serve the purpose of protecting other partners from actions against a debtor partner. With an SMLLC, there could be no concern for protecting other members because there is only one member.

**Observation.** After the *Olmstead* case, the Florida legislature passed into law the "Olmstead patch," which added the missing language to the LLC statute and established that the charging order was the sole and exclusive remedy for all Florida LLC entities, including SMLLCs.[66]

Other cases have also served as precedent for denying charging order protection with SMLLCs.[67]

64. *Olmstead, et al v. Federal Trade Commission*, 44 So.3d 76 (Jun. 24, 2010).

65. *Federal Trade Commission v. Olmstead et al.*, 528 F.3d 1310 (11th Cir. 2008).

66. See Florida Limited Liability Company Act, §608.433.

67. See *In re Ashley Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003) and *In re Modonlo*, 412 B.R. 715 (Bankr. D. Md. 2006).

An Illinois bankruptcy court found that a charging order protection to protect other partners from a debtor partner's actions was unnecessary for an LP with a husband and wife as the sole partners when a tax lien was attached to the property of both spouses. The bankruptcy court held that the tax department was not limited by the Illinois statutory provision that made a charging order the "exclusive remedy" to enforce a judgment-creditor's interest.[68]

> **Observation.** The outcome of this Illinois bankruptcy case may indicate that even when there are other partners to protect, they do not require charging order protection from another partner or member who is a debtor if all the partners or members are also debtors. Situations in which all partners are debtors of the same creditor are very common. In these situations, charging order protection may not be available if this case is used as precedent. The rationale of this case could also be used in the context of a multi-member LLC in which all members are debtors.

> **Note.** Wyoming and Nevada LLC laws are unique because charging order protection is specifically provided for SMLLC entities.[69] Other states may gradually follow this trend by also amending their respective LLC statutes to.

### Use of Multiple Entities for Liability Protection

Under the Code, S corporations are only permitted to have certain types of shareholders. An S corporation shareholder must be one of the following.

- A person who is a U.S. citizen or U.S. resident[70]
- An estate or certain trusts[71]
- Another S corporation under the qualified subchapter S subsidiary (QSSS) rules[72]

If a nonqualified shareholder becomes the owner of stock in an S corporation, the S corporation loses its status as an S corporation and can no longer be taxed as a pass-through entity. It instead is taxed as a C corporation.

However, the IRS permitted an SMLLC to be a shareholder of an S corporation. This was permitted because the SMLLC is considered a disregarded entity for tax purposes (with the individual LLC owner being treated as the S corporation shareholder instead of the SMLLC). Three letter rulings (Ltr. Ruls. 200816002, 200816003, and 200816004), all issued on January 14, 2008, discuss the permitted SMLLC ownership of S corporation shares.

In states with statutes or case law that provide an SMLLC with charging order protection, placing S corporation shares within the safety net of an SMLLC may eliminate the liability concerns associated with corporate share ownership.

Similarly, C corporation shareholders could have their shares held by LLC entities to invoke charging order protection in connection with the ownership of their shares. This may present an added measure of liability protection, particularly in states that have LLC statutes that provide stronger charging order protection. In addition, many state partnership statutes allow a partnership interest to be owned by an LLC.

> **Note.** It is essential to consult applicable state statutes as well as federal and state tax rules that may become implicated with the use of multiple-entity structures.

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68. *United States v. Zabka*, 900 F.Supp.2d 864 (C.D. Ill. 2012).
69. See Wyoming Limited Liability Company Act, §17-29-503; and the Nevada Limited Liability Companies Act, NRS 86.401.
70. Treas. Reg. §1.1361-1(b)(1)(iii).
71. IRC §§1361(b)(1)(B) and §1361(c)(2); Treas. Reg. §1.1361-1(j).
72. IRC §1361(b)(3).

## ENTITY CHOICE: FAMILY BUSINESS CONSIDERATIONS

### SPOUSAL OWNERSHIP RULES

Generally, spouses who jointly own an unincorporated business cannot file as a sole proprietor. The general rule is that the spousal business ownership constitutes a partnership.[73] A partnership arrangement exists between spouses even if there is no formal partnership agreement.[74] Accordingly, a Form 1065, *U.S. Return of Partnership Income,* must be filed for the business. Each spouse's respective share of profits or losses is reported on a separate partnership Schedule K-1. In addition, each spouse's share of income is reported on Schedule SE, *Self-Employment Tax,* and is subject to self-employment (SE) tax. Partnership tax treatment for spouses reflects the default partnership tax treatment under the classification rules for a business with two or more owners. Because the business is not considered a sole proprietorship, Schedule C, *Profit or Loss From Business,* should not be used.

**Note.** Nothing prevents the spouses from structuring the business so that **one** spouse owns the business and the other spouse works as an employee of the business. This prevents a default partnership classification. However, appropriate documentation regarding the ownership of the sole proprietorship should exist. In this circumstance, the owner-spouse reports business activity using Schedule C.

**Observation.** Although spouses who are co-owners of a business are generally treated as two separate business owners, spouses residing in states with community property laws have the option of being treated as one or two taxpayers owning the business. Therefore, spouses in community property states may choose to treat their business as a sole proprietorship or a partnership. This choice is only available in community property states.[75]

**Example 17.** Logan and Laurie are married and own Double L Boutique, LLC, a business that sells antique furniture. Logan and Laurie reside in Illinois. Logan and Laurie should generally treat the LLC as a partnership because the tax classification rules (Treas. Reg. §301.7701-3) provide default partnership tax treatment for two or more owners. However, the tax classification rules provide Logan and Laurie with the option to elect C corporation tax treatment (Form 8832) or S corporation tax treatment (Form 2553) for the LLC.

73. See IRS Pub. 334, *Tax Guide for Small Business;* and IRS Pub. 541, *Partnerships.*

74. Ibid.

75. Rev. Proc. 2002-69, 2002-2 CB 831. Note that Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin are community property states.

### Qualified Joint Ventures

Spouses who are co-owners of a business can elect out of partnership tax treatment. The spouses can elect to treat the business as a qualified joint venture (QJV)[76] if they meet the following conditions.[77]

- Are the only members of the joint venture
- Use the MFJ filing status
- Agree to elect out of partnership tax treatment
- Materially participate in the business (Material participation is defined in IRC §469 and Temp. Treas. Reg. §1.469-5T.)
- Co-own the business, which is not held in the name of a business entity created under state law such as an LLC, limited partnership, or corporation

> **Observation.** Electing as a QJV is a way to ensure that each spouse obtains credit for their respective social security and Medicare payments while avoiding the complexities of filing a partnership return and completing a Schedule K-1 for each spouse. Incorrectly reporting the business activity as a sole proprietorship under only one spouse's name results in only that spouse obtaining credit for social security and Medicare payments.

**Making the Election and Proper Reporting.** The QJV election is made by filing an MFJ return with each spouse dividing the business activity (income or losses, gains, deductions, and credits) between them. Each spouse reports their share of the business activity on a separate Schedule C. A separate Schedule SE for each spouse's applicable SE tax is also completed. Each spouse reports their share of business activity as a sole proprietor under this method. Although the QJV ownership may be structured so that each spouse owns half of the venture, other proportions are permissible.

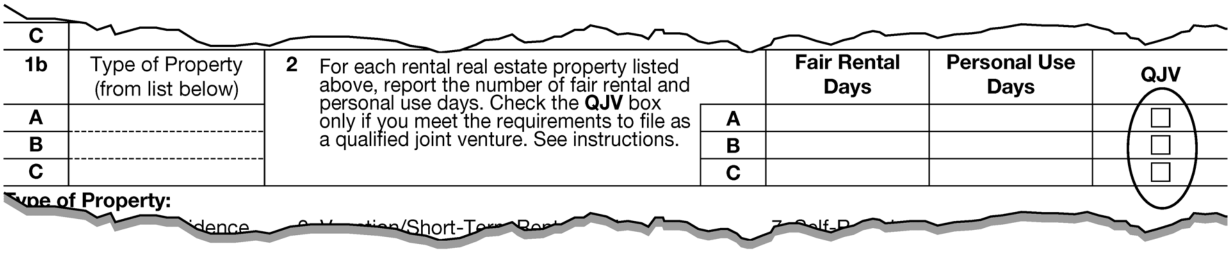
> **Note.** Although the spouses may make the QJV election for the very first year of the trade or business activity, it is possible to make this election one or more years after the trade or business activity was treated as a partnership. If the QJV election is made after one or more partnership years, the QJV election triggers the termination of the partnership. The effective date of partnership termination is the last day of the tax year before the initial QJV year.[78]

**Reporting of Real Estate Rental Income.** As a general rule, real estate rental income is not subject to SE tax. If real estate is rented out by the QJV, the rental income remains exempt from SE tax[79] and the spouses must report all rental income and expenses using **one** Schedule E, *Supplemental Income and Loss* (with each spouse's separate interest reported as a separate property on its own line)[80] rather than using Schedules C.

> **Note.** In the Schedule E instructions, the IRS points out that once the QJV election is made by the spouses, it can only be revoked with the IRS's permission. However, the IRS also indicates that the election only remains in effect for as long as the spouses filing as a QJV continue to meet the requirements. If those requirements are not met for the year, a new election must be made when the requirements are again met and the spouses desire to file as a QJV.[81]

76. IRC §761(f)(1).
77. IRS Pub. 541, *Partnerships*.
78. Instructions for Schedule E, *Supplemental Income and Loss*.
79. CCA 200816030 (Mar. 18, 2008).
80. Instructions for Schedule E.
81. Ibid.

The election to report as a QJV instead of a partnership is indicated by checking the appropriate box on Schedule E, as shown here.



| | | | | | | |
|---|---|---|---|---|---|---|
| C | | | | | | |
| 1b | Type of Property (from list below) | 2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions. | | Fair Rental Days | Personal Use Days | QJV |
| A | | | A | | | ☐ |
| B | | | B | | | ☐ |
| C | | | C | | | ☐ |

Type of Property:

## ENTITIES AND FAMILY FICA EXEMPTIONS

As a general rule, an employer is required to withhold social security and Medicare taxes from an employee's wages. The employer must also pay the employer share of social security and Medicare taxes for those wages.

As a general rule, if a parent hires a child under the age of 18 as an employee, the child's wages are exempt from FICA (social security and Medicare taxes).[82] However, this is only the case if the business is **not incorporated.** If the business is incorporated, the employer-employee relationship is not one of parent and child because the corporation is not considered a parent under the applicable rules.[83]

Under the classification rules for FICA, a disregarded entity is treated as a separate entity and the employee and employer are each liable for their respective share of FICA.[84] This rule became effective with the 2009 tax year.[85] The result was the elimination of the child-employee FICA exemption for disregarded entities, because separate entity treatment created an employer-employee relationship with the child instead of the parent-child relationship that was necessary for the FICA exemption. However, temporary regulations have preserved the FICA exemption for disregarded entities that are treated as separate entities for FICA purposes.[86] The IRS indicated that it had not intended to remove the parent-child relationship and corresponding FICA exemption for child-employees under age 18 with the 2009 changes that were made to the FICA rules.[87]

In addition, the FICA exemption on child wages is only available with a partnership if a family relationship exists between all partners.[88]

**Note.** The temporary regulation that allows the FICA exemption for a corporation that is a disregarded entity for tax purposes expires October 31, 2014.[89]

The IRS may closely scrutinize child employment to ensure that the child actually performed services. A deduction for the child's wage amount is generally allowed if evidence shows that actual services were in fact performed by the child.[90]

82. IRC §3121(b)(3); TD 9554, 2011-50 IRB 843; Temp. Treas. Reg. §31.3121(b)(3)-1(T); and Social Security Handbook, §§926 and 928.

83. See TD 9554, 2011-50 IRB 843.

84. Treas. Reg. §301.7701-2(c)(2)(iv).

85. Ibid.

86. Temp. Treas. Reg. §31.3121(b)(3)-1(T).

87. Ibid.

88. Social Security Handbook, §928.

89. Temp. Treas. Reg. §31.3121(b)(3)-1(T)(f).

90. *H.G. Hatt v. Comm'r*, TC Memo 1969-229 (Oct. 28, 1969), *aff'd per curiam*, 457 F.2d 499 (7th Cir. 1972).

**Example 18.** Brad and Barbara are married and are professional equestrians. Each spouse owns a 50% interest in B&B Stables and Training, LLC. Brad and Barbara each pay SE tax on their respective half of the partnership profits. For 2013, the partnership recognized a profit of $100,000. Brad and Barbara paid the following SE taxes.

| 2013 Amounts | Brad | Barbara |
|---|---|---|
| Share of profits | $50,000 | $50,000 |
| Amount subject to SE tax (92.35%) | 46,175 | 46,175 |
| SE tax (15.3%) | 7,065 | 7,065 |

Accordingly, Brad and Barbara paid SE tax of $14,130 ($7,065 + $7,065) in connection with the $100,000 of LLC profits for 2013.

At the beginning of 2014, after consulting with their tax professional, they hire their twin 16-year-old daughters, Diana and Daphne, to clean the stables, feed the six horses used for training, and assist with training horses. Despite their young age, Diana and Daphne are both accomplished riders and have extensive knowledge regarding horse training and equipment. Brad and Barbara also put the girls in charge of all the necessary equipment for the horses and stable, including maintenance of existing equipment and the acquisition of new equipment when required. Diana and Daphne both maintain logs regarding their hours of work each day and Brad and Barbara pay Diana and Daphne $10,000 each. This is established as a reasonable amount for the services provided by each daughter because it is the amount that Brad and Barbara would need to pay someone else for the same services.

Because Diana and Daphne are Brad and Barbara's daughters, their wages are exempt from social security and Medicare taxes. The tax professional advised that the daughters should be hired in order to shift $20,000 of income from the parents to the girls so they could save SE tax. If the partnership again recognizes a $100,000 profit for 2014, after paying and deducting the girls' $20,000 wages, a total of $80,000 of partnership profits are split equally between the spouses. Accordingly, for 2014, the following SE taxes are paid in connection with the LLC's profits.

| 2014 Amounts | Brad | Barbara |
|---|---|---|
| Share of profits | $40,000 | $40,000 |
| Amount subject to SE tax (92.35%) | 36,940 | 36,940 |
| SE tax (15.3%) | 5,652 | 5,652 |

Brad and Barbara paid 2014 SE tax of $11,304 ($5,652 + $5,652). The following table shows the SE tax savings as a result of hiring Diana and Daphne.

| | |
|---|---|
| Amount of SE tax paid in 2013 | $14,130 |
| Amount of SE tax paid in 2014 | (11,304) |
| SE tax savings | $ 2,826 |

### Planning Considerations with Child-Employees

In **Example 18,** Diana and Daphne may be able to establish an IRA in each of their respective names (if state law allows a minor-owned account or allows a parent/guardian to establish such an account for a minor).

> **Note.** Several major brokers, mutual fund dealers, and banks can assist a parent in establishing a custodial IRA (sometimes called a "guardian IRA") for a child. As custodian of the account, the parent controls the child's account until the child attains the age of majority in their state of residence (generally age 18 or, in some states, 19 or 21), at which point the account's control is relinquished to the child.

A dependent child only needs to file a return for the year if the child's income exceeds the greater of the following filing threshold amounts (applicable to the 2014 tax year).[91]

- $1,000
- The dependent's earned income plus $350 (up to a maximum of $6,200)

Accordingly, if the child has enough earned income, the child may be able to make a contribution to a traditional IRA account to eliminate tax on the income from the family business. The child could use the IRA funds for higher education purposes under the rules for qualified higher education expenses and make the necessary withdrawals without the 10% penalty.[92] Children without enough income to make use of an IRA deduction may be able to make a contribution to a Roth IRA.

> **Observation.** Paying a child within a family business may not only result in a FICA exemption but it can also provide the child with tax-sheltered funding for education and make the parents less vulnerable to disadvantageous tax rules for higher-income taxpayers. These include the phaseout of itemized deductions and personal exemptions that became effective with the American Taxpayer Relief Act (ATRA) of 2012. In addition, the kiddie tax does not apply to the child's earned income — only the child's unearned income.

> **Note.** For further details on the tax rules (including the kiddie tax) and filing requirements applicable to children, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers.

91. 2014 Form 1040-ES, *Estimated Tax for Individuals.*

92. IRC §72(t)(2)(E).

## TAXATION OF FRINGE BENEFITS

The choice of which business entity to use may have an impact on how fringe benefits are taxed to the owners of the business. Accordingly, **the taxation of fringe benefits may be an important consideration in the selection of an entity.**

### GENERAL RULES

**Fringe benefits are taxable to the business owner** unless a specific exclusion from income exists. As a general rule, the fair market value of the entire amount of the fringe benefit must be included in the business owner's gross income, minus the following.

- The amount for which there is a specific exclusion
- The amount, if any, that the business owner paid for the fringe benefit

Fringe benefits that are not specifically excluded from income are subject to payroll taxes.[93]

The following table shows the forms that are used to report the taxable value of fringe benefits received by various types of workers.

| Worker | Form |
|---|---|
| Employee | Form W-2 |
| Partner | Schedule K-1 (for Form 1065) |
| Independent contractor | Form 1099-MISC |

**Note.** Additional information on the tax treatment of various fringe benefits can be found in IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits,* and IRS Pub. 525, *Taxable and Nontaxable Income.*

### STATUTORY FRINGE BENEFITS

Specific statutory exclusions exist for the following fringe benefits, which are called **statutory fringe benefits.**

| Statutory Fringe Benefit | Code Section Providing Income Exclusion |
|---|---|
| No-additional-cost services | §132(b) |
| Employee discounts | §132(c) |
| Working condition fringe benefits | §132(d) |
| De minimis fringe benefits | §132(e) |

**Note.** This table lists some of the more important statutory fringe benefits. For a complete list, see IRC §132.

These statutory fringe benefits, when provided by an employer to an employee (or a business owner who is considered an employee for fringe benefit purposes), are **excludable from gross income and are not subject to payroll taxes.**

93. House Committee Report to PL 98-369, (1984), H.R. Rep. No. 98-432.

### Definition of Employee

For a business owner to qualify for an exclusion under the fringe benefit rules, the business owner must generally meet the definition of an employee under IRC §401(c)(1). The definition of employee is expanded to include certain business owners for some of the statutory fringe benefits but not others. For specific guidance on who is considered an employee for purposes of statutory fringe benefits, see Treas. Reg. §1.132-1(b).

### Partnerships

The value of fringe benefits received by a partner is generally treated as a **guaranteed payment. This includes health insurance premiums.**[94] The value of fringe benefits provided to the partner for the year is generally:

- Deductible by the partnership as a necessary and ordinary business expense under IRC §162, and
- Included in the partner's gross income unless there is specific guidance that excludes the value of the fringe benefit for a partner.

Specific guidance excludes the value of the statutory benefits listed previously for partners.[95] These exclusionary rules are found in IRC §132.

> **Note.** Because the value of fringe benefits to partners is treated as a guaranteed payment, these amounts are subject to SE tax.

A partner may deduct the amount of health insurance premiums included in income. If the partner qualifies to claim the deduction, the amount of premiums paid in connection with medical, dental, and qualified long-term care coverage for the taxpayer, the taxpayer's spouse, and any dependents may be deducted on Form 1040, line 29.[96] The deductible premiums also include any premiums paid for coverage for a child under the age of 27 at the end of the tax year, even if that child was not a dependent.

A partner cannot claim this deduction for any month or partial month that the partner was eligible to participate in a health plan provided by any other employer the partner works for, or an employer of a spouse or dependent.[97] In addition, the health plan must be **established by** the partnership. In order for a policy to be considered established by the partnership, it must be in the name of either the individual partner or the partnership.[98] Either the partnership or the individual partner may pay the premium. If the partner pays the premium, the partnership must reimburse the partner or the policy is not considered **established by** the partnership. A premium reimbursed in this fashion is treated as a guaranteed payment to the partner.

**The amount of the deduction is limited by the amount of earned income from the partnership under which the plan has been established.**[99]

> **Observation.** For taxpayers with multiple businesses, these rules make it imperative to adequately document which business established the plan.

> **Note.** For further details on the self-employed health insurance deduction, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

94. Rev. Rul. 91-26, 1991-1 CB 184.
95. Treas. Reg. §1.132-1.
96. IRC §162(l).
97. IRC §162(l)(2)(B).
98. IRS Pub. 535, *Business Expenses*.
99. IRC §162(l)(2)(A).

> **Note.** The treatment of health insurance premiums for partners (and other types of business owners) is likely to become a more important issue due to the **individual mandate** in the Affordable Care Act (ACA). This mandate, requiring all persons to maintain minimum essential coverage or pay a penalty, became effective January 1, 2014. For further details on the ACA, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update.

### S Corporations

An S corporation owner who is a more-than-2% shareholder is generally treated the same as a partner for fringe benefits taxation. A more-than-2% owner is an S corporation owner who owns one of the following.

- More than 2% of the outstanding stock of the S corporation
- Stock that has more than 2% of the total voting power of the S corporation.[100]

For the purposes of determining whether a shareholder owns more than 2% of the stock, the attribution rules of IRC §318 apply.[101]

As stated earlier, the Code fringe benefit rules generally treat a more-than-2% owner the same as a partner in a partnership.[102] Accordingly, the S corporation may deduct the cost of the fringe benefits provided to these owners, and that amount is included in the gross income of the owners for the tax year. The amount to be included in income is reported as additional wages on Form W-2, *Wage and Tax Statement*. The S corporation deducts the health insurance premium amount as wages.

The owners may deduct the health insurance premiums included in wages as a self-employed health insurance deduction.[103] The requirements for S corporation shareholders owning more than 2% are similar to those for partners.

- The policy must be in the name of either the S corporation or the shareholder.
- The premiums may be paid by either the S corporation or the shareholder.
- If the shareholder pays the premium, the S corporation must reimburse the shareholder. If this is not done, the policy is not considered **established** under the S corporation business and the self-employed health insurance deduction is not available for those premiums.[104]

Regarding amounts qualifying for the deduction, the rules mentioned previously for partners also apply to S corporation shareholders. In addition, the deduction amount is limited to the earned income received from the S corporation.

> **Note.** Health insurance premiums in excess of Medicare wages are not deductible as self-employed health insurance.

100. IRC §1372(b).
101. Ibid.
102. IRC §1372(a).
103. Rev. Rul. 91-26, 1991-1 CB 184; and IRC §162(l).
104. IRS Pub. 535, *Business Expenses;* and IRS Notice 2008-1, 2008-2 IRB 251.

Because a more-than-2% owner is generally provided the same treatment as a partner for fringe benefit purposes, the partner exclusionary rules in connection with the statutory fringe benefits under IRC §132 (noted previously) also apply to the more-than-2% shareholder of an S corporation.

**Note.** For S corporation owners affected by the fringe benefit rules, health insurance premiums that are included as additional wages are subject to income tax but are not subject to FICA tax if the plan is compliant with provisions of the ACA.[105] Accordingly, the income amount should be included in box 1 (wages) of Form W-2 but not boxes 3 (social security wages) and 5 (Medicare wages). This is in contrast to the treatment of such amounts for a partner, which are subject to both income tax and SE tax.

### C Corporations

Generally, health insurance premiums paid by a C corporation for employees, including owner-employees, are 100% deductible by the C corporation as an ordinary and necessary business expense under IRC §162.[106] A C corporation employee-shareholder does have additional income tax, social security, and Medicare tax payments associated with a health insurance premium paid by the corporation if the plan is not ACA-compliant.[107] Although a partner must pay income and SE tax on the additional guaranteed payment amount and a more-than-2% S corporation shareholder must pay income tax on the additional wage amount associated with the health insurance premiums paid, under §162(l), a deduction is allowed as an adjustment to income.

It appears that if the plan is ACA-compliant, the health insurance premiums continue to be a tax-free benefit. The AICPA has requested formal guidance on this issue.

**Note.** For a detailed discussion on the taxation of several types of fringe benefits for employees, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Employment Issues. This can be found at **www.taxschool.illinois.edu/taxbookarchive.**

## OTHER TAXATION CONSIDERATIONS

There are numerous tax considerations that may be taken into account in deciding on the type of entity. The relevant tax considerations vary among clients, with some of the important factors being the amount of anticipated business income subject to taxation each year, the ability to pay income to other family members, and other nonbusiness sources of income that are subject to tax. Evaluating the tax considerations applicable to a client requires a careful and comprehensive assessment of the client's tax picture and isolation of the relevant aspects that the choice of entity will affect. This section discusses some tax issues that should be kept in mind in advising a client on a choice of entity, with a focus on C corporation tax issues.

**Note.** For details and tax issues regarding partnership taxation, see the 2013 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Partnership. For information regarding S corporation taxation, see the 2012 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: S Corporation. The latter can be found at **www.taxschool.illinois.edu/taxbookarchive.**

105. *S Corporation Compensation and Medical Insurance Issues.* [www.irs.gov/Businesses/Small-Businesses-%26-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues] Accessed on Feb. 10, 2014.

106. IRC §162(a).

107. IRS Notice 2013-54, 2013-40 IRB 287.

Owners of C corporations can issue qualified dividends to themselves or other family members. These dividends obtain preferred tax treatment at the personal tax level, but this is only because the C corporation has paid tax on the nondeductible dividend at the corporate level.

**Note.** See IRC §1(h)(11)(B) for the definition of a qualified dividend. Because this definition includes a dividend from a domestic corporation, an owner of a domestic C corporation may characterize dividend income received as qualified dividend income.

For 2014, the personal tax brackets and rates for single filers and MFJ filers are as follows.

| Personal Income Tax Rates for 2014 | | | Qualified |
|---|---|---|---|
| Tax Rate (%) | Single | MFJ | Dividend Rates (%) |
| 10 | $ 0– 9,075 | $ 0– 18,150 | 0 |
| 15 | 9,076– 36,900 | 18,151– 73,800 | 0 |
| 25 | 36,901– 89,350 | 73,801–148,850 | 15 |
| 28 | 89,351–186,350 | 148,851–226,850 | 15 |
| 33 | 186,351–405,100 | 226,851–405,100 | 15 |
| 35 | 405,101–406,750 | 405,101–457,600 | 15 |
| 39.6 | 406,751+ | 457,601+ | 20 |

In addition, the tax rates for C corporations are as follows.

| Rate (%) | Income Bracket |
|---|---|
| 15 | $ 0– 50,000 |
| 25 | 50,001– 75,000 |
| 34 | 75,001– 100,000 |
| 39 | 100,001– 335,000 |
| 34 | 335,001–10,000,000 |
| 35 | 10,000,001–15,000,000 |
| 38 | 15,000,001–18,333,333 |
| 35 | 18,333,334+ |

## C CORPORATIONS AND THE DOUBLE TAXATION ISSUE

The issue of double taxation is seen as a major disadvantage of C corporations. The corporation pays tax at the corporate level. If those taxed earnings are subsequently paid to the shareholders as dividends, the shareholders pay tax on those same dollars again at the personal level. This can lead to a very high effective tax rate on the earnings subject to tax at both the corporate and personal levels.

**Example 19.** Milton's bakery business is a C corporation. The corporation's 2014 net earnings are $100,000. Using the 2014 corporate brackets and rates (and ignoring any corporate tax credits or other tax-reducing items), the corporation's liability for federal taxes on $100,000 of net earnings is calculated as follows.

| Bracket | Tax Rate (%) | Number of Dollars in the Bracket | Tax Liability |
|---|---|---|---|
| $ 0– 50,000 | 15 | $ 50,000 | $ 7,500 |
| 50,001– 75,000 | 25 | 25,000 | 6,250 |
| 75,001–100,000 | 34 | 25,000 | 8,500 |
| Total | | $100,000 | $22,250 |

Accordingly, after taking into account the $22,250 of tax liability, the corporation has $77,750 of after-tax earnings ($100,000 − $22,250). If the corporation distributes these earnings to Milton as dividends, Milton pays tax on this amount at the personal level. Assuming Milton's capital gains tax rate is 20%, he incurs tax of $15,550. Combined with the corporate tax of $22,250, the total tax liability is $37,800, for an effective tax rate of 37.8%.

However, if Milton is a typical small business owner, the following should be noted.

- Milton likely has a need for regular income and would not retain all the income in the corporation. Paying a wage to Milton results in deductible wage amounts for the corporation.
- Milton can choose to retain within the corporation just enough funds for the various equipment purchases and expenses the bakery business will have throughout the year (eliminating or reducing corporate-level taxation).
- Milton can maximize the use of fringe benefits to further increase deductions for the corporation.
- Milton may have family members that can also work in the business to facilitate income splitting.
- The C corporation provides the ability to make use of different classes of shares, which may facilitate income splitting with other family members using dividends (reducing Milton's own personal tax liability on any dividend amount received). These dividends are qualified dividends because they are from a domestic corporation.
- Depending on the level of income subject to taxation, Milton may find that the C corporation can be used to reduce taxes, because its income up to $50,000 is taxed at only a 15% tax rate. Milton's tax rate is substantially higher with higher amounts of income.
- Milton (and perhaps other family members) can make use of an IRA or a corporate-sponsored retirement plan to further shelter funds and reduce the overall tax liability.

If double taxation does become an issue, proper planning can frequently reduce or eliminate it. With an S corporation, any business profits pass through to the shareholders. However, a C corporation provides some degree of control over what passes through to the owners and what remains at the corporate level. This may provide the business owner with an additional measure of control that a pass-through entity cannot provide.

Compensation paid by a closely-held C corporation may be subject to IRS scrutiny to ensure that a shareholder-employee was not paid an excessive amount. In order for the corporation to deduct compensation paid, the compensation must be reasonable and be attributable to services actually rendered.[108] Reasonable compensation is defined as an amount that would ordinarily be paid for the same employee services by other businesses under similar circumstances.[109] Circumstances taken into consideration include those that exist at the time the employment contract is created, not at the time the IRS later scrutinizes the contract.

**Observation.** An IRS review of C corporation compensation to a shareholder-employee frequently involves a concern over an excessive compensation amount (for which a C corporation deduction is claimed) that should, in fact, have been characterized as a dividend (which is not deductible by the C corporation).

**Note.** Higher-income taxpayers now face a personal top bracket of 39.6%, along with the phaseout of exemptions and itemized deductions as enacted by the American Taxpayer Relief Act (ATRA) of 2012 (which passed into law January 2, 2013). However, the top corporate tax bracket is unchanged at 35% (albeit with intermediate brackets at 38% and 39%). Many practitioners believe this makes C corporations more attractive than S corporations or LLCs. Application of the ACA's net investment income tax (NIIT) provisions may also contribute to the attractiveness of C corporations for higher-income individuals. For more details about the ACA, see the 2014 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Affordable Care Act Update. For further details about ATRA, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation.

Because a C corporation has characteristics that can shelter funds, the IRS developed special rules to limit such use. The next section discusses this and other limitations the tax practitioner should be aware of when advising clients on the choice-of-entity question.

## ACCUMULATED EARNINGS TAX

The accumulated earnings tax (AET) is a penalty tax that applies to any entity subject to corporate income tax (other than those specifically excluded) that was formed for the purpose of avoiding income tax on its shareholders. Such a business protects its shareholders from taxation by permitting earnings and profits to accumulate. Certain types of corporations, including the following, are excluded from the AET.[110]

- Personal holding companies
- Tax-exempt corporations
- Passive foreign investment companies

S corporations are also exempt from the AET because they do not accumulate earnings and profits. Under the AET rules, a **presumption** of tax avoidance exists if the corporation accumulates earnings and profits beyond the reasonable needs of the corporation, which is based on an analysis of facts and circumstances. The following factors are considered in deciding whether the corporation has accumulated earnings and profits to a degree that constitutes tax avoidance under the AET rules.

- Use of loans to shareholders (instead of using taxable distributions)
- Use of corporate funds to benefit shareholders

108. Treas. Reg. §1.162-7(a).

109. Treas. Reg. §1.162-7(b)(3).

110. IRC §532(b).

- Investments that were acquired in the corporation's name that are not related to the corporation's business
- The distribution history of the corporation
- Characteristics or actions of the shareholders that indicate a tax-avoidance use of the corporation

However, the presumption of tax avoidance may be rebutted if the corporation can show that there was a reasonable business need for the accumulation of earnings and profits. Such reasonable needs include the following.

- Anticipated future needs for capital
- Working capital needs
- Debt retirement
- Modernization or expansion
- Relocation
- Product liability
- Stock redemptions

AET is applied to accumulated taxable income, which is the corporation's taxable income subject to specific adjustments.

**Note.** IRC §535(b) provides details about various adjustments that must be made to the corporation's taxable income to arrive at accumulated taxable income.

When calculating the corporation's accumulated taxable income, the corporation is entitled to a credit for the amount of earnings and profits it can justify for reasonable business needs.[111] The minimum credit amount the corporation is automatically entitled to is $250,000 (or $150,000 for a personal service corporation, which is discussed in the next section). Any credit amount beyond this minimum level must be justified by the corporation as a necessary accumulation for reasonable business needs.

The AET is 20% of the corporation's accumulated taxable income. The corporation is subject to AET in addition to any usual income tax.

**Note.** The 20% AET rate is equal to the top tax rate on dividend income. Through 2012, the AET rate was 15%.

**Observation.** Although the AET applies to both publicly-held and closely-held corporations, it is far easier for the IRS to invoke the AET rules against a closely-held corporation because it is easier to prove tax avoidance in that setting.

111. IRC §535(c).

## PERSONAL SERVICE CORPORATIONS

A personal service corporation (PSC) is defined as a corporation whose principal activity is performing personal services for (or on behalf of) one other entity[112] when such services are substantially performed by employee-owners.[113] Special tax rules apply if an employee-owner owns more than 10% of the outstanding stock of the corporation on any day during the tax year. For purposes of determining whether the 10%-ownership test is met, the attribution rules of IRC §318 apply (and the 50% threshold for attribution of stock through a corporation is reduced to 5% for purposes of these rules).[114] If the principal purpose of the PSC is tax avoidance or evasion by reducing any employee-owner's income or obtaining tax benefits that otherwise would not exist, the IRS can reallocate amounts of income and tax deductions.

**Example 20.** Briana is employed as an executive chef and restaurant manager at the Seaside Resort and Gourmet Grille (Seaside). She is a high-income employee who has substantial income in the top bracket (39.6% tax rate). Instead of remaining an employee of Seaside, she decides to establish a corporation and have Seaside pay the corporation, which has a maximum tax rate of 35% (after an intermediate 38% and 39% tax bracket) on the amount of her annual income — substantially less than the 39.6% she paid on her income as an employee. In addition, payment of her compensation to the corporation eliminates the 0.9% additional Medicare tax that she would otherwise pay on her wages that exceed $250,000 (the applicable threshold for application of the additional Medicare tax for Briana's filing status).

She also makes her husband a shareholder in the corporation and issues qualified dividends to him each year. Because Briana is an employee-owner who substantially performs services for one entity (Seaside) and the 10%-ownership test is met, the IRS may characterize her corporation as a PSC and eliminate some of the tax advantages she gave herself by establishing the corporation.[115]

In addition to PSCs under IRC §269A, there are also **qualified** PSCs as defined by IRC §448(d)(2). A qualified PSC is one that is:

- Used for the performance of services in health, law, engineering, architecture, accounting, actuarial science, or performing arts; and
- Owned by employee-owners (active or retired) who own substantially all the stock and who also perform the professional services.

**Substantially all** of the stock means ownership of 95% or more of the value of the corporation's stock.[116] In determining whether substantially all the stock is owned by employee-owners, stock that is directly or indirectly owned by the following taxpayers is included.[117]

1. All employees of the corporation who are performing services in connection with activities in the fields of health, law, engineering, architecture, accounting, actuarial science, or performing arts
2. Retired employees who previously provided such services in the past
3. The estate of an employee described in 1 or 2 above
4. A person who acquired stock through inheritance from an employee described in 1 or 2 above (Such stock is only included for the 2-year period from the deceased shareholder's date of death.)

**PSCs are taxed at a flat rate of 35%.**

**Note.** For further information concerning qualified PSCs, see IRC §448 and Temp. Treas. Reg. §1.448-1T.

112. IRC §269A(a)(1).
113. IRC §269A(b)(1).
114. IRC §269A(b)(2).
115. IRC §269A(a).
116. Temp. Treas. Reg. §1.448-1T(e)(5)(i).
117. Ibid.

**Example 21.** Greta is a licensed pathologist and a partner in a partnership formed to provide pathology services to a variety of hospitals and clinics. Greta forms a corporation to receive all of her income, and the corporation takes Greta's place as partner in the partnership. Greta has the corporation adopt a defined benefit pension plan and a medical reimbursement plan. The IRS will likely characterize Greta's corporation as a qualified PSC and tax its earnings at a flat 35%, denying the corporation the use of the usual progressive corporate tax rate structure.[118]

**Observation.** The IRS may take an expansive view of what particular job descriptions are included within the enumerated professions that come under the definition of a qualified PSC. For example, in *Kraatz & Craig Surveying, Inc. v. Comm'r,*[119] the Tax Court agreed with the IRS assertion that land surveying constitutes "engineering," despite the lack of any clear definition of any of the professions under the qualified PSC rules and despite the taxpayer's argument that under state law, surveyors are not considered to be the same as engineers and are separately regulated and licensed from engineers.

## ENTITY SELECTION SCENARIOS FOR DISCUSSION

**Observation.** There are many factors to consider when advising a client on which entity to choose for the operation of a business. Most frequently, there is no clear "right" answer to this question. Relevant aspects of the client's tax and other considerations, including liability concerns, must be superimposed upon the characteristics of each type of entity (including but not limited to tax characteristics) to determine which option or options are a good fit for the business enterprise, the taxpayers involved, and their objectives.

### SCENARIO 1

Cary owns C's Landscaping Services and has operated it as a sole proprietor since its inception in 2009. Cary is single and is 48 years old. Gradually the business grew, and at the beginning of 2014, Cary acquired a large contract for lawn maintenance and snow removal with the local school board and a second contract for mowing large tracts of grassland around the municipal airport. He anticipates that his 2014 net income will be approximately $70,000 after purchasing necessary equipment plus other expenses. Cary usually pays himself $30,000 per year. He anticipates hiring one or two permanent employees once the season opens for lawn maintenance.

Cary meets with his tax preparer, Jenna, to discuss details regarding his 2013 tax return preparation. Cary asks Jenna whether he should keep operating as a sole proprietor. Jenna knows that Cary likes to keep recordkeeping and tax reporting as simple as possible.

Cary has an increasing need for liability protection due to the operation of a tractor and plowing on school property and around an airport. Cary also plans to hire employees in 2014, which requires liability protection.

Once Cary pays himself $30,000, he has $40,000 remaining. Jenna would like to minimize his overall tax liability. Jenna considers other entity choices for Cary, such as a C corporation or an S corporation and begins to consider some of the features of each. She considers the similarities and differences between these entities and Cary's existing sole proprietorship. She develops a brief summary of these features to discuss with Cary. Jenna's summary is shown in the following table.

118. The facts of this example are based on *Keller v. Comm'r*, 723 F.2d 58 (10th Cir. 1983), *aff'g* 77 TC 1104 (1983).

119. *Kraatz & Craig Surveying, Inc. v. Comm'r,* 134 TC 8 (2010).

| Entity Option | Recordkeeping | Liability Protection | Tax Treatment of Net Income | SE Tax |
|---|---|---|---|---|
| Current sole proprietorship | Easy | No | • Fully taxable at personal rates | • All net income taxed |
| S corporation | More complex | Yes | • Fully taxable at personal rates (pass-through) | • Only reasonable salary taxed (FICA)<br>• Distributions not taxed |
| C corporation | More complex | Yes | • Fully taxable (personal and corporate rates may apply)<br>• Income can be allocated between corporation and shareholder/employee<br>• Double taxation may be an issue | • Only salary taxed (FICA)<br>• Distributions not taxed |

With a pass-through entity such as an S corporation (or LLC that elects S corporation tax treatment), the entire $70,000 would pass through to Cary. Cary could presumably be paid $30,000 to meet the reasonable compensation requirement associated with S corporation rules. This $30,000 would be subject to income tax and social security and Medicare taxes. The remaining $40,000 would be distributed to Cary; although it would be subject to income tax, it would not be subject to SE tax. Jenna should calculate the approximate amount of individual tax Cary would pay (taking into account his personal exemption and other deductions and credits for which he qualifies). If the use of a C corporation would provide a lower tax rate on the $40,000 but would result in more complicated tax reporting and recordkeeping, Jenna should discuss with Cary whether the tax savings would be worth the additional complexity.

### SCENARIO 2

Klaus is an engineer who is a partner with Donna in a consulting business. Each partner has a 50% interest in the profits of the partnership. Because Klaus and Donna are specialists in petroleum and pipeline engineering and they have obtained several large consulting projects, they have substantial income for 2014.

Klaus meets with Guido, his tax preparer, and discusses the details regarding his 2014 tax return. Klaus is single and he itemizes deductions each year.

Klaus's income for 2014 is high enough that he will have substantial income in the top tax bracket (39.6% tax rate). In addition, Klaus's high income will also trigger a substantial reduction in his itemized deductions and will likely reduce his personal exemption to zero. Further, the income from the partnership is subject to the 0.9% additional Medicare tax for amounts over $200,000 (the threshold for a single filer).

Guido provides Klaus and Donna the following summary of entity options.

| Entity Option | Recordkeeping | Liability Protection | Tax Rates | Health Premium | Additional Medicare Tax |
|---|---|---|---|---|---|
| Current general partnership | More complex | No | • No control over exposure to top personal bracket | • Treated as a guaranteed payment<br>• Income tax and SE tax apply<br>• Deductible under IRC §162(l) | • Little control over exposure |
| C corporation | More complex | Yes | • More control over exposure to top bracket<br>• Flat 35% PSC rate may apply | • Fringe benefit to employee<br>• Deductible by corporation | • More control over exposure |

Guido notices that part of the guaranteed payments Klaus must report consists of a $22,000 health insurance premium on which Klaus must pay SE tax and income tax, even though Klaus can claim the amount as a self-employed health insurance deduction.

Guido realizes that although an S corporation structure would save Klaus some SE tax (because S corporation distributions are not subject to SE tax) and some additional Medicare tax, this still would not have much of an impact on Klaus's tax rates. However, Guido knows that a C corporation would provide similar benefits to an S corporation while also providing lower tax rates to Klaus on much of his income. In addition, Klaus would be considered an employee of the C corporation, so the C corporation could simply deduct the $22,000 health insurance premium. This benefit would not be taxable to Klaus as an employee. A C corporation would also give Klaus the ability to control how much income would be paid to him and taxed at personal rates.

Guido mentions to Klaus that perhaps he and Donna should consider a C corporation structure for 2015 onward. The business would likely be taxed at a flat rate of 35% as a qualified PSC, but this could be used to reduce or eliminate income in the top 39.6% tax bracket for both partners and provide some added advantages such as a health insurance premium deduction and additional liability protection. An analysis that includes a comparison of PSC income tax liability with personal income tax liability (using the graduated personal tax brackets and rates) is needed to determine whether a PSC would provide meaningful tax savings at current income levels.

### SCENARIO 3

Peter and Paula file jointly each year. In 2011, Peter and Paula started an Internet sales business. During the first year, they used the space in their garage as a small warehouse. However, as the business grew, they began to rent warehouse space in an old factory in their neighborhood. They were able to reduce the cost of shipping materials from year to year because Paula left her part-time job and worked full-time for the Internet business since 2013.

Peter is employed as a commercial artist with a major advertising company and receives $35,000 of employment income per year.

Peter and Paula have always prepared their own return but, because the Internet business has grown dramatically over the past couple of years, they decide to have their 2014 tax return professionally prepared. Accordingly, they meet with Yasmine, a tax preparer in their neighborhood. Peter and Paula bring in historical business information and copies of their returns for 2011, 2012, and 2013.

For the 2011, 2012, and 2013 tax years, Peter reported all the business activity on a Schedule C. In 2011 and 2012, Peter noticed that the business loss served to reduce his income from employment and generated a larger refund. However, in 2013, Peter and Paula ended up paying additional income tax, and estimated tax payments were triggered for 2014.

Yasmine also discusses the notion of liability concerns with Peter and Paula. The three of them agree that the Internet business is not a high-liability undertaking. Regardless, Peter and Paula have a comprehensive insurance policy in place for the business which provides adequate liability protection. However, the current policy is written in Peter's name only due to Paula's credit problems, and Peter must remain an owner of the business in order for the liability coverage to remain effective.

Yasmine recommends that in order to keep the annual tax reporting simple, Peter and Paula elect out of partnership tax treatment and instead characterize the business as a qualified joint venture. Yasmine provides the following comparison of the two entities.

| Entity Option | Liability Protection | Recordkeeping | SE Tax |
|---|---|---|---|
| Current partnership | No | • Easy, but the business is really a partnership<br>• Partnership Form 1065 complicates recordkeeping | • Use of Schedule C gives only Peter social security credit |
| QJV | No | • Could elect QJV treatment<br>• QJV continues to use Schedule C and recordkeeping remains easy | • QJV treatment will give both spouses social security credit<br>• Paula's QJV interest can be greater than Peter's interest to augment social security credit to her<br>• Providing Paula with 100% interest may be investigated when liability policy can be issued in her name |

Yasmine points out that a business enterprise operated by spouses is considered a partnership, which would require them to file Form 1065 each year and the prepare Schedules K-1 for each spouse for their respective share in the profits or losses of the business. In addition, if Peter continues to report all of the business activity in his name on a Schedule C and the business remains profitable, only Peter would obtain credit for social security purposes. Obtaining credit for social security for Paula is important to her because she left her part-time employment in 2013 and will otherwise not receive any social security credit. On the other hand, Peter's full-time employment as a commercial artist would continue to provide him with social security credit.

Yasmine recommends that, in order to keep the annual tax reporting simple, Peter and Paula elect out of partnership tax treatment and instead characterize the business as a qualified joint venture (QJV). This eliminates the need for a partnership return and Schedule K-1 preparation each year. Instead, the business activity is reported on Schedule C, which Peter and Paula are already familiar with. In addition, because Paula works full-time for the business, her interest in the QJV could be more than 50%, augmenting her credit for social security.