Distribution and Compensation Issues
In Starting a Business

Illinois State Bar Association

Business Advice & Financial Planning Section Law Ed Series

Back to Basics: The Fundamentals of Starting a Business

Chicago, Illinois
May 17, 2007

James A. Nepple
Nepple Law, PLC
1515 Fourth Avenue, Suite 300
Rock Island, IL 61201

jim@nepplelaw.com
309/732-1230

Table of Contents

<u>Basic Income Taxation of Entities and their Owners</u>

This article reviews how entities and their owners are taxed as sole proprietorships, partnerships, and corporations.

I. <u>Corporation</u>

A. <u>C Corporations</u>

A C Corporation pays income taxes on its earnings and the shareholders pay income tax on any dividends. Corporations whose stock is publicly traded are generally C Corporations.

Some C Corporations are C Corporations simply because they were formed before S Corporation taxation was even available. Other corporations are C Corporations because S Corporations use and tax planning was not explored. In other situations, the S Corporation status may not have been available to the corporation because of too many shareholders, ineligible shareholders, or a capital structure that has more than one class of stock. Other corporations are C Corporations to minimize taxes. The income tax on the first $50,000 of a corporation's taxable income is only 22.3% (15% federal plus 4.8% Illinois income tax and 2.5% personal property replacement tax). The shareholders of a C Corporation are not subject to income tax or self-employment tax on reinvested income. In addition, more fringe benefits are allowed to C Corporation shareholders than owners of S Corporations or Partnerships.

B. <u>S Corporations</u>

An S Corporation is a corporation whose income is taxed to its owners. It avoids double taxation that exists in a C Corporation, where the C Corporation pays tax on its earnings and shareholders pay tax on the dividends.

To be an S Corporation, an election is made by filing Form 2553 with the Internal Revenue Service. It must be filed no later than two months and 15 days after the beginning of its tax year

An S Corporation reduces the risk of self-employment taxes that exists in a partnership. S Corporations do not pay self-employment tax on their earnings. Instead S Corporations pay payroll taxes on the compensation paid to the owners and the corporation's earnings that are not payroll related to reasonable compensation are not subject to self-employment tax.

Also, another reason for using the S Corporation is if one of the shareholders decides to retire and still receive substantial distributions from the corporation. If the company was a C Corporation and paid compensation to a retired shareholder, the Internal Revenue Service could deny the deduction for the payment and treat it as a dividend. With the S Corporation in lieu of a salary, the retiring shareholder could receive a pro-rata share of the corporation earnings and the remaining shareholders receive salaries and their pro-rata share of the earnings.

Although S Corporations cannot have more than one class a stock preferences in voting rights do not by themselves create a second class of stock. As long as the shares have identical rights to distribution and liquidation proceeds, the corporation is treated as having one class a stock.

It is normal for new S Corporations to start with one type of voting stock, and then later issue a stock dividend of nonvoting stock. The purpose of nonvoting stock is generally to transfer those nonvoting shares to the next generation or to key employees.

S Corporations can give an employee a cash bonus based on company's profitability. But how far can an S Corporation employer go in compensating an employee with stock ownership rights in an S Corporation? It can use a call option to provide equity compensation to its employees provided the call option does not constitute excessive compensation, is not transferable, and does not have an ascertainable fair market value when issued. Under these conditions such option will not be treated as a second class of stock. Normally, the call option is in a written agreement which follows the Treasury Regulations, Reg. 1.1361-1.

Also, agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether there are two classes of stock. Buy-sell agreements among shareholders restricting transferability of stock and redemption agreements are also disregarded in determining whether a corporation has more than one class a stock. This is true as long as the principal purpose of the agreement is not to circumvent the one class a stock requirement and the agreement establishes a price that at the time it is entered into is not significant in excess of or below the fair market value of the stock.

II. Limited Liability Company

A limited liability company has liability protection similar to a corporation.

A. Disregarded Entity Taxed as a Sole Proprietorship

If the liability company only has one member it is disregarded for federal income taxes and taxed as a Sole Proprietorship, unless the limited liability company elects to be taxed otherwise.

B. Taxed as a Partnership

If the limited liability company has more than one member, it is taxed as a partnership unless it elects to be taxed otherwise.

C. Taxed as either a C Corporation or an S Corporation

A limited liability company can elect to be taxed as a corporation by filing Form 8832 with the Internal Revenue Service. Further, if the limited liability company wishes to be an S Corporation it can also file Form 2553 with the Internal Revenue Service.

D. Examples

Typically, a sole owner of real estate, which may have inherent liability issues, may want to consider a limited liability company (LLC). A LLC would protect the sole owner from liabilities while being taxed as a sole proprietorship on Schedule C of the owner's personal income tax return. It does not require any additional tax returns to be filed. If a real estate has co-owners in a general partnership form, the owners are liable for each others acts or omissions. If one of the general partners gets in trouble with creditors or has other financial problems, that partner can jeopardize the real estate investment. A solution would be to form a LLC that, while taxed as a partnership, relieves the owners of joint and several liabilities and can provide in the operating agreement that a creditor of an owner cannot obtain voting rights in the LLC.

If one starts a new business and wants to keep it simple, a sole proprietorship is an excellent form of ownership. However, starting with a LLC but taxed as a sole proprietorship may be better. As new owners become a part of the business the LLC would be taxed as a partnership. If the earnings are needed for reinvestment, the C Corporation election can be made. And if it is best to be taxed as an S Corporation, the LLC could make the tax election by filing the proper forms. In addition, holding assets in the LLC would not require a change in asset ownership. Sometimes leases, patents, copyrights, and franchise rights would be easier maintained in the same form of ownership rather than changed to a new entity.

III. Partnership

A. General Partnership

General partnerships are generally governed by the Illinois Uniform Partnership Act. In general all partners share management rights and all are jointly and several liable for partnerships activities. This partnership agreement can be either oral or written.

B. Limited Partnership

Limited partnerships are formed by filing a Certificate of Limited Partnership with the Illinois Secretary of State under the Uniform Limited Partnership Act. The rights and liabilities of the general partners in a limited partnership include joint and several liabilities and a sharing of the management rights. Limited partners in a limited partnership are not subject to personal liability for the acts of the partnership or judgments of the partnership. But, they also do not participate in the management of the company.

IV. Income Tax Issues for the Business

A. Starting a Business

1. C Corporations & S Corporations

When starting a C Corporation the initial transfer of assets to the corporation is not a taxable event except to the extent that liabilities assumed by the corporation exceed the adjusted basis of assets contributed to the corporation. In addition, the owners transferring such assets must end up owning at least 80% of the shares, both voting and nonvoting.

2. Partnerships

Generally a partner who contributes property to a partnership does not recognize any gain or loss at the time the property is transferred to the partnership. The basis of the contributed property remains the same as it was in the partner who contributed the property to the partnership. However, if the assets being transferred are investment company assets such as stocks, securities, which results in the diversification among the partners, a taxable event occurs. This generally is avoided by partners transferring in like stock portfolios or transferring in non investment assets that are greater than 20% of the total value of assets such as real estate.

Another exception to the general no recognition rule for partners occurs when a partner transfers liabilities into the partnership. At that point, the contributing partner may recognize gain to the extent that partner's share of the liabilities after the transfer to the partnership is reduced provided such reduction is greater than the partner's tax basis. In other words, when the partnership assumes the liability, the transfer may be considered a sale of all or some of the contributing partner's liability. If the liability is a qualified liability, it is not treated as recognized gain. This is a liability where the partner had the liability on the property for more than two years, and that the liability was not incurred in anticipation of transferring it to the partnership. Also, if the contributing partner of a liability to the partnership continues to be the only recourse party for that liability than, that too is not treated as recognized gain.

Avoiding recognition gain is much easier for partnerships than corporations because a partner who contributes a liability generally receives a special allocation of that liability under the partnership tax rules and partnership agreement.

B. <u>Operating the Business</u>

1. C Corporations

C Corporations are taxed on their own earnings and have losses that carry back and carry forward. C Corporations generally can not take current deductions for a decrease in the value of stock unless it becomes worthless. Stock that becomes worthless is generally treated as a capital loss. However, when the value of the stock becomes worthless, a founding shareholder may be able to take an ordinary loss under Section 1244 the Internal Revenue Code. The amount is up to $50,000 or if a joint return is filed the amount increases up to $100,000.

2. S Corporations and Partnerships

S Corporations and partnerships generally do not pay income taxes. Instead their income is taxed to their owners whether or not their owners receive any distributions. Consequently it is not uncommon for the organizational documents to mandate distributions to pay the income taxes. Partners or shareholder owners generally may deduct losses to the extent of the owner's basis in their partnership interest or corporate stock. However, S Corporation shareholders generally may not deduct losses financed by corporate debt. Thus guaranteeing a corporate bank debt will not increase basis to the shareholder. But if the shareholder is the lender, then basis is increased. In contrast, partners can generally deduct losses financed by bank loans to the partnership to the extent permitted by the at risk rules under Section 465 of the Internal Revenue Code.

Partnership income taxation of owners is much more complex and more flexible than the S Corporation income taxation of owners. In partnerships, the income, deductions and credits among the partners are governed by what is called the substantial economic effect rule in accordance with the partner's interest in the partnership. When a partner is allocated income the partner must be able to enjoy the economic benefit and when a partner is allocated a loss, the partner must suffer the economic loss. This is all kept track by capital accounts for each of the partners.

Special partnership allocation rules govern contributions of property in determining the income, gain, or loss associated with the contributed property. These allocation rules account for differences between the partnership basis of the property at the fair market of the property at the time of the contribution and the partner's basis. This allocation ensures that the partner who contributed the property will realize any net precontribution gain or loss. If the partnership distributes that property to another partner within seven years of the contribution, the contributing partner is treated as though the property were sold by the contributing partner at its fair market value. A contributing partner cannot erase this taxable event by transferring his or her partnership interest to a third party since the third-party steps in the shoes of the contributing partner. In addition, in allocating gains and losses, the substantial economic effect rule also requires an allocation of depreciation or amortization related to the contributing partner's basis.

S Corporations generally must have a single class of stock. Special allocations of profits are not permitted and the substantial economic effect rule does not apply.

3. Stock as Compensation

Employees who receive stock for compensation generally pay tax on the stock. However, if a corporation awards nonvested stock, the employee does not recognize compensation until the stock vests. Internal Revenue Code Section 83(b) provides an exception where the employee can elect to pay tax on the value of the stock at the date of the issuance provided the employee makes a Section 83(b) election within 30 days of the issuance. Usually a corporation will gross up the employee's salary to pay the employee's taxes on the value of the stock.

On the other hand, a partnership can award a profits interest to a partner. A profits interest is less expensive because it does not require a new partner to buy into any current business value. Under Rev. Proc. 93-27, if a person receives a profits interest the IRS generally will not treat such receipt of an interest as a taxable event to the partner.

Performance bonuses that are paid within 2 1/2 months after the year end are also used to motivate employees provided the compensation is reasonable. Further, such performance payment paid within the 2 1/2 month rule is an exception to the nonqualified deferred compensation plan rules in Internal Revenue Code Section 409A. In addition, a fixed payment upon attaining a particular age also satisfies an exception to the nonqualified deferred compensation rules. For example, if there is a buyout of a senior employee as a part of a buy sell agreement and that employee receives $100,000 a year payments beginning at age 65 for 10 years, receipt of this deferred compensation would not subject that employee to immediate taxation on the full amount. This exception would also apply when payment of the full amount of deferred compensation is triggered by an event such as a change in control of the business.

4. Withholding, FICA and Self Employment Taxes

C Corporations and S Corporations must withhold taxes and file quarterly forms 941 and annual forms W-2 for their employees. An owner's compensation from partnerships and sole proprietorships does not involve withholding taxes and payroll taxes. Instead, partners and sole proprietors must file quarterly estimated taxes to pay their income taxes and self-employment taxes. Generally for sole proprietorships and most partnerships, the operating income is subject to both income tax and self-employment tax. Self-employment taxes are 15.3% on the taxable wage base, which for 2007 is $97,500. Any amount over $97,500 continues to be subject to the 2.9% tax on Medicare since it has no wage base limit like the one for social security. Sole proprietorships and partnerships that engage in nontrade or nonbusiness activities or rental activities are generally not subject to self-employment tax. In addition, a limited partner's income is not subject to self employment tax except for guaranteed payments for services. The Internal Revenue Service defines a limited partner as a partner who has no personal liability for the partnership debts, has no authority to contract for the partnership, and does not participate in the trade or business more than 500 hours per year. In addition, there is a generally recognized exception for LLC members who do not participate in the management of the business and members who have more than one class of units such as preferred units. In all cases service members and service partners will be subject to self-employment tax.

For corporations, compensation, including distributions recharacterized as salaries, are subject to the social security tax and medicare tax (FICA tax). For C Corporations, income that is retained by the corporation and not paid out as compensation is not subject to the FICA tax. For S Corporations, shareholders' health insurance and other fringe benefits are deductible by the S Corporation, but considered compensation to the shareholders. However, these fringe benefits are not subject to FICA tax unless the plan discriminates in favor of the owners.

Only C Corporations can deduct benefits for dependent care, meals and lodging for the employer's convenience, and nondiscriminatory premiums up to $50,000 for group term life insurance.

C. Ownership Changes

1. Buy Sell Agreements

A buy sell agreement is a contract among the owners or the owners and the entity that provides for the sale of the owner's interest upon an event such as disability, retirement, or death. This is generally done with redemption agreements, cross purchase agreements, or perhaps an agreement that combines elements of redemption and cross purchase. These agreements determine the price and payment terms and restrict who can own interests of the business. In a LLC the buy sell agreement is normally included in the operating agreement and in a partnership the buy sell agreement is normally integrated into the partnership agreement. In a corporation, whether it is a C Corporation or an S Corporation, buy sell agreements are normally stand alone shareholder agreements.

Certain other events such as an owner's divorce or an owner's bankruptcy can trigger the buy sell provisions. In addition, some courts have held owners buy sell agreements not binding on spouses even if those spouses consented in writing to the buy sell agreement. However, such written consent generally prevents spouses from participating in the business and prevents spouses from leaving their community property interest in the business to a third party. To accomplish these objectives the buy sell agreement must specifically address these involuntary transfers.

2. Entity Choices

Often when starting a business the entity of choice will be a partnership or S Corporation which enables the owners to deduct initial losses. Then, the owners convert to a C Corporation when profitability is achieved. The liquidation of a C Corporation however, is a taxable event. The corporation is taxed to the extent the fair market value of the assets exceed their basis and the shareholders realized capital gains on the difference between the fair market value of the assets they receive in their stock basis.

Moving from a C Corporation to an S Corporation is not a taxable event. However, if assets are sold within 10 years of the S Corporation election, the double taxation rules apply. This includes inventory, and for cash basis taxpayers, their accounts receivable.

A conversion from an S Corporation to a C Corporation is not a taxable event. However, it precludes the S Corporation election for 60 months.

3. Examples

Dividing a business or when one of the owners wishes to sell his or her share is typically handled through third-party financing, seller financing, and on occasion, through equity financing. When the buyer uses debt to pay for a business there are two layers of taxes imposed. The buyer must pay income tax on the earnings used to repay the debt. For partnership and S Corporation owners who are taxed on the income from operations using 40% for ordinary federal and state income tax rates, a business must earn $167 of profits to fund the $100 principal payments on the debt. For a C Corporation this structure is exacerbated if dividends are taxed at 15% and 5% at the state level. $125 dividend generates $100 after-tax. However to distribute $125 to shareholders from a C Corporation that is subject to the tax on income from operations at 40% for federal and state capital gain/income tax rates the business must earn $208 of income to be able to pay the $125 dividend, which in turn funds the $100 principal payment of the debt. On the other hand, since the seller pays tax on the sale using a combined 20% federal and state capital gain/income tax rate, the seller receives $80 after taxes. What happens is that principal payments require somewhere between $167 and $208 of income to provide the seller with $80 of after tax income. There are ways to make this more tax efficient. For example, perhaps the seller should lease some of the assets to the new owners, especially if assets like real estate are held outside of the business.

When a business entity acquires key employees and the seller's goodwill there are advantages to allocate some of the purchase price to a covenant not to compete and goodwill. When goodwill is sold generally, the seller receives favorable capital gains treatment and the buyer deducts the payments over 15 years. For a covenant not to compete, the seller receives ordinary income treatment and the buyer deducts the payments over 15 years. Since the buyer receives an income tax deduction for the covenant not to compete although over 15 years the buyer is generally willing to pay a little more to the seller for such covenant. The seller will probably ask for a larger payment for the difference between the capital gain rate and ordinary income. At a 40% combined federal and state rate, the seller would need to receive $133 to net $80 of after tax income. If the capital gains rate of 20% for federal and state were used, the seller would need to receive $100 to net $80 of after tax income.

In the past, another way to make the situation more tax efficient was to pay deferred compensation for past services. However, under the new nonqualified deferred compensation rules generally an owner must pay all the income taxes immediately in a lump sum unless a buy sell plan was already in place.

James A. Nepple