

LEIMBERG'S THINK ABOUT IT

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ENTITY PLANNING WHY ENTITY PLANNING IS IMPORTANT TO YOU:

A great deal of creative business and estate liquidity life insurance planning -- (and showing the value-added services you provide) is based on your knowledge of a client's business entity -- and the pros and cons of its viable alternatives.

What you are about to learn (or review) will help you when a client or prospective client is considering a new business venture, and wants to select the form of entity which will best achieve his or her tax and non-tax goals. It will help you advise a client with respect to the problem of how to respond to, or take advantage of, changes in the law (e.g. the advent of LLCs or Check-The-Box Regs) or changes in the nature of the client's current business. And it will help you help your clients achieve their dreams, such as when one or more children come into the family business, or take a more prominent role, or when the client needs to harvest a lifetime of effort and assure a smooth business transition to younger family members or employees.

Choice of entity impacts on the cost of forming and operating a business or investment enterprise, the tax treatment of the entity's income, the value of the entity, and the ability to separate and break it up or withdraw income or principal (without triggering a taxable event). It greatly affects the entity owners' legal liability for the debts, liabilities, and other obligations of the entity, and the extent to which creditors can reach the entity's assets, or even go beyond and reach the owners' personal assets. And choice of entity will help determine the ability and ease in transferring interests in the entity to family members or charity.

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So this month, we will look at the classic entity types -- and their pros and cons.

I will start with a discussion of the non-tax objectives clients often have and the description, pros, and cons of the major categories of business entities. Then I will explain the importance of state law, the type of property the client owns, and the incredible benefits of "multiplicity." As you will see, to achieve a client's objectives, it may be appropriate to utilize more than one business entity in a tailor-made combination of entity types.

WHAT DOES THE CLIENT REALLY REALLY WANT?

Aside from tax savings, ask how important each of the following is:

1. Limited liability from business/personal creditors (and protection from exposure to lawsuits and government environmental agencies, etc.)?
2. Ability to restrict transfers of business interests to keep the business in the family?
3. Ability to control who "calls the shots" and "runs the show?"
4. Ability to operate the business with minimal paperwork, expense, and aggravation?
5. Ability to prevent family disputes and promote family harmony?
6. Flexibility in getting income/assets in or out of business?
7. Ability to use business to solve personal and family's financial planning problems?
8. Ability to make gifts - and obtain valuation discount?
9. Ability to operate the business? and
10. Facilitate succession planning?

WHY AN OWNER MIGHT SWITCH RATHER THAN FIGHT:

The objectives listed above can be viewed in a different context:

A change from one form of entity to another may be indicated whenever:

- Additional liability protection for business/personal assets is desired,
- An infusion of outside capital is needed,
- Owners want to create a market for their interests,
- Separation of ownership and management is desired,
- Income tax savings are possible,
- Business succession and estate planning are underway,
- Tax-Favored Employee Benefits are needed,
- It is important to assure that the business will continue after the owner's death, disability, or withdrawal, and
- A fiscal rather than calendar year method of accounting is desirable.

THE CLASSIC ENTITY FORMS

SOLE PROPRIETORSHIPS:

DEFINED: A sole proprietorship is an unincorporated trade or business entity with only one owner (although it can have one or any number of employees). It has no legal existence apart from its owner. The business may be operated in that individual's actual name (e.g. John Jacob Jingleheimer Schmidt) or an assumed name (e.g. JJ's MotorBikes).

PROS: From a legal standpoint, a sole proprietorship is easy to implement and operate. The payment of a small business license fee is all that is generally required. No special legal documents are required. Many businesses start off as sole proprietorships because there are few professional fees and little burdensome paperwork. Since all business income flows through to the owner, tax planning is relatively simple. It is easy to get assets into and out of the business. And it is easy to convert the business into another form.

CONS: This entity type offers no protection from the claims of the business's or owner-operator's creditors. Personal as well as business assets may be totally lost in the satisfaction of the business's liabilities. The owner is subject - without limit - to all the debts and other liabilities related to the operation and conduct of the business.

Most states will require a person acting under an assumed name to file with the county in which the business will operate, and to publish notices in local newspapers stating his/her actual name. So this form of entity does not provide anonymity for its owner. The business ends at the death of the owner. It is impossible to engage in any meaningful gift-giving of business interests for estate planning purposes, or utilize sophisticated business succession planning. Raising capital for operating or expanding the business is difficult when the business is a sole proprietorship.

COMMENT: The sole proprietorship is the single most popular form of business in the U.S. Most sole proprietorships (about 2/3rds) employ one or more individuals other than the sole proprietor, while the balance are operated only by the owner. The owner must register with both the IRS and state revenue authorities and apply for a taxpayer identification number (TIN) if the business either has employees other than the owner-operator or is subject to a retailer/service occupation tax.

GENERAL PARTNERSHIPS:

DEFINED: A general partnership is a business or investment enterprise consisting of at least two owners, both or all of whom are personally liable (without limit) -- jointly and severally -- for the recourse debts and other obligations of the entity. Likewise, each general partner is personally liable for the negligent or wrongful acts committed by other partners in the conduct of the partnership's business operations. In return, all partners are legally entitled to participate in the management of the partnership. Each general partner can act on behalf of the partnership and, thus, legally bind the other partners. A formal written partnership agreement is not legally necessary in many states but obviously is preferable. Absent written agreement, the entity will be governed by the appropriate state's adoption version of the UPA (Uniform Partnership Agreement).

PROS: A general partnership can be created almost as easily as a sole proprietorship since no special legal documents are needed. (As a practical matter, however, the parties would be well advised to reduce their agreement to writing as quickly as possible.) By definition, there are two or more parties involved - which typically means having more than one person share the burdens of starting and running the business and expanding the idea-base - as well as the risks (and increasing the business's capital raising abilities). Having a partner often creates an exit strategy during lifetime as well as a market for the business interest at the death of a partner. Tax-wise, it is relatively easy and painless to move assets into, or out of, a partnership, or to obtain assets upon a liquidation of a partnership on a typically tax-free basis.

CONS: Absent compliance with state limited liability partnership laws, liability is joint, several, and without limit. Partners can literally lose their homes. Absent a written partnership agreement that specifically provides for the contingency, the death of a partner will result in a legal dissolution, and the long-term disability of a partner can be an economic disaster. It is difficult for an entity in partnership form to raise a large amount of capital from outside sources - because of the potential for personal liability.

COMMENTS: A general partnership must register under its state's Assumed Business Name laws and may have to obtain a "Certificate of Partnership." If the business employs someone other than the owners, registration with the IRS and application for a TIN (Taxpayer Identification Number) will be required for payroll tax purposes. If the firm provides substantial services or is an operating partnership, it must file a separate income tax return from its owners - even if no tax is levied at the partnership level. (If the firm holds only real estate or some other income producing asset and performs no services, it could "elect out" of the separate filing of the Partnership Form 1065 and each partner would be responsible for filing his/her share of partnership income on an individual return.)

FAMILY LIMITED PARTNERSHIPS:

DEFINED: A family partnership is an entity created when two or more related parties (not necessarily individuals and not necessarily legally related) act together for their common economic benefit and at least one party transfers title to property to an enterprise. This generally implies that two or more parties are carrying on a business or enterprise for a profit. The parties typically contribute money or other assets, labor, or skills and, in return, receive the right to share in the profits of the business or enterprise.

A limited partnership is a more recently evolved form of partnership created by a state law that allows limited liability protection to owners specified as "limited partners." A limited partnership has at least one general partner who accepts unlimited personal liability, and at least one limited partner who has limited liability. Here, only the general partner assumes full liability for the recourse debts of the firm. Correspondingly, only the general partner may manage the business and act on behalf of the partnership. Limited partners are liable for debt assumed by the partnership - but only up to the assets they have contributed. Consequently, they are not allowed to act on behalf of the firm or participate in its management decisions, or even work in the day-to-day operations of the business as partners. In essence, limited partners are merely passive investors who receive a return on their investment from the partnership rather than directly from its underlying assets. In general, a limited partner is like a nonvoting minority shareholder who cannot exercise any control over the business.

A family limited partnership (FLP) is a combination of family partnership and limited partnership characterized by a relationship between the parties so close that they are considered part of the same economic unit. (Note, however, that nothing in the tax or other law requires a blood or even legal relationship and FLPs can involve unrelated friends of the same gender, partnerships, LLCs, or even corporations.) In a typical FLP, parents or grandparents will transfer cash, real estate, publicly traded securities, an interest in a closely-held business, or some combination of these or other business/income producing/appreciating assets into a partnership entity. The transferors will (initially at least) retain both a general partnership and limited partnership interests. Other family members are given - all at once or over a period of time - limited partnership interests. So the senior generation controls all major business, investment, and payout decisions while the younger generation receives a distribution, if and when, and to the extent, the senior generation deems it appropriate (within the bounds of fiduciary reasonableness).

PROS: Limited partners receive asset protection since their liability generally cannot be greater than their investment in the partnership. Their own creditors can't - in many states - obtain more than a "charging order" (approximately the equivalent to a garnishment in divorce). This encourages favorable settlements.

To some extent, an FLP structure promotes organization, separation of responsibilities, and centralized management. Gifts of limited interests legitimately obtain valuation discounts and facilitate estate planning and wealth transfers. Clients appreciate the ability to retain significant control (albeit subject to fiduciary standards) over their wealth, yet remove a significant amount of wealth from their estates. Unlike a sole proprietorship, partners in a FLP can provide for business continuation upon the death, disability, or withdrawal of a partner for any reason. Senior family members can restrict transferability of partnership interest, so they can keep family business interests within the family unit. There is substantial case law on the taxation and operation of FLPs -- thereby furthering the predictability of the outcome of various planning techniques. An FLP's ability to hold assets, to lease to an operating business, essentially allows a bailout of the operating business earnings -- without FICA or Self-Employment tax.

CONS: Set-up costs for FLPs are higher than those for sole proprietorships or general partnerships because of the time and cost of the appropriate government filing, and the need to have more extensive, flexible, and responsive legal documents. General partners remain exposed to unlimited liability, unless the firm has elected and complied with state limited liability partnership laws, where general partners can achieve a level of protection that may approach that of limited partners. (Some planners use a corporation or LLC as managing partner of the FLP to achieve another level of protection. This, of course, entails additional cost and paperwork and is effective only if the "parent" entity is adequately funded.) The general partner's liability (and by definition, the family aspect of FLP) makes them less able to attract outside capital than a corporation.

COMMENTS: A written agreement is required among the general and limited partners spelling out the rights and responsibilities of the parties. Absent specific language in the written agreement, the RULPA (Revised Uniform Limited Partnership Agreement) in the state in which the firm does business will govern. The parties must register with the appropriate Secretary of State and file for, and obtain a Certificate of Registration. If the business employs someone other than the owners, registration with the IRS and application for a TIN (Taxpayer Identification Number) will be required for payroll tax purposes. If the firm provides substantial services or is an operating partnership, it must file a separate income tax return from its owners - even if no tax is levied at the partnership level. It is particularly important for estate and income tax planning purposes that the FLP meticulously keep books and records, and file and keep bank accounts separate from its owners.

REGULAR "C" CORPORATIONS:

DEFINED: A C (Regular) corporation is an entity which is created under a state's BCA, Business Corporation Act. It provides limited liability to all the parties that own its stock. That means owners are not jeopardizing their personal assets when they invest since trade creditors of the business

cannot generally reach beyond corporate assets to that property. Corporations are legally managed by their Board of Directors -- who do not have to be shareholders. There is no limit on who (domestic or foreign, trust or otherwise) may own an interest in a corporation, or how many owners can hold an interest. Income and equity interests can be bifurcated in an unlimited number of ways (e.g. the same corporation can have both voting and non-voting stock, common and preferred, and Class A and Class B -- as well as issue debt in the form of bonds). Tax is imposed at the corporate level by both federal and state taxing authorities. TINs must be obtained for both federal and state purposes.

PROS: The corporate form of business is highly desirable where family members are active, highly compensated employees. There are a number of tax-favored fringe benefits (e.g. pension plans, medical reimbursement plans, health insurance plans, group term life insurance, etc.) that are not available (or not available to the same extent) in FLPs or LLCs, or even S corporations. Unless the shareholders have signed a personal guarantee for a corporate loan, or a creditor of a majority shareholder gains control of the corporation, the corporate form provides the highest possible degree of limited liability among the possible types of business entities.

The separation of ownership and management in a corporation can lead to a more efficient and effective business structure. The fact that a corporation is a legal entity distinct and separate from its owners makes a high level of confidentiality possible. The ease of transferability of shares facilitates estate and charitable planning, enables annual exclusion and discounted valuation gifts, and encourages outside investors. It also helps provide a market for a shareholder's stock. A corporation's income tax rates can be -- in some instances -- lower than that of its owners. This, combined with the fact that a corporation is a separate taxpayer, makes innovative tax planning possible. Corporate earnings can be accumulated to some extent inside the corporation and taxed at its relatively low rates. A corporation can use a fiscal year of accounting and is not limited to a calendar year method.

CONS: Corporations are inherently more complex in formation and operation than sole proprietorships or partnerships. Corporate income -- to the extent not taken in reasonable salaries and to the extent paid out to shareholders -- can be taxed at both the corporate and shareholder levels. Moving assets into, and out of, corporations is always a potentially taxable event -- as is changing the form of the entity. So, C corporation is not the best possible non-operating asset-holding structure. Corporate assets receive no internal step-up in basis upon the death of a stockholder.

COMMENTS: Corporate pre-tax income, such as deductible salaries must take the form of reasonable compensation for services rendered, although post-tax distributions of income (in the form of dividends) can be made to the corporation's owners on a pre-specified preferential basis.

Filing with the Secretary of State is essential to obtain liability protection as well as to assure corporate tax treatment. As is the case with other forms of business (except sole proprietorship), it is essential for the owners of a corporation to maintain books and records, and bank accounts that are separate from their own.

S CORPORATIONS:

DEFINED: An S (a/k/a Subchapter S) corporation is essentially a regular corporation, formed in the same way and run in the same manner, as the C corporations described above. The major distinction is that an S corporation is allowed, by specific Internal Revenue Code provision, to pass-through items similar in some respects to a partnership, yet maintains most of the other characteristics of a corporation. The cost of this special tax treatment is that an election must be made to obtain this treatment and certain requirements must be met -- continually. S corporations cannot be held by more than 75 domestic individuals and/or specified domestic trusts. It may issue only one type of stock, common stock (although that stock may have both voting and non-voting shares). Preferred stock is not permissible -- so all of the common stock must share equally in dividends and liquidation rights.

PROS: Aside from having almost all of the advantages described under C corporations, an S corporation permits the flow through of income, deductions, credits, etc. from the business to shareholders on a per day, per share (of ownership) basis. The major advantage is that the potential double taxation of C corporations is avoided -- as well as the accumulated earnings tax and the penalty taxes on personal holding companies. This flow-through attribute of the entity also makes it possible to share income with, and shift taxes to, family members (preferably in lower brackets than that of the client) who do not work in the family business. The ease of transferability (compared to a sole proprietorship and absent deliberate restrictions in a buy-sell) provides much latitude that can facilitate the owners' estate planning objectives. As is the case with other forms of business, valuation discounts for minority interest and lack of control are available -- and perhaps even enhanced because a minority shareholder of an S corporation could conceivably be taxed on income the corporation earns, but which the majority shareholder decides not to distribute.

CONS: The restrictions on the number and type of shareholders who can safely hold S stock and the "one class of stock" rule all diminish its appeal to outside investors. These characteristics of an S corporation reduce its ability to raise capital, increase the probability of an inadvertent loss of the

S election and the consequent adverse tax implications, and can make creative estate planning more difficult. Owners are taxed on their share of income -- even if income is not distributed to them. S corporation working shareholders do not enjoy the same level of tax-favored employee benefits as those in C corporations.

COMMENTS: As is the case with C corporations, S corporations must obtain TINs -- even though generally, no federal tax is paid at the entity level. Note that although many states follow federal law in allowing a flow-through of items for tax purposes, some do not. And some states allow an "election-out" of S status at the state level only to save out-of-state shareholders from filing individual tax returns on corporate income.

LIMITED LIABILITY COMPANY (LLC):

DEFINED: An LLC is an unincorporated organization formed under a state law Limited Liability Act that protects its equity owners (called "members") from the personal liability for the entity's debts and obligations. In other words, the limit of a member's liability in an LLC is the extent of a member's investment. Even managers cannot be held personally liable for the LLC's debts or liabilities. So, with both corporation and partnership characteristics, an LLC is the centaur of the tax world. The objective is to receive "pass through of income, deductions, and credits" without "pass through of liability." So it attempts to combine the most favorable characteristics of both corporations and partnerships to provide a unique combination of advantages and flexibility. The LLC must be created for either transacting business or for holding investments. Members can contribute cash, property, and, in some states, services (or an enforceable written promise to contribute cash, property, or services).

An LLC is created by the filing of "Articles of Organization" (analogous to a Certificate of Partnership) with the appropriate state agency. The LLC will typically become effective upon the filing of the proper articles of organization with the Secretary of State of the state in which it is to be organized. Unlike a partnership, it is possible to have a one-person LLC (although such a single member entity would be taxed as a sole proprietorship -- unless it elects to be taxed as a corporation). Members can retain the right to vote in accordance with their proportionate interests, or can specify an inside or outside party to act as a manager (with more or less the operational powers of a general partner). Typically, management is vested in a "managing member" (or in a professional manager who is not a member). There is no limit on the type of members (they can be domestic or foreign) and there can be multiple levels of participation in equity or income. The entity can conduct almost any type of business, unless specifically prohibited by state law. Distributions are made, and profits and losses are allocated, proportionately by reference to the respective contributions of the members.

PROS: LLCs can accomplish a number of desirable objectives. The LLC is the only form of business entity that allows every member, including managers, to enjoy limited liability while the entity is treated as a partnership for federal income tax purposes. Creditor protection is the single most important characteristic of the LLC, and a key distinguishing factor from a partnership which provides limited liability only for limited but not its general partners. (Of course, to the extent owners must agree to be personally liable to obtain loans or credit, the benefits of limited liability are diminished.)

An LLC can serve as a "flow through" organization for federal income tax purposes, stimulate investment by investors familiar with LLC type organizations, and achieve a number of estate planning objectives. There is no limit to the number or types of members an LLC may have. So it is a more flexible device than an S corporation. As is the case with a partnership, special allocations can be made -- enabling creative income tax planning among family members. An LLC can provide that membership is restricted to family members. As long as an outsider is not needed for capital or to keep the business running, this control over ownership can be a significant benefit.

CONS: LLCs are relatively new. The absence of a uniform law, the disparity among various state laws, and the lack of depth in court cases make the LLC a less reliable form of entity for some purposes particularly with respect to the level of liability protection. Filing fees are often higher than for corporate or FLP entities. Even the limitation of a member's liability has its own limits. For instance, an individual member is not protected from his or her own tortious conduct -- so this may make the liability protection illusory to the extent an owner actually works for the firm. Furthermore, the LLC's members may be required to contractually give up some of their limitation on liability and sign personal guarantees for the firm's performance in order to borrow money or do business with certain parties. Managers of an LLC have certain fiduciary duties to members and can be sued for breach of such responsibilities. As is the case with S corporations and partnerships, a member in an LLC is taxable on his/her/its share of the firm's income -- even if no distribution is made to that member. Unless the Articles of Organization or the Operating Agreement provide otherwise, a member's death or withdrawal could result in the dissolution of the LLC.

COMMENTS: All 50 states and the District of Columbia have LLC laws, but there is no "uniform" law that applies to all jurisdictions. To obtain protection under state law, registration with the appropriate Secretary of State is required, and a Certificate of Registration and periodic re-registration is necessary. If the LLC has more than one owner, it must apply for a TIN and file tax forms separate from its owners -- even though generally there is no federal income tax at the entity level. A number of states impose an intangibles tax on LLCs.

TWO, THREE -SOMETIMES FOUR HEADS ARE BETTER THAN ONE!

Clients should consider a "mixing and matching" of ownership forms. These techniques enable them to accomplish two of the most important goals in estate and financial planning: (1) shifting wealth and (2) splitting income among the family unit. I'm talking about fractionalizing and transferring wealth -- in a timely and tax efficient manner.

IMPACT OF STATE LAW:

It is dangerous to ignore state law when planning for the optimal entity mix. There are both tax and non-tax reasons why it is necessary to understand the important role state law plays in the selection of an entity form. For example, taxation of S corporations in some states may be more favorable than in others. Some states tax LLCs at higher levels than FLPs. Another reason why state law must be considered carefully before moving forward in the entity selection process is that federal law usually respects an entity that meets and complies with the entity requirements under state law -- and ignores those that do not. In fact, federal law generally will allow "forum shopping" so that it is often possible to incorporate, or form an FLP or LLC in a state where the laws are more favorable to meeting the client's tax and non-tax goals. On the other hand, if saving taxes is the only reason for the choice of law, the IRS might ignore the choice of state and treat the taxpayer as though -- for tax purposes -- the state of residence's rules apply.

WHAT YOU ARE PUTTING IN COUNTS:

The entity or combination of entities selected may be dictated to a great extent by the nature of the assets the client owns. For example, if the client owns an asset, or intellectual property (such as a medical break-through patent) that is likely to grow so quickly that "going public" is a real possibility, a C corporation may be indicated. If the assets are likely to increase significantly -- but the client is unlikely to take the business public, an LLC might be the best choice. S corporations may make the most sense where the client owns assets likely to generate significant income, and the client wants to provide financial security for a number of children and grandchildren -- but the business will probably not grow significantly in value because of the annual distributions of all or most of the firm's income. If the asset is actively managed real estate, or a portfolio of marketable and non-marketable, relatively passive investments, the entity of choice might be an LLC.

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CONCLUSION:

There are no boundaries to the array of possibilities or the number of possible combinations business entities may take -- but the limits of the planning teams' imagination. A competent team of professionals can use the major types of entities to accomplish a multiplicity of a client's objectives. [Of course, "imagination" must be coupled with a strong regard for both the letter and the spirit of the law and the reality of the situation.]

Start by making a list of the client's objectives. Be sure to include "people," "creditor proofing," and charitable objectives, as well as saving income, estate, or generation-skipping taxes.

Next, make a list of the resources available (or that can be obtained) to accomplish those goals.

Third, assemble a list of the various tools and techniques -- including entity choices -- that may be appropriate to help the client meet his or her objectives and move the tools or techniques around in your mind like building blocks until you have assembled the right combination to do the job.

Don't overlook the potential of multiple trusts, multiple corporations (for separate liability and creditor protection, potential for separate sale and tax planning, separate unions, separate and different dispositions during lifetime and at death, separate ownership for multiple children/heirs), multiple partnerships -- as well as different layers of ownership or interest for each.

Understand and help your clients exploit the many advantages of entity planning and you will find they will appreciate your services and relationship more than ever.

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