

**LEGAL AND TAX TREATMENT OF
VARIOUS TYPES OF BUSINESS ENTITIES**

By: Attorney Fred J. Forman
Forman, Corcoran & Associates, P.A.
Londonderry and Portsmouth, New Hampshire
York and Portland, Maine

**A. CHOICE OF ENTITY
Sole Proprietorships.**

A sole proprietorship results when an individual operates a business without filing an entity with the state, unless the individual registers a trade name. The advantage to a sole proprietorship is that it is a simple and inexpensive way to run a business. Nothing needs to be filed with the state to recognize an entity. No legal fees are required for formation. All receivables and payables can be run through the individual's checking account if they so choose. No tax return is required for the business. The individual merely places income or loss on Schedule C to the individual's personal 1040. The owners will incur FICA, social security and Medicare tax for salary taken, just as in a corporation, but the payment is called self-employment tax.

The disadvantage to a sole proprietorship is the fact that the individual remains personally liable for all debts and actions of the business. Some of this liability can be mitigated through insurance products, such as Errors and Omissions Insurance, Professional Liability Insurance, Umbrella Liability Insurance and Product Liability Insurance. For example, if the individual is merely selling a product manufactured by a third party who is covering the individual for product liability and the individual is not stocking merchandise, having customers come to the individual's location or incurring a lot of business debt, an entity may be unnecessary.

Partnerships.

A partnership may either be a *de facto* or *de jure* partnership. The first type results whether or not the owners register the partnership with the state. The IRS and creditor law will create a partnership whenever there is a voluntary association of two or more persons for the purpose of engaging in a business or profit making venture. The second type results when a partnership is officially formed with the state. Partnerships

are also relatively inexpensive and easy to set up. Partners can either enter into agreements defining their relationship or allow the state to define their relationship by reference to state statute. The partnership does file its own tax return as an entity and issues a K-1 reporting income or loss to the partners in relation to their partnership interest. The partners then report the same on Schedule E of their personal 1040. The owners will incur FICA, social security and Medicare tax for salary taken, just as in a corporation, but the payment is called self-employment tax.

Much like a sole proprietorship, the downside to a partnership is the personal liability of the partners. Worse than a sole proprietorship, however, is the fact that partners are jointly and severally liable for the acts and omissions of the other partners and for all partnership debt. Therefore, one partner may become liable for the acts of another partner. This is risky since, generally, all partners in a general partnership are agents of the partnership and can bind the partnership and its partners. Agency can result from three types of authority. The first is actual authority whereby a partner is authorized to act. The second is apparent authority whereby a partner can bind the partnership if the partner reasonably appears to have authority, even if that partner lacks actual authority. The third is lingering apparent authority whereby the partner once had authority and no longer has authority but third parties are not given notice of the same.

Limited Partnerships.

A limited partnership is generally made up of two types of partners. The first is the general partner. The second is the limited partner. The general partner has all of the say over day-to-day operations and generally runs the partnership. The limited partner has say only over major decisions, such as sale, merger or dissolution. The limited partner generally is passive and is not permitted to act on behalf of the partnership or bind the partnership to debt or contract. The advantage to a limited partnership is that the limited partners (so long as they do not become actively involved in management) can be free of the liability associated with partners in a general partnership. They are like shareholders in a corporation; however they are treated like partners for tax purposes. The general partner maintains the same type of liability that a partner in a general partnership has.

A limited partnership can be an appropriate entity for soliciting investment or running a family business. The entity can offer investors or future heirs ownership and favorable tax treatment while not exposing those individuals to liability and while not exposing the general partner to unnecessary meddling. The downside is that the general partner has liability exposure unless that general partner is itself an entity such as an S corporation or an LLC. This means having an entity within an entity and all of the complexity and expense associated therewith.

Prior to the IRS implementation of the passive loss rules, LPs were used as investment and fundraising tools among the wealthy. For example, an individual who wanted to invest in real estate but did not have the capital would act as a general partner and offer limited partnership interests to high income and high tax bracket individuals. This would allow the general partner to run the show. Since the investors had no interest in actually managing real estate, those investors were happy to remain limited/silent partners. Because the LP was a flow-through entity for tax purposes, the depreciation deductions and paper losses of the real estate could be allocated to the limited partners who would then take those losses against their ordinary income. The general partner ended up with money to buy the real estate and the limited partners ended up with healthy tax deductions and no liability exposure.

Unfortunately, in the 1980s the passive loss rules under the 469 Section of the code eradicated this tax strategy. Under those rules, limited partnership interests were deemed to be passive interests. The losses on passive interests were deemed to be passive losses. Individuals earning over a certain amount of money could only take passive losses against passive gains and not against other ordinary income. Those rules also limited the ability to disproportionately shift losses to limited partners.

Corporations.

Corporations are separate and distinct entities from their owners/shareholders. The first publicly traded corporation was the Dutch West India Company. The British adopted the notion from the Dutch and the United States had some form of corporation from our founding as a British Commonwealth Nation. The modern corporate entity really evolved during the Industrial Revolution. The economic theory behind the

corporation was to encourage people to be entrepreneurial and start new businesses that would employ people and grow the economy. The fear was that people would be afraid to start a business if failure meant losing all of one's assets (including the family farm). Therefore, the modern corporation offered its owners a protection against certain liabilities which could result from its operation.

The liability protection of a corporation is not absolute. The shareholders can still be personally liable for corporation debts and liabilities if a creditor is able to pierce the corporate veil of liability protection. Generally, there are six ways to pierce the corporate veil.

First, if the shareholder signs a corporate debt personally, the shareholder will be personally liable. This is most common when shareholders are required to guarantee lines of credit and equipment or vehicle purchases.

Second, if the shareholder fails to pay certain corporate taxes, such as 941/withholdings taxes. The shareholder will be assessed personally.

Third, if the shareholder commits an act of fraud. A corporation was not intended to shield one from intentional acts of fraud.

Fourth, if the entity is thinly capitalized. This is akin to fraud since the entity, by way of its shareholders, is promising to pay debt with little or no prospect of having the resources to do so.

Fifth, if the creditor was unaware of the fact that the entity was a corporation. This results when the entity does not use the words "corp.", "corporation", "inc.", "incorporated", "Ltd." or "limited" on its business cards, stationary, checks, order forms, etc. Essentially, the argument is that a creditor is entitled to know with whom they are dealing at the outset and cannot be surprised to learn of the corporate status only after a claim arises.

Sixth, if the entity failed to keep corporate formalities. The law essentially states that it will not provide the protections of a separate entity to those who did not treat the entity as separate themselves. This is why practitioners will counsel their clients to have By-Laws, annual meetings and special meetings and votes when certain corporate actions take place. Generally, a vote is a good idea if a shareholder or director or officer is

engaging in a transaction with the corporation, such as a loan or purchase of corporate assets. A vote is also a good idea whenever the corporation is purchasing or leasing an asset of significant value outside the ordinary course of business. While a vote is not required to buy paper clips and staples and to hire and fire employees, a vote is a good idea for an automobile purchase, a building lease or a purchase of a piece of equipment.

A failure to keep corporate formalities can also result when money is commingled. This is why clients are counseled to always keep corporate money separate from personal money and not to use corporate checks to buy personal items. Clients are also counseled not to use personal checks to pay corporate bills. If a corporation does not have money to pay a bill the shareholders should loan the money to the corporation and record the same a loan transaction complete with a corporate vote.

C Corporations - A C corporation treats the corporation and the shareholders as separate for tax purposes. Any corporate profits and losses are reported on the corporation's tax return and any tax due on profits is then paid at the prevailing corporate tax rate. The downside can be that a shareholder will be unable to take losses on the shareholder's personal tax return against the shareholder's income since those losses will be pent up at the corporate level to be taken against future corporate profits, if any. Also, there is a potential for double taxation. If the corporation makes a \$100,000.00 profit it would pay taxes at the corporate level. If the corporate tax rate were 34%, there would be after tax profits of \$66,000.00. When that money is paid to the shareholders as dividends, the shareholders must then pay tax on the \$66,000.00 at their personal tax rate. Dividends are not deductible to the corporation but are income to the shareholders. Therefore, less than 1/2 of the original profit is left. Also, New Hampshire will tax dividends coming out of the corporation on the state level under the interest and dividends tax to the shareholder and include the dividend in corporate profits for business profits tax.

Many accountants will meet with corporate clients near the end of the year and counsel the clients to have the corporation bonus its profit out to the shareholders so that the corporation does not have a taxable profit since the bonus is a deductible payroll item to the corporation. This is called zeroing out the corporate income and shifts all of the

profit to the shareholder where only 1 tax is paid. Unfortunately, when a corporation has a highly profitable year not all of its profits can be transferred to the shareholders as a bonus. The IRS and New Hampshire can take the position that too large a bonus is excessive compensation. The IRS and/or the state will argue that a third party doing the job of the shareholder would never have been paid such a large bonus and the only reason such a large bonus was paid was due to the ownership status of the shareholder. Therefore, the excess bonus is really a dividend and must be taxed twice (at the corporate level and at the shareholder level). Interest and penalties may also result.

A C corporation can actually be taxed at a lower rate than a shareholder's individual tax rate as profits become higher. Also, a C corporation is a good vehicle when a shareholder wants to be able to deduct certain personal expenses which cannot be deducted in an S corporation, such as shareholder health insurance. A C corporation is also a good vehicle when shareholders do not want the business profits declared on their personal tax returns. This has creditor protection and privacy advantages. It also protects the shareholder against phantom income which could result when the corporation has a paper profit and no capital to make distributions. That is why a C corporation can be an attractive entity for soliciting investors.

S Corporations - All corporations are C corporations unless they elect to be taxed as S corporations. The C corporation and the S corporation are merely tax distinctions and have no effect on state law creditor protection. The S corporation was designed for the small business owner who was concerned about the double taxation potential of a C corporation. If a corporation has less than 100 shareholders, if all shareholders are US citizens, if all shareholders are individuals or qualified trusts (as opposed to entities) and if there is only 1 class of stock or a second class of stock which only differs from the first class over voting rights, a corporation can elect to be treated as an S corporation for tax purposes. In that event, the corporation files a corporate tax return (1120S), but pays no tax on its profits. All profits and losses are allocated to the shareholders and reported on Schedule E of their personal 1040s. The advantage is the elimination of the potential for double taxation on corporate profits. The shareholders are also able to take corporate losses against their other income. There is no need to zero out

corporate income or risk excessive compensation issues. The shareholders will still incur FICA, social security and Medicare tax for salary taken, just as in a C corporation. **CAVEAT:** New Hampshire has indicated that it will be examining S corporations in the future for the possibility of excessive compensation and the resulting build back into interest and dividends taxation as well as business profits tax..

There can be many downsides to an S corp. The shareholders cannot take certain expenses as deductible items, such as certain health insurance on the shareholders. In very profitable situations, the shareholder's income tax rate may be higher than a corporate tax rate. The S corp. may also lack flexibility given the limitations on who can be a shareholder, the number of shareholders, and classes of stock. For example, if the goal is to take on investors, they must all be individuals. Many investors like to invest as entities. This is not permissible in an S corp. An investor cannot be a non-US citizen. Some investors want to know that if the corporation makes a profit they will be paid first (a priority dividend right) or that in the event of dissolution they will be paid back first (a priority dissolution right). Since this would create a class of stock with different rights, the same is not permissible in an S corp. Investors may also be concerned about the potential for phantom income.

Even if the client is not concerned about investor issues, the client needs to be mindful of the fact that an S corporation will still require the expense of a corporate tax return filing (the 1120S). Also, when the shareholder takes money from the corporation, the shareholder will have to go through a payroll and withholdings system. Both of these concerns are irrelevant in a single member LLC context. The second concern is irrelevant in a multi-member LLC context.

Limited Liability Companies - Although Limited Liability Companies (LLCs) are relatively new to the United States; they have been long established and widely used in civil law countries of Central America and Europe. The origin of LLCs is generally traced to an 1892 German law that allowed companies of the form Gesellschaft mit beschränkter Haftung (GmbH). This German LLC concept became a focal point of discussion among other countries and Germany's success led many of these countries to adopt similar LLC laws: Portugal (1917); Brazil (1919); France (1925); Turkey (1926);

Cuba (1929); Argentina (1932); Uruguay (1933); Mexico (1934); Belgium (1935); Switzerland (1936); Italy (1936); Peru (1936); Columbia (1937); Costa Rica (1942); Guatemala (1942); and Honduras (1950). In France, by 1950 the limited liability entity known as "societes de responsabilite limitee" was more popular than a traditional stock corporation and comprised one-third of all French societes. See Eder, *Limited Liability Firms Abroad*, 13 Univ. Pitt. L. Rev. 193 (1952).

In addition to providing limited liability to the members of limited liability companies, each of the LLC laws of the countries listed above had four distinguishing characteristics that differentiated them from other business entities: 1) all the laws require the use of the word "Limited" in the company name; 2) the entity is given full entity status, i.e., the ability to sign contracts, own land, conduct business, and all other acts of a person; 3) the partnership of "*delectus personae*", i.e., the right of a partner to control the admission of new members; and 4) the dissolution of the entity upon death of a member unless otherwise expressly provided for in the articles of association. See Eder, *Limited Liability Firms Abroad*, 13 Univ Pitt L Rev 193 (1952).

In the late 19th century several states including Pennsylvania, New Jersey, Michigan, and Ohio had passed a law allowing the formation of "limited partnership associations". However, although these entities provided liability protection to the members of the association, the statutes required that either the principal office or place of business be located within the enacting state. Because of this requirement to be based within the particular state, these entities have failed to attract as many businesses as did later LLC statutes.

The first true law allowing the formation of LLCs in the United States was passed in Wyoming and was modeled after the 1892 German GmbH code. The Wyoming LLC statute permits the formation of LLCs for any lawful purpose except for banking and insurance. In addition, the Wyoming LLC statute provided the same four basic characteristics as the European and Central American codes, that is: 1) all the laws require the use of the word limited in the company name; 2) the entity is given full entity status, i.e., the ability to sign contracts, own land, conduct business, and all other acts of a person; 3) the partnership of "*delectus personae*", i.e., the right of a partner to control the

admission of new members; and 4) the dissolution of the entity upon death of a member and for the probate or sale of a deceased member's share.

LLCs became legal corporate entities in New Hampshire with the passage of Chapter 304-C Limited Liability Companies in 1993. LLCs in New Hampshire can be organized for any purpose except for the business of banking; the construction and maintenance of railroads; the business of making contracts for the payment of money at a fixed date or upon the happening of some contingency; or the business of a trust, surety, indemnity or safe deposit company. The New Hampshire LLC statute incorporates three of the four characteristics of the original German GmbH law as well. First, the New Hampshire LLC statute requires the name of the entity shall contain the words "limited liability company" or the abbreviation "L.L.C." or similar abbreviation. NH RSA Ch. 304-C:3. Second, an LLC has the same powers as an individual to do all things necessary or convenient to carry out its business and affairs. NH RSA Ch. 304-C:7. Third, the members of an LLC are allowed to control the admission of new members. NH RSA Ch. 304-C:23. However, RSA Ch. 304-C specifies that the LLC shall continue in existence until dissolved by the cancellation of the certificate of existence. NH RSA Ch. 304-C:12.

As a result, the New Hampshire LLC statute can be seen to be a direct descendent of the German 1892 GmbH law. Originally, the New Hampshire LLC was only available in a multi-member format. The New Hampshire LLC is now available as a single member entity as well.

When LLCs first became available as an entity, practitioners seeking to qualify the entity for sole proprietorship or partnership tax status had to be mindful of the so-called Kintner regulations set forth in Treas. Reg. Section 301.7701-2 which were promulgated in response to *United States v Kintner*, 216 F.2d 418 (9th Cir. 1954). These regulations made it necessary for LLCs to avoid having centralized management. The regulations used multiple factors to determine whether the LLC would be taxed as a partnership or as a corporation. The more factors that made the LLC similar to a corporation, the more likely it would be that the IRS would tax the entity as a corporation. Therefore, many LLCs were formed as member run as opposed to manager run.

In 1997, the IRS abandoned the Kintner regulations by promulgating “check-the-box” regulations. This allows LLCs to select how they want to be taxed as entities. Therefore, LLCs no longer had to worry about having decentralized management and limited duration and other non-corporate Kintner attributes. Given the charging order cases which were to follow, many LLCs became manager run.

Today, LLCs may be single member or multi-member. LLCs may be manager run or member run. LLCs may be given fixed duration or perpetual duration. LLCs may chose to be taxed as sole proprietorships (if one member), partnerships (if multi-member) or corporations.

The limited liability company is treated like a corporation for liability purposes. Therefore, subject to the same arguments which would result in a piercing of the entity’s veil, owners, known as members, are only liable to the extent of the assets within the LLC. However, for federal tax purposes, the single member LLC is deemed a disregarded entity. Therefore, like a sole proprietorship, income or loss is placed on the member’s 1040. As a result, no profits get double taxed as in a C corp. and no losses get pent up at the corporate level. Moreover, the owner does not need to file a separate corporate tax return. The members will incur FICA, social security and Medicare tax for salary taken, just as in a corporation, but the payment is called self-employment tax.

CAVEAT: In New Hampshire, the single member LLC is a recognized tax entity and must file a state return. Also, New Hampshire takes the position that a revocable trust which is a member of an LLC is not a natural person even if the trust is a grantor trust under IRC Section 671. Therefore, the compensation deduction for the owner is disallowed and is placed back into business profits. Therefore, thought may be given to transferring the membership to the trust effective at death (like a life estate).

In a multi-member LLC, the entity is treated like a partnership for tax purposes. Therefore, a partnership return is filed, the members receive a K-1 for any income or loss and the same is recorded on Schedule E of the members’ 1040. In either a single member LLC or a multi-member LLC, the members do not have the burden of payroll and withholdings obligations when they draw income from the LLC; they will incur FICA,

social security and Medicare tax for salary taken, just as in a corporation, but the payment is called self-employment tax. They simply pay estimated quarterly taxes.

The LLC can also check the box and choose to be treated like a corporation for tax purposes. While the LLC can be treated like a partnership for tax purposes and income and losses can flow through to owners as in an S corp., unlike an S corp. there is no restriction on the number of owners, the citizenship of owners, the status of owners as individuals and the ability to have multiple classes of ownership with varying rights. In that sense, the LLC can be a flexible way to include investors, silent partners and owners with differing interests. **CAVEAT:** an LLC which has real estate ownership as its dominant business purpose will be subject to a New Hampshire business profits tax if it sells its real property. Some practitioners counsel clients holding real estate in LLCs to transfer the real property to the individual member of the LLC and pay the transfer tax before the sale if the transfer tax is a smaller than the resulting business profits tax. Care must be given to do this well in advance of the sale since the state will argue that the transaction was a tax avoidance sham.

The LLC has thus been described as the hybrid between the corporation and the sole proprietorship/partnership. The LLC is also similar to a limited partnership since it can be set up to have managing members who act like general partners and non-managing members who act like limited partners. Unlike a limited partnership, however, the managing members do not have personal liability exposure.

The LLC has the ability to offer more liability protection to the owners than a corporation. While a corporation can protect its owners against personal liability for lawsuits against the entity, the LLC can also discourage lawsuits against the owner's very interest in the entity. If an owner is the subject of a lawsuit for something outside the business (car accident, divorce, uninsured claim, claim arising out of another business, etc.), the creditor will seek to recover all assets which the defendant owns. If the defendant owns stock in a corporation the creditor may recover that stock and have all ownership and other rights over that stock. While a creditor of a member of an LLC may force the member to transfer his or her membership interest to the creditor, the creditor becomes merely an "assignee" of that member for distribution purposes and not a

member as it relates to management. Therefore, that creditor is not eligible to participate in management of the entity. The creditor may obtain a “charging order.” This entitles the creditor to the debtor’s share of any company distributions that are actually made. Therefore, the creditor is treated as a partner for income tax purposes and is taxed on the debtor’s proportionate share of company income, even if the company does not make any distributions. Therefore, the creditor is taxed on income which the creditor has not received (sometimes called “phantom income”). See RSA 304-B:41; *Baybank v. Catamount Construction* 141 NH 780 (1997). This can create a disincentive for creditors to go after limited liability company interests. Given out of state decisions [starting in the bankruptcy context in *In Re: Ashley Albright, No. 01-11367 (Bkrptc.D.Col. 04/04/2003)* in which the United States bankruptcy court for the District of Colorado held that since there was no other member to protect, there was no reason to limit the ability of a creditor to reach the assets of the LLC] which have refused to relegate creditors to a charging order in a single member LLC entity, many practitioners are counseling the use of multi-member LLCs. This may involve the use of the member’s spouse as a member holding some small percentage of ownership.

The Colorado limited liability statute at issue in *Ashley Albright* was similar to the New Hampshire statute since it treated the limited liability company interest as personal property. Therefore, no member has an interest in limited liability company property. RSA 304-C:45. This can also have probate implications; for example an LLC holding real estate may still be considered personal property not subject to ancillary probate requirements for out of state decedents. Upon a member dissociating from the company, and unless the operating agreement provides otherwise, that member is entitled to receive any distribution to which that member is entitled under the operating agreement, however, that member is not entitled to any payment for the value of that member’s limited liability company interest. RSA 304-C:41, I. As in a limited partnership, a member has no right to demand a cash distribution unless that right is provided in the operating agreement. The company can choose to pay in cash or by payment in kind. RSA 304-C:42. As in a limited partnership, and unless the operating agreement provides otherwise, a member who

does have rights to distributions has the same rights as a creditor of the company. RSA 304-C:43. As in a limited partnership, a limited liability company distribution cannot be made to a member if that distribution will exceed the fair market value of the assets of the company after considering all liabilities against those assets. RSA 304-C:44, II.

Unless otherwise provided in the operating agreement, a limited liability company interest can be assigned by any member. As in a limited partnership, however, the assignee is not entitled to participate in the management affairs of the company or to exercise the rights or powers of a member unless the operating agreement allows such participation or exercise or all of the members consent. RSA 304-C:46, I. Unless the operating agreement provides otherwise, the assignee may share in profits and losses and receive distributions and allocation of income, gain, loss, deduction, or credit to which the assignor was entitled. RSA 304-C:46, II. Moreover, a judgment creditor of a member may petition the court to charge the company interest of the member with payment of the unsatisfied amount of the judgment, with interest. RSA 304-C:47. While presumably intended to protect judgment creditors by giving those creditors an asset to execute upon, it is the combination of RSA 304-C:46, II and RSA 304-C:47 which allows a limited liability company to discourage members from assigning their interests and which creates a disincentive for creditors to seek to obtain a membership interest. That assignee or creditor could end up with allocated income without a corresponding distribution. This results in the assignee or creditor paying taxes on phantom income.

Therefore, while a creditor of a member may force the member to transfer his or her membership interest to the creditor, the creditor merely becomes an “assignee” and not a member. Therefore, that creditor is not eligible to participate in management of the entity. The creditor may obtain a “charging order.” This entitles the creditor to the debtor’s share of any company distributions that are actually made. Therefore, the creditor is treated as a partner for income tax purposes and is taxed on the debtor’s proportionate share of partnership income, even if the company does not make any distributions. Therefore, the creditor is taxed on income which the creditor has not received (sometimes called phantom income). See RSA 304-B:41. *Baybank v. Catamount Construction 141 NH 780.*

As stated above, the Colorado limited liability statute at issue in *Ashley Albright* was similar to the New Hampshire statute since it treated the limited liability company interest as personal property. The court made note of the fact that the statute requiring the consent of all other members in order to allow a substitute member was irrelevant where there were no other members. The court also cited the portion of the Colorado statute that allowed members to change managers.

The court did, however, ultimately reinforce the notion of the charging order remedy by stating that the result would have been different had there been other non-debtor members of the LLC at issue. In fact the court stated that a trustee in bankruptcy would have no voting rights in the LLC as against a debtor holding the control and domination of the membership and management of the LLC.

Practitioners, in response to *Ashley Albright*, are advising the use of multi-member LLCs if charging order protection is sought. Many are recommending at least a 10% interest in the second member, even though the court in *Ashley Albright* suggested that a “minimal interest” held by a second member would be enough. Some practitioners are also putting provisions in their operating agreements limiting the ability of a member or assignee of a member to replace a manager. This may involve a management appointment for life. Other practitioners are putting reserve clauses in their operating agreements which allow managers to set profits aside for future business purposes so that a creditor cannot ask a court to force a distribution. This allows the managers to withhold distributions to members (and, therefore, creditors of members) by asserting future business needs such as future purchases or capital needs. The agreement may also have a clause requiring the LLC to only be taxed as a flow through partnership entity for tax purposes. This cuts off a creditor arguing that the entity should be treated like a corporation for tax purposes to avoid a phantom income result.

Limited liability companies have also been used to establish a hierarchy for decision making among potential competing and conflicting owners. For example, multiple owners may be involved in a family held business or family owned real estate. Parents in estate planning may want to ensure that all owners have equity rights but that certain persons make decisions. The decision makers would be the managing members. Limited liability companies have also been used in estate planning to produce estate discounts and freezes by transferring non-managing interests from an estate using minority and marketability

discounts while keeping control in the hands of the donor; all the while making sure that part of the growth in the value of the company grows outside of the donor's estate. While the LLC seems to offer the best of both worlds as a supercharged liability protection tool with the tax attributes of a sole proprietorship or partnership, there can be reasons to not use an LLC as an entity. First, some clients are not disciplined in meeting the estimate quarterly tax payment requirements of an LLC taxed as a sole proprietorship or partnership.

Second, a client doing business internationally needs to be mindful of the fact that not all nations recognized the concept of an LLC as a business entity. While these jurisdictions may treat the LLC as a corporation, they may also treat the LLC as no entity at all. This could result in personal liability to the owners.

Third, if a client has an exit strategy that includes a sale or merger with a publicly traded company (such as clients developing software or other intellectual property), the client may lose the ability to engage in a like kind exchange with that publicly traded entity. Many publicly traded entities who purchase a client's business will offer a portion of the purchase price in cash and a portion in their own securities. If securities are offered in exchange for corporate stock, the capital gain on that part of the purchase price paid for in such securities can be deferred as a like kind exchange with a basis rollover into the new securities. Of course, the LLC could convert itself to a corporation to take advantage of such like kind exchanges.

Fourth, the LLC treated like a flow through for tax purposes can be a disincentive to potential investors. Much like a creditor confronting a phantom income situation, some investors do not want the LLC income to appear on their personal tax returns. Some investors fear that the entity could have profits on paper but not have the capital to pay owners since that capital may get reinvested into equipment or other assets with long term depreciation. Therefore, the investor receives a K-1 requiring a tax payment with no corresponding distribution to help pay that tax. This can be addressed in the operating agreement by having provisions which require the LLC to make distributions to members in at least an amount equal to the tax resulting from reported income. Other investors do not want income from the entity reported on their personal tax returns for privacy and general creditor protection purposes.

Fifth, converting a corporation to an LLC can have big adverse tax consequences. The conversion is treated as a liquidating event. Therefore, the corporation is treated as having sold its assets for fair market value to a third party and pays taxes on the sale price (fair market value) versus its tax basis in the assets. In addition, the shareholders are deemed to have received those assets at fair market value and they pay tax as if they received a distribution in the amount of that fair market value.

COMPARISON OF ENTITY STRUCTURES				
Entity Type	Types of Owners.	Filing Required	Entity Name	Organization Costs
Limited Partnership	No restrictions.	Certificate of Limited Partnership.	Must contain "Limited Partnership", "Limited", "L.P.", or "Ltd".	Varies.
Limited Liability Company	No restrictions.	NH requires filing registration and securities forms only.	Must contain "Limited", "Ltd.", "LC", or "LLC".	Varies.
S Corporation	Ownership is limited to U.S. residents and citizens and to certain U.S. trusts (no corporations, nonresident aliens, partnerships, certain trust, and pension plans.)	Articles of Incorporation.	Must contain "Corporation", "Company", "Incorporated", or abbreviation thereof.	Varies.
C Corporation	No restrictions.	Articles of Incorporation.	Must contain "Corporation", "Company", "Incorporated", or abbreviation thereof.	Varies.

COMPARISON OF ENTITY STRUCTURES

Entity Type	Liability for Debts of Entity	Participation in Management	Transferability of Interests	Term
General & Limited Partnership	General Partner liable. Limited partners protected unless participate in management.	Participation by limited partners generally restricted to preserve limited liability.	Restrictions imposed by state law, by securities laws, and generally by the partnership agreement. Generally, partner may assign right to receive distributions /allocations, but assignee becomes partner only if all partners consent.	Partnership Agreement specifies terms.
Limited Liability Company	All members protected.	No restrictions.	Restrictions imposed by state laws, securities laws, and LLC agreement, if any. Generally, member may assign right to receive distributions /allocations, but assignee becomes member only if all members consent.	Varies by state. NH provides for perpetual LLC existence. The LLC agreement may govern.
S Corporation	All shareholders protected.	No restrictions.	Restrictions are imposed by securities laws, and by a shareholder's agreement, if any.	Perpetual.
C Corporation	All shareholders protected.	No restrictions.	Restrictions are imposed by securities laws, & by a shareholder's agreement, if any. Also, shareholders usually agree not to make transfers that would terminate S election.	Perpetual.

COMPARISON OF ENTITY STRUCTURES pt.2

Entity Type	Will Entity be Dissolved Upon Death, Retirement, Resignation, Expulsion, Bankruptcy or Dissolution of Participant?	Are Ownership Interests Securities?	Subject to Federal Income Tax at Entity Level?
Limited Partnership	Yes, if general partner is affected; but can be reconstituted by remaining general partner or by agreement of all remaining partners.	Limited partners' interests are securities.	No, if lacks two of four corporate characteristics: (i) limited liability; (iii) continuity of life, and (iv) centralized management.
Limited Liability Company	Maybe, this is governed by state statute, (NH is a perpetual LLC state) or LLC agreement, unless the remaining members unanimously consent to continue or discontinue business.	Possibly not, if all members have management rights or defined by state statute. However, in NH, yes.	No, if lack free transferability of interests and continuity of life. Occasionally, a LLC may lack centralized management.
S Corporation	No.	Shares are securities.	No, however, any shareholder may cause loss of tax status.
C Corporation	No.	Shares are securities.	Yes.

COMPARISON OF ENTITY STRUCTURES

Entity Type	Qualifications	Number of Owners	Form of Permissible Interest	Will Contribution of Appreciated Property be Taxable?
Limited Partnership	A limited partnership generally needs an individual general partner or a corporate general partner with substantial assets.	At least 2; no upper limits.	In most states, cash, property, services rendered, promissory notes, or obligation to transfer property.	No, regardless of control by partner, unless re-characterized as sale or partner has net reduction in liabilities in excess of tax basis in contributed property. IRC Section 752
Limited Liability Company	No restrictions.	Depends on state. NH allows single member LLCs; no upper limits.	In most states, cash, property, services rendered, promissory notes, or obligation to transfer property.	No, regardless of control by member.
S Corporation	Various eligibility requirements, including a restriction on the number of shareholders and on the ownership of subsidiaries.	No lower limits; upper limit is 35.	Any tangible or intangible benefit to the corporation, including cash, promissory notes, and services rendered, contracts for future services, or other securities of the corporation.	Yes, except if controls corporation (80% voting power) immediately after transfer.
C Corporation	No restrictions.	No lower or upper limits.	Any tangible or intangible benefit to the corporation, including cash, promissory notes, and services rendered, contracts for future services, or other securities of the corporation.	Yes, except if controls corporation (80% voting power) immediately after transfer.

COMPARISON OF ENTITY STRUCTURES

Entity Type	Managing Body	Officers	Rules for Management of Entity	Must Formalities be Observed to Preserved Limited Liability?
Limited Partnership	General partner. Limited partners may not participate in management.	No.	Limited Partnership Agreement.	No.
Limited Liability Company	Managers, unless statutes or LLC agreement reserves management to members, then all members can participate in management.	Yes, if designated by managers.	Regulations and/or LLC operating agreement.	Unclear.
S Corporation	Board of Directors.	Yes, if designated by managers.	Bylaws.	Yes, unless corporation adopts close corporation status.
C Corporation	Board of Directors.	Yes, must have at least president and secretary.	Bylaws.	Yes, unless corporation adopts close corporation status.

COMPARISON OF ENTITY STRUCTURES

Entity Type	Ability to do Business in other States	Limited Liability of Participants Recognized in Other States	Levels of Income Tax
Limited Partnership	Yes.	Yes.	Partner level only.
Limited Liability Company	Yes in states with an LLC statute. Unclear in those states that do not have an LLC statute.	Yes in states with an LLC statute. Unclear in those states that do not have an LLC statute.	Member level only.
S Corporation	Yes.	Yes.	Generally, only shareholder level. However, former C corporations may be subject to tax. In addition, some states will tax S corporations.
C Corporation	Yes.	Yes.	Corporate and shareholder level.

COMPARISON OF ENTITY STRUCTURES				
Entity Type	Formation	Special Allocation of Income and Loss Between Participants	Deductibility of Losses Attributable to Entity Debt	At-Risk Limitations
Limited Partnership	Nontaxable, unless disguised sale or the partner is relieved from debt.	Yes.	General partners only may deduct partnership losses to extent of basis, unless limited partnership assumes liability.	Applicable.
Limited Liability Company	Nontaxable, unless disguised sale or the partner is relieved from debt.	Yes.	Members may deduct the LLC's losses only to the extent of their tax basis on their LLC interest which includes their allocable share of LLC debt.	Applicable.
S Corporation	Taxable; however, if the transferors meet the 80% control test of IRC, Section 351, nontaxable except to the extent of debt relief.	No, all allocations are pro rata since only one class of stock is permitted.	Shareholders may deduct the corporation's losses only to the extent of their tax basis in their stock which does not include any portion of the corporation's debt.	Applicable.
C Corporation	Taxable; however, if the transferors meet the 80% control test of IRC, Section 351, nontaxable except to the extent of debt relief.	Preference in distribution can be given to certain classes/series of stock.	Shareholders may not deduct any of the corporation's losses.	Applicable, if closely held.

Practical Alert: With individuals who are engaged in on-site work on any construction site within the State of New Hampshire and who form an LLC or a corporation, only the first three officers or members are exempt from carrying worker's compensation insurance on themselves. This requirement will not apply to a construction site tradesperson who operates outside of an entity, such as a sole proprietor.

B. TAX IMPLICATIONS TO TRANSFERRING ASSETS INTO AND OUT OF ENTITIES

There is generally no income tax implication to transferring property into a partnership, limited partnership, corporation (C or S) or limited liability company so long as the party contributing the assets receives an interest in the entity in exchange for those assets. The question to be explored with the client and their tax advisors is whether or not to treat a contribution of property as an equity contribution or as a loan. This will affect the set up of the company's balance sheet.

There is also generally no income tax implication to converting a partnership or limited liability company into a corporation. The basis of the assets on the partnership books will carry over onto the books of the corporation. There may be an income tax implication to converting between a C corporation and an S corporation. This will depend upon accumulated earnings and assets on the books of the company.

However, if a C corporation dissolves or converts to a sole proprietorship, partnership, limited partnership or limited liability company, a significant income tax implication may result. Specifically, under IRC Section 311, the corporation is deemed to have been liquidated and is deemed to have sold its assets for their fair market value. In a C corporation, this means the corporation must pay corporate tax on the difference between the fair market value of those assets and the corporation's basis in those assets. In addition, the shareholders are deemed to have received a distribution of the corporation's assets. This means that the shareholders must pay individual income tax as if they received a fair market value of the corporation's assets as income. In an S corporation, all taxable gain at the corporate level resulting from the presumed liquidation is passed through to the shareholders as an increase in basis.

Caveat: In New Hampshire, real estate transfers into and out of entities are subject to the New Hampshire transfer tax. That tax is 1.5% of the fair market value of the real property being transferred. Often, a client will purchase a property before establishing the LLC only to find out that they have to pay transfer taxes at the time of purchase and again when the property is transferred to the LLC. Obviously, establishing the LLC before the closing and taking title in the LLC will avoid the second transfer tax. This will require having your client communicate with their lender well in advance of the closing so that the

lender is aware that your client will be taking title in the name of the LLC. Some clients will be told that their lender will not permit title to be held in an LLC and/or their interest rate will increase as a result of the LLC holding title. Other clients will find out that they must remove their property from an LLC before refinancing the property. This could result in as many as four (4) transfer taxes (when the property is purchased in the individual's name, when the property is placed in the LLC, when the property is transferred back to the individual to accommodate the refinance, and when the property is placed back into the LLC). Practitioners may also need to counsel their clients that a transfer into or out of an LLC may violate existing loan documents and even trigger mortgage acceleration clauses (such as due on transfer clauses). Some clients will incur the transfer tax and remove property from entities and opt to pay a 1.5% transfer tax rather than declaring a business profits tax at 7.25%.

A transfer of an ownership interest in an entity holding real property will also trigger the New Hampshire transfer tax. The tax is calculated by taking the fair market value of the real property and multiplying that value by the percentage of the entity being transferred and then multiplying the result by 1.5%. For example, a sale or transfer of a 10% interest in a corporation or an LLC holding real property will trigger a transfer tax of 10% of the fair market value of the real property held by the entity multiplied by 1.5%.

Some clients choose to purchase and/or keep the property outside of entities and purchase umbrella insurance to cover most liabilities. Other clients establish an entity (such as an LLC) and lease their property to the entity. The entity then sub-leases the property to the tenants. The lease with the tenants provides that the tenants are not in privity of contract with the owner and that the tenant's sole remedy is against the leasing entity. This is a relatively untested area of law and the question remains as to tort liability and/or equitable liability even if contractual liability is waived.

Some clients also allocate a portion of the purchase price and corresponding fair market value of the property to personalty and fixtures associated with the real property to decrease the value. Other clients will rely upon a municipal real estate tax assessment if that assessment (after application of applicable equalization ratio) is less than the true value at the time of the transfer into or out of the entity.

C. FACTORS WHICH MAY LEAD A COURT TO DENY THE SEPARATE LEGAL EXISTENCE OF A CORPORATION

The liability protection of a corporation is not absolute. The shareholders can still be personally liable for corporation debts and liabilities if a creditor is able to pierce the corporate veil of liability protection. Generally, there are six ways to pierce the corporate veil.

First, if the shareholder signs a corporate debt personally, the shareholder will be personally liable. This is most common when shareholders are required to guarantee lines of credit and equipment or vehicle purchases.

Second, if the shareholder fails to pay certain corporate taxes, such as 941/withholdings taxes. The shareholder will be assessed personally.

Third, if the shareholder commits an act of fraud. A corporation was not intended to shield one from intentional acts of fraud.

Fourth, if the entity is thinly capitalized. This is akin to fraud since the entity, by way of its shareholders, is promising to pay debt with little or no prospect of having the resources to do so.

Fifth, if the creditor was unaware of the fact that the entity was a corporation. This results when the entity does not use the words “corp.,” “corporation”, “inc.,” “incorporated”, “Ltd.” or “limited” on its business cards, stationary, checks, order forms, etc. Essentially, the argument is that a creditor is entitled to know with whom they are dealing at the outset and cannot be surprised to learn of the corporate status only after a claim arises.

Sixth, if the entity failed to keep corporate formalities. The law essentially states that it will not provide the protections of a separate entity to those who did not treat the entity as separate themselves. This is why practitioners will counsel their clients to have By-Laws, annual meetings and special meetings and votes when certain corporate actions take place. Generally, a vote is a good idea if a shareholder or director or officer is engaging in a transaction with the corporation, such as a loan or purchase of corporate assets. A vote is also a good idea whenever the corporation is purchasing or leasing an asset of significant value outside the ordinary course of business. While a vote is not required to buy paper clips and staples and to hire and fire employees, a vote is a good idea for an automobile purchase, a building lease or a purchase of a piece of equipment. A failure to keep corporate formalities

can also result when money is commingled. This is why clients are counseled to always keep corporate money separate from personal money and not to use corporate checks to buy personal items. Clients are also counseled not to use personal checks to pay corporate bills. If a corporation does not have money to pay a bill the shareholders should loan the money to the corporation and record the same a loan transaction complete with a corporate vote.

D. OTHER ASSET PROTECTION ISSUES RELATED TO ENTITIES

Many individuals who are in high risk businesses or occupations transfer assets to their spouses in an effort to shield those assets from liability. Such transfers often are set aside by courts on theories ranging from constructive trusts to violations of the Uniform Fraudulent Transfer Act (N.H. RSA 545-A). However, if the individual can show that he/she had a valid non creditor-avoidance reason for making the transfer, and so long as no claims are on the horizon or anticipated at the time of the transfer, the individual will generally be given a presumption that the transfer was done for non creditor-avoidance reasons and is a valid transfer. One such reason is estate tax planning.

One strategy is the use of limited liability companies with charging order protections.

Another such strategy is the use of credit shelter trust planning to split assets between spouses. Section 2010 of the Internal Revenue Code provides a credit for computing the federal estate tax. Section 2505 provides the same credit for gifts. Presently, there is an "exemption equivalent" or "credit shelter amount" of \$3,500,000.00, provided by that Code Section. By use of this credit, every individual can transfer either during his or her lifetime or on death \$3,500,000.00 free of federal gift and estate taxes. Any portion of the Unified Credit used during life will reduce the amount available on death.

The federal estate tax law also provides a credit for state death taxes (IRC Section 2011) which may be used in addition to the Unified Credit to reduce federal estate taxes if state death taxes are paid on the estate.

Key to estate planning for a married couple is designing a plan that utilizes both spouses' available Unified Credits. If the spouses leave their assets to each other, the credit for one spouse will not be used and, therefore, **will be wasted**. Instead of being able to transfer \$7,000,000.00 with the payment of no federal tax, only \$3,500,000.00 would be able to be transferred tax-free. The simplest way for each spouse to use their respective credits is

for each of them to leave \$3,500,000.00 to someone other than his or her spouse. This, however, would deprive the surviving spouse of the benefit of the \$3,500,000.00 during his or her lifetime. To give the surviving spouse the benefit of the \$3,500,000.00 and yet prevent it from being taxed in his or her subsequent estate, a Credit Shelter Trust (also called a "bypass trust" or a "family trust" or "A/B trust") can be used.

A Credit Shelter Trust is a trust created by one spouse for the benefit of the other. The trust is funded with the Exemption Equivalent Amount (\$3,500,000.00) either during the lifetime of the grantor of the trust or on his or her death. Generally, the Trustee has the discretionary power to make distributions of income and principal to the surviving spouse during his or her lifetime. Upon his or her death, the remaining trust property is distributed as the grantor directs, usually to the grantor's children. The surviving spouse's power to demand income and principal from the trust is limited to avoid the inclusion of the trust property in his or her gross estate.

These trusts can be set up in such a way that either spouse can change their trusts while both spouses are living. The trusts can also limit or prohibit the right of the surviving spouse to change his or her trust after the death of the first spouse. This is particularly useful in planning when one or both spouses have previously been married and one or more spouses have children from prior marriages. This requires the couple to set up 2 separate trusts, thereby splitting their assets between the 2 trusts.

A **third strategy** is using multiple entities. For example, a client may have its equipment or vehicles owned by one entity (a leasing company) owned by the client's spouse and an operating company that deals with the customers and takes on the liability exposure; such company to be owned by the client. Clients that own multiple pieces of real estate may have separate entities owning each piece of real estate and may even have another entity set up as a management company dealing with tenants. In Massachusetts, the need for multiple entities owning real estate can be mitigated by the use of a Series LLC which permits each piece of real estate to be in one entity and in the event of a lawsuit involving a piece of property, only that piece will be at risk and subject to the creditor claim. Clients who develop real estate may have the real estate held in one entity and undertake the construction and sale of the real estate through a different entity.

A **fourth strategy** is to place provisions in a buy/sell agreement between owners that allows one owner to buy out the other at a reduced value if one owner is subject to a claim involving that owner's interest in the company. The owner subject to the claim is placing their trust in their partner(s) over the third party creditor.

E. **THE ADVISABILITY OF BUY-SELL AGREEMENTS**

Non-Tax Considerations:

While many Buy-Sell Agreements are entered into for transfer tax and succession planning reasons, others are entered into for day to day practical business reasons. For example, an owner may want to give a key employee or an heir incentive to stay with a business by assuring that person that they have a future right to own all or a part of the business.

Some agreements are entered into so that one co-owner can recover the stock of the other co-owner in the event that that co-owner leaves the business, becomes permanently disabled or dies. Other agreements exist to allow a co-owner to recover the stock of an owner who doesn't meet certain requirements (such as hours worked or results achieved). Some agreements are designed to penalize a co-owner who acts wrongfully, such as a co-owner who engages in a competing business. In that instance the non-compete housed within a broader Buy-Sell Agreement is also often designed to give the courts a basis, beyond mere employment, with which to enforce a non-compete clause.

Other co-owners want to have agreements in place so that if an owner is sued and if that owner's stock is a target of the creditor, there is some way to protect the company against the outside creditor.

Some Buy-Sell Agreements are drafted to assure the current owner that he or she will have a ready buyer when that owner is ready to retire. These agreements are often coupled with some requirement that the buyer establish some type of buy-out fund prior to his or her purchase.

One of the most common types of a Buy-Sell Agreement is one in which one co-owner wants to make certain that another co-owner cannot sell his or her stock to a third party without that owner's consent. This often takes the form of a stock sale restriction such as a right of first refusal.

Estate and Income Tax Considerations (Traps for the Unwary):

Before drafting a Buy-Sell Agreement, the attorney must be familiar with some of the more common tax traps for the unwary.

A. Pre-October 9, 1990 Agreements:

An attorney confronted with a client who has a Buy-Sell Agreement in place and which was entered into prior to October 9, 1990, will want to strongly consider whether to make changes to that agreement. The value of the business set forth in a Buy-Sell Agreement entered into prior to that date will be binding upon the IRS for transfer tax purposes if there was some business purpose to the agreement, even if the objective value of the business exceeds the amount set forth in the agreement. Therefore, unless the agreement really needs fixing, you may not want to amend it. Once you change the value, that value is no longer binding upon the IRS.

B. Life Insurance Payable To Or Owned By The Corporation:

Another common trap is to fund a Buy-Sell Agreement with life insurance and have the policy owned by a corporation (or have that corporation as the beneficiary). This creates income to the corporation. When the policy is paid out, this could trigger an alternative minimum tax. This risk has been somewhat mitigated by virtue of the fact that the alternative minimum tax for small corporations has been repealed. A corporation that has average gross receipts of less than \$5 Million for a three year period (beginning after 1993) is deemed a "small corporation" for its tax years beginning after 1997. The exemption continues for every year in which gross receipts do not exceed \$7.5 Million annually for the prior three-year period. With other corporations, a corporate alternative minimum tax must be paid instead of the corporation's regular tax if the alternative minimum tax amount is higher. There is a \$40,000.00 exemption amount. This exemption phases out at the rate of 25 cents for each dollar of income subject to the tax that exceeds \$150,000.00 and reduces to zero when the amount reaches \$310,000.00.

There is also a potential for double tax when a C corporation is the owner or beneficiary of a policy. First, the value of the policy is in the value of the business. In addition, the policy can create incidents of ownership under Code Section 2042. Moreover, if the corporation receives the death benefit and the agreement is structured so as to have that death benefit paid to the surviving shareholder so that the surviving shareholder can buy the stock of the deceased shareholder, the issue becomes whether or not the IRS will treat the payment to the surviving

shareholder as a dividend. If this happens, the payment to the surviving shareholder is not deductible to the corporation but is considered income to the surviving shareholder.

Having the life insurance payable to the entity, as opposed to the surviving shareholder(s) will also deprive the surviving shareholder(s) of using the death benefit on the insurance to obtain a stepped up basis. By using a cross-purchase agreement by which the shareholders own life insurance on each other and the death benefit is payable to the surviving shareholders, those surviving shareholders can use the death benefit to purchase the stock of the deceased shareholder and include that purchase price (derived from insurance death benefits which they receive tax free) in their basis. If there are multiple shareholders, rather than purchasing multiple small cross policies, consider using a trustee arrangement whereby one policy is purchased on each shareholder and the policies and death benefit are held by a trustee who acts as trustee for the surviving shareholders.

If the corporation is named as the owner or beneficiary and the insured has already died, consider delaying the appointment of a personal representative for the estate until the next year, convert to S corporation status, file a Code Section 1377(a)(2) election and then collect the insurance death benefit. The 1377(a)(2) election will allow you to allocate basis from the proceeds to the shareholders.

Practitioners using life insurance to fund Buy-Sell Agreements should also be aware of the new rules governing the tax treatment of Split-Dollar Agreements. This will be discussed in more detail under “Funding Methods”.

Practitioners should also use a Trustee to receive the death benefit and then forward the stock to the surviving shareholders or corporation so that multiple partners can lessen the number of policies needed and the resulting costs thereof. Having a trustee with the policies collaterally assigned also eliminates litigation over insurance proceeds and enforcing the agreement later.

C. Formulas Which Overstate Value:

Another pitfall in drafting a Buy-Sell Agreement is the use of a formula that overstates the value of the business. For example, if the formula states that the deceased shareholder’s estate is to receive “the greater of fair market value or the insurance proceeds payable on policy #_____”, and if the insurance proceeds exceed the fair market value of the business, several things may result.

First, the IRS may take the position that the insurance proceed amount is to be used in determining the deceased shareholder's gross estate for estate tax purposes. Given the current estate tax rates, this could add a significant amount to the decedent's transfer tax. Alternatively, the difference between fair market value and insurance proceeds could be viewed as a dividend. As such, and in a C corporation, that difference would be taxed as ordinary income to the estate and would not be deductible to the corporation, thereby resulting in a double tax.

Often, however, the parties entering into the Buy-Sell Agreement want their families to receive the entire death benefit on their life insurance since the parties are ultimately paying for the insurance. Therefore, they will insist on a "greater of" formula. If that happens, consider having a clause in the agreement which makes the difference between fair market value and insurance proceeds a deferred compensation item to be paid to the estate of the deceased shareholder. If accepted, at least the difference would be deductible to the corporation; although it would still be ordinary income to the deceased shareholder's estate. The agreement should clearly spell out this type of tax treatment and the shareholders should agree up front that any overage may be treated as ordinary income to their estates.

Death Of One Business Owner/ Surviving Shareholder Acquiring The Insurance Policy Insuring The Surviving Shareholder's Life:

Assume that a corporation has two 50 percent owners and that each have purchased life insurance on the life of the other, with each being the beneficiary of the policy which they own. When the first shareholder dies, the proceeds from the life insurance policy owned by the surviving shareholder (or owned by the corporation) will be available to purchase the stock of the deceased shareholder. However, what do the parties do with the life insurance policy on the life of the surviving shareholder?

The surviving shareholder is now the 100 percent owner of the business. He or she now has more net worth and may need the policy insuring him or her to plan for payment of his or her own future estate taxes. The surviving shareholder may also want the policy on his or her life because it is paid up, insurance was taken when costs were cheaper or the surviving shareholder no longer qualifies for insurance. As a result, many agreements give the surviving shareholder the right to buy the policy on his or her life during some period of time.

The agreement may require the purchasing shareholder to pay an amount equal to the cash surrender value of the policy at the time. This means that the surviving shareholder has to come up with a great deal of money at one time to acquire his or her policy.

Also, if the surrender value exceeds the premiums paid into the policy (as is the goal), then the amount paid above premiums would be considered a gain above the owner's basis in the policy. The owner's basis in the policy is generally equal to the premiums paid. Therefore, when the surviving shareholder pays the estate of the deceased shareholder or the corporation a cash surrender value in excess of premiums paid/basis, that additional money is taxed as ordinary income to the estate or to the corporation. Since a life insurance contract is not a capital asset, there is no step-up in basis at the time of the owner's death in the case of a policy owned by shareholders on each other. In the case of a policy owned by a corporation under a stock redemption agreement, the corporation will lose favorable long-term capital gains treatment. Thus, one of the advantages of owning an insurance policy (tax-deferred growth) is lost as a result of the purchase triggering gains on surrender value above premiums paid.

Similarly, if an agreement funded with life insurance is cancelled prior to the death of either shareholder, the shareholders may want to simply take back the policies insuring their own lives from each other or from the corporation. In a cross purchase agreement, if the agreement requires a policy purchase for surrender value and the policy on the life of one shareholder exceeds the value of the policy of the life of the other shareholder, the parties cannot simply exchange policies and one party will have to come up with out of pocket funds. This may occur when there is an age disparity or a health disparity between owners.

Moreover, the difference between surrender value and premiums paid is considered income to the shareholder selling the policy.

In a redemption agreement, if a shareholder pays less than the surrender value to the corporation, the difference between cash surrender value and the amount paid would be treated as compensation or dividend income to the shareholder. In a C corporation, dividend income is not deductible to the company. Therefore, it may be more advisable to have the shareholder finance the purchase price through loans or withdrawals from the policy after purchase. This will, however, reduce the values inside the policy and could create non-deductible interest expenses for the shareholder. As in the cross purchase agreement context, the difference between surrender value and premiums paid is considered income to the corporation selling the policy.

There are some creative split ownership options which can be considered when purchasing the life insurance policies. In such an arrangement, the insured would retain ownership of and access to the cash value of the policy while the prospective purchasing shareholder will own only the net death benefit that is needed to carry out the purchaser's obligations under the terms of the agreement.

Valuation Methods:

Often the most difficult part of drafting a succession plan involves the issue of how to value the business interest being purchased. Attorneys sometimes overlook the fact that their clients are often the best experts on the value of their business. The client is in the industry and has probably seen other similar businesses bought and sold. Sometimes the client will be a member of a trade organization which publishes sales or valuation statistics on that particular industry. Some clients don't care what the objective value of their business is; they simply have come up with a number and want their employee or co-owner to pay that amount or are willing to accept a certain amount offered by that employee or co-owner. Other clients are content to have their regularly engaged accountant simply provide a number.

Some sellers are content to receive a multiple of their compensation at the time of the sale.

Another common method for creating a value is to tie that value to the amount of insurance being held on a shareholder. As discussed above, using a "greater of fair market value or insurance" formula can result in unforeseen tax ramifications. However, using a "lesser of fair market value or insurance" formula can result in a shareholder not having their family receive the full value of death benefit for a policy which that shareholder paid for (often with after-tax dollars).

Another valuation method that can create problems is a set value coupled with an agreement that the parties will meet from time to time to update values. This seldom occurs once the parties focus on day to day business and no longer focus on their agreement once in place.

For those clients who are looking for guidance in coming up with a valuation, the following suggestions might be considered.

Depending upon the industry in which the business operates, it may be useful to use a formula based on a multiple of gross sales. Of course, care must be taken to determine whether or not the cost of goods sold/cost of production makes gross sales a meaningful number. This is especially true in low mark-up industries.

Other businesses will use a multiple of net sales or earnings. Obviously defining what a net sale or an earning is becomes the challenge. These can be easily manipulated. Therefore, often the formula will reference “earnings before interest, dividends and taxes” based on Generally Accepted Accounting Principles. This can be established, in the first instance, by the regularly engaged accounting firm for the company. The agreement may contain a right to have an independent review done of the company’s accountant’s conclusions. Sometimes the party will want to have an outside accounting firm conduct the analysis in the first instance.

If a sales or earnings approach is to be used, the next issue becomes whether or not to use a relevant year, such as the year preceding the death of the shareholder or the year of purchase, or to weight several years. If weighting several years is to be used, often the agreement will set forth the amount of weight to be given to each year. For example, the formula may use a multiple of three for the current, a multiple of two for the prior year and a multiple of one for the year prior to that. The total would then be divided by six.

Many agreements provide for an appraisal to be conducted at the relevant time of transfer (such as the date of death or date of purchase). This approach is often used to value businesses which hold real estate as a primary asset or to value the real estate portion of the business. The key to this type of approach is to agree on the appraiser and the standard to be employed.

For example, in valuing real estate it may be necessary to state that the appraiser shall be a licensed or certified appraiser for a certain state. It may also be necessary to state that the appraiser is to consider a fair market value sale with adequate exposure to the open market and with no consideration given to the unique circumstances of the sale. The agreement may also state that no minority or marketability discounts are to be used.

In cases where the parties cannot agree on an appraiser or the parties want to provide for a buyer who may not agree with an appraisal, the use of the following formula may be helpful:

The fair market value of the Corporation shall, in the first instance, be determined within ninety days of the date of death of the deceased Stockholder by the accountant or accounting firm regularly engaged by the Corporation prior to the death of the Stockholder or by such independent qualified business appraisers as that accountant may engage, all without regard to any minority, marketability or other discounts. The Corporation shall pay the cost of this appraisal.

If the estate of the deceased Stockholder disagrees with the fair market value as determined by the Corporation's appraisal, the estate of the deceased Stockholder shall notify the Corporation, in writing, within thirty (30) days of the later of: (1) the estate of the deceased Stockholder receiving the Corporation's appraisal and copies of all information relied upon by that appraiser or being permitted access to all information relied upon by the appraiser; or (2) thirty (30) days following the appointment of a personal representative of the estate of the deceased Stockholder. If the estate of the deceased Stockholder fails to give notice as and when required above, the estate of the deceased Stockholder shall be deemed to have accepted the fair market value as determined by the Corporation's appraisal.

If the estate of the deceased Stockholder has given notice as and when required above, the estate of the deceased Stockholder shall have twenty-one (21) days following that notice to obtain its own written appraisal of the fair market value of the Corporation as of the date of death of the Stockholder. The estate of the deceased Stockholder shall pay the cost of such an appraisal. This appraisal shall be undertaken by a licensed or certified business appraiser in and for the State of New Hampshire or by a Certified Public Accountant or Enrolled Agent or by such appraisers as that Certified Public Accountant or Enrolled Agent shall retain. If the appraisal is not obtained as and when provided above, the appraisal of the Corporation shall be deemed the only binding appraisal of fair market value.

If the resulting value between the appraisal obtained by the Corporation and the appraisal obtained by the estate of the deceased Stockholder differ ten (10) percent or less, the resulting values of the two appraisals shall be averaged to determine the fair market value of the Corporation. If the resulting value between the appraisal obtained by the Corporation and the appraisal obtained by the estate of the deceased Stockholder differ by greater than ten (10) percent, the two appraisers who conducted the prior appraisals shall select a third appraiser to conduct a third appraisal of the fair market

value of the Corporation as of the date of death of the deceased Stockholder. The cost of the third appraisal shall be shared equally between the Corporation and the estate of the deceased Stockholder. The resulting value of the appraisal which represents the middle of the three (3) valuation amounts shall be used to determine the fair market value of the Corporation, with the highest valuation and the lowest valuation being disregarded.

Types of Agreements:

Redemption Agreements:

In this type of agreement, the company is purchasing the ownership interests of the owner whose interests are being purchased. The co-owners enter into an agreement with the company whereby the company can purchase the interests of a deceased or departing co-owner.

The advantage to this type of agreement is that multiple owners do not need to take action to consolidate their ownership. The company simply purchases the stock or other ownership interest of an owner, thereby automatically making the remaining owners larger owners of the company, while keeping their ownership pro rata.

For example, assume that a company has five shareholders, each holding 20% of the issued and outstanding stock of the company. If the company purchases the stock of one of the shareholders, there will be four shareholders left, each holding 25% of the issued and outstanding stock of the company.

This type of agreement also eliminates the need to have multiple cross purchase life insurance policies on the lives of each owner. With multiple owners, generally multiple policies must be procured or a trusteed arrangement for life insurance must be put in place.

Some redemption agreements are "trusteed". This type of agreement is used where the parties desire that some disinterested third party carry out the terms of the agreement. Often, the trustee serves as custodian of the stock and any life insurance policies insuring the lives of the shareholders and the trustee is named as the beneficiary of such insurance, subject to an obligation to use the proceeds to complete the stock

purchase. For example, at the death of an insured shareholder, the trustee will pay the proceeds to his or her estate and transfer the stock to the company. This eliminates the need to have the company dealing with the estate over obtaining the stock.

Cross Purchase Agreements:

In this type of agreement, co-owners enter into an agreement among themselves whereby the remaining co-owners can purchase the interests of a deceased or departing co-owner.

This type of agreement eliminates the potential negative tax ramifications of having the company as purchaser of the ownership interests (such as a loss of a stepped up basis). However, this type of agreement often requires action on the part of the remaining owners and/or a trusteed arrangement.

One Way Buy-Sell Agreement:

In this type of agreement, one or more owners enter into an agreement whereby only a select owner or non-owner can purchase the interests of a deceased or departing co-owner. This form of agreement is often used when an older owner focused on retirement wants to provide for the purchase of his or her ownership by a younger partner or by an employee. Unlike the previous forms of agreement, there is only one potential seller and one or more potential buyers; as opposed to an agreement under which the parties rights and responsibilities are mutual and dependent on who departs or dies first.

The employee or younger owner may buy life insurance on the life of the owner whose interests are being purchased. The cash value may be used to fund all or part of a lifetime buyout and the death benefit may be used to fund a death purchase. Alternatively, the company may bonus money to an employee who may then be required to establish a buyout fund using their after tax income. This often helps give the employee a commitment to the purchase. Some agreements vest the employee with a discounted purchase price based on years of service. This is akin to a stock option without creating the immediate tax ramifications of a stock option.

This is often used in conjunction with a phantom/incentive stock plan which gives the employee ownership over time or a credit against the purchase price over time. However, this will be structured so as not to result in the employee realizing taxable

income for a transfer of stock for the phantom/incentive shares. This will also mean that the employer does not have to chase their stock back if the employee leaves the company. It can also form the legal consideration for an enforceable non-compete agreement.

Stock v. Asset Sale:

The issue of whether the owner should sell his or her stock in a company or the assets of the company generally turns on two factors. The first factor is the income tax implications associated with each type of transaction. A more complete discussion of these tax considerations is contained in below.

The second factor is liability exposure and risk. In an asset sale, the buyer can generally cleanse any liabilities associated with the assets. In a stock sale, the buyer generally takes subject to any known or unknown liabilities associated with the business. This can be mitigated somewhat by a personal indemnity agreement from the seller to the buyer. However, the indemnity is only as good as the financial strength and personal assets of the party giving the indemnity.

Stock Restriction and Transfer Agreement (which can be equally applied in a partnership or LLC context):

The Stock Restriction and Transfer Agreement should, at a minimum, consider the following:

1. If one shareholder wants to sell his or her stock, does the corporation or do the other shareholders have a right of first refusal?
 - a. For tax purposes, should the corporation or the shareholders have the right?
 - b. Should the corporation or the remaining shareholders be entitled to a discounted purchase price or should they have to match the third party offer?
 - c. Should the corporation or the remaining shareholders have to match the terms offered by the third party or should they have the right to more favorable terms?

- d. Should the remaining shareholders have the right to require that the business be sold if they do not want to continue without the selling shareholder?
 - e. Should the corporation set up some investment or other fund to have assets available to exercise their option?
2. If one shareholder dies, does the corporation or do the other shareholders have a right to purchase the deceased shareholder's stock from his or her estate/does the deceased shareholder's estate have a right to have the stock repurchased?
- a. For tax purposes, should the corporation or the surviving shareholders have the right?
 - b. Should the corporation or the surviving shareholders have an option or an obligation to purchase?
 - c. What should the purchase price be?
 - i. Insurance proceeds
 - ii. Formula
 - iii. Fair market value appraisal
 - iv. Greater of insurance proceeds and formula or fair market value appraisal (if such a value is used and the insurance proceeds exceed fair market value, how do you deal with the potential transfer for value/income tax/estate tax ramifications).
 - d. Will the corporation or the shareholders purchase life insurance to fund the purchase?
 - i. Who should own the policy?
 - (a) Should there be a split dollar agreement?
 - (b) Should there be a trustee arrangement?
 - ii. Who should be the beneficiary?

- (a) Could there be an alternative minimum tax to the corporation?
 - (b) Should there be a 1377 (a)(2) election?

- 3. If one shareholder becomes disabled and is no longer able to participate in the affairs of the corporation, does the corporation or do the other shareholders have a right to purchase the disabled shareholder's stock/does the disabled shareholder have the right to require the corporation to purchase his or her stock?
 - a. For tax purposes, should the corporation or the non-disabled shareholders have the right?
 - b. Should the corporation or the surviving shareholders have an option or an obligation to purchase?
 - c. What should the purchase price be?
 - i. Insurance proceeds
 - ii. Formula
 - iii. Fair market value appraisal
 - iv. Greater of insurance proceeds and formula or fair market value appraisal
 - d. Will the corporation or the shareholders purchase disability buy-out insurance to fund the purchase?
 - i. Who should own the policy?
 - ii. Who should be the beneficiary?
 - iii. Should the shareholders have long term care insurance?
 - e. How do you define disability?
 - i. Reference to insurance policy?
 - ii. Other?
 - f. Should there be a distinction between short, intermediate

and long term disability?

4. If one shareholder retires, does the corporation or do the other shareholders have a right to purchase the retiring shareholder's stock/does the retiring shareholder have the right to require the corporation to purchase his or her stock?
 - a. For tax purposes, should the corporation or the non-retiring shareholders have the right?
 - b. Should the corporation or the non-retiring shareholders have an option or an obligation to purchase?
 - c. What should the purchase price be?
 - i. Formula
 - ii. Fair market value appraisal
 - iii. Other
 - d. Should the corporation set up some investment or other fund to have assets available to exercise their option?
 - e. Should the retiring shareholder be required to give advanced notice?
 - f. Should the retiring shareholder be required to have obtained a minimum age?
 - g. Should the retiring shareholder be required to have obtained a minimum number of years in service?
 - h. Should the retiring shareholder be required to execute a non-competition agreement?
5. Should shareholders have employment provisions which protect them against termination or which set specific procedures for termination/should shareholders be employees at will/should shareholder employment be addressed in the agreement?
 - a. If a shareholder quits the employ of the corporation, should the corporation or the remaining shareholders have a right to repurchase his or her stock?

- i. What should the purchase price be?
 - (a) Formula
 - (b) Fair market value appraisal
 - (c) Value minus a penalty
 - (d) Other
 - b. If an at-will shareholder is terminated from the employ of the corporation, should the corporation or the remaining shareholders have a right to repurchase his or her stock?
 - i. What should the purchase price be?
 - (a) Formula
 - (b) Fair market value appraisal
 - (c) Value minus a penalty
 - (d) Other
 - c. If a shareholder is terminated from the employ of the corporation for cause, should the corporation or the remaining shareholders have a right to repurchase his or her stock?
 - i. What should the purchase price be?
 - (a) Formula
 - (b) Fair market value appraisal
 - (c) Value minus a penalty
 - (d) Other
- 6. If a shareholder's stock becomes the subject of a lien, attachment, encumbrance or claim of a divorcing spouse, does the corporation or do the other shareholders have a right to purchase the retiring shareholder's stock?
 - a. What should the purchase price be?
 - i. Disincentive to attaching creditor
 - b. For tax purposes, should the corporation or the non-retiring shareholders have the right?

7. Should shareholders be required to sign non-compete agreements?
 - a. Disincentive to terminate relationship
8. Should shareholders be required to sign invention assignment/intellectual property/proprietary rights agreements in favor of the corporation?

Funding Methods/Split Dollar Agreements:

Some employers will bonus money to potential employee buyers. The employee will then pay tax on the bonus received and re-contribute the net amount to a fund to be used to fund a future purchase. The employee is then giving a commitment to the company. However, the employee is using fully taxable compensation to fund the purchase.

Other employers will credit the employee with a discounted purchase price for each year of service completed. To the extent, however, that the purchase price is less than the fair market value of the company, taxable income could result.

Some owners are content to sell their interest in exchange for payments over time. While this may have certain income tax advantages, such as the potential for installment sale treatment, the seller is always at risk as to payment. Even if the seller receives a security interest in the assets sold, many sellers have no desire to return to the business in the event of a default.

Using insurance has become one of the most common ways to fund a purchase. Such insurance may take the form of disability buy-out insurance whereby a disabled shareholder's stock can be purchased using insurance funds in the event of a "disability" as defined by the policy.

The most common type of insurance used to help fund a purchase is life insurance. Often the death benefit is contractually required to be used to pay for the purchase of a deceased shareholder's stock. When death is the only consideration, and depending on the age of the shareholders, a term policy may be used to keep insurance costs down. However, a policy which builds a loan or cash value (such as whole life or variable universal life) may be used to assure permanent insurability and to provide a tax-deferred investment growth which can be used to fund a lifetime buy-out.

When life insurance is going to become part of a business succession plan, the practitioner needs to be aware of the so-called “Split Dollar” rules. A Split Dollar plan allows co-owners and/or the company to co-own a policy with another co-owner or insured. For example, a company may be paying the premiums on a life insurance policy owned by an employee, subject to the right to have the company receive reimbursement for the premiums which it pays upon the death of the insured or the termination of the policy. The following is a very brief outline of the concept of a Split Dollar agreement. Attorneys wading into this area of law need to be familiar with a wide body of code sections, regulations, private letter rulings and case law involved in this complex area of business succession planning.

In general, there are four types of Split Dollar agreements.

Endorsement Method:

In this type of arrangement the policy is owned by the employer or the person or company agreeing to assist in the payment of premiums. The policy itself contains an endorsement which provides, for example, that the investment portion policy is owned by the company and the at risk element of the policy is owned by the employee. The employer is listed as the beneficiary up to the greater of the cash value or the premiums it has paid. The employee’s designated beneficiary receives the balance.

The advantage to the employer is that the employer controls the policy and is the owner of the policy. This also avoids transfer for value problems if the employee does not want to keep the policy and is not an officer or shareholder. This arrangement also avoids the appearance of a loan transaction and the resulting corporate loans to officers and shareholders issues under state law. This arrangement also makes it easier to combine payments as an employee benefit with other non-qualified retirement or benefit plans.

The disadvantage is that this can create administrative problems, especially with beneficiary changes. This can also cause the proceeds to be considered part of the gross estate of the insured controlling shareholder under Treas. Reg. Section 20.2042-1(c)(6).

Collateral Assignment Method:

In this type of arrangement, the policy is owned by the insured or someone who has and insurable interest in the insured. The policy is assigned to the employer or person agreeing to pay all or part of the premiums as security for the premiums actually paid. The employer becomes the beneficiary to the extent of the premiums paid and the balance is paid to the beneficiary designated by the policy owner.

The advantage to this type of arrangement is that it is a simple arrangement to establish and administer. The policy does not have to be transferred to the employee on termination of the plan; avoiding the transfer for value problems. If a spouse, trust or third party is the owner of the policy, there is no inclusion of the policy in the gross estate of the insured controlling shareholder.

However, the employer is not fully secured if the plan requires the employer to pay all premiums or premiums are leveled.

Co-Ownership or Split Ownership Method:

In this type of arrangement, the policy is owned by the insured or someone who has and insurable interest in the insured. Ownership rights are assigned for the portion of the cash value or death benefit equal to the premiums paid by the employer or person sharing in the payment of premiums. This would be an absolute assignment.

The advantage to this type of arrangement is that it is a simple arrangement to establish and administer. The policy does not have to be transferred to the employee on termination of the plan; avoiding the transfer for value problems. If a spouse, trust or third party is the owner of the policy, there is no inclusion of the policy in the gross estate of the insured controlling shareholder.

The disadvantage to this method results from the fact that an absolute assignment may limit flexibility.

Sole Ownership Method:

A person or company other than the insured owns the policy. The employer or person sharing in the payment of premiums has no interest in the policy on its face. There is a separate agreement or unsecured promise to repay the portion of the premiums advanced on the surrender or maturity of the policy.

The advantage to this method is that the insured has no incidents of ownership in the policy. The employer or person sharing in the premium payments maintains security for the repayment of those funds.

Attorneys using Split Dollar agreements need to be aware of the fact that the Internal Revenue Service recently changed the income tax reporting rules to require the use of yearly renewable term cost (all risks) charts in calculating the economic opportunity costs associated with many Split Dollar plans, as opposed to the old P.S. 58 cost rules.

Split Dollar Considerations for S corporations:

If a Split Dollar plan is used in an S corporation to provide insurance for a shareholder, that shareholder will be taxed twice. First, no deduction is allowed for the premiums paid by the corporation and, as a result, the shareholder is taxed on his or her share of the corporation's income that is used to pay premiums. Second, the insured shareholder will be taxed on the economic benefit generated on the net insurance amount provided by the plan.

Some attorneys have argued that a Split Dollar arrangement might create a second class of stock because of the special economic benefits that the insured shareholder receives. In PLRs 9331009, 9318007 and 9235020, the IRS determined that no second class of stock was created. If the shareholder is required to reimburse the corporation for any economic benefit he or she received as a result of the corporation's premium payments.