Legal Formation

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Abstract

What type of legal entity is right for a new business? What is the difference between estate planning and asset protection? What is a living trust? What is a family limited partnership? What is the difference between a limited liability company and a corporation? What is a "C" corporation? What is an "S" corporation? What is the difference between the two? Individuals and business professionals commonly ask these types of questions. Over the past ten years there has been an increase in the number of people who want to use these types of entities. This paper will explore what these entities are and how they are best used.

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Legal Formation

Possibly ninety percent of the individuals who are interested in estate planning do not have a will or a living trust. Most of these individuals are high-income earners with sizable asset holdings. Some of these individuals are elderly. It is shocking that so many individuals are without an estate plan. The reader may be one of them. "Estate planning deals with what happens to your assets after you die. Even if you are a person of modest means, you have an estate — and several strategies to choose from to make sure that your assets are distributed as you wish and in a timely way. The right strategies depend on your individual circumstances. That is, what is best for your neighbor might not make the most sense for you." (Federal Trade Commission, 2008, p. 1)

So what is the correct choice? The first answer is to set up a living trust. "Revocable living trusts are by far the most widely used type of trust. In fact, revocable living trusts have become the centerpiece for many estate plans. Thus, it is important that planners understand what revocable living trusts can and can not accomplish." (Kleinrock 17-6, 2008, p. 1)

A living trust is a document that an individual or a married couple can create that will spell out how to handle an estate after their death. "It is a written legal document that partially substitutes for a will. With a living trust, your assets (your home, bank accounts and stocks, for example) are put into the trust, administered for your benefit during your lifetime, and then transferred to your beneficiaries when you die." (The State Bar of California, 2007, p. 3)

> By far the most widely used type of trust is the revocable living trust. This is generally a trust for which the grantor is the trustee, and reserves the

> right to revoke or amend the trust at any time. The grantor is typically the primary beneficiary during his lifetime with possible discretionary distributions during the grantor's disability to individuals who are dependent on the grantor. At the grantor's death, the trust becomes irrevocable, and, after payment of taxes, expenses, and debts, the corpus is distributed to designated beneficiaries or allocated among new trusts created at death of the grantor under the trust agreement. (Kleinrock 720.5, 2008, p. 1)

A living trust can be set up for either a single person or a married couple. There are some additional tax advantages for married couples, though there are still great benefits for single individuals. For small estates without a living trust, the use of probate may not be necessary.

> In certain circumstances, a decedent's personal property may be transferred to the "successors" of the decedent without the need to open a probate with the probate court. The decedent's entire estate must qualify as a small estate and must meet all of the requirements of sections 13100-13115 of the California Probate Code. The decedent's successors may make their claims to the property and take title (assuming no conflicting claims) by presenting an affidavit which meets certain requirements to the holders of the property. Title to real property may not be transferred under this procedure. (Superior Court of California County of Los Angeles, 2008, p. 1)

However, in these situations a living trust still will be valuable to demonstrate the intent of the decedent and to ease the transfer of assets.

The current tax laws for estates are in a state of change. What will happen in three to four years is still not concrete. In general, the estate tax savings is not the prime driver for the decision to set up a living trust. The amount of an estate that is exempt from taxes is and will continue to be high enough to reduce the concern over paying taxes on most estates. The prime reason for creating a living trust is probate avoidance and assurance as to the integrity of the estate and how the family will be taken care of. “Perhaps the biggest advantage of a living trust is that it does not have to go through probate, as does a will.” (Office of the New York State Attorney General, 2008, p. 2) A simple will can solve some of these issues, but cannot take care of the issue of the cost and difficulty of probate.

Let's assume that a husband and wife die in a car accident. They do not have a living trust or a will. Let's also state that they have two minor children together. What happens next? Well to start off, someone in their family will have to start a probate hearing to decide who gets what and how and who will take care of their kids. When someone else is appointed to take care of the children, the parents’ wishes may not be carried out. There are horror stories about families fighting over money and who is the best qualified to manage the kids. In addition to all this confusion, an attorney and probably a certified public accountant will be selected to help sort things out as far as legality and accounting for all the assets and liabilities. This can get expensive. Even though there are some probate code sections on fees that can be charged, the lawyers and accountants tend to

rack up a sizable bill when working on a probate case. I have even heard reports of some cases where the fees wiped out the estate and even left unpaid fees.

With a properly prepared living trust document, most if not all of these problems can be avoided. There is a lot of liberty in how assets may be distributed and who will take care of the kids. Parameters such as at what age kids will receive money, achieving predetermined goals like college, and other timeline or economic goals can be set. A living trust can be modified as often as needed. For example laws have been clarified and updated to achieve this. "One of the principles of the proposed law is that a person should be free to make an estate planning change during dissolution of marriage, so long as the change does not affect the rights of the other spouse." (California Law, 2008, p. 4)

In addition to planning out the estate from a fiscal and typical approach, advance directives and living wills should be considered.

> Advance directives/living wills are an essential part of estate planning. Advance health care directives, which include living wills, health care powers of attorney, and do-not-resuscitate orders, are used to provide clear and convincing evidence of an individual's wishes regarding medical treatment when that person is no longer able to do so. This article explains the statutory and case law requirements for creating living wills and examines the legal issues and difficulties that can arise for the relatives of a terminally ill individual in the absence of a living will. (Pozzuolo, 2008, p. 1)

One of the most difficult decisions to make when setting up a living trust is selecting the trustee of the estate and the guardian of the children. "The trustee has a duty to keep

the beneficiaries of the trust reasonably informed of the trust and its administration." (Justia, 2008, p. 1) It's also important to work with an advisor who demonstrates "due diligence and best practices of documentation" (Hughes, 2008, p. 1) along with education and experience.

With minor children involved, the trustee and the guardian should not be the same person. If the two were the same, money might be spent on the children on things like exotic travel that was to enrich them but also in turn benefited the trustee/guardian. After a period of time a lot of money could end up going toward travel and other items and reduce the estate to a very minimal amount by the time the children reach high school or college. A person setting up a living trust can be as picky as desired in these matters, and should take all the time necessary to think this part out.

It is a very good idea to update a living trust on a periodic basis - at least every couple of years and more often if a material change has taken place in the mechanics of the living trust. It's important to keep in touch with the trust advisor for other changes that may take place in the state of residence. The following is an example from the State of California in regard to the types of changes that take place. "Specifically, the bill would recast and update the 1931 and 1962 Acts to support the now widespread use of the revocable living trust as an estate planning tool and will substitute." (Senate Judiciary Committee, 1998, pp. 1-2) Another example of changes in Trust Law is demonstrated as follows:

> This recommendation rejects the rule of Evangelho v. Presoto, 67 Cal. App. 4th 615, 79 Cal. Rptr. 2d 146 (1998). That case misinterprets existing law, giving beneficiaries of a revocable trust the right, after the

> death of the settlor, to require an accounting covering the period when the trust was revocable. Trust beneficiaries do not have rights under the Trust Law while the trust is revocable. Consequently, they cannot require a trust accounting covering the period when the trust was revocable. The recommended legislation would make a clear statement of this existing principle.
>
> This recommendation was prepared pursuant to Resolution Chapter 81 of the Statutes of 1999. (California Law Revision Commission, 1999, p. 2)

A lot of individuals are under the impression that a living trust provides some form of asset protection, such as protection from creditors, litigations, and or claims and assessments. A living trust does not provide asset protection. A living trust is an estate-planning tool and provides probate avoidance. A good tool for asset protection is a family limited partnership (FLP or FLIP) or a family limited liability company.

> Family limited partnerships and family corporations have long been used in the conduct of active businesses, primarily to provide a vehicle for family involvement in the enterprise and for succession planning. In the early 1990's, however, estate planners began using family limited partnerships and family limited liability corporations to hold and transfer passive assets such as stock portfolios, mutual funds, bond portfolios, cash, and similar passive assets that are easily liquidated. The alleged "business" purpose for forming family partnerships or corporations with

> passive assets was to engage a younger generation in investment decision making. (IRS, 2008, p. 1)

I prefer the family limited partnership to the family limited liability company because there is more court case history and the discharging order of creditors is very advantageous for family limited partnerships. One fault I found with firms that make this recommendation is that they make a family member the general partner along with being a limited partner. The other family members are the additional limited partners. The problem with this is that the general partner in a limited partnership is personally liable for acts and actions. I recommend creating a "C" corporation to be the general partner, possibly a one percent owner of the FLIP. One, some, or all of the family members can then be shareholders in the corporation. With this there is corporate protection for the general partner and shareholders. I recommend the use of a family limited partnership for long-term holdings and asset protection.

> A FLIP does provide asset protection. Before the transfer, 100% of the parents' assets were subject to their creditors, now only 1% is exposed. But what if the kids are sued? Well, against a limited partner, a creditor can only get a judgment called a "charging order." This places the creditor in the same shoes as the limited partner. So if the partnership earns $100,000 and the limited partner owns 99%, the creditor is going to be taxed on $99,000. But as general partners, the parents decide whether to distribute any cash to the limited partners. So the creditors could then end up getting taxed on $99,000 in income every year, even though the general

> partners aren't giving them a single penny. This is a great motivator for creditors to settle. (Schnepper, 2008, p. 3)

"Family Limited Partnerships also have some attraction as asset protection vehicles, primarily because the limited partnership interests may be subject to "charging order protection" in some states." (The Asset Protection Book, 2008, p.1)

> An FLP also protects assets from claims of future creditors and spouses of failed marriages. Creditors may not force cash distributions, vote, or own the interest of a limited partner without the consent of the general partners. And in the event of a divorce, where a limited partner ceases to be a family member, the partnership documents can require a transfer back to the family for fair market value, keeping the asset within the family structure. (LegalZoom, 2008, p. 2)

When setting up and utilizing a family limited partnership, it is important to work with a professional in this area. "Establishing a family limited partnership is a complex estate-planning strategy festooned with regulations. Subsequently, business owners are strongly encouraged to secure qualified legal and/or accounting help in setting up such plans." (Business Encyclopedia, 2008, p. 7)

> In addition to their popularity as income and estate planning tools, FLPs are often established to safeguard assets from the claims of creditors. Planners must exercise caution to ensure that the FLP conforms to all state organizational laws and must review the applicable state's charging order protection status. A properly structured asset-protection plan is effective only if it is designed in advance of any claim or pending claim. In

addition, the effectiveness of any asset-protection plan clearly depends on the adviser's skill in drafting and creating the structure, administering the arrangement, and, when necessary, defending the plan. (Brinker, 2005, p. 3)

Along with the proper setup, there are many issues to consider. The following are examples of these issues.

> Failure to Fund the FLP – Many people will go to great lengths to form their FLP and pay substantial fees to a planner to do so, but then never transfer any significant assets to it. Obviously, to the extent that assets are not contributed to the FLP those assets are not afforded either the tax benefits or asset protection benefits of the arrangement.
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> Failure to Maintain the FLP – Limited partnership[s] require the payment of annual fees, and the failure to pay these fees can mean that the entity will eventually be stricken by whatever governmental entity formed it in the first place. If the entity is stricken, it ceases to exist as far as the state and IRS [are] concerned.
>
> Failure to Follow Formalities – Although they do not have nearly the level of formalities as do corporations, limited partnerships are required to have Operating Agreements which must be followed, and the failure to have an Operating Agreement or to follow it can mean that the FLP could be disregarded by a court and treated as [if] it never existed.
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> Non-Business Assets or Activities – Notwithstanding the use of the term “Family” in FLP, these are still limited partnerships, which are

fundamentally business entities and are not meant for personal use. The family residence should not, for instance, be placed into a FLP, nor should normal family expenses (utilities, clothing, educational expenses, etc.) be paid from the FLP. The use of the FLP for personal purposes could result in the entity being disregarded for tax and asset protection purposes.

Parent as General Partner – From an asset protection viewpoint (and arguably an estate planning viewpoint as well) making the Parent the General Partner (GP) of the FLP is the single most common mistake in FLP structuring. The reason is that charging order protection relies on the GP to not make distributions to a limited partner's interest for the benefit of a creditor. However, if the Parent gets sued, the creditor could probably persuade the court to enter an order compelling the Parent to make a distribution to the Parent's LP interest, thus totally subverting the charging order protection.

Parent as both General Partner and only Limited Partner – If the Parent is both the General Partner and the only Limited Partner (LP), then a court may deem that since the Parent owns all the interests, there is no partnership and the Parent simply owns the FLP's assets outright (thus negating the charging order protection and any hoped-for tax benefits). As dumb as making the Parent both the GP and LP seems, there are actually promoters who sell cookie-cutter structures that make exactly this mistake.

Parent's Living Trust as the GP – A variation of the foregoing has the Parent form a revocable grantor trust (a/k/a "Living Trust") that acts as the

General Partner. The problem here is that a savvy creditor of the Parent will go to the court and ask for an order compelling the Parent to revoke his or her Living Trust, thus making the Parent the direct GP of the FLP with all the problems that entails. The same problem exists for structures that make the GP a corporation or LLC which is wholly-owned by the Parent's living trust, since revocation of the living trust will put the creditor in control of those entities, and thus in control of the FLP.

Individual as General Partner – If an individual dies, or is sued, the management of the FLP may be thrown into disarray and the potential exists for an heir or creditor to take control of the FLP's assets. Thus, it is a very bad practice to make an individual the GP of a FLP.

Formation in a Bad Jurisdiction – Some jurisdictions do not limit the creditor's remedy to a charging order, thus allowing a judgment creditor to attempt a wide variety of possible remedies to get at the FLP assets to satisfy its judgment. These jurisdictions should be avoided.

Holding Assets in a Bad Jurisdiction – Even if the FLP is formed in a jurisdiction that limits creditors' remedies to a charging order, that doesn't mean that if the FLP has assets in a state that doesn't limit the creditors' remedies that charging order protection will apply. Indeed, a smart creditor will attempt to "forum shop" its collection efforts by locating the FLP's assets in jurisdictions that do not limit the creditor's remedy to a charging order. The upshot of all this is that a FLP should restrict the

physical domicile of its assets to states that do affirmatively limit creditors' remedies to a charging order.

Failure to Limit Remedies – Amazingly, many FLP operating agreements are draft[ed in such] a way that they do not limit creditors' remedies to a charging order, thus creating opportunities for creditors to pursue alternative strategies to get at the FLP assets.

Avoid the Hammer-Nail Approach – There is an old saying that "when the only tool in your toolbox is a hammer, everything looks like a nail." Some planners have FLPs (or FLP/FAPT combo platters) as their only tool, and thus of course those planners solve every client problem with a FLP whether the FLP is the best solution for that problem or not. Contrary to what some promoters claim, not every estate planning or asset protection problem should be solved with Family Limited Partnerships. Other methods and structures will be better for some situations, and for particular problems within the family estate.

Failure to Diversify/One Big FLP – The second most common error in FLP structuring is to place all of the client's significant assets into a single FLP, thus creating a large, single target for creditors to relentlessly attack. As with most other asset protection methods, an FLP will be more effective if it is just one of several diverse methods used to protect assets.

Combined with Foreign Asset Protection Trust – Called the "Combo Platter", the idea is that the limited partnership interests will be owned by an offshore trust, and when a creditor comes along the partnership will

simply be liquidated and all the assets transferred offshore to the trust. Among the many problems with this structure is that it has been so heavily overmarketed that it is readily identified as a blatant asset protection structure. Probably a worse problem is that offshore trust component only "works" if the client is willing to flee the jurisdiction of U.S. courts. Promoters of this structure will not, of course, share these little tidbits of knowledge with their customers for fear of losing a sale. If you bought an asset protection plan prior to 2000, the Combo Platter is probably what you ended up with. It needs to be fixed immediately.

Fraudulent Transfer – Charging order protection only works for assets that are already in the FLP structure. If the initial transfer to the FLP was a fraudulent transfer, however, the court can simply void the transaction to the FLP as if it never existed. Promoters make a variety of representations about transfers of assets to FLP as being "for value" and thus ipso facto not a fraudulent transfer. However, whether a transfer is for value is not dispositive and a court can set aside a transfer whether or not it is for value if the transfer was made in defraud of creditors. The court can make such a determination based on, for example, statements in the promoter's marketing materials that one of the advantages of an FLP is to avoid creditors. Another reason to avoid promoters who heavily market FLPs as an asset protection tool.

Failure to Make Gifts of the LP Interests – Some people will go to great trouble to fund their FLPs, but never get around to actually gifting the LP

interests to the children. This results in wasted opportunities to take advantage of the annual unified exclusion, and ultimately in higher estate taxes paid by the parents' estate. It also unnecessarily exposes the LP interests to the parents' creditors during the interim.

Failure to Obtain Valuations – If the FLP will be used to avoid estate taxes by way of discounting the limited partnership interests that are gifted, it is critically important that the limited partnership interests be the subject of a valuation by a qualified appraiser. If no appraisal is conducted, the odds of the discounting standing up to IRS scrutiny are very low.

Excessive Discount – Some promoters to induce a sale will promise clients that the limited partnership interests can be significantly discounted, sometimes in excess of 50%. While there is no certain number that will pass IRS scrutiny, discounts in the 20% or less range are much more conservative and less likely to draw attention. The old adage "Pigs get fat, and hogs get slaughtered" applies to discounting LP interests.

Gifting Limited Partnership Interests Directly to Children – By gifting limited partnership interests directly to a child, the possibility arises of creditors or an ex-spouse of the child getting possession of (or at least a charging order against) the limited partnership interest. By the parents gifting the limited partnership interest to a spendthrift trust instead, claims against the limited partnership interest by the child's creditors and ex-spouses are avoided. (The Asset Protection Book, 2008, pp. 2-5)

Family limited partnerships provide benefits taxation. In the area of wealth transfer along with the associated taxes, family limited partnerships can be a valuable tool. “Limited partnerships can be an important component of a family’s comprehensive wealth transfer plan. A number of recent Tax Court cases confirm the continuing viability of the family limited partnership as an estate planning tool but highlight the need to observe the form and function of the entity to insure that it accomplishes its purpose, that is, as a mechanism for managing the family wealth and reducing estate and gift taxes.” (Hirschson, 2001, p. 1) “The best protection against an IRS onslaught is in the careful planning and implementation of the family limited partnership from its inception and throughout its life. The taxpayers who have been successful in sustaining a family limited partnership and the associated discounts have, as the Tax Court stated in Strangi, dotted their “i’s” and crossed their “t’s”. For those taxpayers, substantial tax benefits continue to be available.” (Hirschson, 2001, p. 5)

“A family limited partnership permits the donor/parent to significantly discount the value of gifts to the donee/children, thus making it possible to save fortunes in gift and estate taxes. A gift of similar value might not be discountable if made outright. Valuation experts generally discount the value of limited partnership interests to reflect the reduced value associated with their limited rights and controls.” (Lange, 2008, pp. 2-3)

> A limited partnership, assuming it is properly drafted and executed, is a pass-through entity and partnership income and deductions are attributed directly to the partners. Since a proportional share of the partnership's income will pass through and be taxed at the limited partners' rates, the family limited partnership can shift income from the parents' high rate to

> the lower income tax rates of the children. This is true even if there are no actual distributions to the children. As the partnership grows, presumably outside of your estate, there are usually income tax implications for the limited partners. The limited partners could end up in a situation where they have taxable income generated from the partnership K-1 and no money to pay the tax on their share of the partnership income. In that case, it is customary for the partnership to distribute enough money to pay the tax on the attributed income. (Lange, 2008, p. 5)

"During the past three decades, charitable lead trusts have had dramatic rises and falls in popularity. Why have lead trusts at times been very attractive and at other times been quite unattractive tax planning methods? The answer is that a lead trust is related to estate size, estate tax laws and the current applicable federal rate." (University of California, Riverside, 2007, p. 1)

Because Sen. Baucus is now Chair of the Senate Finance Committee, the Democratic position in favor of retaining the estate tax is likely to prevail. It now is quite possible that the 2009 estate tax exemption of $3.5 million and the 45% estate tax rate will be extended for several years into the future. Many estate plans are now based upon this assumption.

With the growth in estates well beyond the existing $2 million exemption and often over the $3.5 million exemption applicable in 2009, there now are many estates with tax problems. In addition, the AFRs have been at or below 6% for most of the past year. As a result, lead trusts have blossomed for the third time in

three decades. These factors have led to renewed popularity of creative lead trusts using several layers and family limited partnerships.

Again, to achieve the tax outcomes we have briefly discussed, much care has to be taken to make sure the purpose of the transactions and the use of the tax law is correct. The following quote demonstrates that depending on the facts and circumstances, two different cases can produce different results depending on how the transactions are handled. “The lesson of the Korby case is that a factual picture not credible in the planning stage can't be redeemed by magic tricks when litigation occurs. Schutt, on the other hand, presented a situation in which the decedent had a consistent and credible approach in his estate planning. The consistent adherence to a strongly held investment philosophy offered significant support for a nontax purpose of the entities holding investment assets.” (Reardon, 2006, p. 2)

> Recent court decisions reinforce the FLP as a form of business that should be treated as such. Simply changing the title of assets contributed to the FLP no longer warrants a reason to discount its partnership interests. The entity should be treated as a going concern with appropriate documentation to support its business purpose of managing the family's assets in an efficient, professional manner. Such an approach is sure to lessen the impact of IRS scrutiny and ultimately assist taxpayers in achieving their estate tax planning goals. (Lieberman, 2005, p. 4)

“Many estate planning techniques are an unabashed effort to achieve tax avoidance. However, transfers to an FLP should be supported by more than a

desire to obtain tax discounts for an ownership arrangement that has a manufactured inconvenience. It is frequently said that a partnership must have a business purpose to be valid." (Reardon, 2004, p. 1)

With any business structure, professional assistance is needed to keep current with legislations and changes that take place. "For by wise counsel you will wage your own war, And in a multitude of counselors there is safety." (Proverbs 24:6) We have explored the area of family limited partnerships and the benefits of asset protection along with tax benefits. I stress that the main advantage here is the asset protection. I recommend that any asset protection plans take into consideration the risks and the rewards.

> Family limited partnerships (FLPs) and family limited liability companies (FLLCs) have become an increasingly popular planning technique to reduce estate taxes by providing substantial valuation discounts. Typically an older family member will be interested in maintaining control over the assets in the FLP while shifting value out of the estate. Control is maintained by controlling the general partnership interest while transferring value in the firm of limited partnership interests distributed to other family members. During the last few years the Internal Revenue Service has grown increasingly hostile to FLPs and FLLCs and has won a number of victories in the Tax Court. Significantly the Tax Court appears to accept the Service's argument that discounts should be disallowed because IRC Sec. 2036(a) operates to include the transferred FLP interests in a decedent's estate. Although FLPs are widely used, any tax savings

> may prove to be illusory[.] Accordingly advisers need to understand both the risks and rewards of this technique. (Jurinski, 2004, p. 1)
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> Choosing an entity that compliments a business's needs is paramount to its success. In the 2006 business environment, entrepreneurs have access to a wide variety of information. Many websites purport to take the place of a lawyer and allow the owner to choose his/her business vehicle online. The website then asks for contact information, files the name of the business with the correct state agency, and drafts the necessary documents and agreements. Absent adequate research and information, owners are uninformed of the advantages and disadvantages of the choice of entities available. Tax implications, liability issues, and management structure are factors that should be considered before the start up of an enterprise. (Spear, 2006, pp. 4-5)

A very common question is: What is the difference between a limited liability company (LLC) and a corporation? The first limited liability company was formed in 1977 in the State of Wyoming. The State of Wyoming wanted an LLC to have the tax benefits of a partnership and the limited liability benefits of a corporation. The history of LLCs is one with much controversy and changes that took place in tax codes. An LLC can now be taxed as either a sole proprietorship, partnership, or as a corporation. “The LLC combines the best tax and legal features of a partnership and a corporation. The result is that LLCs have become the favored form for new business and investment undertakings.” (Spear, 2006, p. 8) “An LLC is an unincorporated business organization of one or more persons who have limited liability for the contractual obligations and

other liabilities of the business. The Limited Liability Company Law governs the formation and operation of an LLC. An LLC may organize for any lawful business purpose or purposes." (New York State Department of State Division of Corporations, 2008, p. 2)

The LLC is a hybrid form that combines corporation-style limited liability with partnership-style flexibility. The flexible management structure allows owners to shape the LLC to meet the needs of the business. The owners of an LLC are "members" rather than shareholders or partners. A member may be an individual, a corporation, a partnership, another limited liability company, or any other legal entity.

A corporation may be set up as either a "C" corporation or an "S" corporation. A "C" corporation is taxed within its own tax bracket. Money or economic benefits to the owners are also taxed accordingly. An "S" corporation does not pay Federal tax and the income or loss from the "S" corporation passes through to the owners. The main reason professionals recommend an LLC versus a corporation to clients is that there is less need for formal meetings and documentation to preserve the legal structure. In addition there are some situations where the economics involved or the tax issues may warrant the use of an LLC.

> In researching the various business structures, one inevitably comes across the S corporation. S corps and limited liability companies (LLCs) are similar in that they are both "pass-through" entities for tax purposes; the income of these companies [is] passed through to their owners and reported on the owners' personal income tax returns, thereby eliminating

the double taxation incurred by owners of a standard corporation, or C corporation. (With a C corporation, the net business income is subject to corporate income tax, and the monies remaining after the corporate income tax are taxed a second time when they are distributed as dividends to its owners who must then pay personal income tax.)

So what is the difference between an S corporation and an LLC? And which structure is right for you?

The answer depends on your own unique situation. If operational ease and flexibility are important to you, an LLC is a good choice. If you are looking to save on employment tax and your situation warrants it, an S corporation could work for you. (Limited Liability Company Center, 2006, p. 1)

I have found in most cases the use of an “S” corporation will be a better fit for the client’s needs.

S corps enjoy many significant tax advantages, including:

Single level of tax. Income earned by an S corp is generally only taxed once, at the shareholder level. Income earned by a C corp is ultimately taxed twice — once at the corporate level, and again as dividend income to shareholders upon distribution.

Exit strategy. An S corp's taxable income flows directly through to its shareholders, increasing their tax bases in the corporation's stock. This increased tax basis will ultimately reduce the gain on any future stock sale, generating more after-tax cash to the owner. A C corp owner is not

> entitled to an increase in the stock basis for his or her share of the corporation's earnings.
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> Similarly, an S corporation is also a desirable target in a tax-advantaged acquisition strategy known as a Section 338(h)(10) transaction. Such an acquisition gives an S corp purchaser significant tax benefits, usually without a corresponding tax increase on the selling shareholders. As a result, this structure can often justify a purchase premium for the selling S corp shareholders. A stand-alone C corp cannot be sold using this type of transaction.
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> Preferential capital gains tax rates. With an S corp, gain from the sale of a capital asset held for at least one year will retain its "tax character" upon flow through to its shareholders and could be taxed at preferential capital gains rates of 15 percent. Regular C corps are not eligible for preferential rates, meaning capital gains can be taxed up to the maximum corporate rate of 35 percent. (Smith, 2005, p. 1)

Even though an “S” corporation has more formalities, I believe that the benefits outweigh the amount of effort needed to preserve the corporation structure. Professionals should be working with the owners of any business structure to make sure they are operating their business in a proper manner. I do not believe that an LLC’s ease of formation allows a member or members the ease of a lackadaisical approach to business. This could be a trap. With formality comes structure and discipline. Businesses need the structure which a corporation provides. There may be situations wherein an LLC is a backup option to an “S”

Corporation. "At first glance, it appears that the LLC accomplishes little that cannot be done by forming a corporation and electing subchapter S status. However, there are enough differences between an LLC and an S corporation to make one, or the other, significantly more desirable to a specific organization. Obviously, for organizations not meeting S requirements, the LLC provides an option similar to the subchapter S corporation." (Wells, 1994, p. 2)

An "S" corporation for the most part should be used when there are fewer than one hundred shareholders and one class of stock (common stock) is going to be issued. In recent court cases the LLC structure has not been as strong in protecting the owners from liability. The case history for LLCs is still new. "Unlike corporations and partnerships, there is not well-established case law or mature statutes to draw upon for LLCs." (Banks, 1994, p. 2) "One remaining drawback is that state LLC statutes are not yet uniform." (Clarkson, Miller, Jentz, Cross, 2006, p. 756) "LLC's are the newest type of business entity. For that reason, the laws surrounding them are uncertain and rapidly changing." (DePaul, 2005, p.3) For corporations case history is established. I believe that an LLC is best used in situations where an entity is to be used for a business transaction or situation whose life is predetermined. Originally LLCs had a shelf life stipulated in the operating agreement. The best example for use of an LLC is in the case of land development. For example you and I decide to develop some land and build residential homes. In our operating agreement we would state that so many days after the last home was sold the LLC would be terminated. I recommend that "S" corporations owned by us would in turn own the LLC. This approach has been

legally available since 1997. Since that date, an “S” corporation may own eighty percent of an LLC. With this approach we will have the legal protection of both an LLC and a corporation along with additional tax benefits. In most business situations, the use of an “S” corporation is better than an LLC or a “C” corporation. The following are some limited reasons you might need a “C” corporation.

Let's say that you are thinking about going public with your business. Your dream is to have a successful company that is publicly traded in the stock market. With that you will need to have a “C” corporation. Besides the use of certain pension plans and other items, the use of a “C” corporation is mandatory if you plan on having a lot of shareholders along with different types of stock such as common, preferred, voting, nonvoting, etc. My recommendation if you are contemplating the idea of going public is to create your corporation in the State of Nevada, Wyoming, Delaware, or Montana. These States allow for a complex capital structure along with more rights and economies for the corporation along with the shareholders.

Since the majority of business owners are best advised to operate within the legal structure of an “S” corporation, let us now go through a step-by-step process on how to properly create this corporation. Then we will conclude with some general tips on legal entities and problems to watch out for.

The first thing we need to do when setting up a corporation is to come up with a name. This name cannot be active with another corporation. Some States also prohibit using certain words in the name of the corporation. For example in

California using the work “bank” is not allowed unless clearance is given by the State for it to be authorized as a lending institution. Suffixes such as Inc., Incorporated, Ent., Enterprises, Ltd., Limited are allowed in most States. In some states a suffix is no longer required. Depending on the marketing involved the name may be very important. Once we have decided on a name that is available with the Secretary of State, Articles of Incorporation will be drafted and submitted to the Secretary of State for approval.

The next item which is very important is ownership of the corporation. Is it going to be owned by one or more individuals or entities? I recommend that if two or more unmarried persons own a corporation, a Buy-Sell Agreement should be used.

> Business owners often ask CPAs about how useful buy-sell agreements can be for them. The answer is "very." A buy-sell contract helps solve many problems at an unsettled juncture. It lets business partners, or shareholders and a corporation, agree to the terms and conditions of a future sale. That can smooth the transfer of ownership interest under disruptive circumstances that may include a partner's death, retirement, termination of employment, loss of a professional license, disability or divorce (or the transfer of ownership to a spouse), bankruptcy, insolvency or receipt of a third-party offer to purchase the business. Having an agreement gives an owner a ready market for his or her business interest, resolves estate liquidity issues, provides a framework for establishing the purchase price of the interest and reduces disputes. By ensuring transition

> stability, a buy-sell contract also improves morale among the owner group. (Burrage, 2004, p. 1)

In community property States a Buy-Sell Agreement may not be necessary for married individuals owning a corporation together. A Buy-Sell Agreement should spell out along with other items, things such as: What if one of the owners dies? What if one of the owners gets divorced, or becomes disabled, or even goes bankrupt? What happens if an owner wants out, or decides to sell part of his or her ownership in the corporation? These types of issues and others need to be addressed in a Buy-Sell Agreement when all interested parties are still happy with each other and in good cheer. Over the past few years I have developed a very comprehensive Buy-Sell Agreement. I highly recommend its use.

> The buy-sell agreement enables businesses to be transferred by plan, not chance. It is a contractual agreement that spells out what will happen to the owners' business interests when certain events, known as triggering events, occur. Although buy-sell agreements come in many flavors, essentially, there are two types: entity purchase and cross purchase. All others are, in effect, variations of the two basic types of buy-sell agreements. Tax consequences can differ significantly depending upon how a buy-sell agreement is arranged, as well as the types of entity involved. (Kang, 2005, p. 1)

Life insurance can be obtained to help buy out members of the company. “Many business owners intend to sell their business to key employees

upon their death. Unfortunately, the employees often do not have the financial resources to buy the business or to acquire life insurance on the owner's life. As a result, the owner will often enter into a buy-sell agreement with the key employees and increase the employees' salaries to fund the cost of an insurance policy on the owner's life." (Scroggin, 2006, p. 1)

As we wait for the Articles of Incorporation to be approved and endorsed by the Secretary of State, we can start to build the corporation file.

Every corporation needs a set of Bylaws. Even if there is one owner, a good set of Bylaws is important. I am not an advocate of setting up a closed corporation – single owner and limited in growth for the sake of ease of legal maintenance. Thus, we need a good set of Bylaws to strengthen the credibility of the corporation. I have developed over time a great set of Bylaws.

An initial set of minutes needs to be written. These minutes can be very comprehensive and have a lot of action. Or they can be more standard and simple. The content of the Bylaws will dictate how the initial set of minutes will be written. I like using a comprehensive set of Bylaws with a set of initial minutes that have action and structure. This way a third party reviewing the incorporation process will discover that this process was taken seriously and done in a professional and prudent manner. This gives us legal strength. In most States it is required to have a meeting at least once a year. I recommend going beyond that and having a meeting documented with minutes every time something material is taking place. Items such as purchasing assets, entering into contracts,

extending benefits to employees, etc., should be discussed and documented in a meeting.

Each corporation should have an employment contract for the owners. This employment contract will spell out the relationship and remuneration to the owner who is also an employee of the corporation. Every owner needs to take a salary commensurate with the work he or she does. As an employee, an owner receives additional protection in certain types of legal complaints.

After the approved Articles of Incorporation are received, a Federal Employer Identification Number needs to be received from the Internal Revenue Service. This can now be achieved online with the IRS via online form SS-4. Also IRS form 2553 needs to be completed and faxed to receive the “S” election from the IRS for the corporation.

And finally the stock certificates need to be properly completed along with a stockholder register identifying the shareholders, the date of their stock issuance, and the number of shares they own.

After the corporation file is complete, all the documents that require signature need to be signed. This file needs to be kept in a safe place. The stock certificates need to be signed on the front and kept by the shareholders. The stock certificate is the ‘pink slip” for the corporation. By signing the back of the stock certificate, the owner is releasing ownership. Be careful not to do this by accident. Each stock certificate should have the proper verbiage placed on the back for transferability rules and to be in compliance with corporate law and Security and Exchange Commission rules. In addition, the stock certificate can be

restricted on the back for agreements such as a Buy-Sell Agreement or other types of limitations on transferability.

Please keep in mind that each individual's or business's facts and circumstances are different. Not one structure fits all. This is why the use of professionals when setting up a business structure is very important.

> The choice of business structure is an extremely important—and ongoing—decision. The ideal form may change as the business, our economic and tax environments, and the goals of the owners change. Unfortunately, no infallible system exists to guarantee the best choice will be made. There are too many combinations of factors, some concerning tax and some not, that will affect the decision. In light of the facts and owners' objectives, the best choice is one that provides a balance of advantages in a changing environment. (Fleischman, 2000, p. 8)

With the help of good professionals who are well versed in these matters, individuals can benefit from estate planning, asset protection, proper legal protection in business with corporations, tax benefits, and the ability to raise capital in the marketplace.

Once in a while I will come across a corporation that has not been set up or maintained properly. The goal here is to keep us as separate as possible from our business transactions. Simple items such as opening up a corporate bank account need to be done. Commingling personal and business funds and transactions needs to be avoided. Keeping good minutes and books and records is a must.

Being wise on which person you choose as an associate (co-owner) is very important. “Do not be unequally yoked together with unbelievers. For what fellowship has righteousness with lawlessness?” (2 Corinthians 6:14) I always explain to each new group of owners of a corporation that achieving success in every sense of the word is very difficult. This is why it is very important for individuals to keep their promises, including contracts and agreements. “We must not promise what we ought not, lest we be called on to perform what we cannot” - Abraham Lincoln (Acquirewisdom, 2008, p. 1) "The man who promises everything is sure to fulfill nothing, and everyone who promises too much is in danger of using evil means in order to carry out his promises, and is already on the road to perdition." - Carl Jung (Acquirewisdom, 2008, p. 2) “But let your 'Yes' be 'Yes,' and your 'No,' 'No.' For whatever is more than these is from the evil one." (Matthew 5:37)

It requires a lot of hard work and cooperation to be in business. Always proceed with caution.

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