

CHOICE OF ENTITY: Decision Points for Income Tax and Benefits Planning



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STETSON UNIVERSITY
Center for Excellence in Elder Law
ACCESS AND SERVICES FOR AUC

Prepared for
Stetson 2020 National Conference on
Special Needs Planning and Special
Needs Trusts
St. Petersburg, Florida
October, 2020

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The Contestants In Entity Selection



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- A sole proprietorship
- A Joint Venture (as an unincorporated association)
- A General Partnership
- A Limited Partnership
- A Limited Liability Partnership ("LLP")
- A Publicly Traded Partnership
- A Regular or "C" Corporation
- An "S" Corporation
- A Limited Liability Company ("LLC")
- A Trust

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Choice of Entity: Tax Considerations



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Minimizing and/or deferring income tax on the profits of the business;

If losses are generated, how can those losses best be used by the business or its owners?


How is appreciation of the business and/or its assets best protected from the income **and** estate taxes (i.e., succession planning); and,

How is termination of the business taxed?

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Choice of Entity: The Non-Tax Considerations

Which entity provides the **best management arrangement** (clients look for **flexibility** and **simplicity**);


Which form of business provides the most flexibility for **designing ownership interests** (and transferring those interests) (for example, preferred returns);

Does state law impose any **limitations** on the type of business which can be undertaken in a given legal form (i.e., LLC, partnership, etc.);

Does it provide a **liability shield**; and

For equity purposes, which entity provides the most flexibility and is preferable for capitalization and financing options. 4

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The Liability Shield Analysis

Only corporations (C or S), limited partnerships (only for limited partners), LLP and LLCs provide liability protection.

In Tennessee (and other no income tax states), the trade-off for such protection is liability for Tennessee franchise and excise taxes.

Remember, an active business owner is always **personally** liable for his/her own negligence. 5

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Organizing the Entity

The Contestant	How Formed
Sole Proprietorship	No legal filings, but need tax ID and business licenses
General Partnership	Can have oral agreements, but best is to have a written Partnership Agreement
Limited Partnership	Certificate of Limited Partnership on file with the appropriate Secretary of State and a Partnership Agreement
LLC	Articles of Organization properly filed with the Secretary of State and an Operating Agreement
Corporation (S or C)	A Charter or Articles of Incorporation properly filed with the Secretary of State and Bylaws
Trust	A trustee, a corpus and a trust agreement

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Organization

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Organizational Structure

Type of Entity	How Managed
Sole Proprietorship	Boss/Owner(s), then everyone else
General Partnership	The general partner(s)
Limited Partnership	General Partner(s); limited partners often have no governance rights
LLC	Member Managed or Board Managed (Board of Governors) elect officers; Chief Manager and Secretary. Can also have a Manager Managed structure.
Corporation (S or C)	Owners elect Board of Directors (or "close corporation" status) who then elect officers; President and Secretary
Trust	The Trustee or a Directed Trustee

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Comparing the Tax Differences

Ownership Restrictions	
Sole Proprietorship	None
Limited Partnership	None (but need 2 owners)
"C" Corporation	None
LLC	None (also single member)
"S" Corporation	No more than 100 shareholders Type Restrictions; no foreigners, etc. One class of stock rules

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STETSONLAW ***Taxing Distributions to Owners***

Of property owned by the entity (e.g., non-cash distributions) (do they create entity level gain?).

- LLC; None Recognized.
- Partnership; None Recognized.
- "S" Corp; Gain Recognized.
- "C" Corp; Gain Recognized.

Are the Owners taxed?

- LLC; Only if the value of the Distribution > basis of member in membership interest or § 751 Property.
- Partnership; Only if the value of the Distribution > basis of partner in partnership interest or § 751 Property.
- "S" Corp; If > AAA and E&P exists.
- "C" Corp; You betcha!

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STETSONLAW ***Other Important Tax Factors***

Termination of the Business Entity.

Are Special Allocations Available? Can a new owner get the optional basis adjustment? § 754, § 743, § 734

Loss Allocations and Basis Rules.

- Owners get Tax Basis for LLC liabilities. § 752
- "S" Corp. limited to direct shareholder transfers (capital & loans). § 1366

Bankruptcy and Cancellation of Debt.

Tax Years.

Self-employment Taxes; What income is subject to FICA or self-employment tax?

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STETSONLAW ***Relevant 2017 Tax Act Changes: 2018 Corporate-Related Rates***

1. Corporate Tax Rate --- 21%.
 - Down from 35%.
 - No More PSC penalty rate.
2. Capital Gain and Qualifying Dividends...0%, 15% or 20%.
 - For 2020 the change from 15% to 20% takes place at \$496,601 of taxable income.

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Relevant 2017 Tax Act Changes: 2018 Individual Tax Rates

- Between \$82,500 and \$157,500 --- 24%
 - **Down** 1% (look at income level breaks)
- Between \$157,500 and \$200,000 --- 32%
 - A surprising **increase** of 4%
- Between \$200,000 and \$416,000 --- 35%
 - For most of this group, an **increase** of 2%
- Between \$416,000 and \$500,000
 - **No change**
- Over \$500,000 --- 37%
 - A **decrease** of 2.6%

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Comparing Total Tax Burdens

Type of Entity and Income Distributed*	Total Tax Rate If Individual in Top Bracket	Total Tax Rate If Individual in Modest Tax Bracket
A corporation distributing 100% of its after-tax net income	47.3%	40.8%
A corporation distributing 50% of its after-tax net income	36.7%	33.4%
No corporate earnings distributed	26.0%	26.0%
S corporations, partnerships or sole proprietorships (all pass-thru entities)	34.6% to 45.8%	27.4% to 46.2%

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The Pass-Thru Business Rate Equalizer

1. Qualifying for the Qualified Business Income ("QBI") deduction constitutes a large part of small business tax planning.
2. The deduction is only available to the owners of pass-through businesses, including estates and trusts (and sole proprietors).
3. The deduction is 20% of the qualified income from a trade or business passed thru to an entity's owners.
4. There are limitations once an owners' taxable income exceeds \$163,300 for singles, \$326,600 for married filing jointly.
5. The income from certain businesses, Specified Service Trades or Businesses ("SSTBs"), does not qualify if an owner's taxable income exceeds the above thresholds.

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 **The Partnership Audit Rules: The Big Picture**

IRS now audits the partnership and collects tax as if it is a separate entity. No longer does the IRS worry about chasing individual partners.


IRS collects tax in year audit concluded at highest rate.


- Potentially shifting the burden of tax to **current partners**.

The new rules create three alternative processes.

- The Default Rules
- The Election Out
- The Push Out Election.

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 **The Partnership Audit Rules: Drafting the Partnership Agreement**

Require the **PR** to engage competent tax professionals to assist in the examination.

Only allow the election for alternative payment of imputed underpayments to be made with partnership approval.


Partners must approve extending the statute of limitation.


And, filing suit.

If the **PR** is himself a partner, what about conflicts of interest? Should those be waived? Identified?

What about including dollar limitations on the **PR's** settlement authority without partnership approval.

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 **The Partnership Audit Rules: Setting the PR's Obligations**


Because the regulations are silent, the partnership or LLC agreement should be clear about what notices the **PR** must provide the partnership and/or the other partners, and when.

Because of the importance of the **PR**, should that position be compensated when someone is actually serving during an IRS audit?

Should the partnership or LLC agreement indemnify or hold the **PR** harmless for actions taken? Must those actions be taken in good faith?

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 **STETSONLAW** ***Elect Out of the Partnership Audit Rules***

Partnerships may only elect out of the rules if the following are true:

- The number of tax schedules (Forms K-1) issued is 100 or less.
- The partnership does not have an "ineligible partner," which includes the following:
 - Partnerships, Trust, Certain foreign entities, Disregarded entities, Estates of individuals other than deceased partners, or Nominees.
- Individuals, C corporations, S corporations, and estates of deceased partners are ok.
- Practitioner should note that shareholders of S corporations which are partners can be an "ineligible partner." Treas. Reg. Section 301.6221(b)-1(b)(3)(iv), Example 2.

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 **STETSONLAW** ***More Drafting Raised By the Partnership Audit Rules***

Requiring an **affirmative** representation that the partner is an *eligible partner* for purposes of the elect out provisions.


That all partners agree that the partnership will elect out of the partnership audit rules.

The partner affirmatively agrees not to transfer his/her/its membership or partnership interest to an ineligible partner (alternatively, or in addition, provide rights of first refusal to the other partners).

Provisions which make it clear what actions need partner approval or notice if the partnership or the partner is audited; be as detailed as the partners need.

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 **STETSONLAW** ***More Drafting Raised By the Partnership Audit Rules***

Are the state audit rules different? Do they need to be addressed?

Limiting the **PR's** powers to make elections, settle audits, or extend statute of limitations without partner participation or, alternatively, having partners acknowledge the **PR's** broad powers.

Express requirements for the **PR**, but equally important, the partners to obtain and provide information that may reduce the partnership's imputed underpayment liability.

Possibly requiring those who were partners in the reviewed year(s) to file amended returns when appropriate.

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 **STETSONLAW** ***More Drafting Raised By the Partnership Audit Rules***

If the partnership needs to “push out,” make sure the PR has the ability to contact former partners.

Specify partners’ notice and participation rights in connection with federal or state audits.


Extend partner indemnification obligations for a period of time after the sale of a partnership interest.

Terms and conditions for amending partnership or LLC operating agreements to address possible changes or updates to the new rules.

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 **STETSONLAW** ***Choice of Entity Factors***

1. Individual Income Tax Rates.
2. Applicable Capital Gain and Qualified Dividend Rates.
3. The 3.8% Net Investment Income (“NII”) Tax.
4. The 3.8% Medicare Tax on Wages and Self-Employment Income (over the social security minimum).
5. Corporate Tax Rates, Including the Repeal of the Corporate AMT.
6. The Two Layers of Tax on Income from C Corporations Versus One Layer for Pass-Thru Entities.
7. Deferral of the Second Layer of Tax through C Corporations.
8. The Partnership Audit Rules.

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 **STETSONLAW** ***Choice of Entity Factors II***

9. The Ability of Owners to Utilize Business Losses on Personal Returns (though now limited to \$250K for singles and \$500K for married taxpayers).
10. The QBI Deduction.
11. The Limit on Individual Deductions for State and Local Taxes.
12. Passive Activity Losses.
13. A Realistic Exit Strategy: Asset Sale or Sale of Equity.

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STETSONLAW *The 2020 Election and Its Likely Effect on Choice of Entity*

Vice President Biden's Proposals:

- **Individual tax rates:** Restore the 39.6% rate beginning with taxable income above \$400,000.
- **Itemized deductions:** Mr. Biden has proposed capping the tax benefit of itemized deductions at the 28% rate.
- **Capital gains and dividends:** Under Vice President Biden's plan, those benefits disappear when the taxpayer's income reaches \$1 million.
- **Individual tax credits:** Mr. Biden would hike the CTC to \$8,000 (\$16,000 for two or more children).
- **Education:** Vice-President Biden proposes a special tax exclusion for student loan forgiveness.

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STETSONLAW *The 2020 Election and Its Likely Effect on Choice of Entity*

- **Corporate tax rates:** Vice President Biden has proposed raising the flat rate to 28% and reinstating the corporate AMT on profits of more than \$100 million.
- **Payroll taxes:** The Biden camp has floated the idea of a 12.4% Social Security payroll tax, split between employers and employees, on earned income above \$400,000.
- **Estate tax:** Under Mr. Trump's 2017 tax changes, the \$5 million estate tax exemption was doubled from \$5 million to \$10 million (\$11.58 million for 2020 after indexing). Mr. Biden proposes to allow the estate tax exclusion to revert \$5 million (possibly even changing it earlier than 2026). More importantly, he reintroduces the idea of eliminating the step-up in basis for inherited assets.

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STETSONLAW *The 2020 Election and Its Likely Effect on Choice of Entity*


President Trump's Proposals:

- **Individual tax rates:** President Trump intends to maintain the top tax rate at 37%. In addition, he would implement a 10% rate cut for middle-income taxpayers, effectively lowering the 22% rate to 15%.
- **Itemized deductions:** No change.
- **Capital gains and dividends:** Without offering any specifics, Mr. Trump has indicated he would reduce tax rates for capital gains, index gains for inflation and create a capital gains tax holiday for a limited time.

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 **STETSONLAW** *The 2020 Election and Its Likely Effect on Choice of Entity*

- **Education:** Under current law, you generally can't realize tax benefits for contributions to state-authorized organizations sponsoring scholarships (other than a possible charitable deduction). The President would provide a tax credit for individual and corporate donations to such organizations.
- **Corporate tax rates:** The President wants to preserve the status quo.
- **Estate taxes:** Mr. Trump has stated that he will push to extend the more generous estate tax exemption past December 31, 2025 and strenuously opposes any change to the rules relating to a step-up in basis.

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 **STETSONLAW** *The Role Choice of Entity Plays in Business Planning*


When working with a client interested in setting up a business or entity to hold investment or rental property or another asset (e.g., a family vacation property or a Montana ranch), the Choice of Entity discussion primarily focuses on the following:

- Management structures,
- Income and estate tax minimization;
- Exit planning strategies,
- The needs of or structures to attract investors, and
- Liability concerns.

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 **STETSONLAW** *The Role Choice of Entity Plays in Public Benefits*

How often are you, whether an attorney or a trustee, concerned about Choice of Entity?

Seldom, I suspect, when first analyzing an individual's eligibility for benefits.


Maybe occasionally when looking at the most efficient structure for managing assets and the associated tax obligations inside a special needs trust ("SNT") or other trust.

More likely, it occurs when considering how to hold property inside a trust which is not an SNT and to reduce the exposure of the trust and/or trustee to liability.

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 **STETSONLAW** *Structures to Consider for Real Estate*

For Personal Residences:

As a **noncountable** asset, it can be owned, individually or jointly, by a person eligible for SSI and/or Medicaid.


Even ownership of a personal residence is impacted by federal, state and local law.

- The exclusion of gain on the sale of a personal residence under IRC § 121, and
- Homestead property tax exclusions.
- Age related property tax reductions or caps.

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 **STETSONLAW** *Structures to Consider for Real Estate*

Do you need to be concerned about your client or perhaps a relative taking advantage of her/him mortgaging or taking some other action regarding the residence not in the client's best interest (which presumes the client does not have a court appointed guardian/conservator)?

Consider a grantor trust, maybe even a first-party SNT, with a family member or professional serving as the trustee.

Does a single-member LLC accomplish the same goals if managed by another (but can't the manager be removed)?


If jointly owned, consider the following:

- A joint tenancy agreement;
- Multi-member LLC (liability protection);
- A combination of the above.

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 **STETSONLAW** *Considerations for Rental or Investment Property*

Should not be held directly or indirectly by an individual applying for or receiving SSI and/or Medicaid due to the income and resource limits.

- A first-party SNT is likely the most viable exception.
- The trustee may wish to use an LLC to minimize liability concerns.
- If there are completely separate properties, a trustee should consider separate LLC's for each.


When such property is part of a gift or inheritance,

- A third-party SNT is always the best choice.

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 **STETSONLAW** *A Business for the Individual with a Disability*


The factors which should go into the decision.

- Liability protection.
- SSA Income limits.
- SSA Resource limits.
- Management.
- State law requirements for the business.

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 **STETSONLAW** *The SSA Resource Limit*


The applicable limit is \$2,000.00.
How can you keep the value of a business interest below \$2,000.00?.

- Have a third party own 100% of the business, either a trust (an SNT) or a relative.
- But what if the individual wants to "be an owner" or state law requires it?

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 **STETSONLAW** *The SSA Resource Limit*

The value of an asset is "the going price for which it can reasonably be expected to sell on the open market in the particular geographic area..." SI 01110.400.

- Restrictions can be placed on the ability to sell an asset. See, e.g., POMS SI 01140.220 (stocks) and RS 02101.510 (Corporations).
- Discounts, especially in the organizational documents should therefore be expressly included.
- Generally, SSA may not disregard corporate structures even if formed for the purpose of securing coverage. RS 02101.510.
- So, preferred stock, preferred interests in an LLC or a partnership provide some planning opportunities.
- If liquidation value not restricted to \$2,000 or less, someone may have to keep track of the entity's overall value.

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STETSONLAW *The SSA Income Limit*

The monthly earned income limit is 2 X Federal Benefit Rate (\$783/mo. in 2020) + \$85.0. SI 00810.350.

The monthly unearned income limit for interest, dividends, etc. is the FBR + \$20.00. Id.

C corporations are the easiest form of business entity in which to control the earned income paid; the wages paid are set and other distributions are not required or are easily restricted based on corporation's structure.

- If same class of stock, dividends must be pro rata based on number of shares owned. So, it can prove difficult to control the stock value or income received if a single class of stock is chosen.
- Flow thru entities are, by their tax structure, more difficult to use when trying to control the amount of income from or the value of an interest in such a business.

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STETSONLAW *A Unique Benefit Scenario: Business Ownership*

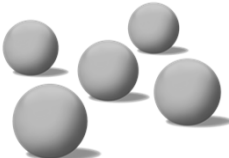
Last year's conference included an excellent presentation on how to help an individual with a disability work without losing SSI, SSDI or health benefits. Linda Landry, *What Is The Effect of Work on SSI and SSDI Recipient Eligibility?* 2019 Stetson National Conference on Special Needs Planning and Special Needs Trusts.

But what about the individual who wants more actual control over benefits eligibility and/or does not want to use/rely on any of the above work incentive programs?

- Is there a business structure which, if owned by the individual with a disability, allows for control of the income and resource values associated with the business so that, under POMS SI 00810.05 and SI 01110.100, benefits are not jeopardized?
- What about a business owned by or in conjunction with a relative and/or the individual's SNT? In other words, can a business structure allowing ownership by the individual and/or a relative or the individual's SNT thread the needle of control over the amount of earned income and noncountable resources to ensure continued eligibility for benefits?

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THE END.
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