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Business Entities: A Reconsideration for Small Businesses

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Traditionally, the ability to pass tax losses through to the business' owners, avoiding double taxation on earnings, was the main reason owners organized their businesses as pass-through entities rather than in the classic corporate form, the C corporation. Moreover, avoiding the accumulated earnings tax, personal holding company status and reasonable compensation issues added to the attractiveness of pass-through entities. The Tax Reform Act of 1986, that made the top corporate tax rate higher than the maximum rate for individuals for the first time ever, was the crucial factor that impelled many small business owners to give up C corporation status in favor of a pass-through entity. Now, with the passage of the Omnibus Budget Reconciliation Act of 1993, many small business owners are reexamining the legal organization of their companies. A brief review of business entities will outline the options available to the small business owner and suggest factors to be considered before making a change.

The Sole Proprietorship and the Partnership

A sole proprietorship is the simplest form of business organization. The business entity has no existence apart from the owner. Its legal liabilities are the personal liabilities of the owner to the extent of all the owner's assets. When sole proprietors figure their individual taxable income for the year, they must add in any profit, or subtract any loss, they may have from their businesses.

When more than one person owns the business, they may run...
it as a partnership. A partnership is the relationship between two or more people who join together to carry on a business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business. As in the sole proprietorship, the partners are personally responsible, to the full extent of all their assets, for the legal liabilities of the partnership. A partnership is not a taxable entity; however, it must figure its profit or loss and file a return. All losses and profits, even if they are not distributed, must be reflected on the partners' individual tax returns. Partnerships have many advantages over other operating forms including the ability to structure varying economic interests by using multiple classes of equity interests and flexibility in allocating profits and losses. Unlike shareholders of a corporation, partners may disproportionately allocate certain items of income, loss, deduction, and credits. Thus, the partnership form has particular merit when the different interests of the partners call for distributions varying in amount, timing or type from a strictly proportional allocation. Furthermore, there are no limitations on the number of partners or on who can own a partnership interest.

The disadvantage of personal liability associated with a partnership can be assuaged somewhat by insurance. Nevertheless, because of the tremendous liability potential entailed in operating a business enterprise as a general partnership, this form of organization is rarely used outside of certain small businesses and professional organizations which, until recently, were required to be operated in the partnership form.

The Limited Partnership

Personal liability can be circumvented to some extent by using the limited partnership form. The great advantage of a limited partnership is that it permits its limited partners to enjoy both limited liability and the benefits of a flow-through tax status. Limited partnerships have been the organizational form of choice for tax advantaged investments in real estate, oil and gas, and other types of ventures which are either intended to generate substantial business income for an initial period, or do not require the accumulation of earned income in order to expand the operations of the enterprise.

A limited partnership functions in the same way as a general partnership but, in addition to the general partners who run the business, there are limited partners who have no part in daily business operations. The liability of a limited partner will not exceed the amounts already invested in the business and amounts the partner is obligated to contribute. Limited partners, however, pay a price for limited liability in that they have no right to participate in the management of their business. If they violate this restriction, they can be held personally liable. The best a partnership can do in approaching full limited liability is to have the general partner be a corporation. Having the general partner be a corporation will limit the legal liability of an S corporation's shareholders to their interests in the assets of the S corporation's assets; however, if the S corporation shareholders own their stock in the same proportion as their partnership interests, the corporation may be deemed a "dummy" or a "shell." Then, the limited liability will be lost. If the general partner is a C corporation, the partnership runs the risk of losing its partnership status and being taxed as a regular corporation if the corporation is deemed a "dummy." The corporation will be viewed as a "dummy" by the IRS if the limited partners own more than 20 per cent of the corporation or the corporate net worth is not at least 10 or 15 per cent of the total contributions to the partnership.

The C Corporation and the S Corporation

These difficulties can be avoided by organizing the small business as a corporation. The legal liability of the shareholders of the corporation is limited to their investment in corporation stock. It is this limited liability characteristic which has made corporations the business form of choice for the vast majority of business enterprises in the United States.

Corporate profits are taxed to the corporation. When the profits are distributed as dividends, the dividends are taxed to the shareholders. In effect, corporate income is taxed twice, once to the corporation and again to the shareholders. This double taxation is the primary drawback to the traditional C corporation form. This has been particularly true during the years from 1966 through 1992 when the corporate tax rate, 34 per cent, has been higher than the maximum individual marginal rate, 31 per cent.

To keep the advantage of corporate limited liability while avoiding double taxation, many business owners chose to be generally exempt from federal income taxes. Shareholders then include on their separate returns, their share of the corporation's income, deductions, losses, and credits which the corporation was entitled to take, thus making this choice in an S corporation. To be eligible for S corporation status, several requirements must be met. The most significant of these is that there can be no more than 35 shareholders; there can be only one class of stock (no preferred stock, for example); only individuals, estates, and certain trusts (not partnerships and corporations) can be shareholders; and, shareholders must be citizens or residents of the United States.

It is relatively easy for a qualifying corporation to elect S corporation status. The corporation merely files a particular form (Form 2553) any time during the previous tax year or during the first two and a half months of the tax year to which the election is to apply. It is also very easy to
terminate S corporation status: a mere statement to the Internal Revenue Service (IRS) is enough to revoke the S corporation status of a business, even if that business has not yet been so recognized. This does not imply that one can begin or end business operations without regard to the S corporation form. In most cases, if a business has been recognized as an S corporation, it generally must pass through five years before it can again become an S corporation. If a C corporation converts to S corporation status, the business is subject to a five-year period after which it will receive pass-through treatment, whereas large capital gains income or passive investment income may have corporate level taxes imposed.

Use of the S corporation may be of particular benefit during the first years of the corporation’s existence when it may be operating at a loss. Individual shareholders may benefit from a reduction in their taxable income when that loss is passed through to them. On the other hand, it should be recognized that the fledgling operation organized as an S corporation instead of as a partnership in order to achieve limited personal liability, may be getting a merely illusory advantage. It is unlikely that creditors will advance funds to a business with no track record without obtaining the personal guarantees of the shareholders.

Another reason for converting to organize an S corporation arises when a business anticipates realizing large capital gains. If the business becomes very successful and the owners decide to sell, an S corporation would incur only a single tax on the profits from the sale instead of the double taxation that would occur for a C corporation. Furthermore, an owner’s cost basis in S corporation stock rises as the owner pays taxes on undistributed income, lowering the owner’s taxable gain when the stock is sold.

Since the late 1980’s there has been an astounding growth in S corporations. More than forty-two per cent of all corporate tax returns are filed by S corporations, representing eleven per cent of corporate gross receipts. Nevertheless, a C corporation has some distinct advantages. For example, it can accumulate its earnings for use in subsequent expansion or for other bona fide business reasons. Whereas, all profits, whether or not they are distributed, are passed through to the S corporation shareholders as taxable income. This advantage is tempered by the ability of incurring an accumulating earnings tax. The accumulated earnings tax applies to corporations that attempt to avoid shareholders in avoiding income tax by retaining earnings and profits in the corporation rather than distributing them. If a corporation allows earnings to accumulate beyond the reasonable needs of the business, it may be subject to an accumulated earnings tax. Generally, an accumulation of earnings and profits is in excess of the reasonable needs of the business if it is more than a prudent business person would consider appropriate for present business purposes and for reasonably anticipated future business needs. IRS guidelines suggest that an accumulation of more than $250,000 is prudently considered needed in the reasonable needs of a business. A reasonable amount is $150,000 or less, however, in the case of a business whose principal function is performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. If earnings are accumulated beyond these amounts without regular distributions being made to shareholders, the corporation will have to demonstrate its viability for additional business reason for not doing so. If the corporation is unable to do so, the corporation will be liable for the accumulated earnings tax.

In J.H. Rutter Rex Mfg. Co., Inc. v. Comm., for example, the corporation, which manufactured work pants and work shirts and other casual clothing, asserted that it was needed to retain large amounts of accumulated earnings in order to cover the expenses associated with swiftly changing styles. It pointed to the costs of adapting its manufacturing facilities and retraining workers to respond to the needs of its customers. Thus, it attempted to justify its retention of earnings and profits of $1,188,723 in 1977 and $1,582,018 in 1978. The United States Court of Appeals for the Fifth Circuit noted that the relevant inquiry in assessing business plans to retain and retrain is "whether the company’s plans appear to have been a real response to the tax year in question rather than simply an afterthought to justify the challenged accumulations." The court then held that there were no specific plans by Rutter for training and improvements and, therefore, the only amounts not subject to the accumulated earnings tax were those actually spent for machinery purchases, $200,665 in 1977 and $875,937 in 1978. Rutter indicated the need for careful documentation. If business owners want to retain earnings in the traditional corporation for future expansion or retooling or retraining, then business meeting minutes should reflect such plans. Such documentation makes it likely that the IRS will "look allowances for retained earnings." In assessing the double tax disadvantage of the C corporation, it should be noted that since many small business owners can take all the profits out of the business as salary as long as the salary does not exceed the value of services provided. In that case, there will be no profits on which to pay corporate income tax, and the owners of a new business take relatively little in salary during the early years and then, suddenly, when the business becomes more successful, increase their compensation dramatically, the IRS could elect to treat only part as salary and declare the rest to be dividends subject to double taxation. The United States Supreme Court has held that extraordinary, unusual and extravagant expense paid by a corporation to its officers in the guise of a legitimate business expense.
no substantial relation to the measure of their services and being utterly disproportionate to their true value, are not income
services, and cannot be regarded as 'ordinary and necessary expenses' within the meaning of [the
predecessor of I.R.C. § 162]. 14
This problem, too, can be mitigated by good record keeping.
Corporate minutes that reflect a business plan not to compensate fully for services rendered during a growth period,
but to increase officers' salaries or to provide bonuses in later years in order to make up for undercompensation, can
be important evidence that compensation is reasonable and not disguised dividends.15
Taking all the profits of the business out as salary also
will not work if the company grows beyond the services
provided by the owner. In addition, it will not be helpful in
eliminating double taxation if the business grows and the
owner wants to sell it. Double taxes will be owed on the
profit. Realistically, this will not be a problem for very
small businesses where the owner is the business and has
nothing to sell beyond his or her own services.
There are other savings that can also be realized through
a C corporation. For example, the corporation can deduct
as a business expense the premiums for up to $50,000 of group
life insurance and the premiums for long-term disability
insurance.16

The Limited Liability Company
Limited liability companies are the newest business
entities and, therefore, probably the least familiar to
the small business person. They may become, however, arguably the
most advantageous form of business organization given their
income tax benefits, their limited liability for all participants, and their flexibility.17
The first state statute authorizing the limited liability
company was enacted in 1977 in Wyoming.18 It was adopted in
order to attract South American investors for a mining
operation.19 Limited liability companies are similar to
subchapter S corporations without the latter's disadvantages
of disallowing foreign investors, subsidiaries and multiple
classes of stock and without a limit on the number of
investors. A limited liability company also resembles a
limited partnership without the latter's disadvantages of
self-liquidation and dissolving on the death of the general partner and without a complicated agreement.20
Other states did not quickly follow Wyoming's lead in
authorizing the limited liability company because of the
uncertainty created by the Treasury Department's inconsistent
treatment of the partnership classification of limited
liability companies. However, in 1986, the IRS issued
Revenue Ruling 86-58 classifying a Wyoming limited liability
company as a partnership for federal tax purposes.21 The IRS
took the following factors into consideration in making its
determination. There are six basic characteristics of a
corporation: associates, an objective to carry on business
for profit, continuity of its life, perpetual existence, interest in corporate debts limited to corporate property, and liability for corporate
debts limited to corporate property.22 If an organization
lacks two of the latter four characteristics, it will be
classified as a partnership.23 In the instant case, Wyoming
law provided that upon the death or withdrawal of any member,
the business would dissolve unless all the remaining members
consent to continue it.24 Therefore, the company lacked the
corporate characteristic of continuity of life.25 Secondly,
under the Wyoming statute, company members cannot assign all
the attributes of their interests in the company unless all
the other members approve the assignment.26 Therefore, the
company lacked the corporate characteristic of free
transferability of interests.27 Without these two
characteristics, the company was classified as a partnership
for federal tax purposes.28
The reason for the popularity of this new form of
business organization is that it helps shield the
organization's members from liability extending beyond their
investment in the business while allowing them to qualify for
partnership tax treatment if it is structured, as described
above, without all the attributes of a corporation.29
Generally, the debts and liabilities of a limited liability
company are not the assets of the company and no member of the
company is personally obligated for those debts and liabilities.30 Another important
characteristic of a limited liability company is the
flexibility it gives its members in contractually deciding how
business will be conducted.31 For example, members can decide
in their agreement about classes of equity, duties and
liabilities of members and managers, allocation of profits,
losses and assets, dissolution and mergers.
Despite its advantages, the owners of this form of
business organization may make small business owners reluctant
to consider it even in states where it is already available. A lack of statutory law and judicial interpretation and non
yet developed and, therefore, variations of transferability and continuity of life provisions may not assure pass-through
tax status. Another disadvantage is that if a limited
liability company intends to do business outside the state in
which it has been organized, it may not be assured of
recognition in foreign jurisdictions.
For these reasons, at least thirty-two states have enacted
statutes recognizing limited liability companies.32 It is
likely that additional states will be adopting the Limited
Liability Company Act in the near future.33

Reconsidering the Business Entity
All these considerations make it extremely important for
small business owners to seriously assess the present and
projected size and success of their enterprises before making
any changes in the legal form of their businesses. After the Tax Reform Act of 1986 was enacted, the desirability of electing S corporation status, both for existing C corporations as well as for new businesses, substantially increased. This was primarily true because, for the first time since Subchapter S was enacted into law in 1958, the maximum rate of tax for individuals (31% per cent) was less than the maximum corporate rate (34 per cent).

Today, however, small business owners are looking at a maximum marginal rate for individuals of 39.6 per cent and a maximum corporate rate of 35 per cent.12 This rate disparity is causing many of the approximately 1.6 million small business owners in the United States who operate their enterprises as S corporations to consider going to back to the pre-1986 approach of switching their profitable businesses from S to C corporate status in order to take advantage of the lower corporate rates. One business owner who operates his 150-employee business as an S corporation estimates that he will pay an additional $15,000 in income taxes on profits of approximately $1 million. The increase in individual tax rates may also make limited liability companies look somewhat less attractive than they did some few short months ago. Nevertheless, while small business owners are understandably upset about the new tax law, they should recall that the new marginal rate for S corporations (and limited liability companies) is no higher than it was before 1986.

Precipitous actions should be avoided and some tax practitioners are reporting that although they are having loud and vehement cries of unfairness from their small business clients, they have not experienced a rush of conversions. Before making a final decision on a possible shift, an accountant or tax attorney should be consulted to work up the actual tax savings available for each type of status, taking into consideration present business profits, losses, credits, and deductions, as well as the business' future possibilities. In addition to these personal reasons suggesting caution, possible additional changes in the law also indicate the wisdom of a wait-and-see attitude. Health care reform may affect different business entities differently. Furthermore, the S Corporation Reform Act of 199312 has been introduced in the United States Senate. This bill, if enacted, would make S corporations more attractive in a variety of ways.14 Another factor to consider is the increasing availability and familiarity with the limited liability company. All these changes will probably make 1994 a year for small businesses to seriously reevaluate their operating status.

ENDNOTES

2. Id. at 186.
3. I.R.C. §§ 1 & 11 (1986) (setting maximum rates on individuals at 31% and on corporations at 34%).
7. Id.
8. Id.
9. Id.
11. Id.
12. Id.
15. Id. at 96-97.
18. Goldwasser, supra note 13, at 730.
19. Id.
24. Id. at 109.
25. Id. at 108.
28. Id.
30. Id.
32. I.R.C. §§ 531-37 (1991); see also Tax Guide for Small Business, supra note 10, at 105. The accumulated earnings tax is equal to the sum of 20% percent of the accumulated taxable income not in excess of $100,000 plus 30% percent of the accumulated taxable income in excess of $100,000. 26 I.R.C. § 531 (1991).
33. I.R.C. § 532(a).
37. Id.
38. Id. Bona fide business uses would include specific and possible business plans for the accumulated funds or an amount that would be required to buy back the corporation's stock from a deceased shareholder's estate. Id.
39. Id.
40. 853 F.2d 1276 (5th Cir. 1988).
41. Id. at 1277-78.
42. Id. at 1294.
43. Id. at 1279.
44. Id. at 1292 (quoting Exempt Carriers, Inc. v. United States, 644 F.2d 1027, 1028 (5th Cir. 1981).
45. Id. at 1294.
47. I.R.C. § 162(a) (1988) authorizes a deduction for all ordinary and necessary expenses in carrying on a business including a reasonable allowance for salaries for personal services actually rendered.
51. Id. If the corporation pays the premiums, the benefits will be taxable, whereas if the individual pays the premiums, the benefits are not taxable. Id.
55. Id.
56. Id.
required in any other state and can cost a business up to $2000. This requirement has caused legal wrangling with much lobbying being done by newspaper publishers who stand to gain substantially if the law is enacted as amended. See John Riley, It's a Matter of Fine Print - Requirement of Local Ad Stalls Business Bill in Albany, Newday, May 29, 1992, at 45 (city ed.).


73. The Act would, inter alia, (1) improve shareholder limitations by increasing the allowable number to fifty; permitting tax exempt organizations, financial institutions, nonresident aliens and more types of trusts to own S corporation stock; (2) permit more than one class of stock; (3) allow S corporation shareholders to have the same fringe benefits position as C corporations shareholders. 139 Cong. Rec. S16433-02, S16441 (daily ed. Nov. 19, 1993) (Statement of Sen. Fraly).

61. Rev. Bal. 86-76, 1988-2 C.B. 360. The unanimous consent rule can be very burdensome on a business. The IRS has proposed a change in Treas. Reg. §301-7901-2(b) (1) so that only a majority of the remaining partners would have to vote to continue the business. See John Cederberg, Continuity of Life, 1 Limited Liability Company Rep. 95-101, 95-102 (1993).

62. Id.

63. Id.

64. Id.

65. Id.


67. Id. at 40.


70. It is unclear, however, whether New York will be one of those even though bills authorizing limited liability companies are making their way through committees in both the Senate (S. 27, 21st G.A., 1st Sess. (N.Y. 1993)) and the House (A. 8676, 21st G.A., 1st Sess. (N.Y. 1993)) and the Governor's position is that if the bill is revenue neutral, it will be enacted. The problem arises because the New York bills have been amended to require that notice of the formation of a limited liability company must be published in two newspapers for six consecutive weeks. A. 8624, 21st G.A., 1st Sess. (N.Y. 1993). Such legal advertising is not