CHOICE OF ENTITY
AFTER
THE 2017 TAX ACT

William C. Staley,
Attorney
LAW OFFICE OF WILLIAM C. STALEY
www.staleylaw.com
818 936-3490

Tax Section
of the
PASADENA BAR ASSOCIATION

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1. THE BOTTOM LINE

The primary choice of entity issues for U.S. taxpayers doing business in the U.S. are (a) protection from liability and (b) avoiding a double tax on profits from the sale of the business. The owners and investors must decide initially whether they plan to use Section 1202 when they eventually sell the business.[1] Other tax issues are of secondary importance.

2. TYPES OF ENTITIES

In California, the alternative for-profit business entities are:

⇒ a sole proprietorship

⇒ a general partnership

⇒ a limited partnership

⇒ a registered limited liability partnership (an "LLP," only for accountants, architects, lawyers, land surveyors and civil, electrical and mechanical engineers)

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[1] See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) below.

⇒ a limited liability company (including a single-member LLC or a series LLC organized under the laws of another state) (may be manager-managed or member-managed)

⇒ a regular corporation (taxed as a C corporation, an S corporation or a QSub), or

⇒ a professional corporation (taxed as a C corporation or an S corporation, rarely as a QSub).

Other states have series LLCs, business trusts, limited liability limited partnerships and professional LLCs.

See *Exhibit A* (Alternate Legal Forms of Doing Business in California).

This outline does not discuss *social purpose* corporations (formerly "flexible purpose" corporations) or *benefit* corporations, which can be formed under California law, or limited profit limited liability company ("L3Cs"), which cannot be formed under California law.[2]

3. IS A BUSINESS ENTITY NEEDED?

3.1 If the owner plans to pursue the Section 1202 gain exclusion, it is necessary to use a C corporation.[3]

3.2 A corporation or LLC is also useful when liability can be imposed on a business owner *without wrongful action by that business owner*.

3.2(a) Employees, like anyone else, are liable for *their own* wrongful acts.

◊ **Employers are also liable** for wrongful acts that employees commit in the course of their employ-

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[2] For more info about these entities, see the outline *Benefit Corporations, Flexible Purpose Corporations and L3Cs* on www.staleylaw.com.

[3] See Section 7 (Eliminate All Federal Tax – or at Least the Double Tax -- with the Section 1202 Exclusion of Gain from the Sale of Qualified Small Business Stock) below.

ment, even if the employee is violating company policy or specific instructions when the wrongful act occurs. The Latin name for this rule is "respondeat superior."

3.2(b) All general partners are liable for all other **general partners' promises and contracts** involving the partnership business and for the wrongful acts of all **partners and employees** of the partnership in the course of the partnership business.

◊ **Limited partners** in a properly organized and operated limited partnership risk only what they invest in the partnership business.

◊ General partners are also liable for any "**strict liability**" imposed on the partnership, to the extent that the liability is not satisfied by the partnership's assets or insurance coverage.

3.2(c) **Strict liability** applies even if no wrong has been done. It is a method of shifting risks. Examples:

◊ **Product liability**, which applies to everyone in the chain of distribution of a product that injures someone, and

◊ **Environmental liabilities**, which can apply to all owners (and some lessees) of a parcel of property over time, even if the spilling or dumping occurred before they bought it or was caused by a tenant.

3.3 Changes in federal and California tax laws in the 1980s greatly reduced the **tax benefits of incorporating**.

3.3(a) Although federal tax rates have changed over the years, for most businesses saving taxes is *not* an important reason to incorporate. However, for business owners plan-

ning on using Section 1202 when they exit the business, Section 1202 issues *will* be important.

3.3(b) However, in choosing a business entity it is important to minimize the risk of a **double tax** on gain from the sale of the business.

3.4 Generally, the **primary reason to incorporate or to use an LLC** now is the desire for *limited liability*: the desire to protect the investors' personal assets and/or the assets of other businesses from creditors of the business.

3.5 Other factors to consider include the availability and sufficiency of **liability insurance** and the fact that the **personal guarantees** of the shareholder/members generally will be required by lending institutions and, possibly, others.

3.6 Other **non-tax reasons to incorporate or to use an LLC** in certain situations include the availability of (a) continuity of the entity in the event of the death of the business owner, (b) centralized management, and (c) different forms of investment participation for investors with different financial needs (examples: common stock, preferred stock, priority returns, debt with equity kickers and debt not guaranteed by the owners).[4]

Also, forming a business entity can

⇒ Minimize the **probate** court's role in operating the business and

⇒ Facilitate **lifetime transfers** of business interests in connection with a succession plan.

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[4] See the bulletin A "FLIP" OR "CARRIED INTEREST" DEAL on www.staleylaw.com.

4. INITIAL LIABILITY ANALYSIS

4.1 The first question is: "What are the liabilities that could result from the operation of this business?"

⇒ An **insurance agent** who is familiar with the business can help the client identify possible sources of liability.

4.2 If the possible liabilities are not significant, the business may be conducted as a sole proprietorship or general partnership. ("Keep it simple.")

4.3 If the possible liabilities are significant, can adequate insurance be obtained at reasonably affordable premiums?

⇒ If so, insurance should be obtained and the business may be conducted as a sole proprietorship or general partnership. ("Keep it simple.")

4.4 If not, whose actions may generate the liabilities?

4.4(a) If all of the activities which may generate liabilities will be conducted by the sole principal, *there is no protection to be gained from incorporating* and the business should be conducted as a sole proprietorship ("Keep it simple."), whether or not adequate insurance is available.

> *This is important:*
>
> An owner cannot limit his liability for *his own* negligence or his other wrongful acts.
>
> Again: An owner cannot limit his liability for *his own* negligence or his other wrongful acts.
>
> But he *can* limit his liability for strict liabilities, including the wrongful acts of his partners and employees.
>
> He can also consider the ease with which his creditors can take his assets after there is a judgment against him.

4.4(b) If liability may be imposed on the sole proprietor *without* wrongful action on his or her part, the business should be conducted in a corporation or LLC – unless the proprietor is able to insure against substantially all of the risks that concern the proprietor.

5. TAX BENEFITS OF INCORPORATING

5.1 The sale of shares of issued to a shareholder by a C corporation after September 27, 2010 and held for five years can qualify for the 100% gain exclusion under Section 1202, if several other requirements are satisfied. If the shares were issued to the taxpayer after August 10, 1993 and the holding period is more than 6 months, the gain might be deferred and the basis carried forward to new "qualified small business stock" under Section 1045.[5]

5.2 Corporations have their own income and their own expenses. The excess of **income** over **deductible expenses** is **taxable income**. A corporation that is a **C corporation** pays its own taxes on this taxable income. The taxable income of a C corporation does *not* flow through to its shareholders and they do *not* pay tax on the C corporation's taxable income.

5.2(a) An S corporation also has taxable income. But -- Each shareholder pays tax on that shareholder's portion of the corporation's taxable income.

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[5] See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) below. For shares issued after August 1993 and before September, 2010, a partial exclusion applied. The excluded gain was a preference for tax purposes . The gain that was not excluded was subject to a 28% tax rate. Taken together, the effect was that Section 1202 generally saved less taxes than an S corporation election.

5.3 Because a **low 21% federal income tax rate** applies to the taxable income of a C corporation, the owners might pay *less tax* in the *short term* by incorporating their profitable business.[6]

5.3(a) However, depending upon their future plans for the business, any short-term tax rate advantages of incorporating as a C corporation might be overcome by the **double tax** that will be incurred when the business assets are sold or distributed to the shareholders.

5.3(b) A C corporation does not have the many **restrictions** that apply to S corporations (for example, the one-class-of-stock rule and eligible shareholder rules).

◊ So a C corporation can issue convertible preferred stock to a venture capital company.

◊ And the C corporation can issue different classes of preferred in various rounds of financing.

5.3(c) C corps can deduct state and local taxes from their income, and are no longer subject to a federal alterative minimum tax. But shareholders of S corporations and partners who are not C corporations cannot deduct more than $10,000 in state or local taxes and continue to be subject to a federal AMT.

5.4 A shareholder can defer the gain on the **sale of shares to an ESOP** of a C corporation, but not an S corporation.

5.4(a) The corporation can convert to a C corporation immediately before the shares are purchased.

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[6] After 2017 tax reform, lower federal income tax rates no longer apply to the first $75,000 of taxable income of a C corporation. The new 21% tax rate applies to the first dollar of C corporation taxable income.

5.4(b) Compare this flexible rule to the Section 1202 requirement that the shares must be issued by a C corporation and the corporation must be a C corporation for substantially all the period during which the seller shareholder held the shares.

5.5 Electing S corporation or C corporation status is generally not a taxable event.

5.5(a) However, once an election to C corporation status or back has been made, the same shareholders cannot make a new S corporation election -- or turn off an S corporation election – for five years.

5.5(b) So an S corporation can issue preferred stock or different classes of shares, or its shareholders can use the deferral for gain in the sale of shares to an ESOP – the shareholders just have to turn off the S corporation status.

5.5(c) In contrast, if shares are issued by an S corporation, turning off the S corporation election does not enable the shareholders to use Section 1202.

5.6 Certain tax-free **fringe benefits** are available to the owners of the business only if they are employees of a C corporation.[7] But this is not really a big reason to use a C corporation.

6. DISADVANTAGES OF USING A CORPORATION

6.1 The primary disadvantage of using a corporation is the dreaded "**double tax**." Cash or property that a C corporation distributes to its shareholders will be taxed twice.

6.1(a) A C corporation pays tax on its own taxable income.

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[7] See Section 9.3(h).

6.1(b) No corporate deduction or credit is allowed for distributions to shareholders.

6.1(c) Shareholders generally pay tax on corporate distributions to them from a C corporation. In addition to the 20% maximum federal tax rate on qualifying dividends, the 3.8% tax on net investment income also applies to high-income taxpayers – even shareholders who are active in the business of the C corporation.

6.1(d) There is no special California income tax rate for long-term capital gain.

6.1(e) For corporations and shareholders in the highest tax brackets, the effective tax rate on distributed income exceeds 54% under current law, taking into account California and federal taxes.[8] For shareholders in the highest tax brackets, this is a higher effective tax rate than would apply to a shareholder who *was active* in a business conducted in a pass-through entity. But a 56% effective rate could apply for a shareholder who was *not active* in the business of a California S corporation – and for which the Section 199A deduction did not apply.[9] If the shareholder is active in the business or the Section 199A deduction applies, the effective rate on pass-through income will be lower than that effective rate for income of a C corporation that is distributed to the shareholders.[10] If the entity is a partnership or sole proprietorship, the effective tax

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[8] See *Exhibit B* (Highest Federal and California Tax Rates - Shareholder IS Active in the Business - NO Section 199A Deduction).

[9] See *Exhibit E* (Highest Federal and California Tax Rates - Shareholder Is NOT Active in the Business - NO Section 199A Deduction).

[1010] See *Exhibit H* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

rates will be essentially the same as for a C corporation that distributes its income.

◊ Note: Before 2018, with appropriate tax planning, double taxation for a closely-held C corporation rarely occurred until it sold its business assets and/or liquidated.

◊ For 2018 and later years:

- A business that invests every dime into growth or debt repayment *and then sells* in a transaction that is tax free under Section 1202 or a tax-free stock swap will avoid the second level of tax.

- For a business that *for a few years* invests every dime into growth or debt repayment and *then becomes a cash cow*, starting as a C corporation and then making an S corporation election might provide the best of both worlds.

  ⇒ Note that Sections 1202 and 1045 will cease to be available to a shareholder when the corporation has been a C corporation for less than "substantially all" of the shareholder's holding period for the shares.

  ⇒ Note also that the value of the assets of the corporation – including its goodwill value – will be subject to the built-in gain rules (a double tax regime) during the "recognition period" – 5 years after the S corporation election for federal

tax purposes and 10 years for California tax purposes.[11]

◊ The double tax problem is particularly acute *if the corporation has* ***appreciated property such as real estate or goodwill***. Is sold these assets would be subject to tax at a low federal capital gain rate if sold by a sole proprietorship or a pass-though entity. The effective tax rate on the sale of the same asset by a C corporation that then distributes the after-tax sale proceeds to the shareholders would be approximately **16 or 20 percentage points** higher![12] For businesses with **appreciating assets** (including goodwill), t*his is the primary reason to use a pass-through entity and not a C corporation*.

6.1(f) Federal **tax reform** did *not* eliminate the double tax.[13]

6.1(g) Can a shareholder have the C corporation pay tax at the 21% federal rate and loan the profits to the shareholder? Maybe for a year or two. Then the federal **accumulated earning** and **personal holding company** penalty taxes will force the corporation to pay dividends to the shareholder. At that point the corporation won't have the cash (because it loaned the cash to the shareholders in a prior year) to distribute, so the corporation will distribute the shareholder's note to the shareholder to avoid a corporate penalty tax. The shareholder will owe tax on the divi-

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[11] See Section 9.3(f) below regarding the built-in gain tax.

[12] See *Exhibit H* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

[13] See *Exhibit B* (Highest Federal and California Tax Rates Shareholder IS Active in the Business - NO Section 199A Deduction).

dend, but will not receive cash to pay it. The piper will be paid with "phantom income."

6.1(h) Compensation will be taxed once, but will is subject to audit (in a C corporation) for *unreasonably high* compensation.

◊ In an unreasonably high comp audit, the corporation will lose its deduction for "excess" compensation.

◊ The shareholder will have paid tax on the compensation at ordinary income rates

- So the excess comp will be taxed at a higher combined effective rate than if it had been distributed as a dividend --

- Unless a protective amended Form 1040 is filed early in the audit process.

6.1(i) Does a C corporation that can pay out its excess cash as "reasonable" compensation to its shareholders permit the **best of all worlds?** A low tax rate on retained income and a single level of tax at ordinary income tax rates on "distributed" income? Probably only if the business assets (including goodwill) are not increasing in value.[14]

6.1(j) Deferring an S corporation election will often increase the built-in gain (including the goodwill) when the election is finally made.

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[14] See Section 6.1(e) above.

◊ The built-in gain will be subject to a double tax if the assets are sold within 5 years (federal) or 10 years (California).[15]

◊ Using an S corporation means risking a double tax if the eligibility rules for an S corporation are violated.[16]

◊ So it will often be better to start with an LLC (*if* Section 1202 is not pursued).

6.1(k) Some shareholders might convert their S corporations to C corporations and some members might **convert LLCs to C corporations**, in each case chasing the famous new 21% C corporation tax rates.

◊ When they become disenchanted with the double tax, they will face a five-year wait to convert to S corporation status[17] -- and then the Section 1374 built-in gains tax will apply based on the values at the date of the new S corporation election.[18]

◊ The cost of converting to an LLC from a C corporation is the recognition of all of the "inside" and all of the "outside" gain – usually far too high a price to make that conversion.[19]

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15 I.R.C. § 1374.

16 I.R.C. § 1361.

17 I.R.C. § 1362(g).

18 I.R.C. § 1374(d)(1).

19 Treas. Reg. § Regs. § 301.7701-3(g)(1).

6.2 Modest additional legal and accounting **expenses** are generally incurred when a sole proprietorship converts to a partnership, LLC or corporation.

⇒ Organizing an LLC with more than one member or a partnership with a written agreement is somewhat more expensive that organizing a corporation or a single-member LLC, for which the documents are more standardized.

6.3 Modest additional **employment taxes** are generally incurred when a sole proprietor becomes an employee of a business entity.

6.4 Corporate **formalities** must be observed to achieve limited liability.[20]

7. ELIMINATE ALL FEDERAL TAX – OR AT LEAST THE DOUBLE TAX -- WITH THE SECTION 1202 EXCLUSION OF GAIN FROM THE SALE OF QUALIFIED SMALL BUSINESS STOCK

7.1 Gain on the sale or exchange of qualified small business stock is excluded from both regular tax and the alternative minimum tax.

7.1(a) As a consequence, in a stock sale there could be no gain to the seller. NO. GAIN. TO. THE. SELLER! The seller keeps all of the sale proceeds, tax free, with no strings – all cash, with no ESOP, no need to reinvest.[21]

7.1(b) Up to $10 million in gain can per taxpayer be excluded by a "taxpayer" for a single corporation.[22]

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[20] See Section 15 "Achieving Limited Liability" below.

[21] See *Exhibit I* (What's the Best Structure for Exiting A Business (under Current Law?).

[22] If the taxpayer contributes to the issuing corporation more than $1 million in cash (or assets with a tax basis of more then $1 million), or a combination of the two totaling more than $1 million, then the $10 million limit on gain is increased to ten times the basis of the contributed

(footnote continued on next page)

7.1(c) In a sale of assets, a distribution of appreciated property or a liquidation, there would be one level of tax – on the "inside" gain – at the 21% federal rate.

7.1(d) The excluded gain is not an AMT preference – and is not subject to the net investment income tax.

7.1(e) The 2007 tax act did not change Section 1202.

7.1(f) For shares issued after 1993 and before 2011, the results are less wonderful – a partial gain exclusion and an AMT preference that substantially reduces the tax benefit.

7.2 To qualify for the Section 1202 exclusion:[23]

7.2(a) The stock must be held for five years.

7.2(b) The issuing corporation must be a C corporation, but not a DISC, a regulated investment company, a REIT, a REMIC or a co-op.

7.2(c) The shares must be issued by the corporation to the taxpayer.

◊ Shares purchased from another shareholder will not qualify for the exclusion.

(footnote continued from previous page)

assets. Let's call this "$10M or 10x" rule the "**$10/10x limit**." Note that the $10/10x limit appears to apply per "taxpayer" realizing the gain – not per issuee.

[23] This is not meant as a complete list of the requirements to qualify for the exclusion. See the detailed outline *Stock Transactions - Tax Issues (including the Gain Exclusion under Section 1202, Documenting a Section 1202 Exclusion or a Section 1045 Rollover, the Section 1045 Gain Exclusion and Rollover, and Section 1244 capital losses recharacterized as ordinary losses)* and the decision tree *Can an Interest in This Business Get the Section 1202 Gain Exclusion?* on www.staleylaw.com.

7.2(d) The taxpayer cannot exchange the stock of another corporation for the stock of the qualified small business. The taxpayer can transfer cash, other property or services for the stock.

7.2(e) The assets of the issuing corporation must not exceed $50 million after the stock is issued to the taxpayer.

7.2(f) The issuing corporation must not redeem its shares from *the taxpayer* for *two years* before or after the qualified small business stock is issued.

◊ Redemptions of stock *from others* within *one year* before or after the stock issuance will break the exclusion.

7.2(g) During substantially all of the taxpayer's holding period for the shares, (1) the corporation must be a C corporation and (2) at least 80% of the assets of the issuing corporation must be used for the active conduct of a "qualified business."[24]

◊ For software companies with income from royalties, special rules apply.

◊ Note that this test requires data for -- *Every* -- *Year* -- of the holding period. And the data needed will

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[24] The following are not "qualified businesses" for this purpose: "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees, any banking, insurance, financing, leasing, investing, or similar business, any farming business (including the business of raising or harvesting trees), any business involving the production or extraction of products of a character with respect to which a [depletion] deduction is allowable …, and any business of operating a hotel, motel, restaurant, or similar business." I.R.C. § 1202(e)(3).

not necessarily be found in the Form 1120. For some data, the best evidence will be *declarations* signed by the president and CFO for the year.[25]

7.3 The donee or heir of qualified small business stock acquired by gift or inheritance can use the exclusion – and each will probably be a separate "taxpayer" with a separate $10/10x limit.

7.3(a) Note that the gift or bequest will have gift and estate tax consequences, so it will be best to transfer the shares when their values are low – probably not just before a sale.

◊ In some cases the information needed to prove that Section 1202 applies will be lost with the decedent.

◊ This indicate the importance of documenting whether the Section 1202 exclusion is available each year, and not waiting until the gain is realized.[26]

7.4 *Sale by* a Pass-Through Entity - A shareholder of an S corporation or a "partner" in an entity classified as a partnership for income tax purposes can use the exclusion if he held his interest in the pass-through entity when that entity acquired the small business stock and if he held his interest in the entity until it disposed of the small business stock.

7.5 *Distribution by* a Pass-Through Entity

7.5(a) The distributee of qualified small business stock from a **partnership** can use the exclusion if the distributee held his interest in the partnership when the partnership acquired the small business stock and if the distributee held

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[25] See footnote 23 above.

[26] See Section 7.2(g) above.

his interest in partnership until it the partnership distributed the small business stock to the distributee. This assumes that the distribution of the stock by the partnership was not a gain recognition event.

◊ Each distributee partner will probably be a separate "taxpayer" with a separate $10/10x limit.

7.5(b) Note that if an **S corporation** distributed the qualified small business stock, the S corporation would recognize the gain on the distribution[27] and the exclusion would apply then.

7.6 The Section 1202 exclusion applies to gain due to *appreciation after the assets are transferred to the corporation*, not to any gain due to appreciation *before* the assets were transferred to the corporation.

7.7 Note the **many ways to blow the exclusion**. For those using a C corporation because they are counting on using the exclusion, it would be a good idea to **conduct an annual review** to see if the shareholders are still on track for the exclusion.

7.8 **Section 1045** allows the gain on qualified small business stock held for at least 6 months be excluded from gross income and the stock basis rolled into new "qualified small business stock."[28] So Section 1045 permits a gain deferral.[29]

7.8(a) Section 1045 deferral will be of particular interest to holders of qualified small business stock that was issued before September 27, 2010, so a gain exclusion of less than

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[27] I.R.C. §§ 311(b), 1371(a).

[28] The Section 1045 rollover is particularly helpful for small business stock issued before 2011. The 2017 tax act did not change the Section 1045 gain deferral.

[29] If the gain is deferred until death of a shareholder, the Section 1014 basis adjustment will eliminate the deferred gain.

100% and an AMT preference apply to gain on the sale that is not deferred.

7.9 There are no provisions corresponding to Section 1045 or 1202 in **California tax law**. So gain excluded from gross income or deferred for federal tax purposes will be taxed for California tax purposes.

7.10 **Recordkeeping** is a big, big deal for those planning to use Section 1202 or 1045 – and for their advisors.[30]

8. How Do the New Federal Section 199A Deduction and the New Federal Tax Rate for C Corporations Affect the Choice of Entity?

In any discussion of an appropriate entity for a business, there are three elephants in the room:

- The Section 1202 exclusion, an modified in 2010,
- The new Section 199A deduction, and
- The new 21% federal income tax rate for C corporations.

8.1 New Section 199A

8.1(a) For 2018 to 2025 a taxpayer who is not a corporation gets a deduction equal to 20% of the taxable income from flow-through businesses and sole proprietorships

◊ The taxpayer does not need to itemize deductions to use the deduction.

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[30] See the detailed outline *Stock Transactions - Tax Issues (including the Gain Exclusion under Section 1202, Documenting a Section 1202 Exclusion or a Section 1045 Rollover, the Section 1045 Gain Exclusion and Rollover, and Section 1244 capital losses recharacterized as ordinary losses)* on www.staleylaw.com.

◊ The deduction does not apply to capital gain or dividend income.

◊ The deduction cannot create a loss.

8.1(b) The 20% deduction is determined by computing the deduction for each business and aggregating the results.

◊ But if the aggregate base amount is negative for a year, the loss is treated as a loss from a noncorporate business for the next year.

8.1(c) If the taxpayer's taxable income is less than $157,500 ($315,000 for a joint return), then the entire 20% deduction is available, without regard to the type of business.

◊ If the taxpayer's taxable income is more than $157,500 ($315,000 for a joint return), then the deduction phases out over the next $50,000 of taxable income ($100,000 for joint returns).

8.1(d) If the taxpayer *is* in a "specified service trade or business," then that's all he can get. So his maximum Section 199A deduction is $31,500 (or $63,000 for a joint return).[31]

8.1(e) If the taxpayer *is not* in a "specified service trade or business," then the 20% deduction can cover bigger dollar amounts.

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[31] A specified service trade or business is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. I.R.C. § 199A(d)(2).

◊ The enhanced limit is based on the wages of the business for the year and the unadjusted basis of depreciable assets that are used in the business and for which the "useful life" has not expired.

◊ For a business with a large payroll and/or that makes major investments in equipment or buildings, the full 20% will be available.

◊ For a business with a lower payroll and smaller equipment or building purchases, less than the whole 20% might be available if the taxpayer has taxable income over the $157,500/$315,000 threshold.

8.1(f) The Section 199A deduction does not apply to compensation or guaranteed payments paid by the business to the taxpayer.

◊ While the **wages paid by an S corporation** to its shareholder *will not* qualify for the Section 199A deduction, the wages paid to a shareholder *will* increase the wage base for the wage limits, possibly increasing the amount of the deduction.

- Because **guaranteed payments** are not wages, those payments do not have this benefit. The will not get the deduction, but will not increase the wage base for the deduction –a double whammy.

- Some recipients of guaranteed payments might be willing to have the **first profits** allocated to them instead of guaranteed payments. This will increase their risk, but allow the deduction to apply.

◊ The concept of unreasonably low compensation might be applied to S corporations to disallow some of the Section 199A deduction.[32]

◊ So a loan-out corporation might not make sense for someone who could otherwise use Section 199A as a sole proprietorship.[33]

8.1(g) The Section 199A 20% deduction does not reduce the stock basis. The full pre-deduction S corporation income increases the stock basis, as in 2017.

8.1(h) The Section 199A deduction is not an AMT preference.

8.1(i) The deduction applies to an S corporation's income from publicly traded partnerships (which is useful to avoid excess passive receipts penalties).

8.1(j) New Section 199A is a horribly complex statute. It was the subject of intense political negotiations Sadly, it bears the scars from all the political compromises.

8.2 For many business owners with high incomes, the 20% Section 199A deduction for S corps and unincorporated businesses will not be available because limitations will apply.

8.2(a) For them an S corporation, LLC or sole proprietorship will save a few percentage points over a C corporation in year-to-year income.[34]

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32 See Section 9.3(d).

33 But can a loan-out corporation ever use the Section 199A deduction if the shareholder's taxable income exceeds the limits and the principal asset of the business is the reputation or skill of the shareholder? See footnote 31 above.

8.2(b) The exception is the *inactive* shareholder of an S corporation at *high federal and California tax rates* who *cannot* use the Section 199A deduction. That shareholder will pay somewhat more tax with S corporation than with the double tax on a C corporation's distributed profits.[35] The effective tax rate for a partnership or sole proprietorship is a bit less than the C corporation effective rate for this taxpayer.

8.3 Because one of the limitations on the Section 199A deduction is the taxable income of the taxpayer, business owners might have an additional incentive to use contributions to qualified plans that provide benefits to the owners.

8.3(a) To the extent that the amounts contributed to the plans are deducible, the taxable income of the owner is reduced.

8.4 If the business will be sold for a multiple of its annual cash flow, the low federal long-term capital gains rate on the sale of goodwill is the giant benefit of pass-through (or sole proprietor) status.[36]

8.4(a) And the 100% gain exclusion of Section 1202 is the giant benefit of C corporation status.

8.4(b) So from a planning standpoint, we arrive at the fork in the road when the entity is organized.

(footnote continued from previous page)

[34] See *Exhibit H* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

[35] See *Exhibit F* (Federal Liquidating Distribution and Highest California Tax Rates - Shareholder Is NOT Active in the Business - WITH Section 199A Deduction.)

[36] See *Exhibits D* (Highest Federal and California Tax Rates - Shareholder IS Active in the Business - Long-Term Capital Gain)and *G* (Federal Liquidating Distribution and Highest California Tax Rates - Shareholder Is NOT Active in the Business - Long-Term Capital Gain).

8.5 What's NOT in the 2017 Tax Act?

8.5(a) Before the House bill was published, there was a concern that there would be a reduced tax rate for C corporations, and that there might be a corresponding tax benefit for S corporations and partnerships, but that sole proprietorships might be left in the dust. Based on that concern, there was speculation that it might be necessary to incorporate or organize an LLC or partnership to benefit from whatever tax benefit was bestowed on flow-through businesses. But in the House, Senate and Conference versions of the 2017 tax act, the 20% deduction under Section 199A has been available for sole proprietorships. *There is no need to incorporate to get the deduction.*

8.5(b) Left behind in the original House bill:

◊ The House and Senate versions of the bill had different approaches to Section 199A. The House bill had a concept of a "capital percentage" of flow-through income that was not included in the final bill.

◊ The House bill applied special tax rates for flow-through income. The Senate and final versions of the bill use a deduction instead of special tax rates.

9. MINIMIZE THE DOUBLE TAX ON CORPORATE PROFITS WITH AN S CORPORATION ELECTION

An existing C corporation should consider electing "**S corporation**" status for tax purposes.

9.1 **Advantages**:

9.1(a) Generally, there is no federal income tax on an S corporation's income.

9.1(b) See Section 9.5 below for the benefits of S corporation status in the sale of a business or for a business that is a "cash cow."

9.1(c) Lower or no state tax. A **lower** 1.5% California **franchise tax** rate applies to S corporations.[37] The rate applies to taxable income. Compare the California total receipts tax that applies to the gross receipts of LLCs.[38]

9.1(d) Generally, there is **no tax on *cash* distributions** from the S corporation to its shareholders of profits earned while the S corporation election was in effect.

◊ However, distributions of appreciated *property* by the S corporation generate gains which are taxed to all the shareholders.

◊ Distributions of C corporation earnings are also taxable to the shareholders.

9.1(e) For the shareholders who *are* active in the corporation's business, neither the active pass-through income nor the distributions of S corporation profits are subject to the 3.8% federal net investment income tax (the "NIIT").

◊ For the shareholders who are *not* active in the business, the NIIT will apply to all flow-through income, to gain on sale of the shares, and to taxable distributions of C corporation profits. But not to tax-free distributions of S corporation profits.

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[37] Compare this to the California 8.84% franchise tax on C corporations. The California franchise tax is deductible in computing federal income tax.

[38] See footnote 61 below.

◊ For the shareholders who *are* active, (1) the NIIT will apply to the passive investment pass-through income and (2) a sale of shares is treated as a sale of assets for the purpose of identifying any passive assets, the gain from which will be subject to the NIIT.

9.1(f) Avoids possible exposure to federal accumulated earnings penalty tax (for post-election earnings).

9.1(g) Avoids possible exposure to federal personal holding company penalty tax (for post-election earnings).[39]

◊ But must address excess passive receipts tax.

9.1(h) Employment taxes may be reduced by taking a modest salary from the S corporation and receiving distributions of earnings instead.

◊ This will also maximize the Section 199A deduction in many cases.[40]

9.1(i) S corporation shareholders are not subject to the onerous partnership tax audit regime.

9.2 Note: Both C corporations and S corporations can issue **incentive stock options** ("ISOs")[41] and new "**qualified stock**" grants and options,[42] all of which have favorable tax consequences for the employee. The con-

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[39] The corresponding S corporation "excess passive receipts" tax might be more manageable than the C corporation personal holding company tax.

[40] But see Section 9.3(d) below.

[41] I.R.C. §§ 421, 422. See 10.6(h) below.

[42] I.R.C. § 83(i).

version from S corp to C corp or back does not affect the qualification of the ISOs or qualified stock arrangement.

9.3 **Disadvantages**:

9.3(a) Shares issued by an S corporation are not eligible for the gain exclusion under Section 1202 or the deferral of gain under Section 1045. Also, if the issuing corporation is an S corporation for a few of the years during the taxpayer's holding period, Sections 1045 and 1202 might not apply to the gain on sale of the shares.[43]

9.3(b) An S corporation cannot use the 21% federal corporate tax rate. All of an S corporation's income is subject to **higher individual rates** for federal income tax purposes. The maximum average federal income tax rates for individuals (32%, 35% and 37%) are substantially higher than the 21% federal income tax rate for C corporations. The maximum California personal income tax rate (13.3%) is higher than the California franchise tax rate (8.84%) for C corporations.[44]

◊ The effective combined federal and California tax rate on the S corporation's income could be 44% to 56%.[45]

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43 See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) above.

44 The California taxes are deductible by a C corporation for federal tax purposes. The California personal income tax rate is 13.3% for income over $1 million.

45 This estimate takes into account the federal deduction for state income tax and the effects of the federal and California limits on itemized deductions. See *Exhibit H* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

◊ For shareholders who are active in a business that generates active income, the effective combined tax rate for a pass-through entity will be lower that the effective 55% tax rate on C corporation income that is *distributed* to shareholders (at the maximum tax brackets) as dividends.[46]

- This observation is true at a wide range of upper tax brackets, and holds true even if the 20% Section 199A deduction is *not* available for the S corporation income.[47]

◊ For shareholders who are **not active** in the business or for businesses that generate substantial passive income, and for whom the Section 199A is **not available**, see Section 6.1(e) above.

9.3(c) An S corporation's income is **taxed directly to shareholders**, *whether or not* distributions are made.

9.3(d) If an S corporations pays its shareholder-employees **less than a reasonable level of compensation**, the IRS can probably disallow the Section 199A deduction on the portion of the S corporation profits that should have been shareholder compensation. There is no requirement that a sole proprietorship or partnership pay compensation, so more of the profit of a sole proprietorship or partnership could get the deduction. Consequently, the need to pay compensation is a disadvantage of using an S corporation.

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[46] This analysis takes into account the new rules that allow a C corporation -- but not an S corporation shareholder -- to deduct the California tax on the corporation's income.

[47] See *Exhibit H* (Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity - Summary - Effective combined federal and CA tax rates on corporate income - after 2017 federal tax act - at highest tax rates).

◊ The IRS has litigated this issue to collect FICA and Medicare taxes, which are due on wages but not on S corporation profits or distributions.

◊ The wages of shareholder-employees should increase the wage base for purposes of the Section 199A limitations based on wages.[48]

9.3(e) **Eligibility requirements** must be satisfied and only **one class of stock** is permitted.[49]

⇒ Every S corporation should be carefully monitored to avoid an inadvertent termination of the election or other adverse consequences.

⇒ Shareholders of an S corporation should enter into a buy-sell agreement to protect the **fragile S election**.

9.3(f) If a C corporation makes the S election, the pre-election appreciation (the "**built-in gain**") in assets acquired by the corporation before the effective date of the S election generally will be taxed to the corporation if and when the assets are sold or distributed during its first S corporation years (five years for federal tax purposes and ten years for California tax purposes).

◊ So it is not a "free shot" to start the business as a C corporation and later make a tax-free conversion to S corporation status.

◊ It is possible that many shareholders will learn this lesson the hard way in the next few years.

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48 See Section 8.1(e) above.

49 Differences in voting rights are permitted.

◊ Advisors need to have the "built-in gain" conversation with their clients who are starting businesses and have heard all about the 21% federal tax rate for C corporations.

9.3(g) Restrictions apply to an S corporation's use of a **taxable year** other than the calendar year.

9.3(h) A corporation can deduct the costs of **fringe benefits** it provides for its employees, including employees who are also its shareholders, and for income tax purposes the employees of a C corporation do not include in their income the value of most of these fringe benefits. *If a corporation elects S status, employees who are also shareholders must include in their income the value of*:

◊ Group life insurance premiums,

◊ Accident or health plan premiums,

◊ Death benefits,

◊ Meals on the employer's business premises and

◊ Lodging furnished by the employer as a condition of employment.

9.4 **C corporation status** allows income from business operations to be taxed at a lower rate and should be used:

◊ When the shareholders want to use Section 1045 or 1202;[50]

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[50] See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) above.

◊ When the business will be sold or its assets exchanged for stock of anther corporation before it must make substantial distributions to its shareholders. (Example: a growing tech company that never has positive cash flow but nevertheless is sold at a high price.)

9.5 Make or keep the **S election** (and avoid the temptation of lower tax rates on corporate income each year):

9.5(a) To avoid a second tax on an eventual **sale of corporate assets** (including goodwill);[51]

9.5(b) To minimize the gain on an eventual **sale of the stock** of a rapidly growing business (because the undistributed earnings will increase the shareholders' basis in their stock of an S corporation, but not a C corporation);[52]

9.5(c) If the business **throws off more cash** than (a) necessary to grow or maintain the business and (b) the shareholders can reasonably take as compensation, rent, royalties and other

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[51] For existing C corporations, the built-in gains tax can reduce or eliminate the benefit of an S corporation election if the business assets are sold less than ten years after the election. The same concern applies to those S corporations that are already subject to the built-in gains tax or that become subject to the tax by acquiring assets in carry-over basis transactions from C corporations or tainted S corporations. However, for a growing business the built-in gain tax merely *freezes* the double tax problem -- appreciation in the value of the business *after* the effective date of the S corporation election is *not* subject to the double tax. Note also that if the target entity was a C corporation and Section 1202 applied, the shareholders could eliminate the shareholder (or "outside") gain on a sale of assets if the corporation made a liquidating distribution of the after-tax sale proceeds. See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) above.

[52] The shareholders' gain on the sale of *stock* is not subject to the built-in gains tax (although a buyer who continues the S corporation status takes the corporation with that tax problem, so that buyer might require a purchase price reduction). This benefit of S corporation status is available even if the corporation is subject to the built-in gains tax.

deductible payments (because the shareholders can receive tax-free cash distributions of S corporation earnings); or

10. MINIMIZE THE DOUBLE TAX ON CORPORATE PROFITS WITH A LIMITED LIABILITY COMPANY [WCS]

10.1 **Limited liability companies** are not subject to the double tax.[53] Consequently, the double tax can be avoided by never using a corporation and using an LLC when limited liability becomes important.

10.2 In contrast to S corporations, there does not appear to be any concept of requiring minimum compensation for an entity classified for income tax purposes as a partnership – including an LLC – or a sole proprietorship.[54]

10.3 Other benefits of LLCs as compared to S corporations:

10.3(a) No eligibility concerns after formation;

10.3(b) Ability to adjust inside tax basis when an LLC interest is sold or inherited, if a permanent election is made to make this adjustment for all transfers of interest in that LLC;

10.3(c) Easy to bring members in and out and to adjust interests;

10.3(d) Distributions and allocations can be tailored precisely (because there is no one-class-of-stock rule for LLCs and LLCs can have priority returns and special allocations)[55];

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[53] The tax discussion in this outline applies to LLCs that are classified as partnerships for tax purposes, and not as corporations. For domestic entities that are not corporations, the default classification is accepted by filing a partnership return. These rules are known as the federal "check-the-box" regs. California conforms generally.

[54] See Section 8.1(f) above.

[55] See the bulletin A "FLIP" OR "CARRIED INTEREST" DEAL on www.staleylaw.com.

10.3(e) Distributions of appreciated assets rarely trigger tax; and

10.3(f) Entity-level borrowings can give members basis in their LLC interest to absorb LLC losses.[56]

10.4 The **conversion** of an S corporation or a C corporation to a partnership or LLC – no matter how achieved – is treated as a taxable liquidation of the corporation.

⇒ Consequently, a corporation with appreciated assets -- including goodwill -- will rarely convert to an LLC.

⇒ Note that there are usually no serious tax impediments to converting an LLC or partnership to a corporation – except the threat of the eventual double tax. The negotiations to obtain the necessary consents of LLC members can be difficult.

10.5 A single-member LLC ("**SMLLC**") can be formed under California law. It's a different kind of cat, tax-wise.

10.5(a) An SMLLC is "disregarded" for federal and California income tax purposes.

Note: Some states do not disregard SMLLCs for state tax purposes.[57]

◊ An SMLLC owned by an individual is taxed as a sole proprietorship.

◊ An SMLLC owned by a corporation is treated as a division. So it avoids the consolidated return rules.

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56 This is not true for S corporations.

57 Primarily Texas and Pennsylvania at this writing, but you should check before you set up an LLC that will be active outside California. California requires a single-member LLC to file Form 568 and to pay the annual minimum tax (currently $800) and the "gross receipts" tax. See fn. 61.

- An SMLLC owned by an S corporation avoids the concerns of a "qualified S corporation subsidiary" (a "**QSub**") – especially when an interest in the subsidiary's business is acquired by someone other than the parent.

- An SMLLC owned by a foreign corporation and doing business in the U.S. is taxed as a branch – not usually a good result.

10.5(b) An SMLLC also is an ideal way to position a sole proprietorship for probate, since it is the least possible disruption in the business, yet insulates the executor or trustee from the liabilities of the business.

10.5(c) A successful **new business** developed by an existing corporation could be dropped into an SMLLC in the same way that the corporation would drop it into a new subsidiary to isolate liabilities. However, it might make more sense from a tax standpoint to get the new business out of the corporation entirely and set up a "sister" LLC.[58]

10.6 Concerns about using LLCs:

10.6(a) Membership interests issued by an LLC are not eligible for the gain exclusion under Section 1202 or the deferral of gain under Section 1045.[59]

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[58] If you own most of the stock of two or more corporations, corporate attorneys would call them "**brother-sister**" corporations. If Corp X owns more than 80% of the stock of Corp Y, Corp X would be the "**parent**" and Corp Y would be the "**subsidiary**." These terms describe only the ownership relationship, not the tax situation.

[59] See Section 7 (Eliminate or Minimize the Double Tax with the Section 1202 Exclusion for Qualified Small Business Stock) above.

10.6(b) An LLC may operate in California a business (and there are quite a few) subject to **licensing** under the California Business and Professions Code *only if* the licensing provisions of the Business and Professions Code specifically allow it.

◊ Note: Not all licensed businesses are licensed under the Business and Professions Code. For example, registered investment advisers are licensed under the Corporations Code and insurance brokers are licensed under the Insurance Code.

◊ Contractors are allowed to use LLCs, but they probably should continue to use corporations until the 2010 law is fixed.[60]

10.6(c) California imposes a flat $800 **annual tax** and a "**total income**" (that is, gross receipts) tax on LLCs, including single-member LLCs. [61]

◊ These taxes apply even if the LLC has losses.

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[60] See the bulletin *California Choice of Entity Developments: LLPs for Engineers and Land Surveyors; LLCs for Contractors - but with Traps*, on www.staleylaw.com.

[61] Cal. Rev. & Tax. Code §§ 17941 (flat tax), 17942 (tax rates on "total income"). The current "total income" tax rates are:

Total Income	Tax
$0-$249,999	$-0-
$250,000 -$499,999	$900
$500,000 - $999,999	$2,500
$1 million - less than $5 mill.	$6,000
$5 million or more	$11,790

The tax applies only to receipts from activities in California.

◊ Note: Owners who operate a high-revenue, low profit business often expect large profits in the future. Should they avoid the LLC because of the California gross receipts tax? No, *just pay it!* Using another form of entity to avoid this tax is short-sighted if the alternative entity makes it more likely that the owners will have to pay the liabilities of the entity.[62]

10.6(d) Some other states (for example, Texas and Pennsylvania) impose a corporate or franchise tax on LLC income.[63]

10.6(e) Active members of an LLC probably will be treated as general partners for **self-employment tax** purposes, and the portion of their share of LLC income that is attributable to the reasonable value of their services to the LLC probably is subject to self-employment tax.

◊ LLC members may render management services to the LLC through an S corporation and take a modest salary from the S corporation to minimize the Medicare tax. But this is the kind of structure we hope to avoid by using an LLC!

◊ Also, the salary will not be subject to the Section 199A deduction, but the taxable income of the LLC can qualify for the deduction.

10.6(f) The company with a **public stock offering** in its future will have a smoother glide path to that goal as a corporation..

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62 See Section 15 (Achieving Limited Liability) below.

63 See footnote 57 above.

◊ Generally, venture capital companies prefer to work with corporations, because corporations go public, and LLCs don't.

◊ But a participants or LLC could in theory use the "Up-C structure" to go public.[64]

- The partnership/LLC would issue an interest to a new corporation that would go public.

- The corporation would contribute the funds that it raised in the offering to the partnership/LLC for use in the business (or could use some of the funds to buy interests from the legacy partners/member). The corporation manages the partnership/LLC.

- The partnership/LLC would retain the business and the legacy partners/members would retain their interests in it (unless they sold their interests to the corporation).

- The historic partners/members would have the right to exchange partnership interests for shares of the corporation, possibly with the right to register and trade those shares. The

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[64] This is also known as the "umbrella partnership–C-corporation structure." *See* M.K. Carnevale, J.P. de Bree, Jr., M.N. Schneider, C.B. Temkin, F.T. Witt, REAL ESTATE INVESTMENT TRUSTS (BNA) Tax Mgmt. Port. No. 742 at Part V (3d 2017); *see also* A. Versprille, *Partnership 'Up-C' Structure Can Go Too Far: IRS Official*, Daily Tax Report (BNA) 10/23/17 at G-1; J.F. Bonnie and J.C. Hart, *The "UP-C" Structure- A Primer on Employing the Umbrella Partnership–C-Corporation Structure in an IPO*, (Simpson Thacher, January 19, 2016) at http://www.stblaw.com/docs/default-source/related-link-pdfs/up-c-slides.pdf?sfvrsn=6; Morrison & Forrester LLP, *Practice Pointers on: The Up-C Structure* (2016) at https://media2.mofo.com/documents/160500practicepointersupcstructure.pdf. The structure is based on the UPREIT structure initially recognized by the Service as not abusive in Treas. Reg. § 1.702-2(d) *Example 4* (T.D. 8588, 95-1 C.B.109).

exchange feature might be attractive when the LLC interest had received a basis adjustment at death or as a result of a purchase.

10.6(g) LLC membership interests cannot be **swapped tax-free** for corporate stock. In contrast, corporate stock can be swapped tax-free (subject to restrictions) for stock of other corporations.

10.6(h) Only corporations can have **incentive stock option** ("ISO") plans, which permit employees to exercise their options without any regular tax (but maybe with alternative minimum tax), and have the entire income element taxed as long-term capital gain.

◊ LLCs can have nonqualified stock options, but the tax treatment of these options in not straightforward.

◊ Employees who receive equity interests in the LLC seldom appreciate the change from wage withholding to the estimated tax regime.

10.6(i) Only corporations (S or C) can have new "**qualified stock**" grants and options.[65]

10.6(j) Distributions of "**hot assets**" from a partnership will be taxed.

10.6(k) The installment method may not be used to defer gain on the sale of a partnership interest to the extent that the gain is attributable to **cash method accounts receivable**.

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[65] I.R.C. § 83(i).

10.6(l) LLC members are subject to the onerous **partnership tax audit** regime. However, currently there are not many audits of entities classified as partnership.

10.7 A **series LLC** (not available under California law) is a single LLC that has within it separate "series" (like compartments or mutual funds). If the LLC is organized and operated properly, then under its home state's law the assets of one series are not available to satisfy claims arising from the activities of another series of the same LLC. The series can have common ownership or can be owned by different groups. A series can have different classes of membership interests.[66]

10.7(a) Although it could be argued that a series LLC with one or more series doing business in California should owe only one $800 tax for all of its series, this is not the position that the FTB takes in the instructions to Form 568.

10.7(b) As compared with a separate LLC for each series, the series LLC might pay more or less California "gross receipts" tax.

10.7(c) No California court has addressed the insulation of one series from claims against another series of the same LLC. California courts probably will respect the liability limitation of the series LLC under the federal constitutional principal that each state must give "full faith and credit" to the laws of other states. However, the defending LLC might have to litigate all the way to the U.S. Supreme Court.

10.7(d) If one series enters bankruptcy, the entire LLC and all the series would probably enter the bankruptcy proceeding. The "stay" in bankruptcy would freeze all of the assets of all of the series until the bankruptcy judge considered and released the other series.

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[66] See, for example, 6 Delaware Code Anno. § 18-215.

10.8 Restrictions apply to an LLC's use of a **taxable year** other than the calendar year.

10.9 LLCs as S Corporations

10.9(a) Why? For charging order protection (or due to "choice of entity" remorse)

◊ To get that protection, the LLC probably needs to have members who are *not* all close family members and who either bought their interests or made capital contributions to acquire them.

◊ Might not be available to a single-member LLC or to a "family limited partnership" organized as an LLC.[67]

10.9(b) How?

◊ Forms 8832 and 2553[68]

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[67] Although a judgment creditor of an LLC member is generally limited to a charging order or becoming a holder of an economic interest – not a voting membership interest -- in the LLC, many doubt that a judgment creditor of a single-member LLC would be prevented from obtaining the LLC's assets. Cal. Civil Code § 708.301, Cal. Corp. Code § 17705.03 (charging order rules, with no statutory exception for single-member LLCs); *but see* In re A-Z Electronics, 350 B.R. 886 (Bankr. D. Idaho, 2006) (bankruptcy trustee of sole member and not member-manager entitled to file bankruptcy petition on behalf of the LLC); In re Albright, 291 B.R. 538 (Bankr. D. Colo. 2003) (allowing a Chapter 7 bankruptcy trustee to reach the assets in the debtor's single-member LLC). *See also* J. Stein, Building Stumbling Blocks, BUSINESS ENTITIES (September/October 2006) 28, 34-36, and J. Stein, Advanced Asset Protection and Tax Planning with LLCs, 29 Los Angeles Lawyer 17 at nn. 20-21 (June 2006) (arguments in favor of respecting charging order protection for the single-member LLC.)

[68] Treas. Reg. § 301.7701-3(c)(1)(v)(C) ("An eligible entity that timely elects to be an S corporation … is treated as having made [a check-the-box-] election under this section [7701] to be classified as an association, provided that (as of the effective date of the [S corporation] election … the entity meets all other requirements to qualify as a small business corporation.…").

◊ The operating agreement must not have any special allocations, priority returns or any distributions based on capital accounts

10.9(c) Why not?[69]

◊ One class of stock rule – risk of becoming a C corporation

◊ Expectations of advisors (who expect a single-member LLC to be disregarded for tax purposes and a multi-member LLC to be classified as a partnership for tax purposes) – and trap for unwary advisors – or for members who rely on "cocktail party" advice

◊ Transaction costs – getting every advisor up to speed

◊ Using a Nevada corporation provides charging order protection – possibly more certain protection than a California LLC.

◊ If the owners started with an LLC and were then advised to use an S corporation (often to minimize employment taxes), the best practice is to convert the LLC to a corporation under state law – not just for tax purposes.

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[69] Is a single-member LLC taxed as an S corporation the perfect entity because it provides pass-through tax treatment, reduces FICA and Medicare taxes for the member, and the member's creditors are limited to charging orders, as opposed to getting the stock of a real S corporation? Probably not, because the S corporation can default to a C corporation, the full SSI should be paid anyway in most active businesses, the structure will cause confusion forever, and a Nevada corp is a better way to get charging order protection.

11. WHEN AN EXISTING BUSINESS ENTITY STARTS A NEW BUSINESS

The liability analysis outlined above also applies to an existing business (or nonprofit) entity which is considering a new venture.

11.1 For business entities, the best arrangement is usually to have the individual owners of the existing business own directly interests in the new entity. (In other words, create a new ***brother-sister*** entity rather than a subsidiary.) This provides the individual owners with the maximum flexibility and avoids taxes generated by taking apart an affiliated group of corporations.

11.2 When creating a brother-sister arrangement is not possible, generally liability-prone businesses should be operated in separate **subsidiary** corporations or single-member LLCs.

The entity with the capital should own the shares or interest in the operating entity that conducts the business.

11.3 When a **holding company** structure is in place or is being implemented, the holding company should not operate directly any liability-prone business. See *Exhibit J*, Choice of Entity (holding company example).

11.4 S corporations can have wholly-owned corporate subsidiaries that are disregarded. These "**QSubs**" are less flexible and have more tax traps than SMLLCs.

11.5 S corp shareholders who want to pursue the **Section 1202 exclusion** or Section 1045 deferral when the business sells might consider dropping the operating business into a C corporation subsidiary.[70]

12. WHAT STATE'S LAW TO USE FOR THE NEW ENTITY

12.1 Generally, use the law of the state where the advisors are and where the activities of the entity will be taxed.

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[70] I.R.C. § 1202(g). The gain on the appreciation before the organization of the subsidiary will not be excluded by Section 1202. I.R.C. § 1202(i).

12.1(a) The first rule is to minimize complexity and the opportunity for problems arising because the advisors were not familiar with the law of the selected state.

12.1(b) Also, a corporation active in California is going to end up filing with the California Secretary of State, EDD and FTB.

- ◊ Organizing in another state will mean additional filings in those states that could be avoided by organizing in California.

- ◊ It probably means paying an agent for service of process in that state and paying some type of minimum tax. For Delaware or Nevada, that might be $500 per year.

- ◊ To avoid extra tax in states like Delaware, the shares of the corporation must have a par value and redeemed shares become "treasury shares". California corporations have not needed to worry about par value or treasury shares since 1979.

12.1(c) Beware advisors who fall in love with something they found in the law of another state that makes its law better than the law in California. Is it worth the year-in, year-out hassle of using the law of that state, and the additional filings that will be required in that state?

12.2 If there will be investors from several states, often Delaware law is used because many corporate attorneys know the law of their home state and the law of Delaware. Delaware has a well developed law that mildly favors management over shareholders, allows LLC members lots of freedom to write their operating agreement, and generally stays out of the way, as compared to, say, California.

12.3 Shareholders of closely-held Nevada corporations have strong charging order protection. So they will not be surprised by having a creditor of another shareholder become their new business partner.

12.4 Charging order protection for California LLCs is weaker than other states.

12.5 California allows transferees of LLC interests who do not become full members to inspect the books of the LLC.

13. CALIFORNIA PROFESSIONALS

13.1 The registered limited liability partnership (the "LLP") is the **entity of choice** for groups of two or more **accountants**, **architects, attorneys, civil engineers** or **land surveyors** practicing in California.

13.1(a) LLPs are general partnerships without the unlimited liability.

13.1(b) Because they are taxed as partnerships, they allow much more **flexibility** for adding and withdrawing members and changing members' relative profit participation, as compared to C or S corporations.

13.1(c) The Secretary of State and each licensing authority has adopted rules and forms to implement the statute.

13.2 The **professional corporation** probably will be used only by solo practitioners (who can't use LLPs) -- who will then encounter tax problems getting out of their PCs if they join LLPs.

13.3 **Cash-method C corporations** that consider electing S corporation status so that they can stop the hassle and anxiety of trying to "zero out" each year must deal with the *built in gain* problem.[71]

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[71] See Section 9.3(f) above.

14. NONPROFIT ORGANIZATIONS

14.1 For nonprofit organizations, limited liability and continuity concerns usually make a **nonprofit corporation** a more attractive vehicle than a nonprofit association or a trust.

14.1(a) A nonprofit corporation, association or trust is not exempt from income tax unless it obtains a favorable determination letter from the IRS declaring it exempt.

14.1(b) It is possible to have a **taxable nonprofit** corporation, association or trust, but this usually results from poor planning.

14.2 The **SMLLC** is an ideal way for a nonprofit entity to isolate liability-prone "**related**" activities without subjecting them to corporate tax or obtaining another tax exemption for a nonprofit "subsidiary" (organized as a supporting organization of the parent).

14.3 Generally, a nonprofit organization's activities of generate substantial "**unrelated** business taxable income" should be isolated in **subsidiary C corporations** to reduce the threat to the nonprofit's tax-exempt status. The C corporation's income will not flow through to – and be considered activities of -- the tax-exempt parent.

14.4 A special tax exemption is available for a corporation **holding real estate** for the use of a tax-exempt organization.[72]

14.5 The SMLLC may qualify for a California property tax "welfare" exemption for certain charities if its member could qualify for the exemption.[73]

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[72] I.R.C. § 501(c)(2) (property held for one tax-exempt organization) or (25) (property held for more than one tax-exempt organization); Cal. Rev. & Tax. Code §§ 23701h, 23701x)

[73] Cal. Rev. & Tax. Code §§ 214, 214.01, 214.02, 214.5, 214.14; Cal. Code Regs. Title 18, § 136.

15. ACHIEVING LIMITED LIABILITY

When a corporate or LLC structure is adopted principally to minimize the risk of personal liability, it is critical to **operate** the business in a way that minimizes the risk that a claimant will "**pierce the corporate veil**," resulting in shareholder/member liability for the entity's obligations.

15.1 Accordingly, particular attention must be directed to the **formalities** of conducting the business in the entity, such as:

15.1(a) For a corporation, regularly prepare shareholders' and directors' **minutes**;

- ◊ For a California LLC, consider eliminating in the operating agreement the requirement of annual meetings;

15.1(b) Show the **corporate name** on all stationery, business cards and invoices;

15.1(c) Shareholders who are also officers of a corporation must sign documents in their capacity as **officers** (not as "owners");

- ◊ Members who are also managers or officers of an LLC must sign documents in their capacity as **managers** or **officers** (not as "owners" or "partners");
- ◊ Eliminate oral and written **references** to another shareholder/member as "my partner";

15.1(d) Maintain **separate** personal and corporate/LLC **bank accounts**;

15.1(e) Carefully **document** and account for **transactions** between the shareholder/member and the corporation/LLC (such as salary, bonuses, rents, royalties, loans, contributions to capital and distributions to sharehold-

ers/members); and when there are multiple partnerships, LLCs and corporations under common control, **document transactions among the entities** with leases, invoices, promissory notes and corporate resolutions, and account carefully for the transactions.

15.1(f) It is important to have the board of directors approve all dividends and distributions, *even routine S corporation distributions*.

15.2 It is especially important to remember that entities that are "**disregarded**" for *income tax* purposes should not be disregarded by their officers and managers for *accounting* and *liability protection* purposes. If the owner does not respect the separateness of the entity, the court might disregard the entity for liability purposes, which would often be a disaster.

15.2(a) In addition to these formalities, each entity must have an **adequate combination of capital and insurance** to satisfy reasonably anticipated claims against the business.

15.2(b) If the business does not have enough capital and can't afford sufficient insurance, the officers should document their attempts to obtain insurance.

15.2(c) Because S corporations, LLCs and partnerships can distribute earnings without adverse tax consequences, it is possible that the earnings will be distributed and not retained as capital. This may increase the need for insurance to avoid the "*thin capitalization*" problem. This factor should be considered in connection with the legal limitations on distributions.

15.2(d) However, a corporation or LLC operating a business generally should have no more capital than is necessary to run the business and to minimize the "alter ego" risk.

15.3 To avoid confusion regarding the capacity in which a particular document is signed, any document requiring the signature of the entity

should identify the entity, the person signing on its behalf, and the office held by that person. The following is an example of a **proper signature block** for a **corporation**:

ANYCOMPANY, INC.,
a California corporation

By ______________________________
Donna J. Any, President

15.3(a) This form of signature clearly indicates that the document is being signed by and on behalf of the corporation and not by an individual.

15.3(b) Signing properly helps to prevent individual liability for claims against the entity and helps to preserve its legal status as a separate entity.

15.3(c) For an **LLC**, the signature is similar:

ANYCOMPANY LLC,
a California limited liability company

By ___________________________________
Donna J. Any, Manager

15.3(d) For a **limited partnership** the signature is more involved (assuming that no individual wants to assume the unlimited personal liability of a general partner):

ANYCOMPANY LP,
a California limited partnership
By its sole general partner
ANY MANAGEMENT, INC.,
a California corporation

By _________________________
Donna J. Any, President

◊ Note that if Donna abbreviates her signature block, she risks personal liability because she leads others to conclude reasonably that she is a general partner or sole proprietor:

WRONG!!! =>

ANYCOMPANY

By ________________________
Donna J. Any

WRONG!!! =>

____
Donna J. Any, Anycompany

15.4 The failure of officers, directors and shareholders/members to conduct business as required by law may have serious adverse consequences.

15.4(a) Third parties could succeed in "**piercing the corporate veil**," potentially resulting in shareholder/member liability for the entity's obligations.

15.4(b) The corporation could be **disregarded as a taxable entity** in certain circumstances, resulting in direct taxation of the shareholders on corporate income.[74]

15.4(c) In addition, significant transactions between the corporation and third parties could be attributed to the shareholders, resulting in tax consequences to the shareholders rather than to the corporation.

15.4(d) The form of transactions and agreements between the shareholders and the corporation could be disregarded, potentially resulting in various adverse income tax conse-

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[74] The IRS has successfully asserted this to ignore family limited partnerships that the partners themselves did not respect.

quences (for example, unintended dividends to the shareholders).[75]

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[75] See footnote 74 above.

Exhibit A

Alternate Legal Forms of Doing Business in California

1. **Sole proprietorship**

2. **Partnership** (two kinds for liability purposes, one kind for tax purposes)

   -- General partnership (all general partners, no liability protection)
   -- Limited partnership (with two kinds of partners)
   - ⇒ One or more general partners (who run the business and are personally liable for all of its obligations)
   - ⇒ One or more limited partners ("silent" partners who risk only their investment in the business, not their other assets)
   - ⇒ A **joint venture** is a partnership formed for a specific project.

3. **LLP**: a limited liability partnership for accountants, architects, attorneys. land surveyors and civil, electrical and mechanical engineers.

4. **Corporation** or **professional corporation** (two kinds for liability purposes, three kinds for tax purposes)
   -- C corporation (the corporation pays tax on its income; the shareholders are taxed on distributions)
   -- S corporation (low California corporate tax; generally no federal corporate income tax; instead, the shareholders pay tax on their shares of the corporation's income; no tax when shareholders receive distributions)
   -- Qualified subchapter S subsidiary ("**QSub**") (disregarded for income tax purposes)

5. **Multiple-Member Limited Liability Company** ("**LLC**")

   -- Members, who own interests in the LLC, are protected from liability like shareholders
   -- Can be taxed like a partnership, which is usually best.
   -- Can also be taxed like a corporation.
   -- Usually "manager-managed," but can be "member-managed"
   -- All states recognize LLCs.

   Single-Member LLC
   -- Disregarded for federal income tax purposes.
   -- Subject to state tax in some states

   Series LLC (not formed under California law)
   -- Separate "series" (like compartments) within the LLC are insulated from claims against assets in other "series."

Exhibit B

Highest Federal and California Tax Rates

Shareholder IS Active in the Business - NO Section 199A Deduction

Before and After Tax Reform - Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder IS Active in the Business - NO Section 199A Deduction

	C Corp, distributed income				Pass-Through (S corp)			
	2017		2018		2017		2018	
	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		8.84%		8.84%		1.5%		1.5%
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	35%	35%	21%	21%				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		13.3%		13.3%		13.3%		13.3%
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							0%	0%
Federal deduction $							$ -	$ -
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 100.00	$ 100.00
Tax rate on dividend income	20%	20%	20%	20%				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	3.8%	3.8%	3.8%	3.8%	0.0%	0.0%	0.0%	0.0%
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ -	$ -	$ -	$ -
Federal taxable income					$ 100.00	$ 85.20	$ 100.00	$ 100.00
Federal tax on shareholder income %					39.6%	39.6%	37%	37%
Federal tax on shareholder income $					$ 39.60	$ 33.74	$ 37.00	$ 37.00
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 39.60	$ 47.04	$ 37.00	$ 50.30
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 39.60	$ 48.54	$ 37.00	$ 51.80
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 60.40	$ 51.46	$ 63.00	$ 48.20
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ 2.60	$ (3.26)
Combined effective individual rate	24%	37%	24%	37%	40%	47%	37%	50%
Effective combined tax rate on corporate income	**50%**		**40%**		**40%**		**37%**	
		63%		**55%**		**49%**		**52%**

Prepared by William C. Staley
818-936-3490

Exhibit B

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Exhibit C

Highest Federal and California Tax Rates

Shareholder IS Active in the Business - WITH Section 199A Deduction

Before and After Tax Reform - Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder IS Active in the Business - WITH Section 199A Deduction

	C Corp, distributed income				Pass-Through (S corp)			
	2017		2018		2017		2018	
	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		8.84%		8.84%		1.5%		1.5%
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	35%	35%	21%	21%				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		13.3%		13.3%		13.3%		13.3%
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							20%	20%
Federal deduction $							$ 20.00	$ 20.00
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 80.00	$ 80.00
Tax rate on dividend income	20%	20%	20%	20%				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	3.8%	3.8%	3.8%	3.8%	0.0%	0.0%	0.0%	0.0%
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ -	$ -	$ -	$ -
Federal taxable income					$ 100.00	$ 85.20	$ 80.00	$ 80.00
Federal tax on shareholder income %					39.6%	39.6%	37%	37%
Federal tax on shareholder income $					$ 39.60	$ 33.74	$ 29.60	$ 29.60
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 39.60	$ 47.04	$ 29.60	$ 42.90
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 39.60	$ 48.54	$ 29.60	$ 44.40
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 60.40	$ 51.46	$ 70.40	$ 55.60
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ 10.00	$ 4.14
Combined effective individual rate	24%	37%	24%	37%	40%	47%	30%	43%
Effective combined tax rate on corporate income	**50%**	**63%**	**40%**	**55%**	**40%**	**49%**	**30%**	**44%**

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818-936-3490

Exhibit C

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Exhibit D

Highest Federal and California Tax Rates

Shareholder IS Active in the Business - Long-Term Capital Gain

Before and After Tax Reform - Comparison of Income Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder IS Active in the Business - Long-Term Capital Gain

	C Corp, distributed income				Pass Through (S corp)			
	2017		2018		2017		2018	
	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		8.84%		8.84%		1.5%		1.5%
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	35%	35%	21%	21%				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		13.3%		13.3%		13.3%		13.3%
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							0%	0%
Federal deduction $							$ -	$ -
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 100.00	$ 100.00
Tax rate on dividend income	20%	20%	20%	20%				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	3.8%	3.8%	3.8%	3.8%	0.0%	0.0%	0.0%	0.0%
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ -	$ -	$ -	$ -
Federal taxable income					$ 100.00	**$ 100.00**	$ 100.00	$ 100.00
Federal tax on shareholder income %					20.0%	20.0%	20%	20%
Federal tax on shareholder income $					$ 20.00	$ 20.00	$ 20.00	$ 20.00
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 20.00	$ 33.30	$ 20.00	$ 33.30
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 20.00	$ 34.80	$ 20.00	$ 34.80
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 80.00	$ 65.20	$ 80.00	$ 65.20
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ -	$ -
Combined effective individual rate	24%	37%	24%	37%	20%	33%	20%	33%
Effective combined tax rate on corporate income	**50%**		**40%**		**20%**		**20%**	
		63%		**55%**		**35%**		**35%**

Exhibit E

Highest Federal and California Tax Rates

Shareholder Is NOT Active in the Business - NO Section 199A Deduction

Before and After Tax Reform - Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder Is NOT Active in the Business - NO Section 199A Deduction

	C Corp, distributed income				Pass-Through (S corp)			
	2017		2018		2017		2018	
	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		8.84%		8.84%		1.5%		1.5%
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	35%	35%	21%	21%				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		13.3%		13.3%		13.3%		13.3%
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							0%	0%
Federal deduction $							$ -	$ -
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 100.00	$ 100.00
Tax rate on dividend income	20%	20%	20%	20%				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ 3.80	$ 3.80	$ 3.80	$ 3.80
Federal taxable income					$ 100.00	$ 85.20	$ 100.00	$ 100.00
Federal tax on shareholder income %					39.6%	39.6%	37%	37%
Federal tax on shareholder income $					$ 39.60	$ 33.74	$ 37.00	$ 37.00
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 43.40	$ 50.84	$ 40.80	$ 54.10
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 43.40	$ 52.34	$ 40.80	$ 55.60
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 56.60	$ 47.66	$ 59.20	$ 44.40
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ 2.60	$ (3.26)
Combined effective individual rate	24%	37%	24%	37%	43%	51%	41%	54%
Effective combined tax rate on corporate income	**50%**	**63%**	**40%**	**55%**	**43%**	**52%**	**41%**	**56%**

Prepared by William C. Staley
818-936-3490

Exhibit E

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Exhibit F

Federal Liquidating Distribution and Highest California Tax Rates
Shareholder Is NOT Active in the Business - WITH Section 199A Deduction

Before and After Tax Reform - Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder Is NOT Active in the Business - WITH Section 199A Deduction

	C Corp, distributed income				Pass-Through (S corp)			
	2017		2018		2017		2018	
	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed	Fed only	California and fed
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		**8.84%**		**8.84%**		**1.5%**		**1.5%**
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	**35%**	**35%**	**21%**	**21%**				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		**13.3%**		**13.3%**		**13.3%**		**13.3%**
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							**20%**	**20%**
Federal deduction $							$ 20.00	$ 20.00
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 80.00	$ 80.00
Tax rate on dividend income	**20%**	**20%**	**20%**	**20%**				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	**3.8%**	**3.8%**	**3.8%**	**3.8%**	**3.8%**	**3.8%**	**3.8%**	**3.8%**
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ 3.80	$ 3.80	$ 3.80	$ 3.80
Federal taxable income					$ 100.00	$ 85.20	$ 80.00	$ 80.00
Federal tax on shareholder income %					**39.6%**	**39.6%**	**37%**	**37%**
Federal tax on shareholder income $					$ 39.60	$ 33.74	$ 29.60	$ 29.60
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 43.40	$ 50.84	$ 33.40	$ 46.70
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 43.40	$ 52.34	$ 33.40	$ 48.20
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 56.60	$ 47.66	$ 66.60	$ 51.80
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ 10.00	$ 4.14
Combined effective individual rate	24%	37%	24%	37%	43%	51%	33%	47%
Effective combined tax rate on corporate income	**50%**		**40%**		**43%**		**33%**	
		63%		**55%**		**52%**		**48%**

Prepared by William C. Staley
818-936-3490

Exhibit F

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Exhibit G

Federal Liquidating Distribution and Highest California Tax Rates
Shareholder Is NOT Active in the Business - Long-Term Capital Gain

Before and After Tax Reform - Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Variables: Shareholder Is NOT Active in the Business - Long-Term Capital Gain

	C Corp, distributed income				**Pass-Through (S corp)**			
	2017		**2018**		**2017**		**2018**	
	Fed only	**California and fed**	**Fed only**	**California and fed**	**Fed only**	**California and fed**	**Fed only**	**California and fed**
Corporation								
California taxable income	$ 100	$ 100.00	100	$ 100.00	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		8.84%		8.84%		1.5%		1.5%
California tax		$ 8.84		$ 8.84		$ 1.50		$ 1.50
Federal taxable income	$ 100.00	$ 91.16	$ 100.00	$ 91.16				
Federal tax rate	35%	35%	21%	21%				
Federal tax	$ 35.00	$ 31.91	$ 21.00	$ 19.14				
Dividend	$ 65.00	$ 59.25	$ 79.00	$ 72.02				
Combined effective corporate rate	35%	41%	21%	28%	0%	1.50%	0%	1.50%
Shareholder								
Dividend or Flow through	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
California tax rate		13.3%		13.3%		13.3%		13.3%
California tax		$ 7.88		$ 9.58		$ 13.30		$ 13.30
Total California tax						$ 14.80		$ 14.80
Federal Section 199A deduction %							0%	0%
Federal deduction $							$ -	$ -
Federal taxable income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 85.20	$ 100.00	$ 100.00
Tax rate on dividend income	20%	20%	20%	20%				
Tax on dividend income	$ 13.00	$ 11.85	$ 15.80	$ 14.40				
Net investment income	$ 65.00	$ 59.25	$ 79.00	$ 72.02	$ 100.00	$ 100.00	$ 100.00	$ 100.00
Net investment income tax %	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%
Net investment income tax $	$ 2.47	$ 2.25	$ 3.00	$ 2.74	$ 3.80	$ 3.80	$ 3.80	$ 3.80
Federal taxable income					$ 100.00	**$ 100.00**	$ 100.00	$ 100.00
Federal tax on shareholder income %					20.0%	20.0%	20%	20%
Federal tax on shareholder income $					$ 20.00	$ 20.00	$ 20.00	$ 20.00
Total shareholder tax	$ 15.47	$ 21.98	$ 18.80	$ 26.72	$ 23.80	$ 37.10	$ 23.80	$ 37.10
Total tax liability	$ 50.47	$ 62.73	$ 39.80	$ 54.71	$ 23.80	$ 38.60	$ 23.80	$ 38.60
Shareholder after tax	$ 49.53	$ 37.27	$ 60.20	$ 45.29	$ 76.20	$ 61.40	$ 76.20	$ 61.40
Savings (tax increase) from 2017 Act			$ 10.67	$ 8.02			$ -	$ -
Combined effective individual rate	24%	37%	24%	37%	24%	37%	24%	37%
Effective combined tax rate on corporate income	**50%**		**40%**		**24%**		**24%**	
		63%		**55%**		**39%**		**39%**

Prepared by William C. Staley
818-936-3490

Exhibit G

Exhibit H

Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity

Summary - Effective combined federal and CA tax rates
on corporate income - after 2017 federal tax act - at highest tax rates

Comparison of Income
Distributed by a C Corporation or Flowing Through a Pass-Through Entity
Summary - Effective combined federal and CA tax rates
on corporate income - after 2017 federal tax act - at highest tax rates

			Shareholder Is NOT Active in the Business	Shareholder IS Active in the Business	Notes
Pass-Through (S corp)	Ordinary income	NO Section 199A deduction	56%	52%	(1)
		WITH Section 199A deduction	48%	44%	(1)
	Long-term capital gain		39%	35%	(1)
C corporation income distributed to shareholder			55%		(2)

Notes

(1)	The difference is the federal 3.8% net investment income tax.
(2)	The federal 3.8% net investment income tax applies whether or not the shareholder is active in the business.

be IRD if held by the decedent[77] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Often difficult to achieve a tax-free combination as a back-up.

I.1.3 **Sale of S corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the estate of the shareholder is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero – unlike a partnership, no basis increase for the heir's share of the S corporation's liabilities - a limitation applies to the basis step up to the extent that the share value is attributable to the S corporation's items that would be IRD if held by the shareholder[78] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Tax-free reorg available as a back-up for lifetime disposition.

I.1.4 **Sale of C corporation stock when the 100% gain exclusion in Section 1202 applies** – Zero federal income tax on the sale (to the extent the gain is attributable to appreciation after the assets were contributed to the corporation). Careful, long-term planning needed to protect the Section 1202 exclusion. No AMT preference for stock acquired after September 27, 2010.[79] This exclusion does not apply for California income tax purposes. Tax-free

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[77] Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

[78] Note that this will severely limit the basis step up for an interest in a partnership used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

[79] See Section 7 (Eliminate All Federal Tax – Or at Least the Double Tax -- With the Section 1202 Exclusion of Gain from the Sale of Qualified Small Business Stock).

reorg available as a back-up. (Note that the ranking assumes that the sale proceeds are not subject to estate tax.)

I.1.5 **Sale of C corporation stock to an ESOP (sponsored by the corporation) in a Section 1042 transaction** – Possible zero federal and California income tax on sale. No gain on sale of shares if sale proceeds rolled into securities of U.S. companies, carryover basis; margin loans available to tap the cash; step up in basis at death escapes any tax. Capital gain on boot or sale of the U.S. securities. Requires feasibility study and annual appraisal and administration costs. A conversion from S to C corporation status immediately before the sale is permitted – unlike for Section 1202. Sale of all shares might require several years. Tax-free reorg available as a back-up.

I.1.6 **Exchange of target[80] stock for buyer stock in a tax-free reorganization** – No tax on exchange for stock, if strict rules are satisfied. Seller's basis in buyer stock equals seller's basis in exchanged target stock. Seller loses control of the business and still has a concentrated, undiversified investment. Cash, if any, received by seller in the exchange is generally taxed as capital gain. Buyer has a carryover basis in the target's assets. Buyer uses newly issued shares and not cash for acquisition. California generally follows federal rules.

I.1.7 **Sale of C corporation stock** to which a **partial gain exclusion would apply under Section 1202**, followed by **Section 1045 reinvestment** in other "qualified small business stock." Zero federal income tax on the sale. Careful, long-term planning needed to protect eligibility for the Section 1045 rollover.81 No liquidity and continued concentration in one asset. No AMT preference. Section 1045 deferral does not apply for California income tax purposes. Tax-free reorg available as a back-up.

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80 The "target" is the corporation that owns the business that is being sold.

81 See Section 7.8 above regarding the Section 1045 deferral.

Exhibit I

What's the Best Structure for Exiting A Business (under Current Law)?

Twenty ways to exit a business, ranked from best to worst, tax-wise:

I.1 **Tax-free dispositions**:

I.1.1 **Sale of C corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the estate of the shareholder is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero. 100% liquidity after the sale. Unlike an S corporation or a partnership, no limitation on the basis step up for the corporation's items that would be IRD if held by the shareholder.[76] No federal *or California* income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. But ... unlike a partnership, no basis increase for the heir's share of the C corporation's liabilities. Section 1202 exclusion, Section 1045 deferral, sale of stock to an ESOP and tax-free reorg all available as a back-ups for lifetime disposition.

I.1.2 **Sale of partnership interest** after a **Section 742/1014 basis step up at the death of the partner** (or the spouse of the partner if the interest was held as community property), when the estate of the partner is less than the **estate tax exclusion**, so the marginal estate tax rate will be zero – unlike a corporation, the basis in the interest increase for the heir's share of the partnership's liabilities - a limitation applies to the basis step up to the extent that the value of the interest is attributable to the partnership's items that would

[76] "IRD" is "income in respect of a decedent." The Section 1014 basis step up does not apply to assets held by the decedent that would generate IRD. An extension of this rule applies to partnership interests attributableto accounts receivable and to the decedent's S corporation stock to the extent that the corporation held items that would be IRD if held directly by the decedent, but not to shares of a C corporation.

I.2 **Taxable dispositions – *one* level of tax**:

I.2.1 **Sale of S corporation stock** – One level of tax. All gain taxed as capital gain, installment sale treatment available. Undistributed S corporation income in prior years will have increased the seller's share basis, decreasing gain on sale. Section 336(e) or 338(h)(10) election (discussed below) and tax-free reorg available as back-ups. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.2 **Sale of stock by C corporation** and buyer makes a **"straight" Section 338 election** (aka a "Section 338(g) election") – One level of tax. Treated as stock sale to seller, followed by a dissolution of the corporation by the buyer (triggering "inside" gain, resulting in a higher basis in the assets for the buyer and permitting the buyer to amortize goodwill over 15 years). Rare before 2018. Usually made sense only for targets with big NOLs to absorb the gain. It appears that the new 100% depreciation deduction applies to assets that are deemed purchased, so the straight Section 338 election might become less rare – because the deduction will wipe out the inside gain triggered by the deemed sale. Tax-free reorg available as a back-up.

I.2.3 **Sale of assets by C corporation followed by a liquidating distribution to which the Section 1202 exclusion applies** – One level of federal tax.[82] Corporate tax rates apply to gain on all assets, including goodwill. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture, but distribution of installment note triggers the deferred gain. The net investment income tax does not apply to the realized but unrecognized gain excluded by Section 1202. Double California income tax (on both sale and distribution of after-tax sale proceeds). Tax-free reorg available as a back-up.

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[82] See Section 7 above regarding using Section 1202 to eliminate or reduce tax on the sale of C corporation stock.

(Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.4 **Sale of assets of a sole proprietorship** – One level of tax. Ordinary income -- and no installment method -- on depreciation recapture. No Section 1202, 1045, sale by ESOP or tax-free reorg available as a backup.

I.2.5 **Sale of C corporation stock when no Section 1042, 1045 or 1202 exclusion is available**. One level of tax. All gain taxed as capital gain, installment sale treatment available. Basis in shares might be tiny. Tax-free reorg available as a back-up. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.6 **Sale of S corporation stock with a Section 336(e) or 338(h)(10) election** – One level of tax. Treated as sale of assets, so ordinary income on gain from cash method receivables, on inventory and depreciation recapture; capital gain (taxed at low federal rates) on sale of goodwill. Big tax benefit to buyer, who might gross up the price to cover the ordinary income. Installment sale method available for income other than depreciation recapture. Tax-free reorg available as a back-up. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.7 **Sale of assets by S corporation** – One level of tax. Ordinary income and capital gain as noted above for sale of S corporation stock with a Section 338(h)(10) or 336(e) election. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture; with proper planning, distribution of installment note does not trigger tax on deferred gain. California tax (at 1.5%) on the S corporation's income. Tax-free reorg available as a back-up. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.8 **Sale of *interest in* multi-member LLC or partnership** – One level of tax. Ordinary income and no installment method to the extent the sale price is allocable to income from providing services and inventory. Capital gain and installment method availa-

ble for rest of price. Often difficult to achieve a tax-free combination as a back-up. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.9 **Sale of *assets by* multi-member LLC or partnership** – One level of tax. Possibly the same as a sale by an S corporation, with a different California entity-level tax (based on gross receipts). Gain might be allocated to the "partner" who contributed the assets sold. Sales tax likely without pre-sale planning. Difficult to do a tax-free combination as a back-up. (Note: the ranking assumes that the sale proceeds are not subject to estate tax.)

I.2.10 **Sale of C corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the **federal 40% estate tax rate applies** – no limitation on the basis step up for the corporation's items that would be IRD if held by the shareholder[83] - no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Unlike a partnership, no basis increase for the heir's share of the C corporation's liabilities - Tax-free reorg available as a back-up for lifetime disposition.

I.2.11 **Sale of partnership interest** after a **Section 742/1014 basis step up at the death of the partner** (or the spouse of the partner if the interest was held as community property), when the **federal 40% estate tax rate applies** – unlike a corporation, the basis in the interest increase for the heir's share of the partnership's liabilities - a limitation applies to the basis step up to the extent that the value of the interest is attributable to the partnership's items that would

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[83] "IRD" is "income in respect of a decedent." The Section 1014 basis step up does not apply to assets held by the decedent that would generate IRD. An extension of his rule applies to partnership interests and S corporation stock held by the decedent, but not to shares of a C corporation.

be IRD if held by the decedent[84] – otherwise, no federal or California income tax on the sale, no complications and limitations of Section 1202, no restrictions on the use of the funds as in Section 1042. Difficult to do a tax-free combination as a back-up.

I.2.12 **Sale of S corporation stock** after a **Section 1014 basis step up at the death of the shareholder** (or the spouse of the shareholder if the shares are held as community property), when the **federal 40% estate tax rate applies** – unlike a partnership, no basis increase for the heir's share of the S corporation's liabilities - a limitation applies to the basis step up to the extent that the share value is attributable to the S corporation's items that would be IRD if held by the shareholder[85] – otherwise, no federal or California income tax on the sale, no complexity and limits of Section 1202, no restrictions on the use of the funds as in Section 1042. Tax-free reorg available as a back-up for lifetime disposition.

I.3 **Taxable dispositions – *two* levels of tax**:

I.3.1 **Sale of assets by C corporation** – Two levels of federal and California tax. Corporation pays tax on "inside" gain from sale. Shareholders pay tax on distribution of after-tax sale proceeds. "Outside" transaction is capital gain, with application of basis *if* the corporation elects to dissolve; otherwise, "outside" transaction is dividend with no application of basis. Sales tax might also apply to sales of tangible personal property not held for resale (generally, furniture, equipment and vehicles). Tax-free reorg available as a back-up.

[End of Exhibit I.]

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84 Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

85 Note that this will severely limit the basis step up for the shares of an S corporation used to conduct a professional practice, if much of the value is attributable to work in process and accounts receivable for personal services, which are IRD items.

Exhibit J

Choice of Entity

(Holding company example)

Choice of Entity

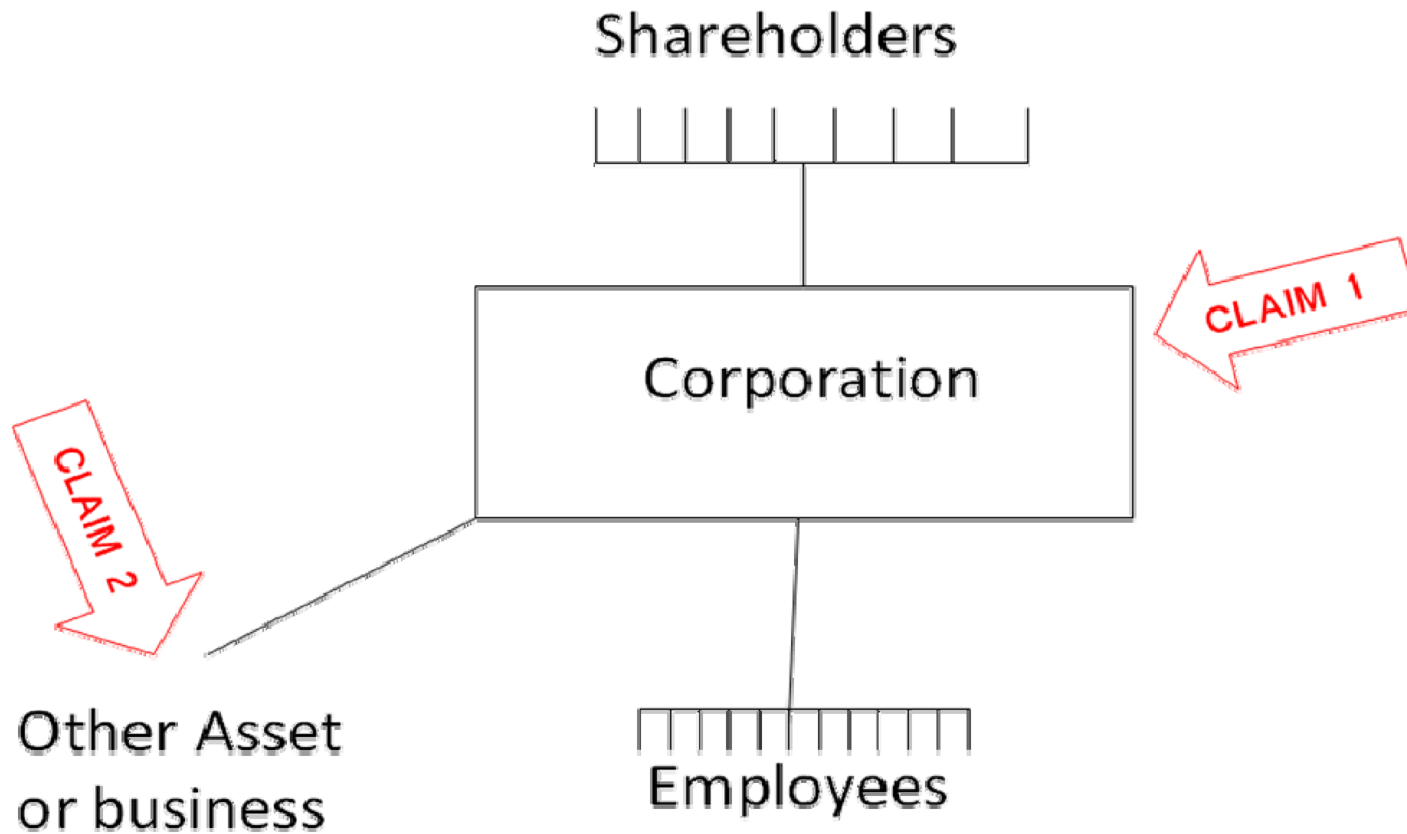
Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

Concern: A claim against the operating business can be satisfied with the other valuable assets.

Tip: Create a holding company structure to isolate the operating business from the valuable assets.

www.staleylaw.com

William C. Staley


Old Structure
Shareholders
Corporation
CLAIM 1
CLAIM 2
Other Asset
or business
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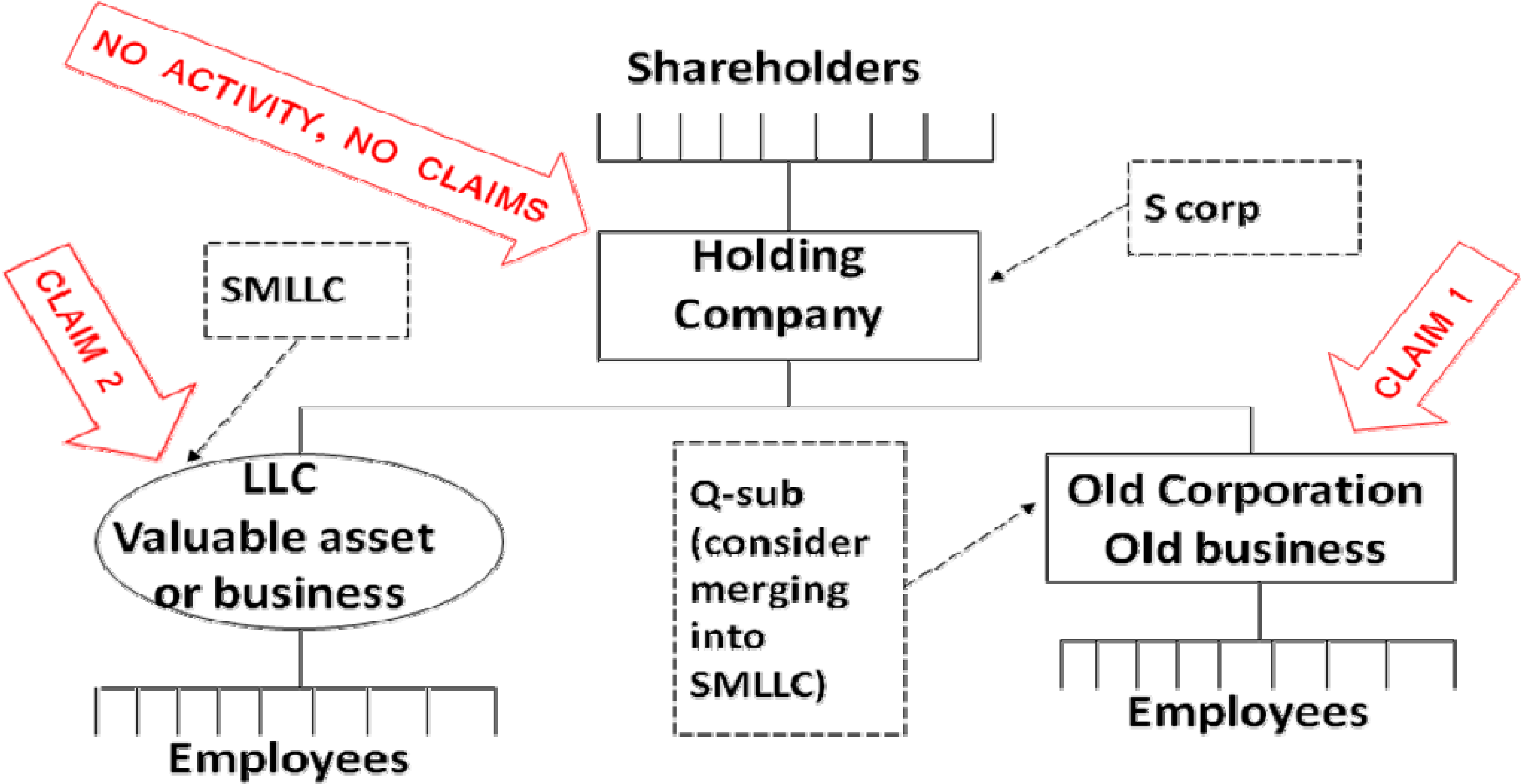

[End of outline.]