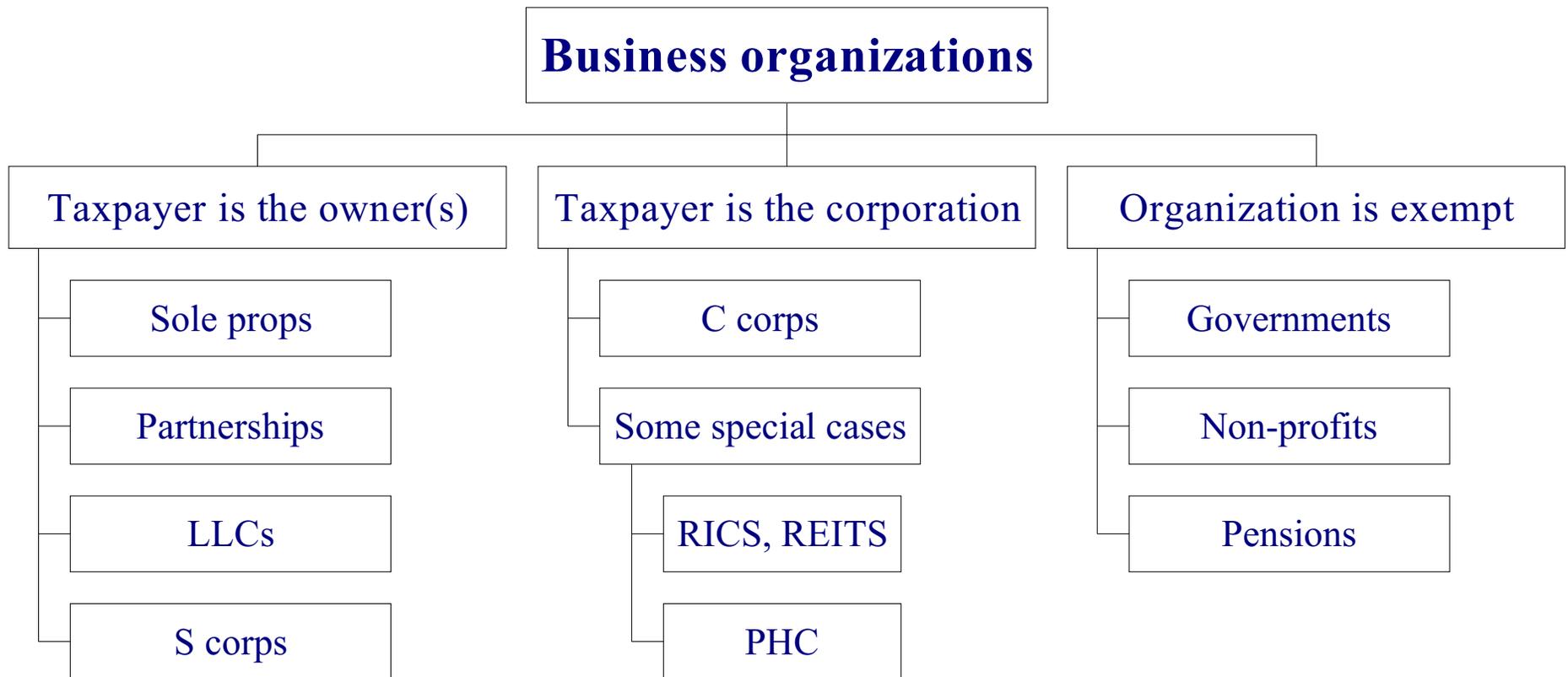


Session 5 - Types of Organizational Forms



Partnerships

▶ Non-tax features

- Flexible ownership
- Limited partners have limited liability
- Must have at least one general partner

▶ Tax features

- No partnership level tax, also no deferral
- Items of income retain character
- Special allocations of income and deductions
- Basis includes share of partnership liabilities (complicated)



C Corporations

▶ Non-tax features

- Limited liability
- Flexible capital structure & ownership

▶ Tax features

- Deferral of personal taxes until dividends are paid or shares are sold
- Double taxation
- Can not pass through losses
- Capital losses can only offset capital gains



S Corporations

▶ Non-tax features

- Limited Liability (No difference between C and S corporations from “legal” perspective)

▶ Tax features

- Limitations on number and type of shareholders
- Generally no entity level tax, also no deferral
- Items of income retain character
- Subject to several special taxes (built in gains tax)
- No special allocations
- Basis not increased by share of S Corp liabilities



Limited Liability Companies (LLCs)

▶ Non-tax features

- No limitations on ownership
- Limited liability
- Less developed case law

▶ Tax features

- Treated as partnership for tax purposes
- Subject to state tax in some states
- Check the box rules



Other Special Provisions (§ 1202)

- ▶ “Qualified small business corporation”
 - Shareholders (other than C corps) can exclude 50% of the gain from the sale or exchange of “qualified small business stock” held for more than 5 years
 - limited to the greater of \$10 million or 10 times the adjusted basis (reduced by gains taken in earlier years)
 - Stock was acquired by taxpayer at original issue for money, property or services
 - “Qualified small business” is a domestic C corporation whose aggregate gross assets before and immediately after the stock issuance did not exceed \$50 million



Other Special Provisions (§ 1244)

- ▶ Permits a limited amount of tax relief for shareholders of small business corporations
 - Shareholders are entitled to an ordinary loss deduction if they sustain a loss upon the sale or exchange of their stock
 - subject to an annual limitation of \$50,000 (or \$100,000 for joint returns)
 - A corporation qualifies for this treatment if the aggregate amount of money and other properties received by it for stock, as a contribution to capital, and as paid in capital does not exceed \$1 million



After-tax accumulations

- ▶ ATA for partnership = $(1 + R_p(1-t_p))^n = (1 + r_p)^n$
- ▶ ATA for non-dividend-paying corporation
 - = $(1 + R_c(1-t_c))^n(1-t_{cg}) + t_{cg}$
 - = $(1 + r_c)^n(1-t_{cg}) + t_{cg}$
- ▶ Prefer partnership form (ignoring non-tax costs) if:
$$(1 + R_p(1-t_p))^n > (1 + R_c(1-t_c))^n(1-t_{cg}) + t_{cg}$$
- ▶ Corporate form becomes more beneficial
 - As n increases
 - As t_{cg} falls
 - As t_p increases



Partnerships Versus Corporations

► Let assume the following:

- Pretax rate of return (R) = 10%
- Initial Investment = \$10
- Personal tax rate (t_p) = 40%
- Corporate tax rate (t_c) = 30%
- Inclusion factor (g) = 1 (no special capital gains rate)
- Horizon (n) = 2



Partnership

Year 1:	Return \$10.00 * 0.10 =	\$1.00
	Investor tax = (1.00 * 0.40) =	0.40
	After tax return =	0.60
Year 2:	Return \$10.60 * 0.10 =	\$1.06
	Investor tax = (1.06 * 0.40) =	0.42
	After tax return =	\$0.64

ATA after 2 years: $(10 + .60 + .64) = \$11.24$

“Money Market” formula for partnership returns

$$[1 + R(1 - t_p)]^n$$



Corporation (No Dividends)

Year 1:	Return $\$10 * 0.10 =$	\$1.00
	Corp tax = $(1.00 * 0.30) =$	0.30
	After tax return =	0.70
Year 2:	Return $\$10.70 * 0.10 =$	\$1.07
	Corp tax = $(1.07 * 0.30) =$	0.32
	After tax return =	\$0.75
	Investor tax = $(0.40 * (0.70+0.75)) =$	0.58

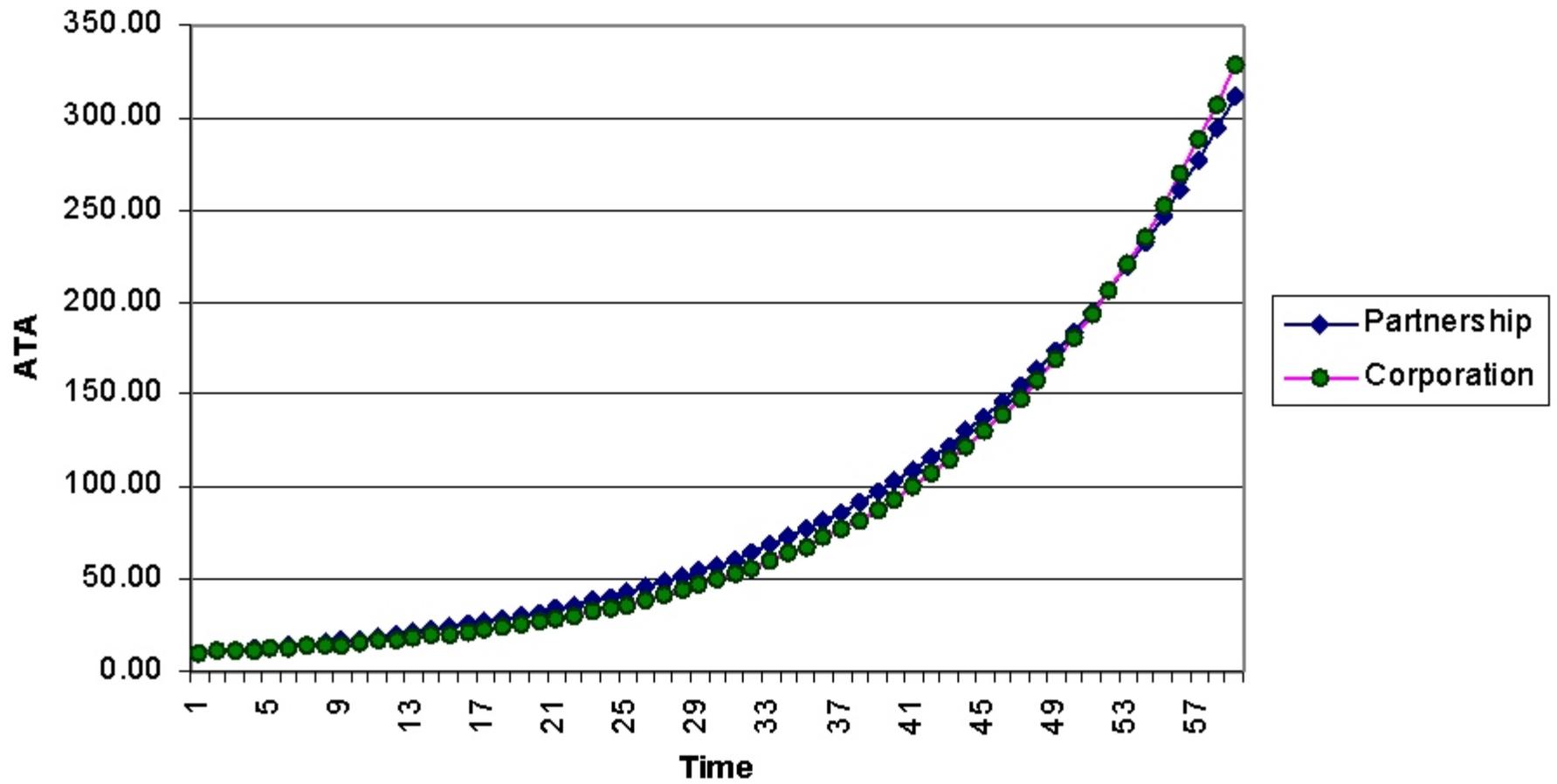
ATA after 2 years: $(10+.7+.75-.58) = \$10.87$

Partnership Wins, but what if “n” increases?

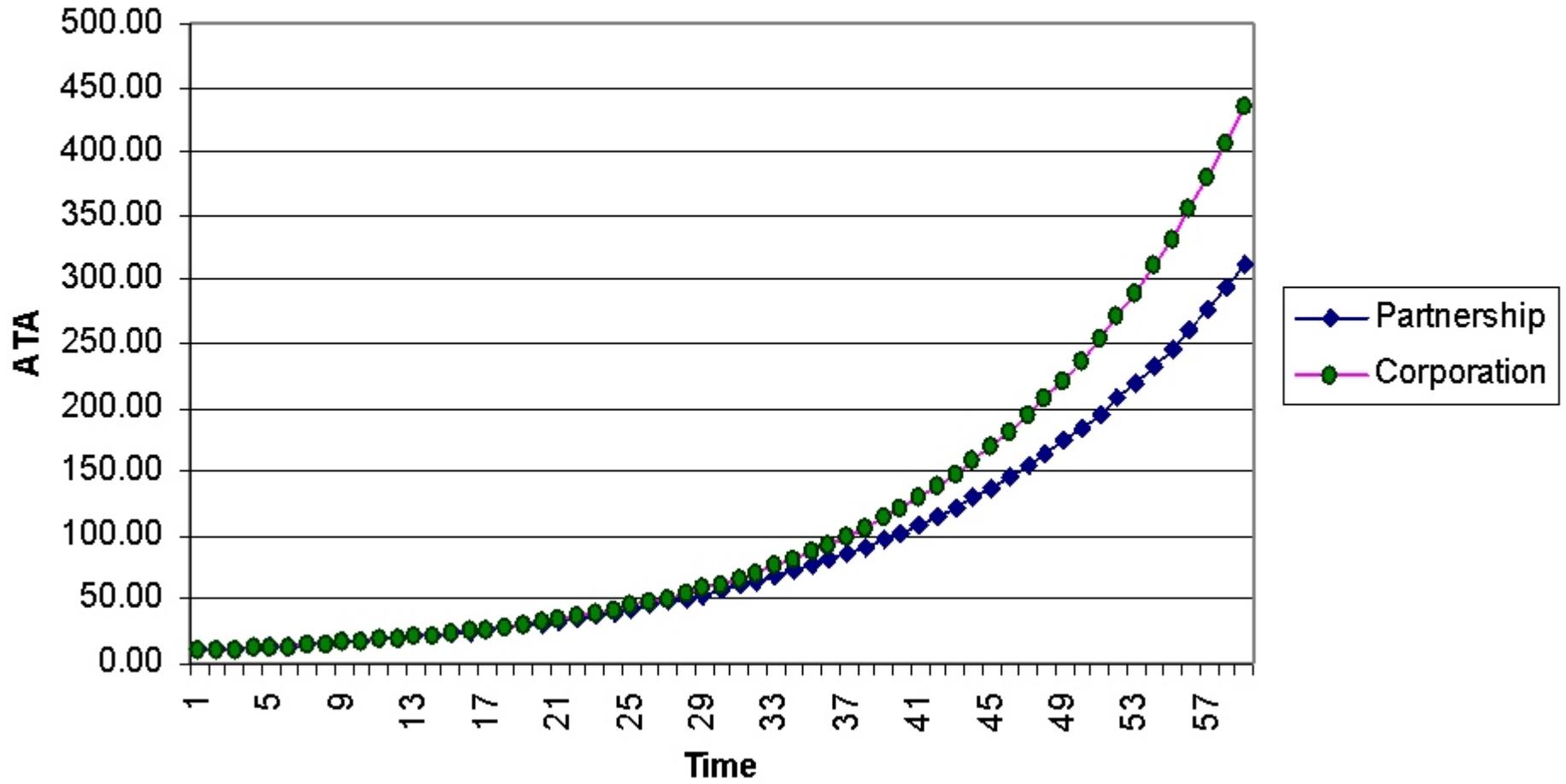
What if you get a reduced capital gains tax on sale of stock (liquidation)?



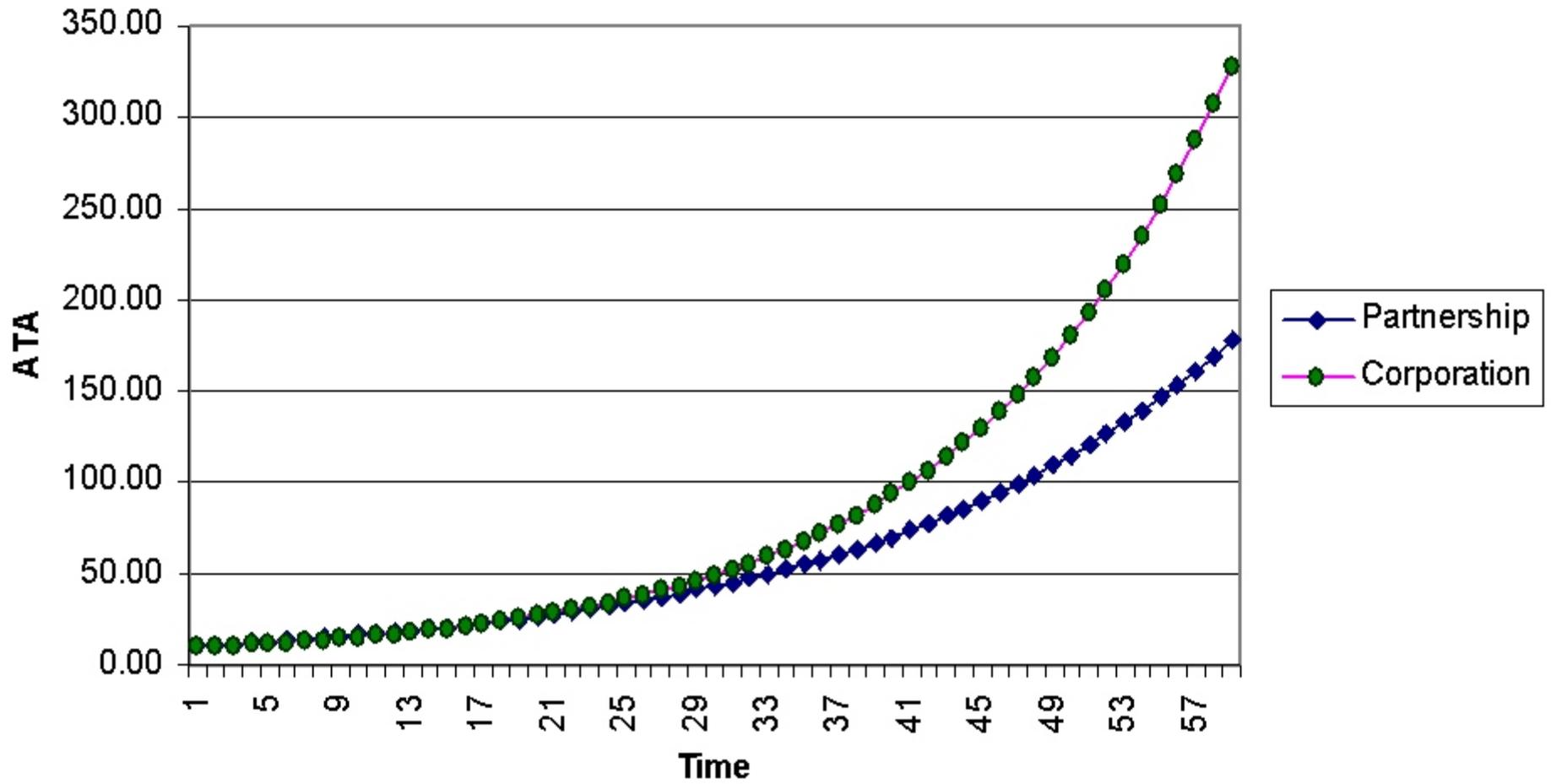
Partnerships versus Corporations (Base Case)



Partnerships versus Corporations (capital gains rate decreased to 20%)



Partnerships versus Corporations (individual rate increased to 50%)



Partnerships Versus Corporations

- ▶ Ignoring non-tax costs, what factors determine whether partnerships or corporations are best?
 - Length of investment horizon
 - as "n" increases, corporate form favored
 - Investor's personal ordinary tax rate
 - as personal rates increase, corporate form favored
 - Corporate tax rate
 - as corporate rates increase, partnership form favored
 - Investor's tax rate on corporate shares
 - as capital gains rate decreases, corporate form favored



What about Start-ups?

- ▶ New businesses generate losses
- ▶ In a partnership (conduit entity), losses flow to owners generating immediate tax savings
- ▶ In a corporation, losses are trapped at the entity level as NOLs
 - Tax savings are deferred
- ▶ Do losses affect our analysis?



Partnerships versus “S” Corporations

▶ Characteristics of Partnerships

- flexibility of income and loss sharing arrangements
- advantage with pass-through losses
- unlimited liability

▶ Characteristics of S Corporations

- limited liability
- considered a “taxable” entity in several states



Pass-through Loss Advantage

- ▶ Example: 2 investors go into business together to purchase an office complex with a FMV of \$1,000,000. The seller wants the purchasers to pay \$100,000 in cash plus assume a \$900,000 mortgage. The investors are considering forming a partnership or an S Corp to carry out this venture. In either case, they would contribute \$50,000 each for a 50% share.



Loss Advantage, continued

- ▶ If the venture is organized as a partnership, each individual will have a basis of $\$50,000 + (50\% \text{ of } \$900,000) = \$500,000$
- ▶ If the venture is organized as an S Corp, each individual will have a basis of $\$50,000$ & the S Corp will have a basis in the building of $\$1,000,000$.
- ▶ Now assume that the venture will have a $\$200,000$ loss in the first year.
- ▶ What's the outcome for each entity type?



Avoiding a Double Tax

- ▶ How can you get cash out of a corporation without paying a corporate level tax?
- ▶ Closely held businesses
 - Compensation
 - Interest
 - Constructive dividends
 - Debt



Leverage

- ▶ Dividend payments are subject to “double taxation” since they are not deductible to the corporation. One tax at the corporate level when the company has earnings and again when they are paid out as dividends
- ▶ Interest payments are only subject to one tax since they are tax deductible to the corporation



Leverage - Converting a Corporation into a Partnership

	<u>All Equity</u>	<u>99.99% Debt</u>
Pretax earnings	1000	1000
Less interest	<u>0</u>	<u>-1000</u>
Taxable income	1000	0
Corp. tax @ 40%	<u>-400</u>	<u>0</u>
After tax earnings (dividends)	600	0
Dividends received	600	0
Interest received	0	1000
Personal tax @ 30%	<u>-180</u>	<u>-300</u>
After tax return	420	700



Leverage

- ▶ Why don't firms have 99% debt?
 - Financial distress costs
 - IRS may recast debt as equity
- ▶ Are there nontax benefits of debt?
 - reduction of agency costs (Jensen's free cash flow argument)
 - signaling value



Alternatives to double taxation

- ▶ No personal level tax (and eliminate the corporate deduction for interest payments).
- ▶ No entity level tax.
- ▶ Both entity and shareholder level taxes but an entity level deduction for dividends paid.
- ▶ Both entity and shareholder level taxes but an investor level credit for corporate taxes deemed paid.
- ▶ Partnership taxation.

