PacificCPE

COURSE
81653A

Business Entities: LLCs, Corporations, and Sole Proprietorship Conversions

Real-world scenarios bring entity selection to life in this course, which uses four business stories to compare LLCs and corporations side by side. From there, the focus shifts to conversions—specifically what happens when a sole proprietorship or partnership outgrows its original structure. If you work with clients who are considering a change in entity type, this course provides practical insight into the tax and legal implications of making that transition.

CREDIT HOURS **2** | FIELD OF STUDY **BUSINESS** | EXAM QUESTIONS **10**

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the entity form chosen by Soaring Duck Machines.
- Identify what IRS Form 1065 is used for.
- Identify the types of conversions that result in taxable events.

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Chapter 1: LLC OR CORPORATION: FOUR BUSINESS STORIES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the entity form chosen by Soaring Duck Machines.

Previous chapters gave you basic legal and tax rules for choosing between an LLC or a corporation (or other business entity). This chapter pulls all of this information together, in a form that should give you some ideas about the best way to structure your decisions. Four fictional examples are presented to illustrate common business scenarios. Hopefully, one of these scenarios will shed some light on your own business entity decision:

- The sole owner of a business wants limited liability protection.
- A two-owner startup chooses its business form.
- A multi-member LLC wants to end pass-through taxation and give key employees ownership stakes.
- A tech startup seeks the right business form.

GABBY'S GEARS: SOLE PROPRIETORSHIP, SINGLE-MEMBER LLC, OR SINGLE-OWNER CORPORATION?

Gabby has decided to leave her 20-year career in medical device sales to pursue her true passion—motorcycle repair. Gabby has worked on her own bikes and many of her friends' bikes over the years. She's very good at it and she knows that bike owners in her area have to travel several towns over for a quality repair service. Gabby has already identified an abandoned gas station with two service bays that would be perfect for her shop. She has a nephew who's a car mechanic but knows his way around motorcycles and might come to work for her. Gabby will be the only owner and she doesn't plan to take on debt—she'll fund the shop from her own savings until it can fund itself.

Gabby is willing to put some of her savings into the shop, but she doesn't want to put her house, car, and 401(k) account at risk. She knows people who've gone into business together and formed LLCs, but she's not sure what entity options are available to her. So, she does a bit of research and learns that she can form a single-member LLC (SMLLC) or a single-owner corporation in her state. She's not sure which would be better for her business, but she has a lawyer friend who owes her a favor after she fixed a problem with the engine on his motorcycle (after two full-time mechanics had failed). The attorney gives her the following advice:

- She should definitely not operate as a sole proprietor, as she could be on the hook for business debts should the business be unable to pay. Even though she doesn't plan to take on business debt, a motorcycle repair shop carries significant risks, such as a customer slipping and falling in the shop, or a problem with a repair that results in a motorcycle accident. Gabby needs limited liability protection from potential lawsuits against the business.
- In choosing between an LLC or a corporation, an SMLLC would give Gabby the same limited liability protection as a single-shareholder corporation. The SMLLC is simpler to administer than a corporation and would allow her to enjoy pass-through taxation.
- Gabby should form and operate the business as an SMLLC.

Gabby agrees, and Gabby's Gears LLC roars into existence.

FAST FOOD FUSION: A TWO-OWNER STARTUP BUSINESS CHOOSES A BUSINESS FORM

Gil and Vera are chefs. They decide to quit their salaried jobs and strike out on their own by opening a multicuisine drive-through restaurant. They reject Gil's first choice for a business name, Kwik Kwisine, after Vera searches the internet and learns that another food company is already using it. Rather than engage in a potential name battle with a national company, Vera suggests Fast Food Fusion, an available choice at the time, which Gil also likes.

Gil and Vera can't fund the restaurant entirely on their own, but Vera has family members who are interested in investing to help get it off the ground. Vera's relatives don't want to be involved in the business, other than as passive investors.

What's the best business entity for this business and its owners? Here's a menu of the choices available to Gil and Vera, and a summary of how each fits—or doesn't fit—their situation:

- **Partnership.** A general partnership isn't a good choice. First, the investors want to be silent partners, not general partners. Second, and more important, a restaurant is a high-risk business. Customers fall and get injured. Even with good quality control, food poisoning can occur. Food allergies can be accidentally triggered. If the restaurant serves alcohol, a customer who is over the blood alcohol level might be served and later get in an accident while under the influence. At any given time, the restaurant might owe significant sums to food suppliers and other vendors. General partners don't have limited liability; they would be personally liable for any obligations the business can't meet.
- **Limited partnership.** A limited partnership is a better choice than a regular partnership—the investors can be made limited partners who won't be personally liable for business debts or have an active voice in managing the business. However, the limited partnership still presents problems, the biggest of which is that Gil and Vera, as general partners, will be personally liable for business debts.

- **Limited liability company.** The LLC, with its limited personal liability, appears to be the right match for Gil and Vera. They can set up a manager-managed LLC—Gil and Vera will have management responsibility, while the investors will become nonmanaging members. The LLC will provide them with pass-through tax treatment, which they all desire. (For more on LLC and corporate taxation, see Chapter 2 of course 81652C.)
- **Corporation.** Gil and Vera could incorporate and serve as the directors and principal officers of the business, while the investors participate as shareholders. This legal structure would meet Gil and Vera's needs, but it is more formal than Gil, Vera, and the investors require—they don't want to hold director and shareholder meetings each year, for example. Also, as noted above, all of the owners want pass-through taxation. If Gil and Vera form a C corporation, they would need to elect S corporation status to have pass-through taxation. Fast Food Fusion LLC would provide pass-through taxation with a simpler structure.

The final verdict: For Gil and Vera, the LLC is the best choice. It will give them limited liability, pass-through tax treatment, and day-to-day control over the business.

SOARING DUCK MACHINES SEEKS A DIFFERENT TAX AND OWNERSHIP STRUCTURE

Mike and Marty Mandrake, brothers, have built up their multi-member LLC manufacturing business, Soaring Duck Machines LLC, to where it has more than 75 employees and occupies the entire ground floor of a reconditioned factory building. Sales and profits are increasing as the business finds new retail outlets and distributor channels for its products.

For the first few years of the business, being an LLC and having pass-through taxation made sense. Profits were modest, but Mike and Marty were able to take out what they needed to live and to cover taxes owed on the pass-through income. More recently, while profits have been growing, the brothers have been leaving more of the profits in the business to fund expansion. Because they are taxed on LLC profits whether distributed or not, each is facing the "phantom income" problem discussed in Chapter 2 of course 81652C—they owe tax on income that hasn't been distributed to them. To make matters worse, the phantom income is driving the brothers into higher individual tax brackets.

Soaring Duck has two senior-level managers, aside from Mike and Marty, who are critical to the company's success. Pat oversees operations on the factory floor and Chris manages the sales team. Both have been with the company since its early days and, together with Mike and Marty, are the leadership team. Mike and Marty want to give Pat and Chris each a 10% ownership stake to recognize their contributions to Soaring Duck and, hopefully, to encourage them to stay with the company for many years to come. Ideally, Pat's and Chris's ownership interests would be nonvoting, as Mike and Marty each owns 50% of the LLC and they don't want to disrupt that parity. Their

primary goal is to give Pat and Chris an economic stake in the company and a share of the proceeds if the company is ever sold.

Soaring Duck's tax adviser has suggested that they convert the LLC to a C corporation. Mike and Marty would become employees of the corporation and be paid salaries. The salaries would be taxable to them individually, but the corporation would deduct the salaries as a business expense. Social Security and Medicare taxes (FICA taxes) would be owed only on their salaries and would be split between the company and them individually (through payroll deductions). Currently, the Mandrakes are paying self- employment tax on all LLC profits.

Most importantly, profits left in the business would be taxed only at the corporate rate (currently 21%), not at the brothers' higher personal tax rates. When it becomes less necessary to keep most of the profits in the business to fund growth, the brothers, as shareholder-employees, can take larger salaries or bonuses (so long as their overall compensation is reasonable).

Converting to a C corporation would also facilitate giving nonvoting ownership stakes to Pat and Chris. The corporation could have two classes of stock, voting and nonvoting, with Mike and Marty holding all the voting stock and Pat and Chris holding the nonvoting shares. Such a structure would also allow the Mandrakes to include other employees in ownership in the future without disrupting the 50/50 voting split between the brothers. The tax adviser cautions Mike and Marty that having a second class of stock would prohibit them from electing S corporation status should they ever want to return to pass-through taxation. Mike and Marty are content to cross that bridge if and when they get to it.

The Mandrakes agree with the adviser's recommendations, and Soaring Duck Machines LLC becomes Soaring Duck Machines Inc., a C corporation. To avoid complicating matters, their lawyer and CPA advise holding off on issuing the nonvoting stock until the conversion is complete. (LLC-to-corporation conversions are discussed further in Chapter 1 of course 81654C.)

SERMIN TECHNOLOGIES: FORMING A TECH STARTUP

Sergei and Min teach university-level courses in developing artificial intelligence large language models (LLMs). They believe that they can work together to develop LLM agents that enterprises can integrate into their websites and application software, which is why they're preparing to form SerMin Technologies.

Neither Sergei nor Min has started a company or worked in a startup, but they realize that they won't get far without at least a handful of employees to help sell LLM agents to commercial clients. Their team might be able to work remotely to begin with, but eventually they'll need some office space. Sergei and Min know that SerMin will also need an experienced business adviser and a lawyer to help them navigate the startup waters. All of which, they know, adds up to money. Where money is concerned, SerMin will need investors early and often—enough at each stage to get to the

next stage of financing. They'll likely start with angel investors and then, hopefully, move on to venture capital.

While they do understand some aspects of startups, Min and Sergei have very little knowledge about business entities or how to legally structure SerMin Technologies. Thankfully, the university operates a business startup lab for students and alumni, and Sergei and Min know Allison, the woman who heads the lab. Allison is able to give them some clear guidance on forming SerMin, including:

- The company will need to be a C corporation—not a partnership, an LLC, or an S corporation. It will need to be a C corporation because investors will require it, as will employees and advisers who are being compensated with shares or stock options.
- SerMin should be a corporation from the outset. Don't start as a partnership or LLC and then convert to a corporation. It's better to have the right structure in place from the beginning.
- The corporation should be a Delaware corporation because that's what investors want. Investors know how Delaware corporate law works.
- A C corporation is also the right form for the company down the road, if it is acquired by another company. Such a sale can be done as a tax-free corporate reorganization that merges SerMin into a larger corporation at minimal tax cost to the corporation and its shareholders. (For more information on corporate mergers, see Chapter 2 of course 81654C.)
- If SerMin will be out looking for seed money right away, Sergei and Min should become familiar with the Seed Series standard transactions and agreements. For financing after the seed round, founders should know their way around the Y Combinator SAFE (Simple Agreement for Future Equity) documents.

Sergei and Min plan to take Allison's advice and form SerMin Technologies Inc., a Delaware C corporation.