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TAX & TRANSACTIONS BULLETIN

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- U.S. Families have accumulated significant wealth.
- Family goals are to preserve this wealth.
- The choice of Entity which will conduct the Family Business is critical to protecting the family's wealth.
- Specific goals for the Family Business include:
  - keep assets within the Family
  - protect assets from creditors
  - reduce income and estate taxes
  - avoid probate and guardianship proceedings
- In many cases tax is a secondary consideration of the owner. Limited liability is often the primary consideration.

CHOICE OF ENTITY FOR THE FAMILY BUSINESS

Many U.S. Families have accumulated significant wealth. Family goals and objectives often focus on preserving this wealth. Specifically, Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate tax taxes; (d) resolve Family disputes quickly (avoid intraFamily litigation); and (e) avoid probate and guardianship proceedings.

A Family will often establish one or more business or investment activities. This Family Business should be set up to protect and grow the family's wealth. The choice of entity which will conduct that Business is critical to protecting the family's wealth.

Organizers of a business or investment activity must choose a legal form to conduct their venture. Federal tax treatment is an important, but not the sole, consideration. In addition to minimizing taxes, the Family (as owner of the business) will desire to limit its liability.[1] The Family should also understand the nature of the business and how it operates. The Family needs to understand the dynamics of its key relationships including: the relationships between Working Family Members and Non-Working Family Members; the relationships between the Family and its creditors, suppliers and customers; and the relationship between the Family and its employees.

From a tax perspective, there are four basic entities to choose from in structuring a business: the sole proprietorship, the partnership (including the LLC), the S corporation, and the C corporation. While tax considerations may be among the most important factors in selecting the structure for a new activity, practitioners should keep tax considerations in perspective. In many cases tax is a secondary consideration of the owner. Limited liability is often the primary consideration. Recall that federal income and transfer taxes apply at marginal rates (i.e. the tax is a percentage of the dollar amount involved), whereas judgment creditors are ordinarily entitled to recover one hundred cents on the dollar from the owner-debtor.

[1]In choosing an entity, the Family should determine its goals and objectives. Identifying goals requires careful thought. In selecting a legal entity to conduct business or investment activity, owners generally identify limited liability as a paramount goal.

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There are two distinct forms of liability. First, there is the liability of the owner for the debts and obligations of the entity ("inside liability"). Second, there is the risk that the owner's equity interest in the entity will be subject to attachment by the owner's personal creditors ("outside liability"). Practitioners need to consider both forms of potential liability.

Frequently businesses begin their life cycle as sole proprietorships which are the most basic form of business organization. In the sole proprietorship, an individual owns 100% of the business equity, conducts business, and holds property in his own name. The sole proprietor has unlimited liability for both contract and tort claims (negligence, fraud, etc.). Personal liability cannot be limited through operation under an assumed name.

The unlimited liability of a sole proprietorship frequently means that the sole proprietor will have few employees. All of the rights and powers of the employees are considered under the law of agency, thus making the sole proprietor personally liable for the acts of the employees. The primary advantages of the sole proprietorship are the lack of formality and the lack of procedural and organizational professional costs.

The most significant disadvantage of a sole proprietorship is the unlimited personal liability of the owner of the business for business-related claims. Another disadvantage is its inability to raise capital through sale of equity interests to investors. A business or investment venture should not be operated as a sole proprietorship if it is either involved in risk-related activities or large enough to have at lease one non-Family employee.

The limited liability company (LLC) is a hybrid between a corporation and a partnership, and can be described as a limited partnership without a general partner. The LLC shields its owners from inside liability in the same way a corporation protects its shareholders or a limited partnership protects its limited partners. Consequently, a member or a manager of the LLC is not personally liable for debts or obligations of the LLC solely by reason of being a member or manager.[2] Moreover, regarding outside liability, a member is not a co-owner of, and has no transferable interest in, property or assets of a limited liability company.[3] Only the member's "distributional interest" is treated as personal property which may be attached by creditors. For this reason, most LLC operating agreements specify that an independent manager has sole discretion as to the timing and amount of distributions. Since the members are not legally entitled to receive distributions,[4] a creditor who obtains a judgment against a debtor-member is limited solely to a charging order or lien against the discretionary distributions which are made to the member.[5] The judgment creditor appears to have no other statutory remedies against the LLC's assets to enforce his claim against the member,[6] although it is possible that a court may permit a creditor to pierce an LLC veil.

[2] 2805 ILCS 180/10-10(a).
[3] 805 ILCS 180/30-1(a).
[4] 805 ILCS/25-20.
[5] 805 ILCS 180/30-20.
[6] 805 ILCS 180/30-20(e).

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<u>Example 1: LLC Provides Liability Protection From IRS Levy</u>. *In IRS Chief Counsel Advice (CCA) 199930013, Taxpayer – an individual who was the sole owner of an LLC - was subject to collection action by the Service. The IRS issued a notice of levy on a business for which Taxpayer was performing services and from which, according to the Taxpayer's instructions, payments were being made to the LLC instead of to Taxpayer directly. District counsel inquired whether it may file a lien against the LLC, since as a single-member LLC it was disregarded for federal income tax purposes.* <u>IRS determined</u> *that under the "check-the-box" regulations, the individual is the person liable for any tax liability. Because the individual does not have an interest in the LLC's property, the Service cannot serve a levy on a third-party employer to seize a debt owed to the LLC to collect the tax liability of the individual. IRS also concluded that it is not inconsistent to disregard the LLC for tax purposes, but recognize it as a valid entity for determining what property the individual owns. However, the Service emphasized that it has several collection options, including (1) collecting from the individual's distributions, and (2) "piercing the LLC veil" in order to collect from the assets of the LLC as an alter ego of the individual.*[7]

[7]Thus, a member's interest in the LLC's assets may be subject to creditor collection efforts. For example, a judgment creditor may attach the member's distributional interest and thus receive the distributions due to the member. Also, a creditor may attempt to "pierce the LLC veil"; see <u>Hollowell v. Orleans Regional Hospital</u>, 1998 U.S. Dist. Lexis 8184 (E.D. La. 1998).

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