Multi-Entity Planning To Provide Benefits and Reduce Risk

Planning with Multiple Business Entities and Life Insurance

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Entity Planning

- Attributes of different entities may necessitate multi-entity planning:
  - S-Corporation K-1 income is not subject to employment taxes
  - Partnerships allow for distribution of appreciated assets without triggering taxation on gain
  - C-Corporations allow business owners to receive fringe benefits
- It is always up to the client’s tax advisor to determine if an additional entity is warranted or necessary

In Many Cases, One Entity is Insufficient

- Some common reasons for multi-entity planning:
  - Business succession planning
  - Fringe benefit planning
  - Estate planning
  - Risk reduction
- Multi-entity planning is not for:
  - Qualified plans
  - Pure tax avoidance
  - Nonqualified deferred compensation plans
    - IRC Section 409A and Employee Retirement Income Security Act (ERISA) issues

The First Hurdle - Is the Entity a Legitimate Business?

- Two tests
  1. Business purpose
     - Must demonstrate that:
       - The taxpayer was motivated by the opportunity to profit from the transaction, or
       - At least had a valid business reason for entering into the transaction other than tax savings
  2. Economic substance
     - Codified in 2010 by Health Care and Education Reconciliation Act of 2010:
       - Section 1409 of Act
       - Amended IRC Section 7701(o)

Economic Substance Doctrine

- A business transaction only has economic substance if:
  - The transaction changes the taxpayer's economic position in a meaningful way (i.e., apart from federal income tax effects), and
  - There is a substantial purpose (i.e., not related to federal income tax effects) for entering into such transaction.
    - Not including reducing state or local income taxes or achieving favorable accounting treatment aimed at reducing federal income taxes.
- Penalties:
  - Penalty of 20% where a transaction fails the economic substance test.
  - Penalty increases to 40% if the transaction is not adequately disclosed.
  - There are no exceptions to the penalty, including "reasonable cause."

What Constitutes Economic Substance?

- Facts and circumstances that show the application of the economic substance doctrine to a transaction is likely not appropriate:
  - Transaction creates a meaningful economic change on a present value basis (pre-tax)
  - Transaction has credible business purpose apart from federal tax benefits
  - Transaction has meaningful potential for profit apart from tax benefits
  - Tax benefit is not artificially generated by the transaction
- Full list available at: http://www.irs.gov/businesses/article/0,,id=242253,00.html

Business Succession Planning

- New or outside entity used as conduit for succession plan
  - Similar to trusteed buy-sell but using a business entity
  - Generally a partnership or a limited liability company (LLC) taxed as a partnership
    - Avoids entanglements with the transfer-for-value rule
- Traditionally, a cross purchase buy-sell structure
  - Entity will own the life insurance policies
    - If partnership, potentially use special allocation rule for death benefits
  - Potential for full step-up in basis for purchasing owners
  - One life insurance policy per owner (owned outside of primary business)

Estate Planning

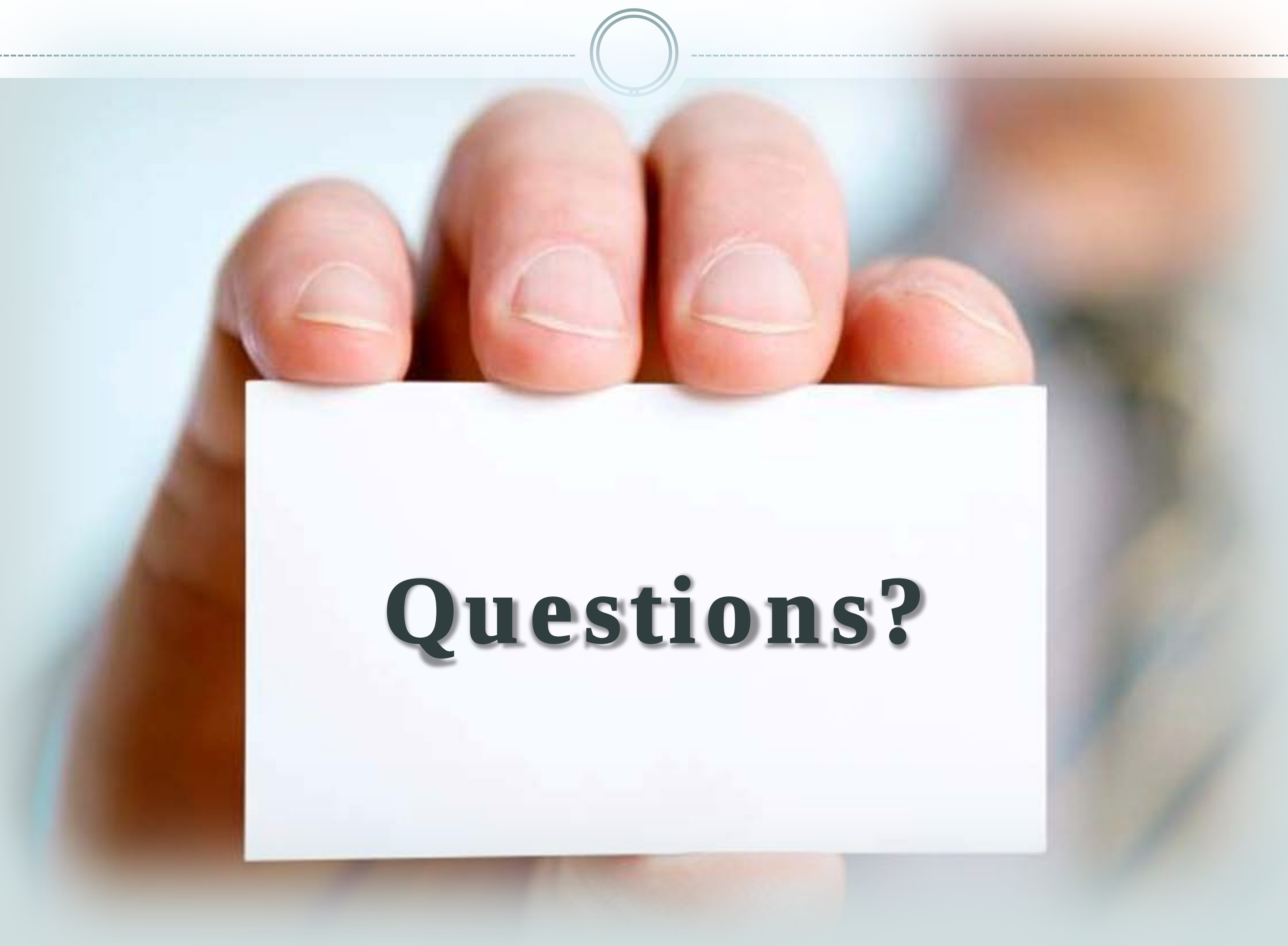
- Creating an entity for efficient wealth transfer
- In most cases, a partnership is the entity of choice
  - Limited partnerships – including family limited partnerships (FLPs)
  - LLCs taxed as partnerships
- In some cases, a corporate structure may be appropriate
  - S-Corporation voting and non-voting shares
    - Make sure it is an eligible S-Corporation shareholder
  - C-Corporation common and preferred stock
- Life insurance may be owned by:
  - The entity if there is an insurable interest
  - A trust that owns both the insurance and the entity
    - Use pass-through or dividend income to pay the premiums

Fringe Benefits Planning

- 2% benefit limitation for pass-through owners (S-Corporations, partnerships, LLCs, etc.)
- Many business owners want to receive additional fringe benefits
- Fringe benefits include:
  - Cafeteria plans
    - Employer provided long-term care
  - Health savings plans
  - Group term life insurance
    - Including permanent benefit section 79 plans

Risk Reduction

- Businesses in high-risk industries may create multiple entities to reduce risk
- Multi-entity structure may limit liability to one entity
- Captive insurance companies:
  - Stand alone C-Corporation
  - Designed to provide a closely held group with supplemental property and casualty insurance
  - Potential wealth transfer planning
    - Have children or a trust own the captive
    - Life insurance opportunities?


Questions?