

TAX AND NON- TAX CONSIDERATIONS IN CHOICE OF BUSINESS ENTITY UNDER THE NEW TAX LAW

Presented by:

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I. NEW TAX LAW. The Tax Cut and Jobs Act of 2017 has made major changes in the tax law that may impact the choice of tax entity for your business. Every business owner should at least consider the impact of the new law on their choice of business entity. Set forth below is brief summary as it relates to the choice of business entity.

A. WHAT HAS NOT CHANGED

1. Step up in basis rules remain
2. 3.8% investment income tax on investment income in excess of \$200,000 if single or \$250,000 if married filing jointly.
3. Retains the exclusion from income tax of \$500,000 of gain on the sale of your home and retains the requirement of living and owning the house two out of five years

B. MISCELLANEOUS CHANGES

1. **Estate Tax.** Federal Estate tax and GST exemption is \$11.2 million per person. Portability exists for estate tax but not for GST tax. Expires after 2025.

2. **Gift Tax.** Annual exclusion is \$15,000 in 2018.

3. **Capital Gains Tax.** Capital gains rate- Retains the three tax rates. However, the rates do not entirely match the tax brackets

- 0% capital gains rate from \$0-\$38,600 if single or if married \$0 - \$77,200

- 15% capital gains rate from \$38,600 - \$425,800 if single or if married \$77,200 - \$479,000. However, you will also be subject to the 3.8% investment rate on income once hit \$200,000 if single and \$250,000 if married.

- 20% capital gains rate if single with income in excess of \$425,800 and married with income over \$479,000 plus 3.8% investment tax rate aka medicare surtax.

4. **Roth Conversion.** No re-characterizations of Roth Conversions. Still can re-characterization a contribution.

5. **Mortgage Interest.** The Act reduces the mortgage interest deduction to interest on \$750,000 of acquisition indebtedness interest for debt incurred after Dec. 15, 2017. The \$1 million limitation remains for older debt. For tax years beginning after Dec. 31, 2025, the limitation reverts back to \$1,000,000 regardless of when the debt was incurred.

The Act eliminates the mortgage interest deduction for interest on home equity indebtedness for tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026.

6. **State and local tax** - The Act provides that individual taxpayers may elect to deduct state and local sales, income, or property taxes up to \$10,000 (\$5,000 for a married taxpayer filing a separate return) for tax years beginning after Dec. 31, 2017, and beginning before Jan. 1, 2026.

C. **S CORPORATION/LLC/SOLE PROPRIETORSHIP.**

SUMMARY – The combination of the lower tax on S corporation shareholders/LLC members and the ability to avoid Ohio income tax or pay at a lower rate strongly favors being an S corporation or an LLC compared to a C corporation. **YOU CAN ELECT TO CHANGE YOUR C CORPORATION STATUS TO S CORPORATION WITHIN 75 DAYS OF THE BEGINNING OF THE TAX YEAR.**

1. **TAX REDUCTION-** A S corporation, LLC or sole proprietorship receives a deduction of 20% of “Qualified Business Income” subject to certain limitations described below which reduces your tax rate on profits generated by your business that show up on your 1040 from the pass-through entity.

2. **WHAT TYPE OF BUSINESSES QUALIFY?** There are two sets of rules. One set of rules for non-service businesses and a more restrictive set of rules for certain service businesses such as accounting, medicine and law as described in paragraph (E) below.

3. **BUSINESS OTHER THAN SERVICE BUSINESS. Go through the following steps.**

(i) Calculate 20% of domestic qualified business income (or taxable income if less) – excluded from qualified business income are capital gains, dividends, interest income unless related to business, salary paid to the owner or guaranteed partnership payments paid to the owner.

(ii) If your personal income is less than \$315,000 for a married couple filing jointly (\$157,500 if single) then the deduction is as set forth in (i) above. If your personal income is greater than \$415,000 if married filing jointly (\$207,500 if single) then the deduction is limited as described in (iii) below. The deduction phases out between the two limits.

(iii) The deduction is 20% of qualified business income or if smaller, either

- 50% of W-2 wages (including 401k deferrals), or

- 25% of W-2 wages plus 2.5% of the original purchase price of your building or equipment. (The original purchase price for the building or equipment applies for the longer of 10 years from when equipment or building is placed in service or the applicable recovery.)

4. **OHIO INCOME TAX-** Ohio allows an income tax deduction of up to the first \$250,000 of (i) pass through income from an S corporation/LLC/Partnership and (ii) if you own at least 20% of the entity, W-2 salary from an S corporation or guaranteed payments from an LLC/partnership. The Ohio tax rate on business income above \$250,000 is capped at 3%.

5. **SERVICE BUSINESSES-** Service businesses will receive the same deduction as non-service business described above except that the deduction is eliminated if your personal income is greater than \$415,000 if married filing jointly (\$207,500 if single). If your personal income is less than \$315,000 if you file as a married couple filing jointly (\$157,500 if single) then the 20% deduction is available. The deduction phases out between the two amounts. Service businesses mean businesses 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 one 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. However engineering and architectural services are not treated as service businesses for this purpose.

D. C CORPORATION.

SUMMARY - C Corporations will now have a flat tax rate of 21%. This is a reduction from the 35% top tax rate for corporations under prior law.

1. **TAX REDUCTION** The top federal individual income tax rate is 37%. This means that for an S corporation pass through, the deduction of 20% will result in a tax rate of 29.6% on S income compared to 21% for C corporations. However, it is an increase from the prior law tax rate of 15% for corporations which have less than \$50,000 in taxable income. C corporations may be able to accumulate earnings at a low tax rate, but care will need to be taken to avoid the accumulated earnings tax and the personal holding tax. A taxpayer in the highest individual rate of 37% might find it saves taxes to accumulate the income at the 21% corporate rate and take the funds out as a dividend which would be taxed at the capital gains rate.

2. **WHAT TYPE OF BUSINESSES QUALIFY?** This even applies to all C corporations even personal service corporations.

E. TAX CONSIDERATION OF CHOICE OF ENTITY.

1. LLC members or sole proprietors face the 15.3% tax on self employment income tax and possibly the 3.8% net investment income tax rate and/or the extra Medicare tax of .9%. S corporation shareholders do not pay self-employment taxes on distributions only pay FICA taxes on salary but the IRS could dispute low salaries. A corporation will which pays out dividends will potentially have a capital gains rate of 23.8% on the dividends depending on the taxpayers income

2. Ohio has not income tax on the first \$250,000 of taxable income to a passthrough entity and only a 3% tax on profits above that. Ohio income tax on other income in excess of \$213, 350 is 4.997%.

3. **Hold ordinary income assets and collectibles in a corporation.** The earnings on interest or sale of assets would be taxed at the low C corporation rate.

4. Also it is possible that capital gains would be lower in a C corporation than the individual rate.
5. An operating business might be able to accumulate earnings and have them taxed at lower rate. Then hold the assets until death and pass them on to the next generation income tax free.

F. PLANNING.

1. If corporate tax rates are below individual tax rates (including S corporations and other pass through entities) this will cause a reversion to the tax planning of the when individual tax rates were much higher than corporate tax rates. In 1980 the top tax rate for individuals was 70%. The top corporate tax rate for C corporations was 46% on income over \$100,000.

2. Retention of income in C Corporation. Incentive to keep earnings in corporation at lower tax bracket. Upon death with step up in basis can remove income tax free.

G. Accumulated Earnings Tax

- Section 531 – imposes a 20% corporate level tax in addition to the regular tax of 20% on accumulated taxable income.

- Section 532 – the tax is imposed on any C corporation, no matter how many shareholders if formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed. The only exceptions are certain foreign entities, personal holding companies or tax exempt companies

Section 533- the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary. The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders

Section 534 – if the IRS issues a deficiency notice the burden of proof is on the taxpayer to prove not accumulating income to avoid taxes.

Section 535 - Accumulated taxable income” is defined as “taxable income” with certain adjustments reduced by the amount of the dividends paid deduction and the accumulated earnings credit (Even though referred to as a credit, it is really a deduction). ATI means taxable income less Federal taxes paid, charitable contributions and certain other deductions such as dividends. (NOLs not allowed.). Dividends can be paid by the 15th day of the fourth month after the end of the tax year or you can “deem” dividends paid even though not paid if agreed to by the shareholders and the company. The dividend will be taxed as if paid in the prior year. Capital gains to a certain extent are excluded from ATI. The accumulated earnings credit is at a minimum \$250,000 except for service businesses which only has a \$150,000 credit. For any tax

year the amount of the accumulate earnings credit is an amount equal to the earnings and profits for that taxable year that are retained for reasonable needs.

1. How to reduce the potential for accumulate earnings tax.

Factors that show a bad purpose:

- No dividends
- Low salaries
- loans to shareholders

The list was set forth in Exhibit 700-5 of the previous version of the Former § 531 Audit Guidelines (from BNA Portfolio 796- 3rd)

Unfavorable Factors for Agent Pursuing Accumulated Earnings Case	Favorable Factors for Agent Pursuing Accumulated Earnings Case
The corporation has a history of paying good dividends.	The dividend history of the corporation is unfavorable, such as: (a) No cash dividend. (b) Cash dividend related to shareholders' tax status. (c) Declaration of stock dividends.
The existence of business indebtedness.	The corporation has no outstanding debt obligations or the debts were incurred for nonbusiness reasons.
The need for the corporation to diversify as a result of: (a) One-customer business. (b) Business obsolescence factor high.	Diversification into an unrelated business is only contemplated.
Documentation of the needs of the business: (a) In the corporate minutes. (b) Performing actual work in fulfilling the needs.	The business needs for the accumulation are vague and indefinite.
Documentation of the needs of the business: (a) In the corporate minutes. (b) Performing actual work in fulfilling the needs.	Investments of a passive nature that are in nonliquid form.
There is an actual entry into an unrelated business.	Loans to shareholders or other businesses of the shareholders.
The payment of a substantial salary to the principal stockholder who is an employee of the corporation.	Inability to pay dividends.
The stock of the corporation is publicly held as opposed to being owned by a small group.	Stock of the corporation is closely held.
	Stock redemptions.
	Investments in subsidiaries that are not controlled.
	The need for working capital can be met from current operations.
	The shareholders are in a high tax bracket.
	High current asset-current liability ratio.

	<p>High current asset-working capital ratio.</p> <p>The corporation is aware of the accumulated earnings tax and made a conscious attempt to avoid its application.</p>
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2. Reasonable Needs of the Business – Section 537

- A parent corporation that owns at least 80% of a subsidiary can accumulate income for purposes of a subsidiary. If less than 80% it can be depending on the facts. A brother sister corporation does not receive that assumption. Section 1.537-3(b) of the regulations.

- Section 1.537 – 1(a) of the Regulations: “In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.”

- “Although it has been held that plans need not be set forth in the minutes of the corporation, in a reserve on the balance sheet, or otherwise in written form, it is clear that some form of concrete evidence is required to illustrate the reasonable need for an accumulation.” BNA Portfolio U.S. Income Portfolios: Corporate Returns and Computation of Tax : Accumulated Earnings Tax VII. Reasonable Portfolio 796-3rd Needs of the Business citing article McClain & Lechner, *Audit Strategies for Defending Against the Accumulated Earnings Tax*, 64 Prac. Tax. Strat. 132 (March 2000), for a discussion of strategies designed to “poke holes” in the IRS's calculation of business needs

- The regulations allow for accumulation of earnings for: (i) acquisition or replacement of property, plant, and equipment or (ii) acquisition of, or expansion into other business.

- IRS audit guidelines allow for the following reasons to accumulate:
- an actual or potential lawsuit;
- a possible liability arising out of some contractual obligation;

- a possible business reversal resulting from the loss of a customer;
- accumulations to guard against competition have been justified in some cases;
- an accumulation to provide funds to finance a self-insurance plan (including key man life insurance as well as the more common types of risk insurance); and
- Accumulations to provide a retirement plan for employees.

Accumulations to redeem a minority shareholder maybe satisfactory, but accumulations to redeem a majority shareholder may not be sufficient reasonable accumulation.

A corporation can accumulate profits for its working capital needs 1.537-2(b)(4). The two cases that can be used to determine the working capital needs of a corporation were decided in *Bardahl Manufacturing Corp. v. Commissioner* T.C. Memo 1965-200. and *Bardahl International Corp. v. Commissioner* T.C. Memo 1966-182.

3. PERSONAL HOLDING COMPANY TAX.

- Section 541 imposes a personal holding company tax equal to 20 percent of the undistributed personal holding company income.
- Section 542 defines a “personal holding company” means any corporation if at least 60 percent of its adjusted ordinary gross income for the taxable year is personal holding company income and at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by not more than 5 individuals.
- Section 544 has attribution rules to determine the percentage of ownership including family attribution rules. An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family or by or for his partner. For purposes of this paragraph, the family of an individual includes only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.

II. BUSINESS ASPECTS IN CHOICE OF ENTITY.

General. There are four basic types of ownership for a profit business – a corporation (“C” or “S”), a partnership (limited or general or a general with limited liability), a limited liability company, or a sole proprietorship. There are several types of corporate formats that I will not discuss because of their limited applicability – co-operative, a SBIC, or a publicly traded partnership. In the future there may be a Benefit Corporation.

A. ORGANIZATION ISSUES.

1. S Corp.

- a. Limit on number of Shareholders – 100 (all members and spouse considered one, plus any lineal descendants with common ancestor five generations back).
- b. Shares - Voting and Non-Voting Common Stock – Limits allocations of profit.
- c. Debt allowed – If straight debt, interest not contingent on profits, nonconvertible, creditor individual or bank otherwise, potential debt to be considered a second class of stock.
- d. Warrants could cause loss of S Corporation stock when exercised or if issued in the money.
- e. Can have Parent subsidiary relationship if 100% owned. Danger of loss of “S” status to subsidiary.
- f. Domestic corporation (a) Shareholders – individual, QSST, ESBT, Grantor Trust, Estate; (b) cannot be certain types of business entity – banks using reserve method).

2. LLC.

- a. No practical limit on investors.
- b. Units – voting/non-voting. Preferred returns allowed.
- c. Debt allowed no restrictions.
- d. Warrants allowed.

Business Planning: LLC Real Estate Holding Companies.

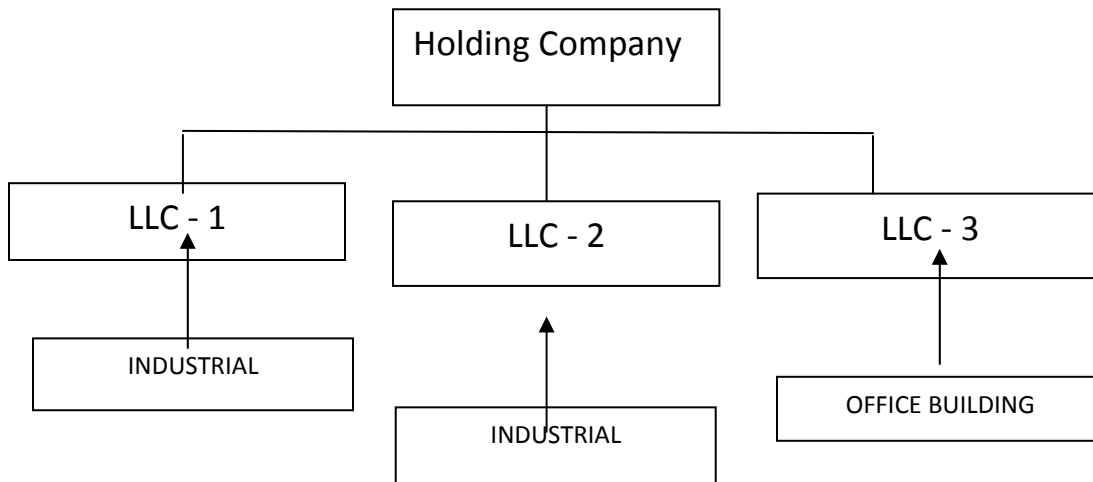
Problem: Many people continue to hold commercial and rental real estate in their individual name or in the name of a general partnership, thereby creating potential personal liability.

Solution: Transfer real estate to a limited liability company. For clients with multiple properties, recommend a “holding company” which, in turn, would own several “subsidiary” companies.

Example: Husband and wife are joint owner of three properties: two industrial buildings and one office building. Create “Holding Company, LLC” that is owned 50/50 by the husband and wife. Then create three subsidiary limited liability

companies owned solely by Holding Company, LLC. Each of the industrial and office properties should be transferred to a subsidiary limited liability company.

Structure:



- a. No practical limit on investments.
- b. Debt allowed - no restrictions.
- c. Warrants allowed.

B. “S” CORPORATION VS. LLC. PRACTICAL REASONS TO USE AN “S” CORP.

1. Corporate law is well-settled; LLC law is only 23 years old in Ohio.
2. People are generally familiar with the underlying structure of a corporation: shareholders, directors, officers; people are generally not familiar with the structure of LLC’s: members, managing members, managers.
3. If there is to be more than one owner and the clients do not wish to pay legal fees to create an Operating Agreement for an LLC, corporate law provides well-defined guidance on the relationship between owners; contrast with LLC law, which is largely untested.
4. A settled point of law is that a shareholder of a corporation can be an employee of the corporation; it is not settled law as to whether a member of an LLC can be an employee of an LLC.
5. Limitation on Transfers of Interest.

LLCs and Partnership law provides that a transfer of an interest does not automatically have any non-economic rights – such as a right to review the books and records or a right

to vote. Transferees of shares automatically have those rights unless a shareholders or close corporation agreement restricts such shares.

6. Business Law Issues.

Many people use a basic incorporation to set up a corporation e.g. election of officers and directors, and rely on the well-established corporate law delineating the responsibilities of officers, shareholders and their respective rights. An LLC has only 23 years of history, so the need for a more detailed operational document is more crucial.

III. LOW DOCUMENTATION BUSINESS ENTITY.

Facts. Three clients walk in your office and say that they set up a new business entity a year ago by themselves and they want you to prepare the returns. What are the legal implications of no operating agreement or corporate documents? Set forth below are some practical implications of the consequences of this low document business entity.

1. **Who owns the company?** Whether you file articles of organization for a limited liability company or articles of incorporation for a corporation, the incorporators have nothing to do with ownership. Anyone can file for the setting up of the entity. Typically the attorney does that.

- The LLC statute makes it clear that you become a member based upon the books and records of the LLC. The articles of organization are not deemed books and records. 1705.01(g) of the ORC. [*McConnell v. Hunt Sports Ents. \(1999\), 132 Ohio App.3d 657, 688-689, 725 N.E.2d 1193.*](#) Normally that is the operating agreement.
- As to a corporation, Section 1701.01(F) of the ORC provides similar language. “Shareholder” means a person whose name appears on the books of the corporation as the owner of shares of the corporation. Share certificates are merely evidence ownership of shares and are not essential to own.

Practical implications

* Since most limited liability companies will be taxed as a partnership, by the time the first tax return is filed the parties will be forced to put in the books and records the actual ownership interests in the various parties.

* If the corporation elects S status within 75 days of incorporation, the parties will have to agree on the ownership interest by filing an S selection. If the Corporation is a C Corporation, 1120 tax form will include the ownership interests of officers, but not necessarily all owners of corporation. Presumably, the filing of a tax return is a book and record, but tax returns are signed by one person is not necessarily binding on all the clients.

Advantage: S Corporation. Decision of ownership made within 75 days and signed by all shareholders.

2. **Voting.**

- **Corporation.** Except to the extent that the voting rights of the shares of any class are increased, limited, or denied by the express terms of such shares, each outstanding share regardless of class shall entitle the holder thereof to one vote subject to the provisions with respect to cumulative voting. Section 1701.44 of the ORC. All of the authority of a corporation shall be exercised by or under the direction of its directors. Section 1701.59 of the ORC. Shareholders authority as to day to day operations is nonexistent. Shareholders merely elect directors. Shares can be voted by proxy. Section 1701.48.
- **LLC.** Unless otherwise provided in writing in the operating agreement, the management of a limited liability company shall be vested in its members in proportion to their contributions to the capital of the company, as adjusted from time to time to properly reflect any additional contributions or withdrawals by the members. Section 1705. 24 of the ORC. Presumably, unless otherwise stated in the ORC, decisions are made by majority vote. For example, under section 1705.25 of the ORC, a unanimous decision is needed to confess judgment or sell goodwill. Also under section 1705.25, any member can bind limited liability company under the apparent authority concept. Shareholders would not have that authority since corporate action is by officers or directors. In particular, note that real estate and mortgages signed by one member could bind the entity. Section 1705.35 of the ORC. An officer of a corporation, even a

president, does not have the authority to enter into a mortgage. 1701.65 of the ORC. It is not clear whether a member's units can be voted by proxy.

Practical Implications

There is much more risk in a limited liability company than a corporation because it may be easier for any one member to bind the limited liability company compared to a corporation.

Advantage: The Corporation over the LLC.

3. **Who runs the day to day operations?**

- **Corporation.**

1. The directors have authority to run the operations of the Corporation. 1701.59 of the ORC. The majority of directors are a quorum and a majority of the quorum is needed for a corporate action. 1701.62 of the ORC.

2. The election of the Board is by majority vote of shareholders but unless the article prohibit, specifically cumulative voting is allowed. Section 1701.55. For example, if there are three directors and if you have one more share than 25% of the outstanding shares, you will be guaranteed a seat on the board. Unless otherwise provided for there will be three directors. Section 1701.56 of the ORC.

3. The directors can also give authority to the officers a corporation. Ohio law requires that there be a president, secretary and treasurer. Section 1701.64 of the ORC. Generally, when someone has a title of president, he or she has significant apparent authority to enter into many contracts on behalf of the corporation. Such apparent authority probably would not apply to a secretary or treasurer.

- **LLC.** Unless otherwise set forth in the operating agreement, all members basically have the authority to run the operations of the business and each has apparent authority to execute most documents on behalf of the company. Section 1705.25 of the ORC.

Practical Implications

Since there is more case law on as to a president of a corporation, it may be easier to enter into contracts by a signature of a president than that of a member. The president of the corporation probably has significant apparent authority to enter into many agreements on behalf of a corporation. As noted above under the ORC, a member probably has authority to bind a limited liability company although the case law is still developing on this.

Advantage: The Corporation over the LLC.

4. **Who gets the money?**

- **Corporation.** The directors are given the authority to issue dividends by majority vote. Section 1701.33 of the ORC. The directors, by the affirmative vote of a majority of those in office, and irrespective of any financial or personal interest of any of them, shall have authority to establish reasonable compensation, that may include pension, disability, and death benefits, for services to the corporation by directors and officers, or to delegate such authority to one or more officers or directors. Section 1701.60 of the ORC.
- **LLC.** The limited liability company may make distribution to its members and, unlike corporations, there are no specific provisions in the LLC statute restricting dividends. 1705.11. Unless otherwise stated, distributions will be based on capital contributions. Irrespective of any financial or personal interest of any member, the members of a limited liability company by the affirmative vote of a majority of the voting power of the company if the management of the company is reserved to the members have authority to establish reasonable compensation for services rendered to the company by its members, managers, and officers or may delegate that authority to one or more managers or officers. The reasonable compensation may include pension, disability, and death benefits. Section 1705.31 of the ORC.

Practical Implications

Some small businesses may have different capital contributions with the intent of equal ownership and others do not. Corporate laws are less flexible, but may be more idiot proof.

Advantage: A push.

5. **Transfers of Interests.**

- **Corporation.** A transferee of shares has all the rights of a shareholder. The board of directors has the authority to set the record date which is the date that determines who is entitled to vote and receive dividends. Section 1701.45 of the ORC.
- **LLC.** When a member transfers his units, the transferee is a mere assignee and does not have any rights of a member except as to the rights as to distributions. The assignor loses its status as a member. Section 1705.18 of the ORC.

Practical Implications

Without any documentation, members of the limited liability company may transfer the economic interest but not any voting rights. In other, shareholders can transfer both economics and voting rights.

Advantage: LLC.

6. **Sale of Assets.**

- **Corporation.** Directors by majority vote affirmed by shareholders with a two thirds vote can sell substantially all the assets of the Corporation subject to the right of dissenting shareholders to dissenters' rights. Section 1701.76 of the ORC.
- **LLC.** The goodwill of a limited liability company cannot be sold without unanimous consent all the members. Section 1705.25 of the ORC.

Practical Implications

The default provisions make it much more difficult for the company to sell the business since under a limited liability company unanimous consent would be needed.

Advantage: Corporation.

7. **New Owners.**

- **Corporation.** The board of directors can decide the terms of the issuance of shares by majority vote subject to preemptive rights if any. Section 1701.14 of the ORC.
- **LLC.** New member can only be issued upon unanimous written consent of all the members. Section 1705.14 of the ORC.

Practical Implications

The limited liability company has more protection for the minority owners since new members cannot be added without the approval of all members.

Advantage: LLC

8. **Meetings.**

- **Corporation.** Section 1701.39 of the ORC provides for annual meetings to elect directors.
- **LLC.** There is no requirement to have meetings.

Practical Implications

Management of a limited liability company is easier because less paper work is required.

Advantage: LLC

IV. LIABILITY ISSUES FOR DIRECTOR/MANGERS

1. FIDUCIARY DUTY FOR CONTROLLING SHAREHOLDERS. Crosby v. Beam, 47 Ohio St. 3d 105(Ohio Supreme Court 1989) - In this case the Ohio Supreme Court stated the law of Ohio is as follows:

“Where a **majority or controlling shareholders** in a close corporation **breach their heightened fiduciary** duty to minority shareholders by utilizing their majority control of the corporation to their own advantage, without providing minority shareholders **with an equal opportunity to benefit**, such breach, absent **any legitimate business purpose**, is actionable”

2. FIDUCIARY DUTY FOR DIRECTORS- Section 1701.59 and 1701.60 of the Ohio Revised Code.

i. Section 1701.59(B) states “A director shall perform the director's duties as a director, in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances....”

This is what is commonly called the “business judgment rule”. The Court will not inquire into the wisdom of actions taken by directors in the absence of fraud, bad faith or abuse of discretion. **Koos v. Central Ohio Cellular Inc.** 94 Ohio. App. 3d 579 (Cuyahoga County Court of Appeals 1994). The business judgment rule means that a decision by **disinterested directors** will not be disturbed if there is any **rational business** purpose for the decision.

ii. To hold a director liable the plaintiff has to prove a lack of good faith by clear and convincing evidence. Section 1701.59(D). However, “Directors may not shut their eyes to corporate misconduct and then claim that because they did not see they misconduct, they do not have a duty to look. **Geygan v. Queen City Grain Co.** 71 Ohio App. 3d 185(1991). In this case the Court held the director liable for not being diligent in watching over the acts of other directors and was liable for the breach of fiduciary duty of the other directors.

iii. However, Section 1701.60 provides that certain self-dealing or contracts in which the director has a financial or personal interest is void or voidable unless certain disclosures are made or the contract or action is fair to the corporation.

- If the material facts are known to the directors and a majority of disinterested directors approve(even if not a quorum); or
- If the material facts are known to the shareholders and a majority of the disinterested shareholders approve the transaction; or
- The contract is fair at the time it is approved by the directors or shareholders.

3. **CAN THE STANDARDS BE LIMITED?** Most states allow the article of incorporation or other documents to limit director liability. Ohio law does not so provide. **Too Many Tiaras: Conflicting Fiduciary Duties in the Family – Owned Business context.** By Karen Boxx, Houston Law Review 2012. Maybe a close corporation agreement under Section 1701.591 of the Ohio Revised Code could alter the standard. However a close corporation agreement must be adopted by all shareholders.

4. **OFFICERS HAVE A FIDUCIARY DUTY TO THE SHAREHOLDERS.** **Thompson v. Central Ohio Cellular Inc.** 93 Ohio App. 3d 550(Cuyahoga County court of Appeals 1994).

i. **Duty to Disclose-** Directors and officers and controlling shareholders have a duty to disclose. This means that an officer and director must keep the minority shareholders informed of any acts of self-dealing such as setting up a competing business. “An officer of a corporation cannot venture into another closely held business without informing the other shareholders.”

5. Shareholders Rights.

Section 1701.37 Of the Ohio Revised Code provides:

(A) Each corporation shall keep correct and complete books and records of account, together with minutes of the proceedings of its incorporators, shareholders, directors, and committees of

the directors, and records of its shareholders showing their names and addresses and the number and class of shares issued or transferred of record to or by them from time to time.

.....

(C) Any shareholder of the corporation, upon written demand stating the specific purpose thereof, shall have the right to examine in person or by agent or attorney at any reasonable time and **for any reasonable and proper purpose**, the articles of the corporation, its regulations, its books and records of account, minutes, and records of shareholders aforesaid, and voting trust agreements, if any, on file with the corporation, and to make copies or extracts thereof.

6. LIMITED LIABILITY STATUTES. Section 1705.281 of the Ohio Revised Code provides that a member's duty to other members and the company is as set forth in the Ohio Revised Code unless modified. The legislative history indicates the statutory definition is consistent with Ohio corporate law. Generally **members** have the following duties:

- i. A duty of care to the LLC in the conduct of business by refraining from engaging in grossly negligent, reckless conduct, intentional conduct or a knowing violation of the law.
- ii. Discharge duties to LLC and other members in good faith and fair dealing.

Prior to 2016 an operating agreement could not eliminate these duties but can describe standards by which these duties are to be measured. Section 1705.081 of the Ohio Revised Code.

In 2016 Section 1705.081 was changed to read **“A written agreement, including a written operating agreement, that modifies, waives, or eliminates the duty of loyalty, the duty of care, or both for one or more members, managers, or officers shall be given effect.”**

Likewise managers who acknowledge in writing that they are a manager are treated under the same standard as a board of directors which are more restricted than the duties of a member. Sections 1705.282 and 1705.29 of the Ohio Revised Code.

V. SUCCESSION PLANNING

A. Assuming not a taxable estate. For real estate use the holding company approach with LLC set forth on page 10.

- Control of entity can be separated from equity
- Step up in basis applies to underlying real estate
- Can take advantage of 20% qualified business income tax reduction
- Can give some members special preferred interests with less upside and more income

- Major disadvantage is that more income may be subject to the 2.9% and the .9% Medicare tax.

B. S corporations for operating business .

- Can have voting and nonvoting stock

- cannot have preferred interest

- limited step up in basis advantages . Stock step up but not asset step up.

C. Corporation has all of the flexibility of LLC but no tax advantage except lower entity rate if keeping funds in the entity.

D. An S corporation or an LLC can be used with a defective grantor trust to eliminate some income tax.

Example.

- If person A sells \$1 million dollars of stock to person B. Person A will owe \$200,000 capital gains and net \$800,000. Person B will have to earn approximately \$1.5 million to pay \$500,000 of income taxes (assume 33% tax bracket) to have enough funds to pay person B his \$1 million dollars.

- Instead assume person A sells his stock to an Intentionally Defective Grantor Trust for \$1.333 million and the pass through entity earns \$1,194,000 million dollars in ordinary income. Under the tax rules the ordinary income is taxed to A and he nets \$800,000($1,194,000 \times .33$ tax rate = \$394,000.). The remaining profit of \$306,000 before taxes stays with B or maybe is divided. ($\$1.5 - \$1.194 = \$306,000$)

This summary is intended to provide general and practical information to assist the public in understanding legal issues. Legal advice should only be given when the lawyer and client have an opportunity to explore fully the factual circumstances related to the client's situation and the legal options, as explained by the lawyer to the client.