PRUDENTIAL COMPARISON OF BUSINESS ENTITIES

GENERAL ENTITY TAX CHARACTERISTICS AND EXECUTIVE BENEFITS USING LIFE INSURANCE

	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY
EASE OF FORMATION	State law requirements for incorporation must be met. Implementation expenses tend to be less than partnership costs.	State law requirement for incorporation must be met.	Few formal restrictions and normally inexpensive to form.	Sate law requirements for formation must be met.	State law requirements for the formation of the LLC must be met. Formation of an LLC can be costly, depending on the operation agreement.
IRS ELECTION REQUIRED	No	Yes: Subchapter S status must be actively elected.	No	No	No: "check-the-box" default classifications automatically apply. Election required for entity to be treated as a corporation for federal tax purposes.
NUMBER OF OWNERS/ LIMITATION ON OWNERSHIP	One or more shareholders. No limits on types of entities or number of shareholders.	Domestic corporation limited to 100 owners who must be one of the following: (1) Individuals (not nonresident aliens) (2) 401(a) qualified plans (3) 503(c) charitable organizations (4) Estates (5) Certain qualifying trusts	Two or more individuals or entities. No limits on types of entities or number of partners	Two or more individuals or entities. Required to have at least one general partner. No limits on types of entities or number of partners.	No limits on types of entities or number of members. Must have at least two members in order to be taxed as a partnership for federal tax purposes. While it is possible in certain states to have a one member LLC, it will generally be treated as a sole proprietorship for federal tax purposes.
DIFFERENT CLASSES OF OWNERSHIP INTERESTS	No limitations on classes of voting stock. Equity interests can be varied through common stock, preferred stock, and voting and nonvoting stock.	Requires one class of stock and pro rata allocations and distributions of earnings to owners. Voting differences permitted.	Different classes of general partners can exist.	Different classes of limited partners and general partners can exist.	Different classes of members can exist.
OWNER'S PARTICIPATION IN MANAGEMENT	In a large corporation, control is generally in the hands of top management. In a closely held corporation, the owners generally exercise management control.	The management of an S corporation is fairly flexible. Active participation is more likely due to the limited numbers of shareholders.	All general partners are eligible to actively participate in management. The partnership agreement can limit management control to certain general partners.	Management limited to general partners. Limited partners risk losing their limited liability if they participate in management.	Depends on LLC statute. However, members are generally free to participate in management unless LLC agreement prohibits participation. Management participation may cause member to become subject to self-employment tax.
LIFE OF BUSINESS	Unlimited or perpetual, unless limited by state law or terms of the charter.	Unlimited or perpetual, unless limited by state law or terms of the charter. Revocation or termination of S election does not affect continuity of life.	Generally for a specific term. The death, withdrawal, insolvency or legal disability of a general partner (member) may terminate the partnership (LLC) for state law purposes, but will not necessarily cause a termination for federal tax purposes.		
LIABILITY OF OWNERS	Stockholders are generally not liable for the entity's debts and obligations. Liability is limited unless the shareholders guarantee notes or loans.		A general partner is usually fully liable as an individual for all debts and obligations of the entity.	A general partner is fully liable. A limited partner's liability is usually limited to the amount of his/her capital contribution.	A member's liability is limited to the amount of his/her contribution unless the member has guaranteed a debt of the LLC.

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Prudential Financial

	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	LIMITED LIABILITY COMPANY
FEDERAL TAXATION/ ENTITY LEVEL OR PASS-THROUGH TAXATION	Entity taxation: The corporation is taxed as a separate entity at graduated rates up to 35%. Qualified personal service corporations are taxed at a flat 35%. Undistributed income may become subject to the accumulated earnings tax or personal holding company tax.	Generally pass-through taxation: Not treated as a separate taxable entity. Shareholders are taxed on their pro rata share of income, loss, deductions, and credits whether distributed or not. S corporations (that were once C corporations) may be subject to tax on built-in gains, passive income, or LIFO inventory.	Pass-through taxation: Not treated as a separate taxable entity. Partners are taxed on their allocable share of income, loss, and deductions whether distributed or not.		Pass-through taxation: Use of the default classifications under the "check-the-box" regulations provides that, at the federal level, a two or more member LLC will be treated as a partnership; a one member LLC will be treated as a sole proprietorship. Members are taxed on their allocable share of income, loss, and deductions whether distributed or not.
TAX RETURNS	Form 1120: Due 15th day of the 3rd month following the close of the taxable year.	Form 1120S: Due 15th day of the 3rd month following the close of the taxable year.	Form 1065: Use with partnerships and LLCs with two or more members. Due 15th day of the 4th month following the close of the taxable year. Form 1040, Schedule C: Use with one member LLCs. Due 15th day of the 4th month following the close of the taxable year (generally April 15th).		
ALTERNATIVE MINIMUM TAX	A corporation must pay alternative minimum tax (AMT) to the extent that the AMT tax exceeds its regular tax liability.	AMT: Not applicable.			
ALLOCATION OF INCOME/LOSS AND DEDUCTIONS	N/A: Corporation does not pass through items to shareholders.	Determined by pro rata stock ownership allocated on a daily basis.	Partners (members) may have non-pro rata rights to profits, losses and distributions if they have "substantial economic effect."		
CHARACTER OF INCOME AND DEDUCTIONS	N/A: no pass-through	Character (ordinary, capital gain, tax-free, loss, etc.) determined at the entity level and passes through as such.			
OWNER'S BASIS: ON FORMATION	Equal to the amount of money plus adjusted basis of property contributed less liabilities assumed by the corporation. Owner's share of corporation's liabilities does not increase basis.		Equal to the amount of money plus adjusted basis of property transferred to the partnership (LLC) less liabilities assumed by the entity. A partner's (member's) pro rata share of partnership liabilities will increase basis.		
OWNER'S BASIS: LIABILITIES	Debt does not increase basis.	Indirect borrowings do not increase basis. Only direct loans from shareholder to S corporation increase basis for purposes of determining the amount of loss deduction.	Basis is increased by a partner's (member's) allocable share of liabilities. A decrease in the share of liabilities is treated as a cash distribution.		
OWNER'S BASIS: SUBSEQUENT ADJUSTMENTS	Only distributions in excess of earnings and profits decrease basis.	Income increases basis. Losses decrease basis. Distributions of cash or property decrease basis.	Income increases basis. Losses decrease basis. Distributions of cash, property and relief of liabilities decrease basis.		
DEDUCTIBILITY OF/ LIMITATION ON BUSINESS LOSSES	A C corporation can deduct net operating losses only to the extent of its taxable income, subject to the carry back/carry-forward rules.	Losses of an S corporation pass-through to its shareholders. Losses are limited to the shareholder's basis plus the amount of money loaned by the shareholder to the corporation.	Losses are limited to a partner's (member's) basis (including allocable share of liabilities) in the partnership (LLC) interest. In addition, the at-risk rules and the passive-activity rules apply to any loss.		
CONTRIBUTIONS TO THE ENTITY	Generally, nonrecognition treatment for all parties on transfer of property where transferors as a group control the corporation immediately after the exchange (ownership of at least 80% of the total combined voting power). Receipt of stock for services is treated as taxable compensation.		Generally, nonrecognition treatment on transfer of property. No control requirement. Exception: When a partner (member) acquires a partnership (LLC) interest in exchange for services: (1) If the partnership (LLC) interest is in partnership (LLC) capital, the service partner (member) realizes compensation income. (2) If the partnership (LLC) interest is in future profits, the service partner (member) generally does not realize income.		

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NONLIQUIDATING DISTRIBUTIONS	Must be proportionate to the extent required by state law. Taxable as a dividend to the extent of earnings and profits (E&P). Distributions in excess of E&P and stock basis generally result in capital gain.	Must be proportionate to the extent required by state law. S corporations with no E&P: Tax free to extent of stock basis, and any excess taxable as capital gain. S corporations with E&P: Basically tax free to the extent of the accumulated adjustments account (AAA) attributable to the shareholder then taxable to the extent of E&P, and any excess taxable as capital gain.	Need not be proportionate to partnership (LLC) ownership. Partners (members) do not recognize income upon receiving distributions unless: ► Money and/or marketable securities are received in excess of the partner's (member's) basis for his interest ► Partner (member) is relieved of debt in excess of adjusted basis of ownership interest ► Partner receives disproportionate amount of property in exchange for unrealized receivables or substantially appreciated inventory (hot assets).		
DISTRIBUTIONS OF APPRECIATED PROPERTY	The corporation recognizes gain on the distribution of appreciated property.	The sale or distribution of S corporation assets may result in a built-in capital gains tax at the corporate level. S corporation distributions reduce stock basis by the FMV of the distributed property.	Generally, partnerships (LLCs) do not recognize gain or loss on distributions of property to partners (members) unless the distribution is considered substantially disproportionate under IRC § 751(b). Partnership (LLC) distributions reduce a partner's (member's) basis in the partnership (LLC) interest to the extent of the basis of the distributed property.		
DISTRIBUTIONS IN REDEMPTION	Test to see if redemption is essentially equivalent to a dividend. If yes, generally ordinary income under IRC § 301. If no, taxed at capital gain rates under IRC § 302. IRC § 318 attribution rules apply. IRC § 303: A qualifying redemption of decreased owners stock to pay qualifying estate expenses receives capital gains treatment.	Determine whether there is any C corporate E&P. Distributions by S corporations without E&P: Basically tax-free to the extent of the shareholder's basis, excess taxable as capital gain. Distributions by S corporations with E&P: Basically tax free to the extent of the accumulated adjustments account (AAA) attributable to the shareholder, then taxable to the extent of E&P, excess taxable as capital gain. IRC § 318 Family attribution rules apply, but will not have a negative tax impact if S corporation does not have E & P.	Payments received in exchange for property, including goodwill, are treated as a sale or exchange (i.e., capital gain treatment). All other payments are taxed as guaranteed payments or as a distributive share of income that may produce ordinary income for the departing owner.		
TRANSFERABILITY OF INTERESTS	Stock is easily transferrable unless bylaws provide restrictive rights. Rights of first refusal, mandatory buy-sell agreements usually exist.	Same as C corporation. Charter should provide that a transfer cannot be made to an ineligible shareholder.	Generally requires approval of all partners and may cause termination of the old partnership and creation of a new partnership. Limited partners may be allowed to freely assign their interest.		Generally, a state's LLC law provides that unanimous, or at least majority, consent is needed to transfer all incidents of membership. LLC members, however, are generally free to assign their economic interests without approval of other members.
SALE OR EXCHANGE OF INTERESTS	Shareholders ordinarily recognize capital, rather than ordinary gains or losses, upon the sale of their stock. Generally, there is no step-up in entity's basis (inside basis) in the assets.		The sale of partnership (LLC) interests produces capital gains or losses, except for amounts received for unrealized receivables and substantially appreciated inventory items (hot assets which are subject to ordinary income tax). The entity may elect to step-up inside basis of assets to reflect sales.		
ASSET BASIS: ADJUSTMENTS ON TRANSFER OF INTEREST	Generally, no adjustment in basis of assets owned by the corporation to reflect transferred stock.		IRC § 754 election permits entity to adjust asset basis to reflect the change in basis of the transferred partnership interest.		
SELF-EMPLOYMENT TAXES FOR OWNERS	A shareholder's compensation for services rendered as an employee is subject to employment taxes. Distributions (dividends) not subject to employment taxes.	A shareholder's compensation for services rendered as an employee is subject to employment taxes. Shareholder's distributive share of S corporation earnings is not subject to self-employment tax.	A general partner's distributive share of partnership trade or business income generally is subject to self-employment taxes. A limited partner's distributive share is not subject to self-employment tax Dual status partners (general and limited partners) generally may allocate between interests.		LLC members are deemed partners under proposed regulations and must meet the test for limited partner status to avoid self-employment taxes.

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	C CORPORATION	S CORPORATION	GENERAL PARTNERSHIP	LIMITED PARNERSHIP	LIMITED LIABILITY COMPANY
FRINGE BENEFITS	Generally excludable from income for shareholder-employee.	A more than 2% shareholder-employee is treated in the same manner, as a partner in a partnership (i.e., the benefit is included in income).	Partners (members) do not receive favorable tax treatment for certain employee fringe benefits, including accident or health insurance, meals and lodging, cafeteria plans, and group term life insurance (i.e., benefits not excludable from income).		
QUALIFIED PLANS	Shareholders must be an employee and receive compensation to be included in the plan. S corporations: Plan loans permitted to shareholders who own more than 5% of stock.		Partners (members) may be included only if partner (member) performs services for the partnership (LLC) and receives either guaranteed payments or is not treated as a limited partner. Plan loans permitted to partners (members) who own more than 10% of the capital interests or profits interest in the partnership (LLC).		
KEY EMPLOYEE COVERAGE*	Key employee life insurance purchased on the life of a key employee by a C corporation is an effective tax strategy since an income-tax-free death benefit is purchased without a tax effect on the shareholders because the corporation is a separate tax entity and the nondeductible premium does not flow through to the shareholders.	Although income earned to pay nondeductible premium is taxed to the owners and reduces their basis, life insurance policies on key executives are still an effective strategy as income-tax-free death benefits [under IRC §101(a)] increase basis. Additionally, if policy proceeds are used to pay deductible expenses, such as additional compensation for a replacement employee, the deduction shelters taxable income. If policy proceeds are used to pay nondeductible expenses, such as loan principal, there is no sheltering of taxable income. However, tax-free proceeds increase basis, which allows for greater amounts of tax-free distributions in the future.			
SECTION 162 BONUS PLANS	A very effective tool where the corporation is in a higher tax bracket than the shareholder employee because the premium on the personally owned policy is deductible by the corporation.	**Plan established for an owner** Because these entities do not pay taxes but pass through income and deductions to their owners, the bonus plan provides little, if any, tax leverage, thus is not generally an effective tool for majority owners but may be of some benefit to a minority owner. A bonus payment does reduce basis in a pass-through entity (nor AAA in an S corporation). Basis reduction is a consideration where the entity expects to make future distributions to its owners, as basis shelters distributions from taxation. **Plan established for an employee** An effective strategy. The employee has taxable income. The owners do not have a tax burden, since the bonus is deductible by the business as compensation to the employee. However, the owners do have a basis reduction (and AAA in an S Corporation).			
SPLIT DOLLAR* (Economic Benefit Tax Regime) The IRS issued final regulations addressing the taxation of split dollar arrangements on September 17, 2003. The split dollar arrangement outlined in this chart is structured as a non-equity endorsement split dollar arrangement involving an employee. Note: The Sarbanes-Oxley Act makes it a crime for publicly-traded companies to, directly or indirectly, enter into a loan with certain directors and officers. It is unclear whether the Act applies to split dollar arrangements. Clients should contact their tax or legal advisors for the most recent developments.	An effective strategy for financing an insurance policy because the corporation is a separate tax entity (i.e., the nondeductible premium effect of increasing income does not flow through to the shareholders). The shareholders receive valuable insurance protection for the smaller economic benefit cost. Upon termination of the split dollar arrangement, generally at retirement, the policy can be used by the corporation to finance a deferred compensation payout; or can be rolled out through purchase by, or bonus to, the insured. There are additional estate issues where a controlling shareholder is party to the agreement.	Split dollar agreements are less effective for tax purposes for owners in a pass-through entity. However, split dollar arrangements are often implemented for gift tax leverage when, for estate purposes, the policy will be owned by a third party or an irrevocable life insurance trust (ILIT). The final regulations retain a special rule for non-equity split dollar insurance arrangements. Under this special rule, non-equity arrangements entered into in a compensatory context or a gift context will be subject to the economic benefit regime. Thus, where an ILIT is the owner of the policy, gift tax leverage is still possible. However, other means for repaying the business must be addressed, since the policy cash values will be unavailable to the trust. Where owners/employees of a pass-through entity need insurance, a bonus arrangement may be less complex. **Sole or Majority Owner** Noncontributory plan: Owner is taxed on income earned to pay premiums and on the economic benefit. As a result, owner is taxed twice on a portion of the premium. Contributory plan: With the enactment of the final regulations, contributory plans lose their tax efficiency since any payment made by the split dollar participant to the business results in taxable income to the business. **Multiple Owner Plans** Same as above. The only difference is that the nondeductible premium expense is spread among multiple owners. S corporation: Nondeductible premium expense is allocated pro rata to all shareholders in direct proportion to their ownership of stock. Depending on percentage ownership, certain shareholders bear more cost of the insurance, which, under a noncontributory split dollar arrangement, may result in termination of the S election. Partnerships and LLCs: Special allocations based on substantial economic effect may allow the nondeductible premium dollars to be directed to specific partners (members) to adjust inequities in premium expense. **Employee (not an owner)** Employees receive valuable insurance coverage for the economic benefit cost, but the owners bear the cost of the plan due to the nondeductible premium amounts.			

*For employer-owned life insurance policies issued after August 17, 2006, IRC § 101(j) provides that the death benefit will be subject to ordinary income tax; however, where specific employee notice and consent requirements are met and certain safe harbor exceptions apply, death proceeds can be received income-tax free. Life insurance proceeds are otherwise generally received income-tax free under IRC § 101(a).

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NONQUALIFIED DEFERRED COMPENSATION*	May be an effective strategy for deferring income for multiple shareholder-employees due to the separation of owners from the entity and tax-bracket differences. The IRS refuses to rule concerning the application of constructive receipt with regard to a controlling shareholder.	Limited deferral opportunities are available for shareholders, depending on the number of owners participating and whether all partners participate proportionately. For an in-depth discussion, refer to: IFS-A077346: Nonqualified Deferred Compensation Plans in an S Corporation. IFS-A072455: Nonqualified Deferred Compensation Plans: The Plan and Life Insurance Tax Impacts. IFS-A066100: Nonqualified Executive Benefits Arrangements. **Sole or Majority Owner** Not an effective strategy. Plan results in double taxation to the owner. First, when the income is deferred and used to pay nondeductible insurance premium. And again, when the owner or his beneficiaries receive benefits. **Multiple Owners** Same as above. The only difference is that the nondeductible expense is spread among multiple owners. S corporation: Nondeductible expense is allocated pro rata to all shareholders in direct proportion to their ownership of stock. Depending on percentage ownership, certain shareholders may bear more of the cost. Partnerships and LLCs: Special allocations based on substantial economic effect may allow the nondeductible expense to be directed to specific partners (members) to adjust other inequities. **Employee (not an owner)** Employees are able to defer income to future dates, but the owners bear the tax burden of the plan due to the nondeductible expense.			

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