

Professional Liability and Alternative Forms of Business Organization

PROFESSIONAL DESIGN FIRMS

Under Illinois law, entities offering professional engineering services or professional structural engineering services must register as professional design firms (225 ILCS 325/23 and 225 ILCS 340/19). Exceptions to this rule are sole proprietorships, where the sole proprietor is a professional engineer, and firms organized as “professional service corporations.” All professional design firms must have a managing agent in charge of engineering activities who is a licensed engineer. The state must be notified within 10 days of the managing agent leaving the firm, and a new managing agent must be appointed within 30 days.

Professional design firms (other than professional service corporations) may have non-engineer equity holders. Professional service corporations may not have non-engineer shareholders.

LIABILITY FOR PERFORMANCE OF ENGINEERING SERVICES

Contract Liability. Since *Hadley v. Baxendale*, Court of Exchequer, 9 Exch. 341, 156 Eng. Rep 145 (1854), the common law rule has been that damages with respect to a breach of a contract to provide services are only recoverable if reasonably foreseeable by both parties to the contract at the time of the contract, or they arise naturally from the breach. Under this rule, generally indirect or consequential damages are not recoverable under contracts absent an agreement to the contrary. Providers of services typically should bargain hard to specifically exclude claims for indirect or consequential damages under written contracts. Success in this area tends to be a function of the relative bargaining positions of the service provider, such as the engineering firm and the party purchasing the services.

Risk Management. Key risk management areas to address in contract negotiations include: language clearly describing the responsibilities of the engineer; no obligation to provide additional services absent an agreement to do so and the right to payment for additional services; language describing the standard of care of the engineer, which should be the ordinary professional standard of care; warranties that do not expand that standard; waiver of indirect and consequential damages; and contractual indemnification provisions. Specific items to avoid, if possible, are any responsibility for an owner's or contractor's budget, including obligations to confirm items are in conformity with a budget. These requests often come in the form of requirements to certify as to various matters, such as that the contractor's work in place is equal to his progress billings, is in accordance with the plan and specifications, or meets all laws, codes and regulations, all utilities, structures, easements and boundaries, and are precisely located on “as-builts,” certification of plat plans and the like. Professional liability policies presently available in the marketplace generally exclude coverage for claims arising from express warranties or guarantees, either by direct exclusion or other policy language. Another area of concern is to avoid taking responsibility for dealing with environmental problems and hazardous materials, which can lead to liability for the problems under federal law.

Tort Liability. The standard principal-agent, professional liability standards and contract rules apply to engineers. Under common law, engineers are required to perform at a level of care consistent with the professional skill and competence normally exercised by others practicing their profession in their community. Put another way, the law holds engineers liable only insofar as it can be proved that they were negligent in providing a reasonable degree of professional care. In addition, at least in Illinois, engineering contracts are deemed to include a requirement that engineering performed be at a level consistent with local customs and standards [*Fifteenth Ave. Christian Church v. Moline Heating and Construction Co.*, 265 N.E.2d 405 (Ill.App. 3rd 1971)].

Engineers in Illinois are entitled to the benefit of the “economic loss doctrine,” which holds that a plaintiff cannot recover in tort solely for economic loss [*Fireman’s Fund v. SEC Donahue, Inc.*, 679 N.E.2d 1197, 1201 (Ill. 1997); *Moorman Manufacturing Co. v. National Tank Co.*, 435 N.E.2d 443, 451 (Ill. 1982)]. This rule is essentially designed to prevent plaintiffs from using tort law as an end run around the limitations placed on the availability of contract damages. There are two general exceptions to the economic loss doctrine: 1) fraud or intentional misrepresentation and 2) negligent misrepresentation by a party who is in the business of supplying information for the guidance of others (435 N.E.2d at 452).

If an engineer’s plans are incorporated into a finished tangible object, then the plans are generally deemed incidental to the finished product and the negligent misrepresentation exception will not apply to the engineer (*Fireman’s Fund*, 679 N.E.2d at 1202). In *Fireman’s Fund*, a construction company hired an engineer to provide plans for a water supply system that required tunneling under a state tollway. The plans were faulty and the construction company had to fix the tollway at a cost of \$57,754. Relying on an earlier decision that dealt with architects, the *Fireman’s Fund* court stated that where an engineer’s plans are incidental to a tangible finished product, the negligent misrepresentation exception does not apply. The court reasoned that the characteristics of a tangible finished product “are readily ascertainable, and they can be memorialized in a contract and studied by the parties” (679 N.E.2d at 1202).

However, if an engineer is hired “solely to provide information rather than to construct a ...structure,” then the negligent misrepresentation exception can apply [*Tolan and Son, Inc. v. KLLM Architects* 719 N.E.2d 288, 291 (Ill.App.1 Dist. 1999)]. “Under *Tolan*, liability for negligent misrepresentation by a provider of tangible goods or non-informational services is a case-by-case inquiry that turns on whether an analytical work product was solely bargained for in the underlying transaction” [*Hon. Sheldon Gardner, Matthew Sheynes*, THE MOORMAN DOCTRINE TODAY: A LOOK AT ILLINOIS’ ECONOMIC-LOSS RULE, 89 Ill. B.J. 406 at 410 (2001)].

In *Tolan* a residential contractor hired architects and a geotechnical engineer (“Engineer 1”) to help plan the building of a residential town home complex. Because the complex was constructed on inappropriate surface material, the town homes’ concrete walls developed cracks. Neither the architect nor Engineer 1 had raised the issue of an inappropriate building surface prior to construction, and they maintained, after the problems arose, that the problems could be fixed without addressing the inappropriate surface. In making their recommendation as to how to deal with the problem, the architects employed a second engineer (“Engineer 2”) to provide an opinion on the structural integrity of the town homes. Eventually the contractor hired a concrete company to repair the cracked walls. The concrete company determined that the cracks were due to the inappropriate surface material. The residential contractor spent an additional \$750,000 to fix the property. The court held that the negligent misrepresentation exception did not apply to the architects or Engineer 1 because they were employed to build a tangible product (the town homes) and not to provide information. The court remanded the negligent misrepresentation claim against Engineer 2 back to the trial court because there “was insufficient evidence...to conclude whether [Engineer 2] was hired solely as a consultant...or whether...he was intimately involved with the construction of the project and his ideas were incorporated into the structures” (719 N.E.2d at 299).

Historically, claims arising out of providing inadequate services tend to be limited to parties with whom the engineer has contracted, on the basis that the engineer has not assumed a duty to any other party. This has left open claims based on liability to a party in privity with the engineer for that party's obligations to pay damages incurred by a third party caused by the engineer's breach of contract, subject to the *Hadley v. Baxendale* standard. Recent litigation in several states has further eroded this limitation. Courts have been deciding that the reasonable skill and judgment expected of professionals must be rendered to those who foreseeably rely upon their services. This loosening of the privity limitation is occurring in jurisdictions across the United States. In *Moransais v. Heathman*, 744 So.2d 973 (Fla. 1999), the Florida Supreme Court held that the economic loss doctrine does not bar a cause of action against a professional for his or her negligence even though the damages are purely economic and the aggrieved party entered into a contract with the professional's employer. The court further held that Florida recognizes a cause of action against professionals in negligence despite the lack of a direct contract between the professional and the aggrieved party.

E&O Insurance. Errors and omissions insurance typically excludes negligence claims beyond common law liability and generally does not cover contract breach claims outside indemnification provisions.

ALTERNATIVE FORMS OF BUSINESS ORGANIZATION

Several alternative forms of entity are available for operation of an engineering firm. The general partnership form is no longer common because all general partners of a partnership are liable for the obligations of the partnership. Limited partnerships must have at least one partner with general liability, but that partner can be a corporation, including an S Corporation, so that no individual need have personal liability beyond his or her investment in the business. Subject to case law concerning inadequately capitalized corporations, the owners of a corporation generally should not be personally liable for the obligations of the corporation.

The ultimate choice of how to structure a business tends to be driven primarily by tax considerations. Under the Internal Revenue Code of 1986, as amended (the "Code"), there are three primary tax schemes, a) traditional corporations under Subchapter C of the Code ("C Corporations"), b) corporations governed by Subchapter S of the Code ("S Corporations") and c) partnerships governed by Subchapter K of the Code. Under "check the box" rules adopted by the Internal Revenue Service (IRS), entities which are Limited Liability Companies (LLCs) or partnerships under State law and have two or more owners, can elect to be taxed as corporations or as partnerships, with the default (absent an election) being treatment as a partnership. The check the box rules replaced a long history of applying a four-part test to non-corporate entities to determine their tax status.

Below, we provide an overview of the primary considerations a businessperson should consider when choosing how to structure the entity through which he or she will conduct his or her business. Unless specifically noted otherwise, references to LLCs in the discussion are references to LLCs that have elected to be taxed as partnerships.

LIMITED LIABILITY COMPANIES AND PARTNERSHIPS

LLCs have become a very popular form of organization. They allow equity owners to fully participate in the entity's business operations without risking liability beyond their investments by virtue of such investment and participation, historically a primary benefit of the corporate form. An election to be subject to the partnership tax regime causes income generated by the entity to be taxed only once, at the member level. Tax items such as income, losses and deductions realized by partnerships and LLCs that elect to be taxed as partnerships "flow through" to the individual partners or members who then must pay taxes on the income or otherwise address the passed through tax items. All taxable income that passes through to a partner or an LLC member is taxed at the partner's or member's individual tax rate.

A partner or member is liable for his or her portion of the tax obligations resulting from the entity's business operations, regardless of whether the partnership or LLC distributes all or any of the income generating the tax. Generally, the governing documents for such entities provide that, to the extent cash is available, they will distribute sufficient cash to cover tax obligations at assumed rates.

Perhaps most importantly, if the assets of a partnership or LLC are sold, there will only be one tax, at the partner or member level. In addition, if the partnership or LLC is liquidated, there will either be no immediate tax or a single tax at the partner or member level.

Each partner in a partnership and member of an LLC has a "tax basis" in the entity. Initially, the tax basis equals the tax basis the contributing owner has in the property contributed to the entity in exchange for his or her interest. The tax basis is then adjusted for the entity's debt and any gain the contributor may have realized on the contribution. When a partner or member pays tax on entity income, the member's tax basis increases in an amount equal to the tax that passed through to the partner or member. Upon distribution of the income, the basis is reduced and no additional tax is due to the extent the owner has sufficient basis to absorb the distribution. Likewise, when a partner or member receives a deduction or a loss that flows through the entity, the partner's or member's tax basis is decreased.

Subject to a number of limitations,¹ an owner of a partnership or LLC can use a flow-through loss or deduction against his or her other taxable income. The primary limitation on the ability to use a flow-through loss or deduction is the owner's basis: a deduction or loss can only be used to the extent it equals or is less than the owner's existing tax basis. A major benefit of partnerships and LLCs over S Corporations is that the tax bases of owners of an entity taxed as a partnership are increased for those owners' proportionate shares of the entity's debts. The basis for a shareholder in an S Corporation is not increased unless he or she actually lent the money in question.

As noted above, when a partnership or LLC distributes income to the partners or members, the distribution is tax free to the extent the receiving partner or member has enough tax basis to absorb the distribution. Special rules will cause distributions of compensation or interest to be taxed as ordinary income. Distributions of property (other than cash) are generally also tax free. The recipient owner takes the property with a tax basis equal to the entity's tax basis in the distributed property. Therefore, any gain or loss inherent in the property will be subject to tax when the property is sold by the new owner.

¹ Two additional important limitations not addressed herein are the "at risk" rules of Code Section 465 and the "passive activity loss limitation" rules of Code Section 469. In general, a taxpayer can not use losses or deductions from a pass-through entity beyond the amount of value the taxpayer has "at risk" in the entity. A taxpayer's "at risk" amount originally includes the money and the tax basis of other property the taxpayer contributes to the LLC. The "at risk" amount is increased by the amount of any tax liability that flows through to the taxpayer to the extent that amount is not distributed to the taxpayer. Amounts borrowed for use in the LLC's operations activity are included in the at-risk amount to the extent the taxpayer is personally liable for repayment or has pledged property (other than property used by the LLC) as security for the debt. The passive activity rules generally require that members be actively involved in the business at issue in order to use the business's pass-through losses.

Entities taxed as partnerships are allowed to make “special allocations” of flow-through tax items. Special allocations allow the members to decide what percentage of each flow-through item will be allocated to each member. The IRS will respect special allocations that have “substantial economic effect.” For instance, an allocation can be made to favor certain members as long as the tax consequences of such an allocation are incurred by the same members who incur the economic benefit (or burden) of the allocation. Special allocations are often used to give capital contributors the initial losses of a start up LLC. In contrast, an S Corporation must “pass through” all taxable items equally to shareholders; special allocations are not allowed.

The special allocation rules are just one example of the complexity of Subchapter K. With the complexity, the owners of partnerships and LLCs are permitted great flexibility to order their economic relationships in the way that best achieves their business purposes. On the other hand, Subchapter K contains some of the more intricate and arcane provisions of the Code. In exchange for flexibility, the legal and accounting expenses of operating an entity taxed as a partnership are greater than those for corporate forms, with the expense for a C Corporation being the least, but at the cost of generally resulting in the greatest tax burden, as discussed below.

The formation requirements for LLCs are straightforward and flexible. Single member LLCs are allowed in many states. A single member LLC is either disregarded as separate from its owner for tax purposes, or the owner can elect to have the entity taxed as a corporation. The default tax treatment for multiple member LLCs is partnership flow-through tax treatment. However, such an entity can elect to be taxed as a corporation. While the IRS has not formally ruled on the issue, an LLC taxed as a corporation should be able to participate in various tax free reorganizations that are restricted to corporations. One drawback of LLC formation is that state laws governing LLCs are much less comprehensive than the laws governing corporations; therefore, it is almost always advisable to have a formal operating agreement delineating the rights and responsibilities of the members. It is important to have competent legal and tax counsel with respect to the preparation of that document. On the other hand, the flexibility afforded permits those agreements to range from agreements essentially equivalent to traditional partnership agreements to agreements essentially equivalent to the charter and by-laws of a corporation, depending on the manner of governance desired by the business owners.

Distributions to members of LLCs who provide service to the LLCs will be subject to the self-employment taxes. There is an exception to this rule for members who are the equivalent of limited partners in a limited partnership. The definition of “limited partner” for the purposes of this exception is currently not entirely clear. But an LLC investor who is not involved in operations and serves no employee-like function should be able to avoid self employment taxes on distributions.² While LLCs have become much more popular than limited partnerships as a structure for operating businesses, clarity as to this issue is one advantage of the limited partnership form.

Historically, a disadvantage of entities taxed as partnerships was that owners could not exclude from income the fringe benefits typically provided by employers (health insurance, cafeteria plans, etc). On the other hand, corporations who are entitled to those deductions pay tax on their income, which partnerships do not; and changes in the Code have had the general effect of reducing the differential treatment. The benefits are generally taxable to the member as compensation and deductible by the partnership or LLC. The deductions for the benefits should flow through to the partners or members so the ultimate tax effect with respect to health insurance, which is fully deductible on the individual’s personal return, subject to the limitation on itemized deductions based on adjusted gross income in excess of \$139,500, should be roughly equivalent to the treatment of benefits provided by a corporation.

² In 1997 the IRS proposed regulations to clarify when a member would be the equivalent of a limited partner. These regulations have not been finalized. Under the regulations, any member of an engineering LLC who provides engineering services would not be able to avoid self-employment taxes on his or her distributions.

An important advantage of partnership tax status over S Corporations for firms wishing to achieve flow-through tax treatment is the ability to reapportion “inside basis.” Each equity owner of a partnership or an LLC will have a share of the entity’s basis in the entity’s assets, commonly referred to as “inside basis” (as opposed to the basis one has in his or her partnership or LLC interest). In-kind distributions, sale of an interest in the entity, or a death of a partner or member can cause the inside basis to be disproportionately allocated among the partners or members, potentially resulting in unfair tax treatment. Owners of a partnership or an LLC can elect to adjust the ratio of inside basis upon a sale or an in-kind distribution, and well drafted partnership agreements and LLC operating agreements make provision for this adjustment. Such adjustments are not available for S Corporations.

Unlike interest on most other personal debt, the interest on debt incurred to purchase a partnership or LLC interest can often be deducted by the purchaser. Investment interest deductions are generally limited to the extent of investment income. However, debt used to purchase a partnership or LLC interest is allocated among the entity’s assets. Interest allocated to the business assets will not be subject to the investment interest deduction limit if the taxpayer materially participates in the business.

LLCs are popular choices for venture capital projects. Unlike S Corporations, there are no restrictions on the nature of the equity owners. For instance, a corporation can be a member of an LLC. There are also no restrictions on the nature of the equity interests. Therefore, preferred interests can be created with terms best suited to the needs of the company and the investors. Illinois law permits the operation of engineering firms through LLCs.

S CORPORATIONS

Like entities taxed as partnerships, S Corporations are not subject to tax and the income they generate is taxed once, at the shareholder level. Income, losses and deductions realized by the entity pass through to the shareholders who then must pay the tax or use the deductions. As with LLCs, a shareholder is liable for tax on his or her portion of the S Corporation’s income, regardless of whether the S Corporation distributes the income generating the tax.

As with the partnership tax regime, if the assets of an S Corporation are sold or the entity is liquidated, there generally will only be one tax, at the shareholder level.

Conversion of C Corporations to S Corporations potentially results in exceptions to the flow-through treatment due to entity level tax imposed on “built-in gains.”

With one major difference, a shareholder in an S Corporation calculates his or her tax basis in much the same way as a partner in a partnership or a member in an LLC. The difference is that S Corporation shareholders do not obtain any increase in basis for the S Corporation’s debt unless the shareholder is the lender. Similar to partnerships and LLCs, distributions of entity profits are generally tax free to the receiving shareholder to the extent they do not exceed the shareholder’s tax basis prior to the distribution. As with partnerships and LLCs, the shareholder’s tax basis is reduced by the amount of the distribution. However, owners are not permitted any flexibility in allocating the flow-through items generated by an S Corporation; all taxable items flow through to the shareholders in proportion to the number of shares they own.

As with LLCs, S Corporation shareholders can deduct interest on debt incurred to purchase shares of an S Corporation if the interest is properly allocated to business assets. Also, 2% or more shareholder-employees of S Corporations can not exclude fringe benefits from income.

Disadvantages of using S Corporations include the strict limits on who can be shareholders and the types of equity S Corporations can issue. An S Corporation can only have 100 shareholders and those shareholders must be either individuals (who are US citizens or residents) or certain types of trusts. In addition, all S Corporation stock must have the same economic rights; preferred interests are not allowed.

Differences in stock voting rights are allowed. This can permit business owners to transfer equity interests in their S Corporation without losing any control over the corporation. In addition, although S Corporations cannot have corporate shareholders, an S Corporation may own interests in corporations or other entities. In many instances, upon initial formation these limitations may not be seriously constraining and S Corporation corporate governance, which follows the State corporation statutes, is simpler than partnership law or the LLC statutes. However, the constraints on the type of interests that can be offered and the nature of the investors do provide limits on access to capital and such limits may prove significant over time. Once the choice is made, there is generally no way to convert an S Corporation or C Corporation to an entity taxed as a partnership other than through a taxable transaction, with the result that the owners will be required to pay tax on the appreciation in value of assets held by the company.

S Corporations are easy to set up and maintain and require much less attorney maintenance than partnerships and LLCs. In addition, a C Corporation can convert to S Corporation status without undergoing a taxable liquidation. For some business owners the lack of flexibility is a cost they are prepared to live with in exchange for lesser ongoing costs of operation.

C CORPORATIONS

Income generated by C Corporations is subject to two levels of taxation. Federal income tax is imposed at the corporate level when income is earned, and tax is again imposed at the shareholder level when the income is distributed. Currently qualified dividends and long-term capital gains are generally taxed at a 15% rate.

The tax rates on income earned by C Corporations (other than personal service corporations, which pay a flat fee of 35%) are as follow:

Taxable Income	Tax Rate
\$1 - \$50,000	15%
\$50,001 - \$75,000	25%
\$75,001 - \$100,000	34%
\$100,001 - \$335,000	39%
\$335,001 - \$10,000,000	34%
\$10,000,001 - \$15,000,000	35%
\$15,000,001 - \$18,333,333	38%
over \$18,333,333	35%

Subject to recharacterization of excess compensation payments to share owners as dividends, many smaller businesses structured as C Corporations pay salaries and incur deductible expenses sufficient to reduce their income to or close to \$0. In this way, these enterprises effectively are subject to little or no double taxation, so long as the salaries are not successfully challenged as being "excessive" and deductions are not challenged as consumption versus business expense, such as country club dues with no evidence of a business benefit from the membership. The current tax rates allow a C Corporation to take advantage of lower tax rates by leaving up to \$75,000 in the corporation (as opposed to zeroing out income). This allows the income to be subject to one level of tax at the 15% and 25% corporate rates, so long as it is retained by the business.

Many service and professional firms use C Corporations because their revenue is almost exclusively generated by personal services. Since such corporation's revenue is a direct result of the employee services, compensation including bonuses essentially equivalent to revenue in excess of other expenses may well constitute reasonable compensation in a given instance. However, the vast majority of distributions to non-employee investors can not qualify as compensation.

The primary advantage of the C Corporation form is that money can be left in the corporation for growth of the business and taxed at rates that have historically been below the individual tax rates. The current tax structure, with individual rates at or below the level of corporate tax rates and dividends taxed at the same rate as capital gains, is very different than the typical situation when individual rates have been substantially higher than corporate rates and dividends have been taxed at ordinary income tax rates. Parties choosing flow-through entity structures are advised not to do so exclusively based on those rate relationships holding for the long term.

The primary disadvantage of C Corporations is that income generated by the corporation is taxed at the corporate level and taxed again upon distribution, whether through dividends or a liquidating distribution upon a sale of the assets of a C Corporation. This disadvantage will be reflected in the value a sophisticated buyer will pay to purchase an equity interest prior to the ultimate sale of the corporation's assets and the price a sophisticated buyer would pay to purchase all of the interests in an exit transaction structured as a stock sale.

The current corporate tax rates create a possible rate advantage for small firms. For a firm making up to \$50,000, the current tax rate is 15%. Firms making up to \$75,000 are subject to a 25% marginal tax rate. The advantage of these rates is limited to situations where the firm makes no distributions (which would subject the income to shareholder level tax) or where a firm taxed at the 15% rate distributes its income as dividends, capping the total tax on the earnings at 30%. Of course, subject to effectively taking out earnings as compensation income, most persons setting up businesses want a structure that is efficient for income levels well in excess of \$75,000, particularly if they expect or hope to be owners after they are no longer the primary service providers in the business.

For more complicated structures, an advantage of the C Corporation structure is the availability of filing consolidated returns. Consolidated returns result in tax imposed on the net income of the group of companies, which among other things means the losses in any group member reduces the tax on income of any other group members. Such returns are generally restricted for pass-through entities. However, the ability of S Corporations, partnerships and LLCs to hold interests in other entities, creating multi level pass through of tax items, permits many of the benefits associated with consolidated returns.

Historically, another advantage of C Corporations (as well as S Corporations) has been the well developed state law with regard to corporations. While this body of law continues to be far better developed than the law governing LLCs, LLCs have become very popular and their tax treatment at the state level, effectiveness as a liability shield and governance are all much better developed than they were 10 years ago.

As discussed above, another advantage of using a C Corporation is that shareholder-employees can exclude fringe benefits from income.

There are no restrictions on classes of stock or who can be a shareholder, which are advantages versus S Corporations but are not limitations imposed on partnerships or LLCs.

There are a couple of other benefits available to certain small C Corporations. Losses on the sale of stock of certain small C Corporations can, in certain circumstances, be converted into ordinary losses as opposed to capital losses. In addition, 50% of the gain on the sale of certain small C Corporations can, in some cases, be excluded from income.

CONCLUSIONS

Generally, liability of persons who are owners and participants in a business can be limited to the same extent regardless of the form of entity through which the business is conducted. Therefore, the choice tends to be primarily driven by tax considerations.

For smaller businesses, the impact of double taxation on earnings can be mitigated to the extent appropriate deductions, including reasonable compensation, minimize the amount of taxable income of the business. However, this strategy is limited with respect to higher levels of income or owners who are not also employees of the business.

In the event of sale of the business, sale of stock of a C Corporation results in one level of tax or no current tax if the sale meets the requirements for a tax-free reorganization.³ However, many buyers are unwilling to buy stock and insist on buying assets to avoid assuming liabilities of the business. In any event, if the purchaser cannot buy assets or obtain a "step-up" in basis upon the acquisition,⁴ they will reduce the purchase price for a stock purchase by the value of the step-up in basis that they would have obtained in an asset purchase.

Lack of a step-up in the basis of a target's assets may be less important to purchasers of a professional firm than it is, for instance, to purchasers of manufacturing firms. A primary benefit of a basis step-up is that the increased basis allows for increased depreciation deductions. However, purchased goodwill can only depreciate over the course of 15 years, as compared to the shorter depreciation periods for many depreciable tangible assets. Where a business has a relatively small proportion of depreciable tangible assets and its value is composed largely of goodwill, the value of a step-up in basis is reduced, thus reducing the price a purchaser is willing to pay for a basis step-up.

S Corporations offer a means to avoid the two layers of tax and maintain most of the simplicity of using a C Corporation, but do so at the expense of substantially less flexibility with respect to the business's capital structure.

Partnerships and LLCs taxed as partnerships offer the maximum flexibility for capitalization and management and flow-through tax treatment, but do so at the expense of the substantially greater complexity of Subchapter K of the Code. The likely higher ultimate value of the business realizable through a sale may be well worth the expense and complexity to be able to have only one level of tax imposed on the sale. However, the increased value of a single level of tax afforded by a more complicated structure may be less for a company with few tangible assets.

³ The Code allows for entities taxed as corporations to be sold or merged with other entities, with no current tax if the transaction qualifies as a tax-free reorganization. The major requirement for a tax-free reorganization is that selling shareholders receive stock in the purchasing corporation as the primary consideration for the transaction. Tax-free reorganizations are most common when the purchaser is a publicly traded corporation.

⁴ Code Section 338 allows a stock purchaser to take a stepped up basis in the assets of a purchased target. However, a standard Section 338 transaction triggers both shareholder level tax for the seller of the target and a corporate level tax for the buyer (the buyer is deemed to sell the assets of target, thus triggering a gain and a step-up in basis). There is a more favorable 338 transaction that avoids the corporate level tax for the buyer, but can only be used if 80% of the target is owned by a corporate shareholder and that corporate seller agrees to make the necessary elections.