CHOOSING THE RIGHT FORM OF ENTITY TO RUN YOUR BUSINESS

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As a new business owner, I am sure many of you have pondered the question of how to set up a business for tax purposes. There are many options available and they have become more complicated in the past few years. So, let's look at what is available to us, what advantages and/or disadvantages they have and then how they may or may not affect us when it comes to taxes.

For years there were basically three forms of doing business: a sole proprietorship, a partnership or a corporation. Let's look at each one.

SOLE PROPRIETORSHIP

A sole proprietorship is a business owned and operated by a single person. It offers no liability protection for lawsuit purposes. Thus, if a judgment is won against your business, the claimant can attach anything that you or the business owns - including future wages.

For tax purposes, your income is only taxed once -at the personal (individual) income tax level. The net income from the business is treated as self-employment income and is subject to not only Federal and (if applicable) state Income Taxes, but also Social Security and Medicare Taxes. Like FICA taken from your employee checks, your net income is treated like your own pay and you will have to pay the FICA for yourself as an employee, but also as the employer - thus you end up paying FICA double the normal 7.65% your employees (themselves) pay.

A final note with respect to income taxes for these types of businesses. IRS has a high rate of auditing these entities. Income reported on the Schedule C (self-employment income) is usually subject to about a 10-12% audit rate. The reason is two-fold. First, the IRS has noted a high rate of fraud for Schedule C's. Example: the ski bum calling him or herself an instructor so he/she can write-off expenses for ski trips, meals, etc. To nab these types of "hobby" income forms - the IRS increases the scope of their review - thus more Schedule C's are audited than ANY other tax form. And once you're tagged (usually by random draw of all Schedule C's) - the IRS agent must complete the audit - even if the numbers look legitimate.

Now I always advise my clients not to worry about an audit - all your numbers should be legitimate and accurate. But the time and trouble of going through an audit (not to mention anxiety for most people) is too much. The second reason why IRS tends to audit Schedule C business has to do with the FICA "bonus". Not only will could they possible get more income tax dollars for every additional taxable dollar they find, but they net the "bonus" of also collecting the extra 15.3% FICA tax.

PARTNERSHIPS

A partnership, is a business run by multiple owners. Like a sole proprietorship, legally you usually have no liability protection. (Note there are such things as a Limited Partnership - but at least one "General Partner" always has full liability exposure (like that of a sole proprietor.) Also, in general, a partnership is generally organized by a partnership agreement. It is wise to consult with professionals in establishing this Partnership Agreement to address issues like voting powers, partner buy-outs, etc. Remember, in a partnership you are essentially "married" to the other person(s) and it can be just as messy as a divorce.

For tax purposes, a partnership is not subject to income tax (like a sole proprietorship) at the Federal level, and depending upon your state law, may or may not be subject to state income taxes (usually not though). A separate tax return is filed at the partnership (Form 1065) which shows all the business income and expenses. Then, the net profit or loss is "flowed through" to the individual partner's returns via a "K-1 Form". Some items of income or expense might be broken out separately on this K-1 form due to tax laws that treat such items differently. Usually, this income is also subject to FICA (social security and Medicare taxes) like a sole proprietor. With respect to audits, a lower percentage of partnerships are audited. The presumption by the IRS is that if you have gone through the time, trouble and finances of becoming a partnership, you probably are not the ski bum they are looking for as noted above.

CORPORATIONS

Lastly, there is the corporation. The key elements of a corporation are twofold. First, it provides liability protection. Thus, the only assets on the line in a lawsuit claim are those of the business and your personal assets are protected. Second - it is a form of business that offer continuity - i.e. the business can continue regardless of changes in ownership. Each owner holds "stock" in the corporation. The downside of a corporation is double taxation. A corporation files its own Federal Income Tax return and pays income taxes on its profits. Then, when this profit is paid to the stockholders in the form of dividends, the dividend is taxed again at the shareholder level on their personal income tax forms.

But a big advantage of being incorporated is that the stockholder, if working in the business, need not be taking any form of paycheck. That is not to say the shareholder cannot withdraw money from the company. And in fact, depending on the profit of the corporation, some of the "shareholder draws" taken within the year may be deemed to be compensation. But some of the "draw" is also deemed as profits. What does that mean? You can save a lot of money for social security and Medicare taxes, federal and state unemployment taxes, and workman's compensation expenses. And, like a partnership, your potential for an audit is dramatically reduced as a corporation.

Additionally, an advantage to the stockholders is that they do not pay income tax until the profits are actually paid to them. Thus, if the shareholder does not withdraw the profits the stockholder will not get taxed on their personal return - yet. This can be advantageous for those stockholders that have college age children and might be seeking financial aid. Since the corporate income is not flowing through, personal income can be controlled.

Again, though the downside is that losses from the corporation cannot be flowed through either. Thus, if the corporation sustained a tax loss, that loss stays with the corporation until it needs it to offset income and/or until the corporation has gone out of business. There is no personal tax relief.

There are some rules regarding how long and how much profits can build up within a company without dividends being paid. Thus, you cannot defer the personal tax consequences indefinitely. Consult with your accountant regarding these specifics.

SUB-CHAPTER S CORPORATIONS

There is a way to be incorporated and have all the benefits therein, without this double taxation. It is called a "Sub Chapter S" corporation. It is only a "status" that is deemed by the IRS and not designated by the individual state agencies governing incorporation. If you meet the IRS's criteria for Sub-S status (see footnote 1) then like a partnership, income will flow through directly to the shareholders without any Federal corporate income taxes. The upside: no double taxation. Additionally, if the company sustains a tax loss - that loss, too, will flow through to the shareholders and help offset income on their personal tax return (i.e. income from other jobs, spousal income, investment income, etc.). The downside of this means a shareholder may be paying some income tax on profit left in the business. Thus, if the regular "C' company has made $10,000 profit, the corporation will pay income tax - but until that profit is paid to the stockholder, it won't get taxed. Still a double taxation - but with a timing difference. A "Sub-S" corporation will not pay corporate tax (See footnote 2) - but the profit is flowed through to the stockholders and they will pay the tax on their personal returns whether or not the profits are paid out to the shareholder.

Let's compare how these business entities may pay income taxes....

Let's say a business makes a profit or $20,000, before any owner / shareholder draws / or paychecks. If the owner / stockholder actually worked within the company, the IRS would deem that a "fair and reasonable" salary be drawn. The IRS determines what you would have had to pay someone from the outside to perform your duties. It also looks at that profit figure. IRS has held in audits that the lesser of the "market pay" or one half the corporate profits is "fair and reasonable". So here is what we have:

	As a Sole Prop. or a Partnership	Regular "C" Corporation	Subchapter S Corporation
Company profit	$20,000	$20,000	$20,000
Owners "deemed" salary	0	-10000	-10000
Net profit	20000	10000	10000
Corporate income tax	0	-1500	0
Net amount available for dividend	20000	8500	10000
Personal Income tax			
15% tax bracket	3000	1275	1500
28% tax bracket	5600	2380	2800
Tax on the salary plus/including FICA/MC			
15% tax bracket	2826	2913	2913
28% tax bracket	2826	4213	4213
TOTAL TAXES on this $20,000 profit			
15% tax bracket	$5,826	$5,688	$4,413
28% tax bracket	$8,426	$8,093	$7,013

As you can see - there is a dramatic tax savings if the right form of business entity is chosen. Depending on your own personal income tax bracket, as in this example, this savings can be as much as $1800.

LIMITED LIABILITY PARTNERSHIPS AND CORPORATIONS

This seems to be the hottest topic around these days - especially among attorneys. You see, prior to these limited liability entities' existence, most states would not allow attorneys or doctors to become incorporated. Remember, as a corporation liability protection is afforded to them. They (the states) did not want this used to protect these individuals from malpractice suits. Then along came these Limited Liability Partnerships (LLP's) and Limited Liability Corporation (LLC's). The attorney's and doctors could use these forms of business to afford them liability protection from everything but their malpractice suits. Thus, this became a golden egg for attorneys. Here is a way for them to afford themselves the same liability relief and, perhaps, get some tax relief.

For LLP, the same general taxation rules apply as stated above.

For LLC's however, a different "gray area" has crept into the tax system. You see, these LLC's are fairly new (at least in IRS' law prospective). The code has not really addressed how to tax these LLC's. As such these are no specific rules that guide the IRS, like those that determine qualification for "Sub-S" status, when it comes to the LLC. So, now, it is left up to the IRS' discretion as to what corporations qualify to be treated like a Sub-S corporation. And because it is discretionary, it is difficult to challenge the IRS rulings. This HUGE gray area leaves the potential open for being taxed in a corporate entity you may not necessary want.

So, my general question I pose to people who tell me they are LLC's is - why? Why would any deliberately go into a gray area to which you may lose the Sub-S status?

I must interject, however, that there is one reason, and only one reason, why a LLC may be better (for tax purposes) than a conventional corporation. If that corporation plans on transacting any Sec. 1231 exchanges the LLC is the vehicle to do this. A Sec. 1231 exchange is that where your business is trading one piece of property for a like-kind piece of property. When done properly, this like-kind exchange can defer its taxation on the capital gains it may incur. This usually is only an issue if the corporation owns real estate.

BUT, in my experience, if your intention is to own real estate as part of your business plan, for liability protection, the real estate should be held separately and outside the quilt shop entity. I usually establish two corporations in these instances and have the operating (the shop's) company pay rent to the real estate holding company. Again, it would be wise to consult with your accountant in this situation. Although this may involve additional income tax returns, annual renewal fees, and other related expenses with stock ownership, it will save you tremendously if/when you may ever get sued.

So, when it comes to setting up your business, as you can see, many issues come into play. Liability protection, continuity, tax issues and business strategies. What is best for you? Consulting with your legal and accounting professionals will help guide the way!

Footnote 1: To qualify for Sub-Chapter S status a corporation must be domestic corporation and

a) Have less than 75 stockholders and all must be individuals, estates or trusts
b) The stockholder must all be US citizens or residents
c) There is only one class of stock
d) Status is requested by the IRS using Form 2553. If filed within the third month, 15th day of incorporating, and all the requirements are met, then approval is automatic. If not filed within that time, IRS will establish the approval (effective) date.

Footnote 2: Note some states will tax Sub-Chapter S corporate profits. By Federal law they cannot assess "income tax" to Sub-Chapter S business but most have instituted some other tax in its place. For example - in Illinois, Sub-S corporations pay a "Replacement Tax" for the privilege of doing business in the state of Illinois. Coincidentally it is based upon the corporate income for the year. Some states tax corporations based upon assets on hand, capitalization, or some other flat tax calculation. Note, however, these taxes are usually LESS than what a regular "C" corporation would be required to pay. Consult with your accountant for specific individual state tax issues.