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CHOOSING THE PROPER ENTITY FOR YOUR BUSINESS

By Victor Sy, CPA, MBA

You have decided to go into business for yourself. Should you operate as a sole proprietorship, partnership, corporation, LLC, or LLP? How do you select which entity is most beneficial for you? Choosing the wrong form could cause unnecessary taxes, increased liability, and unnecessary exposure to lawsuits. What you should *not* do is listen to your neighbor or friend because each one has a different set of circumstances calling for a different set of strategies, a different form of entity. What you should do is seek professional advice to help you understand the attributes of each form and evaluate a whole multitude of confusing tax, legal and personal issues. The objective here is to set *you* up with a form that is tailored to *your* particular needs, *your* particular industry, and *your* particular business. Read on and allow me to describe the nature, advantages and disadvantages of each form of entity.

SOLE PROPRIETORSHIP: This is the simplest form of doing business. The business is your own alter ego. It does not require any legal filing with the State of California. It does not file a separate return. You merely include form Schedule C with your individual income tax return. This is often referred as a DBA (Doing Business As) that is rather inaccurate because a partnership or corporation can also have a DBA. The need for a DBA occurs when you decide not to use your name and instead opt to use a fictitious name to hold your business out to the public. For example, John Smith decides to run his auto parts retail business as Acme Auto Parts. This name has to be registered in the county where the business is located. Caveat: The most common error of sole proprietors that I have encountered over 23 years of practice is the commingling of personal and business assets, income, and expenses. You need to open a business checking account to which all business revenues are deposited and from which all business expenses are paid. Take a periodic draw. Deposit a check from the business account to your personal account from which you pay mortgage, grocery and other personal expenses. Read on to review the pluses and minuses of being a sole proprietor.

A. Advantages:

1. It is simple. Administration and organizational needs are less complicated.
2. It is less expensive to organize because there are no legal papers except minimal DBA filing costs.
3. Federal and state taxes are usually lower (no double taxation for regular corporations).
4. You save on FICA (Social Security tax) on the wages of your children under 18 years old.
5. You save on FUTA (unemployment tax) on the wages of your children under 21 years old.

B. Disadvantages:

1. You are exposed to personal liabilities from business-related lawsuits. So is your business from personal-related lawsuits. A successful plaintiff against the business can come after your personal assets; so can a plaintiff against you go after your business assets.
2. You have to pay self-employment tax (social security tax) of about 15%.
3. Your audit profile under conventional IRS guidelines is higher than other entities.
4. Your fringe benefits are limited (compared to other forms of entity).

C CORPORATIONS: A “C” corporation (as opposed to an “S” corporation that we will discuss below) is a legal fiction. It exists only in contemplation of law. It has a separate legal identity. That entity, not you, operates the business. It owns the business assets, owes business debts, collects business revenues and pays business expenses. It possesses characteristics such as continuity of life, centralized management, free transferability of ownership, and that limited liability that we all look for in our business dealings.

A. Advantages:

1. Limited liability - business problems can be kept in the corporation without exposing personal assets; likewise, personal problems do not have to put the business in jeopardy.
2. Income splitting - between family members is possible as spouse and children can work for and get paid by the corporation.
3. Passive activity losses - can be deducted in full. Closely held C corporations may offset passive losses and credits against active business income (but not portfolio income).
4. Exclusion of capital gain - by investors who hold qualified business stock for five years are able to exclude 50% of gain from sale of stock.
5. Dividend received exclusion - of 80% from another domestic corporation.
6. Multiple corporations - can be used, subject to some limitations.
7. Election of fiscal year - can choose fiscal year ends from January to November.
8. ESOP - can use employee stock ownership plans.
9. Trust Fund - Discuss with your tax adviser how you can save on the employer's portion of problematic delinquent payroll taxes.

B. Disadvantages:

1. Double taxation - Corporations pay tax on net income. Shareholders pay tax again later upon receipt of dividends. New law reduces this disadvantage by taxing dividends at a very low rate of 15%. Traditional tax planning ideas of "zeroing out" bottom lines should be re-examined to consider leaving net income that can be distributed later as dividends. Along the same lines, S corporations with accumulated earnings and profits from years of operating as regular C corporations should consider declaring and distributing dividends at the low rate of 15%.
2. Constructive dividends - can be asserted for personal use of assets in an IRS audit.
3. Accumulated earnings tax - of 15% can be assessed on accumulated taxable income in excess of reasonable needs. This is in addition to regular income tax.
4. Personal holding company tax - of 15% applies to undistributed personal holding company income in addition to the regular income tax.
5. Alternative minimum tax - of 20% applies to taxpayers who would otherwise escape taxation.
6. Accrual method of accounting - is generally required. The cash basis, of course, is easier to operate as one does not have to account for receivables, payables and inventory.

S CORPORATIONS enjoy both the limited liability of corporations and absence of double taxation of sole proprietorships and partnerships. It is a regular corporation that elects to be exempt from federal taxation at the corporate level. The corporation pays zero federal income tax and only 1-1/2% state franchise tax. It derives its name from subchapter S of the Internal Revenue Code. Entities who are eligible and who get approval as S corporations enjoy the best of both worlds of sole proprietorships and corporations.

A. Advantages:

1. Single tax - The entity escapes taxation at the corporate level. There is only a one-time tax at the shareholder level. The net income is passed through a K-1 to the shareholder who includes that net income in Schedule E.
2. Corporate net losses - are also passed through and taken advantage by the shareholder to offset other income. For example, a shareholder's loss of \$20,000 can offset the spouse's \$30,000 wage leaving the couple with zero taxable income after deducting standard deduction and personal exemptions. Nice.
3. Limited liability - is enjoyed since it is a corporation, a separate entity.
4. Self-employment tax - does not apply to the net income of S corporations. This savings can be substantial as the shareholder does not have to pay FICA of about 15% on the net income passed through from the corporation. This savings in the first year alone can pay for the cost of incorporating.
5. Accumulated earnings tax - does not apply to S corporations.
6. Personal holdings tax - does not apply to S corporations.
7. Alternative minimum tax - also does not apply to S corporations.
8. Trust Fund - Discuss with your tax adviser how you can save on the employer's portion of problematic delinquent payroll taxes.
9. Passive losses - of passive S corporation shareholders can be offset against passive loss activities with their S corporate earnings.
10. Deductible business interest - S corporate shareholders who have incurred debt to acquire company stock may be able to deduct the expense as business interest if they materially participate (as opposed to sole proprietorships which will be treated as investment interest that can only be offset against investment income).

B. Disadvantages:

1. Some fringe benefits received by 2% shareholders are not excludable from shareholder income. These include \$50,000 group term insurance, health insurance premiums, meals and lodging for the convenience of the employer, and the \$5000 death benefit exclusion.
2. Calendar year - must be used generally.
3. Pension plan borrowings - prohibited for 5% shareholders.
4. New shareholders may miss to file S election documents or existing dissident shareholders may purposely cause trouble by making a disqualified transfer of stock.
5. Higher marginal tax - than a C corporation could result.
6. Limitation on the use of cash basis - an S corporation that has more than 35% of its losses allocated to shareholders who do not actively participate in the management of the company will be treated as a tax shelter and therefore will be required to use the accrual method of accounting.
7. Tax liabilities of an S corporation in trouble could end up with the shareholders (as opposed to being trapped inside a C corporation). You could enjoy the tax benefits of an S corp and switch to C corp as soon as problems are anticipated.

PARTNERSHIP: An association of two or more persons as co-owners who intend to carry on a business for profit. Each person must contribute money, property, labor, or skill. Mere co-ownership of property that is leased or rented is not a partnership. Spouses carrying on a business together and sharing profits are partners. The burden of filing partnership returns may be alleviated by having one spouse work for the other, the sole proprietor.

A. Advantages:

1. The partnership avoids double taxation as any net income is passed through to the partners.
2. Losses are also passed through and may be used to offset income.
3. Partnerships are allowed to specially allocate income and expenses.

4. Partnerships are not subject to either the accumulated earnings tax or personal holding company tax.
5. A special election allows a step-up in the basis of assets upon the death of a partner, the sale or exchange of partnership interest, or in certain partnership distributions.
6. A partner's basis includes the partner's share of partnership debts.
7. It has traditionally lower audit profile than sole proprietors.

B. Disadvantages:

1. General partners have unlimited liability. Their situation is even worse than sole proprietors because they also have to worry about other partners' liabilities that can affect business operations as well their own personal assets.
2. Partner fringe benefits are not excludable from their income. This includes 100% health insurance deductibility, meals and lodging, and group term insurance.
3. Partner earnings from a trade or business are subject to FICA tax even if earnings are not distributed.
4. Partnerships must use calendar years (December) in the absence of a business purpose to use a fiscal year end (January to December)

LIMITED LIABILITY COMPANY (LLC) is a hybrid that combines the pass-through attributes of a partnership with the limited liability of a corporation. An LLC with more than one member is taxed as a partnership (or as a corporation if not organized properly). The owners are called “members” who hold “interests” and are governed by an “operating agreement.”

A. Advantages:

1. The liabilities of members are limited to their investments.
2. No double income tax.
3. A Limited Liability Partnership (LLP) for professionals allows protection from claims involving the wrongful acts of other partners (vicarious liability).
4. No double tax on liquidation.
5. Can specially allocate profits and losses.
6. A member contributing appreciated assets to an LLC in exchange for membership interest is not required to recognize gain on that exchange.
7. Distributions of appreciated property from an LLC are generally received without gain.
8. Receipt of an interest in an LLC for a profit interest is generally not taxable.
9. It is not subject to accumulated earnings tax, personal holdings tax, or alternative minimum tax.
10. It is not required to maintain certain formalities such as corporate minutes.
11. The basis of a member's interest can be increased by the member's share of LLC debts.

B. Disadvantages:

1. California LLC's pay additional annual fee based on gross receipts. (This is the main reason why I seldom recommend LLC's for my clientele). The annual fee increased every year and has doubled since its introduction. It is now permanently set at \$900/2500/6000/ 11790 for gross receipts of \$250K, 500K, 1M, 5M.
2. A member's net earnings are subject to self-employment tax, whether distributed or not.
3. Loss from the sale of LLC interest is a capital loss (limited to \$3000 per year).
4. An LLC will be constructively terminated if 50% or more of total interest is sold or exchanged within 12 months.
5. Disassociation events such as death, retirement or bankruptcy dissolves the LLC unless all remaining members consent to reinstate the entity.