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Laying the Foundation

When starting your business, take care of the basics properly and all the rest will fall into place.

The first determination an owner needs to make is which basic structure to choose for the business. One challenge is that while you know much of how the arterial system works, you do not know how the tax system works. While there are many business structure options from which to choose, the rationale behind choosing one is not so simple. Your lawyer will advise choosing a structure that will help protect you from litigation. From a legal perspective, then, you are protected if you choose anything other than a sole proprietorship or partnership. Your accountant will focus on the issues related to filing income taxes. The tax perspective, however, is much more complex.

Following are the four most common business structures.

1. Sole Proprietorship

Sole proprietorship is one individual owning a business. All the assets of the sole proprietorship are co-mingled with the personal assets of the owner. All the income of the sole proprietorship is co-mingled with the income and assets of the owner. A sole proprietorship exists in entity only, and there are no walls to the structure. There is no separate tax entity; the individual files a tax return for his or her income and includes an informational form with the income and expenses of the business.

In the event of litigation, there is no protection afforded the sole proprietor. A judgment can attach to the business assets or to the owner's personal assets.

2. Partnership

A partnership is two or more people operating a business. They can be equal in ownership rights or diverse. All the income of the partnership is co-mingled with the income of the owners. The partnership income is split along the ownership percentages. All the assets are co-mingled with the assets of the owners based on the ownership percentages. There is no separate tax entity.

There is a separate tax return for the partnership, and it includes a disclosure of the income and expenses of the partnership. The income is passed through to the owners in their percentage of ownership. Each owner files a tax return with his or her share of the income from the partnership. If a sole proprietorship is akin to a cell, a partnership is akin to the cell after it divides.

Partnership control can be held by one of the partners, who would be known as the general partner. That person can make operating and other decisions on behalf of the other partners, known as limited partners.

Another way to operate a partnership is for all to be in charge equally. This is often known as bedlam (that's a descriptive term, not a legal or tax term). The reason this form of partnership is generally not recommended is that one partner can take out a loan or commit the partnership without the express permission of the other partner(s).

In the event of litigation, there is no protection afforded the partnership or partners. A judgment can attach to the partnership assets or to each partner's personal assets.

3. Corporation

A corporation is a separate taxable entity operating a business. (Harking back to my example of cell division, this is now a complex organism.) The corporation is run by its officers (president, vice president, treasurer, secretary or more), and the officers are elected by the shareholders. The shareholders have the ownership of the company and have some rights to cast their vote to have the company take certain actions.

The corporate entity segregates the assets of the corporation from the assets of the owners. If a judgment is registered against a corporation, in most cases, the judgment can only be satisfied by the assets of the corporation.

A corporation files a tax return declaring its income. It can pay the tax at the corporate level, if it is a C Corporation, or it can elect to be taxed at the shareholders' income tax brackets as an S Corporation.

4. Limited Liability Company

This is the newest choice of business entity. Even though the first limited liability entity was created in Wyoming in 1977, the structure wasn't frequently used until the turn of the century. Today, about 66% of all new business entities choose to register as LLCs. Before its adoption, owners wanting to have a separate taxable entity and a tax rate at the shareholders' level chose to be Sub Chapter S Corporations.

Just like corporations, LLCs segregate the assets of the company from the assets of the owners. If a judgment is levied on the LLC, it will be limited to the assets of the LLC.

LLCs can have the internal organization of either a corporation or a partnership, and this can get complicated. As a corporation, the managing parties present themselves with a corporate title, while the leaders of a partnership present themselves as if they were a partnership. Still, both structures protect assets and both pass income through to be taxed at the owners' level.

If you're still with me, you must be asking, "Which is right for me?" Unfortunately, you can't make a determination based solely on this brief description. But in my benevolence and sense of responsibility, I will narrow it down.

First, I'll tell you what not to do.

I don't believe anyone wants their personal net worth used to satisfy a judgment. And in this litigious world, I also do not believe anyone can swear that there is no chance their business will be sued. Therefore, I can conclude with certainty what not to choose. I have never recommended a client operate a going concern business as a sole proprietorship or a partnership. With that assertion, let's deal with the other methods of business structure.

Three main issues must be discussed when deciding what type of enterprise to form.

1. Taxation

Taxation is a choice. The options are either to have the enterprise taxed or allow the owners to be taxed. If you want to pay taxes at the individual owner level, you can choose a Sub S Corporation or an LLC. If you want to pay taxes at the enterprise level, chose a C Corporation. However, just considering taxes is akin to looking only at a baseball team's outfielders in judging the team's success.

The assets within this entity are a bigger issue. For example, some assets don't change in value, such as cash or accounts receivable. Some assets decline in value, including autos, furniture, fixtures and equipment. Some, such as real estate, appreciate. If you have assets declining or staying the same in value, they can be held by any of these three enterprise types. Appreciating assets should not be held within a C Corporation.

Appreciating assets should be held within an S Corporation or LLC. Even if you take "depreciation" on real estate, it probably still appreciates over the long term. A C Corporation is a taxable entity. Unfortunately, it does not have the same tax preference an individual has, called capital gains; capital gains are taxed at a special rate for individuals. But when a C Corporation has a gain in an asset, that gain is taxed as any other business income. Therefore, you might wind up paying taxes in the C Corporation when you sell an appreciated asset, and then upon liquidating the C Corporation pay a tax again at the personal level.

Imagine Tom's Funeral Home is a C Corporation. If Tom owns his real estate in the corporation and decides to sell it, he will pay a tax on the appreciation over its basis, the tax the same as any other corporate ordinary income.

If Tom bought the property for $1 million and took depreciation for many years, it might be on his books today at $300,000. If he were to sell it for $1.5 million, it would result in corporate income of $1.2 million! That means his C Corporation would pay federal income tax on the gain equal to about $444,000 ($1.2 million X a tax rate of 37%)! Then, when distributing the total after-tax amount out of his corporation, Tom could be taxed on the $1.5 million, less $444,000, or about $1,056,000, which could bear additional tax of up to $221,000. So, out of a sale of $1.5 million, he would lose about $665,000! If Tom were an S Corporation and paid only one tax, his tax might have been $252,000 ($1.5 million sale price - basis of $300,000 X a capital gains tax of 21%). This is a savings of about 67% – all by choosing the proper entity to own the real estate!

2. Transferability

A corporation or LLC is transferred in one of two ways. Either we are dealing with a sale of assets or a sale of shares. Most buyers prefer to buy assets. Again, the C Corporation may have more taxes to be paid upon a sale than an S Corporation or LLC. Therefore, for most closely held businesses, an S Corporation or LLC are better methods if it is anticipated that the future transfer may be an asset sale.

3. Liability

In each case, the matters of liability are going to be the same for corporations and LLCs. For most major debt amounts, the lender is going to want personal guarantees as additional collateral to a business guarantee, and maybe a mortgage interest in the collateral.

A common question: "Can I change the structure if I made an improper decision?" You can change from a C Corporation to an S Corporation and from an S Corporation to a C Corporation, but you would have to wait five years if you already made the change once. If you are a C Corporation and have the real estate in the corporation, you simply elect S Corporation status. You would have to wait five years before selling any appreciated assets and only pay one tax. You cannot change back and forth.

Changing from a corporation to an LLC is more restrictive. It may be doable, but it is a taxable event. Changing from a C corporation to an S corporation or vice versa is a tax-free exchange.

Once you are a corporation, can you have total security that your personal assets cannot be attacked? No. Nothing is absolute. Lawyers learn how to pierce the corporate shell to get claims against owners and their assets. It's not easy, but it's not difficult either.

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