

How Should You Set Up Your New Business?

If you are forming a small business, you face several choices: Sole Proprietorship, Partnership, C-corporation, S-corporation, Limited Liability Partnership and Limited Liability Company. Here are the basics.

When you start a business, you have many choices to make. One key decision is choosing the form of business entity in which you will operate. For starters, you can set up your business as a Sole Proprietorship, C-Corporation, S-Corporation, LLP (Limited Liability Partnership), or an LLC (Limited Liability Company).

How can you narrow that list down? Small businesses typically decide against a C-Corporation, because C-Corps generate two levels of federal income tax. The C-Corporation pays one level of tax when it files its federal corporate tax return, Form 1120. A second layer of tax is imposed when the C-Corporation's profits are distributed to the shareholders as dividends. Those dividends are reported and taxed on the individual's federal tax return, Form 1040. Together, these two levels of taxes are referred to as "double taxation." State income taxes may also apply to both C-Corporation profits and distributed dividends. Overall, the tax picture for C-Corps is far from ideal for small businesses. Even the current 15% tax rate on dividends does not completely do away with the disadvantages of double taxation.

Doing business as a sole proprietor eliminates the double taxation curse. There are no corporate taxes to pay, and you only pay individual taxes on your net profits, typically reported on Form 1040, Schedule C. However, as a sole proprietor, you lack the legal protection that corporate status gives you. Owners of corporations enjoy limited liability, but sole proprietors do not. Simply stated, if you're a sole-proprietor, your personal assets are at risk if the business is sued—very risky indeed!

That leaves LLCs, LLPs, and S-Corporations. LLPs and LLCs are similar in many ways. One key difference is that LLPs must be owned by more than one individual. Remember, the "P" in LLP stands for partnership, and so by definition a single individual can't own a partnership. So if you had an LLP with two owners and one died, serious problems that might even cause the business to close could result.

The choice quickly narrows to an LLC or an S-Corporation. Which is more appropriate for your business?

Well, they are both "pass-through" entities that allow you to avoid double taxation, operating a business without paying corporate taxes. Net profits are reported by the owners in their individual tax returns, and both also offer protection from unlimited liability. Your liability will be limited to your investment in either entity.

When choosing between an S-Corporation and an LLC you need to consider many things. What may be appropriate under one set of circumstances may not be in another. Every business is different, and every owner has different needs and expectations. Let's review the attributes of each type of entity to help you decide.

THE S CORPORATION

Created in 1958, the S Corporation was, for many years, the standard form of organization for conducting a small business. S Corporation status provides a way for you to avoid the double taxation imposed upon C Corporations and their shareholders. One advantage of the S Corporation is that income is taxed personally to the shareholders. However, your personal risk remains limited to your investment. In other words, double taxation is avoided and you get the protection of limited liability.

Your corporation chooses "S-Status" by filing a special election, Form 2553. Bear in mind that the "S" status of the Corporation only impacts taxes. Shareholders of S Corporations have all of the same legal protections as those in C Corporations. But as once said by a famous Tax Court judge, "A corporation is like a lobster pot. It's easy to get into...difficult to get out of." In other words, once you have established an S Corporation, it would first have to be liquidated if you wanted to change to an LLC, and liquidation of a corporation can result in taxable gains to the shareholders.

THE LIMITED LIABILITY COMPANY (LLC)

LLCs started in 1977 in Wyoming and have quickly become a popular form of business entity across the country. By default, LLCs with more than one owner (member) are taxed as partnerships, while single-member LLCs are taxed as sole proprietorships. As with S corporations, with an LLC you only pay taxes with your personal return. However, if you decide to do business as an LLC, you are not stuck with it. Simply by filing a Form 2553 at the appropriate time, an LLC can become an S Corporation without having to liquidate. There is little risk of triggering a tax by changing from this form of doing business.

SETTING UP SHOP

Establishing an S corporation is relatively simple and inexpensive. An attorney or even you yourself can form a corporation by completing a series of "boilerplate" documents. These forms require you to complete the following information: who will own the business, the business's activity and address, and other miscellaneous details. Aside from being registered as an "Inc., Co. or Corp.", a corporation can also be registered as P.C. (Professional Corporation). This designation is for professionals who choose to operate in corporate form and is popular with doctors, lawyers, and accountants.

An LLC requires a bit more work to get started. Articles of Organization to be filed with the state and an Operating Agreement (like a Partnership Agreement) should be drafted by a lawyer. In addition, business information about the LLC must be placed in a published ad to give notice to the public that the company is being started. An LLC can choose to be registered as a P.L.L.C. (Professional Limited Liability Company) when its owners are licensed by the state to engage in a professional practice -- doctors, lawyers, accountants, etc.

DISTINGUISHING CHARACTERISTICS

An S Corporation might be more restrictive than an LLC. There can't be more than 100 shareholders in an S Corporation. In addition, only individuals, estates, and qualifying trusts are permitted shareholders. An S Corporation may not have any non-resident alien shareholders. There can only be one class of stock ownership. Adding a second category or class of ownership terminates the "S" Election, which could lead to unintended and unexpected tax consequences. The income and expenses from an S Corporation are allocated on a per-share/per-day basis. Your business's net income, after paying you a reasonable salary, would not be subject to self-employment taxes on your individual return.

The amount of your investment in the S Corporation -- your cost basis -- includes:

- 1) Your contributions of cash and property
- 2) Your share of S corporation profits not distributed to you
- 3) Loans made directly to the Corporation by you

This "basis" calculation is important because it is your tax cost. The more you have invested, the more "write-offs" you can claim when there are losses.

LLCs offer more flexibility than S Corporations. They can have an unlimited number of owners and any person, business, or trust can be a member or owner. With an LLC you can choose to allocate particular types of income and expenses among owners. Doing this can get pretty complicated, so be sure to speak with us about "special allocations." On the negative side, the status of the business's net income as subject to self-employment taxes is unclear. Current thinking is that reasonable compensation should be paid in the form of guaranteed payments, subject to SE tax, with the balance of income -- attributable to capital or the work of employees -- not subject to SE tax.

Your basis (tax cost) in an LLC includes:

- 1) Your contributions of cash and property
- 2) Your share of LLC profits not distributed to you
- 3) Your share of the LLCs debts to others. (In an LLC, loans to the company can increase your tax basis if you are personally liable for them. In an S corporation, only your direct loans to the company can increase your tax basis.)

LLCs provide more ways to increase your tax basis. This illustrates a significant advantage of LLCs over S Corporations. Because of the way these calculations are done, your cost basis may be higher for an investment in an LLC than if you set up shop as an S Corporation.

CONCLUSION

Many businesses should probably start as an LLC. Advantages include flexibility of ownership, ability to gain tax basis from liabilities, and pass-through of profits and losses. If a corporate entity is determined to be required later, the change from LLC to corporation is quick and generally tax-free.