# **College Tax Strategy**



**Choice of Business Entity** 

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# Section

# Introduction

One of the most frequently asked questions by business owners is, "Which business entity is right for my business?" Although you should always seek proper tax and legal advice before making that decision, the following are some key questions you will need to consider first:

### What is your starting point?

What are you "selling"? Do you currently have employees? How big is your business? When you need money, where is it coming from?

### Where are your goals?

What is your vision and what are your goals to attain that vision? How big do you see your business becoming and how quickly do you want to get there?

### What will you need in the future?

Now that you know where you're going, how will you get there? How much funding will you require? Where and from whom will you get it? Do you want to become a public company and issue shares or stay private?

### What are the risk factors?

How much risk is there in the business? Do you seek to limit your personal liability and have a hard line between your personal and business assets? How hard do you want that line to be?

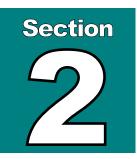
### How long will your business last?

Do you see your business ending with you or do you hope to create a lasting entity that can be passed on to family or sold to another owner?

The five entities used by most businesses are:

- 1. Sole Proprietor
- 2. Partnership
- 3. C-Corporation
- 4. S-Corporation
- 5. Limited Liability Company

The following is a list of the advantages and disadvantages of each entity.



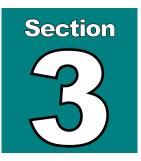
# **Sole Proprietorship**

Sole-Proprietorships are the simplest form of business entity since they are not a separate tax or legal entity from the individual owner. The income and expenses are reported on the individual owner's personal tax return on Schedule C, Schedule E, or Schedule F.

### **Advantages**

- ➤ Ease of formation because there are few filings, licenses, elections, and registrations that are required.
- Simple to operate because the owner makes all the decisions for the business and less administration than other types of entities.
- > Simple to liquidate or to sell the assets of the business.
- > The owner is taxed on the net income on his personal tax return.
- > A sole proprietorship can be easily converted to another type of entity.
- Upon the death of the individual owner, the assets receive a "step-up" in basis to their fair market value at the date of death.

- > If the owner decides to retire or dies, there is no business continuation.
- > The owner is personally liable for all of the liabilities of the business
- > The net income is subject to the 15.3% self-employment tax rate.
- > The business income cannot be split among other persons.
- > The business has limited fringe benefits available to it.
- A business that loses income may come under IRS scrutiny as a "hobby loss



## **Partnerships**

A partnership is a relationship between two or more persons who together carry on a trade or business with each person (partner) contributing money, property, labor or skill, and each person shares in the net income of the business. The partnership's net income is split between each partner and flows through to the individual partner's personal tax return and is reported on Schedule E.

### **Advantages**

- Since there is more than one partner involved there may be more management ideas available to the business.
- In a limited partnership there must be a general partner that does not have limited liability.
- > They are easier to form and operate than corporations. In a limited partnership the general partner maintains control.
- If the business has a loss, the loss can be allocated in a percentage that is different than the partner's ownership percentage.
- Generally, the partnership can be terminated without creating a tax liability for the owners.
- > Partnership income can be split between family members.
- Unlike corporate entities, there is no IRS "unreasonable compensation" issue for the wages of the partners.
- Except for guaranteed payments, limited partners are not subject to the 15.3% self-employment tax.
- Upon the death of a partner, the partner's interest receives a "step-up" in basis to its fair market

- > The partner's interest is not easily transferable.
- Each partner is personally liable for all of the partnership's liabilities even though another partner is not paying his share of the liabilities. The only exception is where the partnership is organized as a limited liability partnership.
- Each partner is subject to the 15.3% self-employment tax on the net business income of the partnership.
- > The partnership has limited tax fringe benefits available.
- > Partnership income tax rules are complicated.



## **C-Corporations**

C corporations are created under state law as an entity to carry on a business or profession to provide a profit for its shareholders. The business net income is taxed to the corporation entity, not the individual shareholders.

### **Advantages**

- > The shareholders have limited liability.
- Because corporations have unlimited lives, there is no "continuity of business" issue.
- Generally, assets can easily be transferred to the corporation without creating a tax liability.
- > C corporation entities have the availability of most tax fringe benefits.
- > C corporation income can be split income among its shareholders.
- Because C corporations can adopt a fiscal tax year, they have more tax planning flexibility than other entities.
- A corporation can have different classes of equity ownership, such as common stock and preferred stock.
- Corporations receive an 80% deduction for dividends received from other corporations.
- If the corporation's stock is eligible to be treated as "Section 1244" stock and the stock becomes worthless, the loss to the shareholders will be treated as an ordinary loss.
- Upon the death of a shareholder, the shareholder's stock receives a "step-up" in basis to its fair market value at the date of death.

- C corporations are subject to "double taxation" which means that the corporation's annual net income is taxed to the corporation, and subsequent dividends, liquidating distributions, or redemptions are taxed to the individual shareholders.
- Corporations are more complicated to form, operate, and dissolve than other types of entities.
- ➤ In order to borrow money, shareholders may have to personally guarantee the loans.
- A "personal holding company" tax may be imposed on certain types of income such as interest, dividends, rents and royalties.
- An "accumulated earnings" tax may be imposed on the corporation if the IRS determines that an excessive amount of earnings is being held in the corporation without a legitimate business purpose for these earnings.
- > C corporations may be subject to the "alternative minimum tax".
- C corporations must allocate its net income to the shareholders based on their ownership percentage.



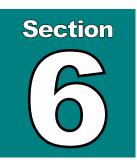
### **S-Corporations**

S corporations are corporations whose net income is passed through to the individual shareholders and taxed on their personal tax returns.

### **Advantages**

- Since the net income is passed through to the individual shareholders, the double taxation affecting C corporations is avoided.
- > As with C corporations, the shareholders have limited liability.
- The tax rate on S corporation earnings, when passed through to the shareholder, may be lower than the applicable corporate tax rate.
- S corporation distributions to its shareholders are not subject to the 15.3% self-employment tax.
- An interest expense deduction is allowed for loan proceeds borrowed by a shareholder to purchase stock in an S corporation. This interest expense is considered business interest expense when the shareholder materially participates in the business.
- An S corporation is not subject to the alternative minimum tax, the personal holding company tax, and the accumulated earnings tax which C corporations may be subject to.
- If the corporation's stock is eligible to be treated as "Section 1244" stock and the stock becomes worthless, the loss to the shareholders will be treated as an ordinary loss.
- Upon the death of a shareholder, the shareholder's stock receives a "step-up" in basis to its fair market value at the date of death.

- An S corporation is limited to 75 shareholders and can only have one class of stock.
- An S corporation cannot have corporate (other than an S corporation owning 100% of another S corporation), partnership, certain trusts, or nonresident alien shareholders.
- Unless a prepaid tax is paid for the shareholders' income, the S corporation must use a calendar year.
- There aren't as many tax fringe benefits available to shareholders owning more than 2% of the stock as to shareholders of a C corporation.
- ➤ The compensation paid to the S corporation shareholders must be "reasonable" or the IRS can impose payroll taxes on distributions.
- S corporations must allocate its net income to the shareholders based on their ownership percentage.
- A shareholder in an S corporation can deduct losses only to the extent of the shareholder's basis in the stock and debt of the corporation.
- > Upon liquidation, the shareholder is taxed.



# **Limited Liability Company (LLC)**

A limited liability company (LLC) is a non-corporate entity that is owned by either a single or multiple owners (members). It provides limited liability for its members. The LLC's net income can either flow through to its members and be taxed on their individual tax return, or it can be taxed like a C corporation.

### **Advantages**

- The members of the LLC have limited liability and the number of members is not limited.
- ➤ The type of LLC members can be individuals, corporations, trusts, partnerships, other LLCs, and other entities.
- LLC distributions to members can be in different percentages than the members' ownership percentages.
- > LLCs can have different classes of ownership.
- > LLCs can be liquidated on a tax-free basis.

- LLCs are terminated on the death or bankruptcy of a member which can cause business continuity issues.
- > It is difficult to transfer interests in a LLC.
- > LLC tax and liability laws vary from state to state.
- > The tax rules governing LLCs can be complicated.
- > LLC members may be subject to the 15.3% self-employment tax.
- ▶ LLC's cannot elect to use a fiscal year.



# The Entity Decision In A Nutshell

Are you still not sure of which entity to choose? If so, consider the typical owner profiles for each business structure:

**Sole Proprietorship** is for owners wanting no red tape and is OK with personal liability. They are comfortable exposing their personal assets to their business liabilities. They envision a small or declining operation that starts and ends with the Sole Proprietor. They seek to own and control 100% of the business. They don't envision needing any significant amount of financing.

**Partnership** is for owners wanting to share ownership with others, but still view the business like the sole proprietor in regards to personal liability protection.

**C-Corporations** are for owners wanting the most independent and separate business entity (for personal asset protection), the least restrictions on transfer, and the greatest ability to raise capital. They desire significant growth and the option to easily exit and sell the business. They're comfortable with the formalities required of a Corporation.

**S-Corporation** is for owners wanting the formalization and identity of a Corporation, but desire the tax flexibility of an LLC (pass through to individual returns). They are also comfortable with some limitations on ownership – the number and mix of owners – and any implications that may have on growth.

**Limited Liability Company** is for owners wanting a separate business entity for the liability protection, with the flexibility on ownership of C-Corporations, but with fewer formalities. They also want the choice between pass-through and corporate taxation, as well as the ability to allocate profits and losses in proportions different from ownership interests.



### **Implementing The Entity**

### **Action Steps To Implement The Entity**

Some, or all, of the following action steps are required for one or more of the above five entities.

- □ Step 1: Identify any assets that need to be transferred.
- □ Step 2: Choose the entity name.
- □ Step 3: Choose the state of organization.

□ Step 4: Prepare the Articles of Incorporation, Operating Agreement, Buy/Sell Agreement, etc.

- □ Step 5: File the Articles of Incorporation with the Secretary of State
- □ Step 6: File Form SS-4 to establish an Employee Identification Number (EIN)
- □ Step 7: File for the appropriate payroll requirements.
- □ Step 8: If S-Corporation, file for S-Corp Election (Form 2553).
- □ Step 9: Open bank account in entity name
- □ Step 10: Obtain necessary state and local licenses and permits
- □ Monthly: Prepare payroll reports
- Quarterly: Prepare payroll reports
- Quarterly: Prepare estimated tax payments
- Yearly: Officially document corporate meetings and minutes
- □ Yearly: Prepare proper tax forms
- □ Yearly: Distribute Form K-1 to partners/members/stockholders

### **Documents Used To Implement The Entity**

The following are the documents you will need to implement the Education Assistance Program:

- Employer identification number (IRS SS-4 Form)
- > Employment Application, W-4 form, and an I-9 form

### **IRS Publications & Forms References**

### **IRS Publications**

Publication 15, Employer's Tax Guide <a href="http://www.irs.gov/pub/irs-pdf/p15.pdf">http://www.irs.gov/pub/irs-pdf/p15.pdf</a>

Publication 15-A, Employer's Supplemental Tax Guide <a href="http://www.irs.gov/pub/irs-pdf/p15a.pdf">http://www.irs.gov/pub/irs-pdf/p15a.pdf</a>

IRS Forms SS-4, W-2, W-4, I-9, and 941 http://www.irs.gov/app/picklist/list/formsInstructions.html