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Choosing the Right Entity for Your Business

Martin L. Fried, Esq.

Choosing the right legal structure under which to operate a business requires a consideration of liability and tax issues. Generally, a business may be operated as a sole proprietorship, general partnership, limited liability partnership, C-corporation, S-corporation, or limited liability company. This article will explore some of the liability and tax issues associated with each.

OVERVIEW OF LIABILITIES

A sole proprietorship is a business entity with no separate existence from its owner. Consequently, there is no limit to the personal liability of a sole proprietor for debts and liabilities incurred by his or her business. The debts of the business are the debts of the owner and a successful lawsuit against the business may be satisfied out of the personal assets of the owner. Thus, it is often unwise to operate a business as a sole proprietorship.

A general partnership is a business conducted by two or more partners in which each remains liable for the debts and liabilities incurred by the business. Each partner's personal assets are vulnerable to a judgment against the partnership. Even if a judgment arises out of the actions of one partner, all partners' personal assets may be in jeopardy.

In a limited liability partnership, a partner's personal assets are protected from claims against the partnership itself, as well as from claims against other partners. Each partner remains personally responsible for his or her own negligence or malfeasance, but not for that of any other partner.

An S-corporation and a C-corporation are virtually identical with regard to liability issues: both are separate and distinct from their shareholders. Thus, the debts and liabilities of a corporation are the corporation's alone. Though an individual shareholder may see the value of his or her shares eliminated, an individual shareholder's personal assets are not available to satisfy a judgment against the corporation except in extremely limited circumstances.

As discussed below, a limited liability company is a hybrid between a partnership and a corporation for tax purposes. For liability purposes, it is treated the same as a corporation, that is, the personal assets of a member of a limited liability company are not available to satisfy judgments against the limited liability company itself.

For liability purposes, it is generally unwise to operate a business as a sole proprietorship or a general partnership. Although there are very limited exceptions under which the liability protections offered by limited liability partnerships, corporations, and limited liability companies do not shield owners from personal liability, these three entities offer significant liability protection for their owners.

Therefore, the choice between operating as a limited liability company, limited liability partnership, C-corporation, or S-corporation is, in large measure, tax-driven. Other costs, such as filing fees, are not a major concern.

INCOME TAX CONSIDERATIONS

Single-Member Limited Liability Company

A single-member limited liability company is treated as a disregarded entity for income tax purposes unless the member decides that the entity should be taxed as a corporation (using what is called the "check-the-box" Income Tax Regulations). This means that all of the net income of the business is taxed to the owner, whether distributed or not. No return is filed for the company; the owner reports all of the income and all of the expenses on Schedule C of his or her individual Form 1040 for the year. What we have, in effect, is a tax picture identical to the one that would arise if the business owner were a sole proprietor, but without the specter of unlimited liability.

Multi-Member Limited Liability Company or Limited Liability Partnership

A multi-member limited liability company or limited liability partnership is treated as a partnership for income tax purposes unless the members choose to be taxed as a corporation (again using the "check-the-box Regulations). The net income is taxed to the business owners in accordance with their respective interests in the entity. The entity files an information return that reports the income and expenses of the group and specifies the amount to be taken into account by the members of the group on their individual tax returns, but the partnership itself pays no tax. The income is includable by the members or partners whether actually received by them or not, although later distributions may be tax-free.

Corporation

The formation of a corporation is governed by state law. The tax consequences of corporate practice flow from the choice to be either a C-corporation or an S-corporation.

A C-corporation is subject to tax on its net income. Any distributions to the shareholders, other than in the form of compensation, permissible expense reimbursements or the furnishing of benefits that further the business of the corporation, are treated as dividends which are taxed at the shareholder level. For example, assume that a corporation has net income of $100,000; it would be subject to a tax of $22,250. Assume, further, that it distributes all of its after-tax income ($77,750) to its shareholders as a dividend. The shareholders would be subject to a 15% rate of tax, the present tax on dividends. The original $100,000 earned by the corporation would end up as $66,087.50 in the hands of the shareholders.

One provision of the Code that is often overlooked suggests that a professional corporation should not be a C-corporation. Generally a C-corporation pays tax based on a graduated rate structure that runs from 15 percent to 35 percent. However, a C-corporation that is a personal service corporation (one in which the principal activity of the corporation is the performance of services by employee-owners) is taxed at the rate of 35 percent on all of its net income. Because the owners of professional corporations must be the professionals performing the services, inevitably a professional corporation will be treated as a personal service corporation and taxed accordingly.

Avoiding personal service corporation status is simple. Have the corporation elect to be an S-corporation with the consent of all of the shareholders (who must be United States citizens or resident aliens). With certain exceptions, the S-corporation does not pay any tax on its income. The shareholders are in much the same position as members of a partnership or multi-member limited liability company. They report their proportionate shares of the income on their individual tax returns even if not paid out to them during the year. Later distributions of previously taxed income are received without any additional tax being due. Therefore, unlike the C-corporation, there is only one tax imposed on the income earned by an S-corporation.

One aspect of S-corporation status affects 2 percent or more shareholder-employees of the corporation. Although they are employees of the corporation for employment tax purposes (discussed below), they are treated as partners and not as employees when it comes to fringe benefits. For example, the Internal Revenue Code permits an employee to exclude from income premiums on employer-provided health insurance or contributions made to health savings accounts (HSAs). If the employer is an S-corporation and the covered employee owns more than 2 percent of the stock of the corporation, the premiums paid by the corporation for the coverage become compensation income for the shareholder-employee. In most cases, however, this additional compensation is not considered compensation on which self-employment taxes must be paid.

Employment Taxes

Employees are subject to a 6.2 percent Social Security tax for on the first $106,800 of compensation paid in 2009, and an additional Medicare tax of 1.45 percent on all compensation; there is no limit on the amount of compensation subject to the Medicare tax. Employers pay the same amount on behalf of their employees.

Self-employed individuals (sole proprietors, members of limited liability companies, and partners) pay a combined rate of 15.3 percent on their earnings from self-employment. Although the 12.4 percent tax is limited to the first $106,800 of earnings in 2009, the 2.9 percent Medicare tax applies to all self-employment earnings. This has led a number of practitioners to replace unincorporated forms of doing business (limited liability companies or limited liability partnerships) with S-corporations, and to pay themselves salaries limited to the amount subject to the Social Security tax. Of course, the balance of profits earned by the S-corporation is still taxable to its shareholders, but the Medicare tax is eliminated.

Consider the following example:

> Dr. A, a sole practitioner, practices as the sole member of a limited liability company. If Dr. A's net income for 2009 from the practice is $400,000, Dr. A will be liable for Social Security taxes of $13,243.20 and Medicare taxes of $11,600, or a total of $24,843.20.
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> If, in 2009, Dr. A had practiced as an S-corporation and limited his compensation to $106,800, he would have paid $6,621.60 in Social Security taxes and $1,548.60 in Medicare taxes. The corporation would have paid a like amount, making a total of $16,340.40 due from employee and employer, a savings of $8,502.80.

Some S-corporation shareholder-employees have sought to reduce the impact of employment taxes further by severely limiting their stated compensation and claiming any additional distributions as dividends from the S-corporation. The Internal Revenue Service has been successful in recharacterizing distributions to S-corporation shareholder-employees as compensation rather than dividends where the compensation is low for those persons as compared to others in similar positions.

Does Your Small Business Need $35,000?

The U.S. Small Business Administration ("SBA") has made interest-free loans up to $35,000 in short-term relief available for viable small businesses facing immediate financial hardship through its America's Recovery Capital Loan Program. These loans are designed to give viable small businesses some temporary financial relief so they can continue to function. The loans, which are available through your bank, are guaranteed by the SBA.

Loan proceeds may be used to make payments on mortgages, secured and unsecured loans, lines of credit and credit cards, as long as the debt was used for eligible business purposes under the program. The disbursement period is followed by twelve months of no repayment and a repayment period of five years.

Factors considered in determining eligibility include: whether a business has an established banking relationship; whether it has been in operation for a minimum of two years; whether it can produce sufficient records to demonstrate a positive cash flow in one of the past two years (or as long as the business has been operating, if less than two years); whether the business's cash flow projection for the next two years indicates sufficient cash flow to meet current and future loan payments; and whether the business can demonstrate that it is suffering an immediate financial hardship such as declining sales and revenues, difficulty in making loan payments on existing debt, difficulty in paying employees, difficulty in purchasing materials, supplies, or inventory, and/or difficulty in paying rent and/or other operating expenses.

The loans are available through September 30, 2010 or until the appropriated funds run out, whichever comes first. If your business qualifies, ***run*** to your bank.

Stimulus Package Expands Small Issue Industrial Development Bonds For Manufacturing Facilities

If you are a manufacturer looking to expand your operations, now may be the time. As part of the American Recovery and Reinvestment Act of 2009 (the "Stimulus Package"), Congress has expanded the types of manufacturing facilities that are eligible for tax-exempt financing.

Under the Internal Revenue Code, interest on "qualified small issue bonds" is exempt from taxation. These bonds are an excellent means of financing manufacturing facilities, as the terms are generally more advantageous than with traditional debt financing. To qualify, the bond issue must not exceed $1 million in most cases ($10 million in some cases) and 95 percent of the bond proceeds must be used to finance manufacturing facilities.

Prior to enactment of the Stimulus Package, the Internal Revenue Code limited tax-exempt financing to manufacturers of tangible personal property. It also limited use of the proceeds of tax-exempt bonds to projects directly related to manufacturing. Only 25 percent of the bond proceeds could be used to finance facilities that were ancillary to the manufacturing project. The Stimulus Package has loosened these rules.

For the 2009 and 2010 calendar years, tax-exempt financing is available for facilities that are used in producing or creating intangible property, such as patents, copyrights, formulae, processes, designs, patterns, know-how, formats, or similar items. Moreover, the Stimulus Package permits manufacturers to finance ancillary facilities with bond proceeds so long as the ancillary facilities are located on the same site as the manufacturing facilities, without regard to the 25 percent limit set forth above.

These expanded rules will allow manufacturers to finance more comprehensive projects. For example, a manufacturer may now use tax-exempt bond proceeds to finance the construction of both a manufacturing facility and a related research and development facility.

Any manufacturer interested in using these Stimulus Package provisions should be aware of two caveats. First, any tax-exempt financing will be subject to the Code's myriad other rules and limitations. Second, interested manufacturers should act quickly, as the expanded provisions expire on January 1, 2011.

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Corporate Practice Group Attorneys:

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