LLC, SUB-S or Partnership

Which Entity Is Right For You?

The Monitor Group Inc.
Wealth Management

So, you want to be a consultant or start a business? Many highly talented individuals hang up a shingle after a rewarding career and make the transition from employee to self-employed business owner. This life change initiates a cascade of business and tax decisions which are critical to the operation of their new firm.

In this paper we will examine the advantages and disadvantages of various business entity structures available to you, the business owner. There will be tax and non-tax issues. You want to accommodate current needs, but you must also keep an eye on the future. And, unfortunately (or not) there is no simple answer, no "one size fits all." Your decision will be unique to your business.

If you do not make a choice, the government has already decided for you. This is similar to estate planning where failing to draft your own will results in the state writing one for you. Thus, it behooves you to study the issues and make the choice which will most benefit you.

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This position paper was edited by The Monitor Group, Inc. ("TMG"), an independent, fee-only wealth management firm based in McLean, Virginia. TMG manages over 500 million dollars in assets for financially established individuals, trust funds, retirement plans, non-profit organizations, and fiduciaries. Furthermore, TMG is part of the Zero Alpha Group, LLC, a global industry group sharing common investment and planning philosophies. Zero Alpha Group currently manages in excess of eight billion dollars.

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Executive Summary

1. The selection of a business entity is complex. You should not make the choice without competent counsel from legal and tax professionals. There are many factors to consider, and your particular situation and concerns are unique. This paper, although technical, should be considered general information and not a specific recommendation for you.

2. A Limited Liability Company (LLC) is simply a partnership with the added benefit of liability protection, similar to a corporation. An LLC chooses how it will be taxed—as a sole proprietorship, a partnership, an S corporation, or as a regular C corporation. While LLCs have become a popular choice, there are disadvantages as well as advantages.

3. Under recent law changes, all business entities can now adopt any retirement plan. However, contributions are limited by the amount of compensation. If the owner keeps his salary low to minimize FICA and Medicare taxation, it will limit retirement plan contributions.

4. A sole proprietorship is the simplest entity to set up and run. This may be appropriate for many businesses, unless features and advantages of other entities are required.

5. The formality of treating a business like a business is important and beneficial. The S corporation demands this formality. If formal records and shareholder meetings are not done, the corporate shield of liability protection can be pierced. Unfortunately, sole proprietorships and partnerships frequently have poor record-keeping and conduct their business affairs informally, which leads to trouble with the IRS. An LLC should be run formally.

6. The regular C Corporation entity is the only one subject to double taxation, but it has a number of advantages not available to other entities.

7. There are many more considerations when selecting an entity. Charts of the advantages and disadvantages comparing each entity with the other entities are provided at the end of this article.

O Sole Mio:

Sole Proprietorships

Unless you choose to make an official selection, your entity will be "Sole Proprietorship." You are a sole proprietor if you do not elect to become a corporation or an LLC (Limited Liability Corporation).

For tax purposes, all a sole proprietor does is file Schedules C and SE with your personal form 1040 tax return. Schedule C is titled "Profit or Loss From Business (Sole Proprietorship)" and Schedule SE is "Self-Employment Tax." While a sole proprietor may have a separate federal tax identification number, it is not required (however, it is required if you will have employees, in which case you must file government forms and remit payroll taxes for them). A sole proprietor is not required to have a separate checking account for the business (although that is highly recommended).

Anyone who receives a form 1099 from any other business must report that income on Schedule C (with minor exceptions). So, there are many people who are sole proprietors and don't even know it! In fact, prior to 1997, if two people were working together in a business and they called each other "my partner," they were not technically a partnership unless there was an actual sharing of profits. If a formal partnership operation did not exist, they were simply a "joint venture" of two sole proprietors working together and splitting revenues and expenses. However, in 1997, new regulations[1] commonly called the "check the box rules" made two unincorporated entities working together a partnership by default.

ADVANTAGES

The primary advantage of the sole proprietorship is simplicity. There are no filings, other than the Schedules C and SE with the personal tax return, and no record-keeping requirements. Of course, you do have to keep track of your income and expenses for the schedule C. Depending on the type of business, you may have to obtain a business license from the city or county in which you reside. And there may be some certification or license requirements for your particular profession. But there is no requirement for bylaws, minutes, annual meetings, partnership agreements, etc.

A sole proprietorship can have employees. If you do, you will need to set up payroll, file reports with the government, and make deposits of payroll taxes with the federal and state agencies. This can be quite involved, and it is usually best to outsource this work. Businesses can (and often do) get into serious trouble by not following the rules and regulations of payroll filings and especially tax deposits. Failure to deposit tax withholdings from employees' paychecks in a timely manner is considered theft by the government, and the penalties are severe.

Although not required, it is a very good idea to set up a separate checking account for your business. The segregation of assets and transactions looks better to the IRS, and the yearly accounting, when tax return time rolls around, is much easier.

Another advantage of the sole proprietorship from a tax perspective is the profits or losses "flow through" directly to your tax return.[2] There is no double taxation as there is with a regular C corporation. If a sole proprietorship has a loss, it is 100% deductible against ordinary income on your individual tax return. However, if the losses persist, the IRS can challenge the business as being a hobby and not a for-profit enterprise. This is known as the "hobby loss rule" found in Section 183 of the Internal Revenue Code. Fortunately, there is a rebuttable presumption your business is not a hobby if it is profitable in at least 3 out of 5 consecutive years.[3]

Until recently, sole proprietors could not deduct 100% of their health insurance premiums. This has changed, so that under current law you can deduct 100% of your health insurance costs, up to the amount of the net profit of your business. If you have a loss, you cannot deduct it. In fact, the deduction is not reported on Schedule C; rather, it is taken on line 29 ("self-employed health insurance deduction") of the 1040 form. This is subject to change in the future, so be aware.

1 Treasury Decision 8697, Federal Register, December 18, 1996; effective January 1, 1997; Treasury Reg. § 301.7701-3

2 Several other entities have this flow through (or, pass through) feature; this is not unique to sole proprietorships.

3 Internal Revenue Code § 183(d)

DISADVANTAGES

From a non-tax standpoint, one of the major problems with a sole proprietorship is liability. The owner—this means you!—is personally liable for anything and everything concerning the business. If you are sued pursuant to something that happened relating to the business, all your personal assets are exposed. There are exceptions, such as in Florida where your personal residence is protected, courtesy of their homestead exemption. So, depending on the nature of your business, this could be a serious problem. Do your personal assets need protection from legal liability? You may be able to purchase additional liability insurance.

Beyond insurance, another solution is for your sole proprietorship to be organized as a single member LLC (LLCs are discussed below). A single member LLC is a disregarded entity for tax purposes; thus, it will still be taxed as a sole proprietorship. But it does provide some protection from liability.

The chief tax disadvantage is the "self-employment tax." All profits of a sole proprietorship business are subject to this tax, which is reported on Schedule SE. This tax is made up of two parts: 1) the employer's half of FICA[4] (Federal Insurance Contributions Act, otherwise known as Social Security) and Medicare payroll taxes; plus 2) the employee's half of FICA and Medicare. The total SE tax is 15.3%, which is two times 7.65% (the sum of 6.2% FICA and 1.45% Medicare.) In 2009, the maximum income subject to FICA tax is $106,800. After that level of income, there is no more FICA tax, but Medicare tax (2.9%) continues with no upper income limit.

Thus, as a sole proprietor you pay both halves (employee's and employer's portions) of FICA and Medicare taxes. This means every sole proprietor pays 15.3% tax plus income taxes on earned income up to $106,800. After that, there is income tax plus SE tax of 2.9% on any amount over $106,800. That's something to think about.

Retirement Plans

Is it permissible for a sole proprietorship to establish tax-deductible retirement plans? Yes. You have several options:

IRA
A sole proprietor can opt for a personal IRA (if otherwise eligible) in lieu of a company plan. Also, depending on the income of the business, this may result in a greater contribution and tax deduction than a plan in which the contribution is limited to a percentage of the income of the business. For 2009, the maximum contribution to an IRA is $5,000 (plus a $1,000 catch-up for ages 50 and over).

Simplified Employee Pension (SEP, also referred to as SEP-IRA)
A SEP is established by the employer and is funded by the employer only, as a percentage of compensation. If the sole proprietorship has employees, the employees do not contribute to the SEP; rather, the owner must contribute to the SEP for each eligible employee. The employer may contribute up to 25% of the total compensation of each employee up to a maximum of $49,000, but you may not discriminate (that is, you must contribute the same percentage for each employee). The maximum annual contribution for the owner is 20% of net self-employment income (after subtracting ½ of self-employment tax) up to $245,000, or $49,000 for 2009; this amount is adjusted annually for inflation.

This convoluted calculation works out to be 25% of the owner's wages after the contribution. Employer contributions are fully vested immediately. A Profit Sharing plan (discussed below) is similar to a SEP, but has a vesting schedule, so employees do not have access to the contributions as quickly.

SEPs are very simple and inexpensive to set up and administer.
NOTE: There is no catch-up provision for those 50 years old or older.

Savings Incentive Match Plan for Employees (SIMPLE-IRA)
A SIMPLE-IRA is an employer-sponsored plan. Contributions are made by both the employee and employer. The employee's contribution is not based on a percentage of income; rather, the employee can contribute a specific dollar amount up to 100% of their income with limits. A sole proprietor is both employer and employee. Thus, a payroll system is recommended if you are going to establish a SIMPLE-IRA plan. There are mandatory matching contributions for the employer, and there are only two choices:

1) 2% contribution for all employees, whether they contribute or not; or 2) 3% match for only the employees who contribute. For 2009, the maximum SIMPLE-IRA employee contribution is $11,500, plus a $2,500 catch-up if age 50 and older.

4 Federal Insurance Contributions Act

This plan can be very attractive if the sole proprietor employs his spouse. He can pay her a salary in the amount of the maximum contribution, and she can thus defer 100% of her income into the plan, plus the employer match.

SIMPLE-IRA plans are relatively simple and inexpensive to set up and administer. However, there is no vesting; employees are 100% vested immediately. But the IRS imposes a 25% tax penalty for withdrawing from a SIMPLE plan within two years of the first contribution.

NOTE: A SIMPLE-IRA plan may not be established if the employer maintains any other qualified retirement plan, including a SEP.

401(k) Plan

A sole proprietor can set up a 401(k) plan. In fact, of all the retirement plan options, the "Solo 401(k)" presents the largest opportunity for tax-deductible contributions. The maximum employee contribution to a 401(k) plan for 2009 is $16,500 (plus a $5,500 catch-up if 50 or older). The maximum matching employer contribution is 25% of compensation; but the combination of employee and employer contributions cannot exceed $49,000 ($54,500 if age 50 or older) in 2009. A word of caution: A Solo 401(k) is simple and inexpensive to set up and administer. However, once you start hiring employees, the 401(k) becomes complex and expensive to administer, as mandatory annual non-discrimination testing must commence. One advantage over the SIMPLE-IRA is the employer can put a vesting schedule on employer contributions; thus, if employees leave the company, their non-vested portion is re-allocated among remaining employees pro-rata.

401(a) Profit Sharing (Defined Contribution) Plans

These plans have the same contribution limits as a SEP. Also, as with a SEP, all contributions are made by the employer, not the employees. However, vesting requirements can be added to employees' accounts, so if they terminate employment and have not vested fully, their forfeitures are spread among the remaining owners and employees on a pro rata basis. Profit Sharing plans are more complex and expensive to administer than SEPs.

Defined Benefit Pension Plan

For sole proprietorships with dependable, consistently high income, a defined benefit plan will provide the opportunity for maximum contributions and thus maximum tax savings. For example, in 2009 the maximum contribution to a Defined Benefit Plan is $195,000. In addition, contributions can be skewed toward the older employees with higher salaries. However, this type of plan is the most complex and expensive to administer, and annual funding is required, even if you don't make any money that year. Enter with caution!

Two Heads Are Better Than One – Or – It Takes Two To Tango:

Partnerships & LLCs

The Limited Liability Company (LLC) has become one of the most popular entity choices since the mid-1990's. It is essentially a partnership with a layer of liability protection added to it. In fact, whenever someone mentions an LLC, you should think "partnership." That said, it is possible for an individual to form a single-member LLC; but generally, LLCs are operated as partnerships.

Let's get acquainted with partnerships and partnership taxation.

According to the Internal Revenue Code, a partnership[5] has four elements: 1) two or more people, 2) engaged in business, 3) sharing profits, and 4) not incorporated.

There are different types of partnerships:

A. General partnership—all members are general partners; they are jointly and severally liable. Very few people *voluntarily* choose this form, but read my following comments carefully.
B. Limited partnership—at least one member is a general partner; the rest are limited partners whose liability is limited to the extent of their contribution of capital. General partners are usually active in the business; limited partners are typically passive investors. This form is typically used for management of real estate or trust assets.
C. Limited Liability Company (LLC)—a relatively new concept in which at least one member is a managing member, but all members' liability is limited (hence the name).

Clearly, a primary issue in a partnership has to do with liability. From a liability standpoint, a general partnership is the worst possible choice, yet many general partnerships are formed annually because they meet the definition above *but have given no thought to this crucial issue*. In a partnership, there is "*joint and several liability*." This means you and your partner(s) are all individually and collectively 100% responsible for any liabilities, wrongful acts or omissions of any partner. For example, if your partner injures someone or incurs a debt, you are liable to the full extent of your personal assets. Liability insurance may be a solution if adequate coverage can be obtained at a reasonable rate.

The limited partnership is used when most of the partners want to contribute capital and reap the profits, but do not want to work in the business or they have limited knowledge or interest in the day-to-day operations of the business. In addition, this entity choice works well in a family situation for estate planning—this is the well-established "Family Limited Partnership." A discussion of this strategy is beyond the scope of this paper, yet it is important to note its application here. The general partners retain control; the limited partners only have a financial interest with limited liability.

There are also "Publicly Traded Partnerships" which are limited partnerships that are traded on a stock exchange.

The LLC is a hybrid of a partnership and the limited liability of a corporation. The concept originated in German law in 1892, but the first LLC in the United States was created in 1977 in Wyoming by an oil company. Wyoming's statute allowed the formation of an LLC for any business purpose other than banking or insurance.[6] In 1980 the IRS issued a Private Letter Ruling stating it would treat this Wyoming LLC as a partnership for tax purposes.[7] But, later that same year, the IRS reversed itself and said it would deny partnership taxation if any member did not bear responsibility for the liabilities of the LLC.[8] Although Florida passed LLC legislation in 1982, no other states did so until the IRS decided to reverse itself again in 1988 and proclaimed it will treat LLCs as partnerships.[9] By 1996, virtually every state had an LLC statute. Thus, the LLC is relatively new.

It is important to understand an LLC is a partnership for tax purposes, unless the members choose to be taxed differently. Following

5 Internal Revenue Code § 761(a)

6 Wyo Stat §17-15-103

7 Priv. Ltr. Rul. 81-06-082, 1980 WL 137231 (Nov. 18, 1980)

8 Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (1980)

9 Rev.Rul. 88-76, 1988-2 C.B. 360.

the aforementioned Treasury Decision in 1997, there is a "check the box" option available to LLC members. An LLC can now be taxed however it wants to be taxed—as a partnership, as an S corporation, or as a regular C corporation. This decision is made by filing IRS Form 8832, "Entity Classification Election." A single member LLC is a disregarded entity for tax purposes, and is taxed as a sole proprietorship, unless the member decides to be taxed as an S corporation or C corporation (you must have at least two members to be a partnership).

Partnerships have unique taxation characteristics which are desirable for certain types of businesses, but not others. Partnership taxation is by far the most complex type of tax law. There is "inside basis" and "outside basis" along with "special allocations" which must have "substantial economic effect." As such, the accounting and tax preparation costs may be higher for this type of entity, depending on the complexity of your business operations.

Be aware that licensed professionals, such as lawyers or architects, generally are not permitted to form partnerships with non-licensed individuals.

ADVANTAGES

General partnerships are simple to set up. Limited partnerships and LLCs are a bit more complex, but are not as complicated as corporations. A formal written partnership agreement is not required by any law for any partnership, but is highly desirable and recommended. Limited partnerships are created by legal documents and will be accompanied by a written partnership agreement in most cases. In fact, certain tax attributes are determined by language which must appear in the partnership agreement. LLCs may or may be not required to have an operating agreement (this varies by state laws), but an operating agreement is highly recommended. Articles of organization must be filed with the state, and capital must be contributed by the members. LLC formation and state registration is similar to that for corporations, thus it has a number of formal legal steps to be followed carefully.

A partnership should apply for a tax ID number as the entity must file a tax return (IRS Form 1065) and generate K-1's for the partners.

Partnerships have "flow through" or "conduit" taxation, similar to sole proprietorships mentioned above. Thus, there is no double taxation on taxable income. Also, losses flow through to the partners' individual tax returns.

Until recently, partners could not deduct 100% of their health insurance premiums. But under current law you can deduct 100% of your health insurance costs, up to the amount of the net self-employment income of the partnership. However, if the partnership has a loss, you cannot deduct health insurance costs. In fact, the deduction is not taken on the partnership return (Form 1065). Rather, the amount paid for health insurance is shown as income to each partner on their K-1, and the deduction is taken on line 29 ("self-employed health insurance") of the 1040 form. However, health insurance premiums for employees are deductible on the partnership tax return.

Partnerships can have unlimited numbers and types of partners. This is not true for an S corporation, to be discussed below.

A key tax benefit of a partnership is the opportunity for special allocations of income and loss items to partners unequally. There are strict limitations on the extent of these special allocations ("substantial economic effect"), but no other entity provides this opportunity. In some business situations, this may be highly desirable. Unique to partnerships is a tax rule which allows debt obtained by a partnership to increase cost basis at the entity level ("inside basis"). This can maximize the use of partnership losses.

Assets removed from the partnership do not result in a capital gain. This is not true for S or C corporations. This is the primary reason most real estate businesses are structured as partnerships, because in many cases real property is contributed to the partnership and later removed. The partner's outside basis is maintained and no gain is recognized when the asset is removed from the partnership. Finally, a partnership can have unlimited investment income with no personal holding company or passive income tax.

DISADVANTAGES

Unlimited liability of the general partners is the primary disadvantage of partnerships. In most cases this can be easily eliminated by simply forming an LLC.

While losses can pass through to the partners' individual tax returns—which is quite beneficial—there is a limitation on the losses. Each partner's losses are limited to the extent the partner has outside basis in the partnership. To over-simplify, the partner's outside basis is the sum of the partner's investment (capital contribution) plus net income plus the partner's share of debt (must be recourse debt or qualified non-recourse debt).

Rental real estate activities in a partnership are subject to the passive activity loss rules. In short, partners with high adjusted gross income cannot deduct losses; also, maximum deductibility for any partner is $25,000 in any tax year. Income from your LLC or partnership that is attributable to rental real estate is treated as such, and will not be treated as self-employment earnings. Thus, it will not be subject to FICA or Medicare taxation.

A partner cannot separate any salary subject to FICA and Medicare from profits. Salaries to partners are called "guaranteed payments" in tax lingo. On the partner's K-1, the guaranteed payments are added to the ordinary business income from the partnership or LLC and the sum is called "self-employment earnings." These self-employment earnings are subject in full to FICA and Medicare taxation, just as the sole proprietor's self-employment tax discussed above. A key advantage of S corporations over partnerships is the ability to limit FICA and Medicare taxation to a "reasonable" level. This strategy could save some shareholders thousands of dollars, and will be discussed fully in the section on S corporations.

Tax-free fringe benefits, which a C corporation is entitled to by law[10], are limited in partnerships. If a partnership pays a fringe benefit, it is considered a distribution of taxable income to the partner. The partner may then deduct it on his or her personal tax return. In a C corporation, the corporation pays for the benefit, the corporation deducts the payment (reduces taxable income), and it is tax-free to the owner and employees.

If there is a desire to take the business public in the future, it is difficult for a partnership to make the transition. S and C corporations have a distinct advantage in this regard. In addition, a tax-free merger of a partnership with a corporation is not possible, although S and C corporations can merge tax-free.

10 Seven types of fringe benefits are available to corporations under Code Section 132(a):

(1) No additional-cost services.

(2) qualified employee discounts.

(3) working condition fringes.

(4) de minimis fringes.

(5) qualified transportation fringes.

(6) qualified moving expense reimbursements.

(7) qualified retirement planning services.
In addition, education assistance benefits are available—see § 127 as well as § 132. Code Section 132 also allows for on-premises athletic facilities provided by an employer, although it does not explicitly characterize the provision of these facilities as a fringe benefit.

SPECIAL NOTE ABOUT LLCs

Since LLCs are essentially the same entity as partnerships, the advantages and disadvantages of partnerships above also apply to LLCs.

The one big exception to that statement is liability. Remember, the two "L"s in LLC mean limited liability. With an LLC, you can have all the advantages of a partnership with what had traditionally been the key advantage of a corporation; that is, a limitation on the partner's liability.

On the other hand, an LLC can elect to be taxed as an S corporation, which may be beneficial if there is a desire to limit the FICA and Medicare taxation of income, and none of the other benefits unique to partnerships are applicable. Many benefits of partnership taxation are common features of S corporation taxation.

Retirement Plans

IRA – same as Sole Proprietorship. Each partner may have their own IRA, if eligible.

SEP – same as Sole Proprietorship.

SIMPLE-IRA – same as Sole Proprietorship.

401(k) Plan

The rules are the same as Sole Proprietorship, with one exception. Since there are at least two partners in a partnership, there cannot be a Solo 401(k). Thus, a 401(k) plan will be more complex and expensive to administer. Generally, the SIMPLE-IRA plan is more attractive unless you have more than 100 employees, or if most of the employees want to contribute more than the SIMPLE-IRA maximum of $11,500 plus the 50 and over catch-up of $2,500. The administration cost will be a primary consideration.

401(a) Profit Sharing (Defined Contribution) Plans – same as Sole Proprietorship

Defined Benefit Pension Plan – same as Sole Proprietorship

Take The "S" Train

Subchapter S Corporations

On the first day of class in the course "Corporate Tax" my professor, a practicing attorney, asked this question: "What business should choose to be a regular C corporation?" His answer was simple: "Any business that cannot qualify to be an S corporation." Why? Two words: double taxation.

First, let's clarify what "C" and "S" mean. Section 1361 of the Internal Revenue Code is found under Subchapter S of the code, so that's why they call it a "Sub S" or "S" corporation. That section defines an S corporation as a small business corporation for which an election under §1362(a) is in effect. Then it defines a C corporation as any corporation which is not an S corporation. Sounds like typical government legalese, doesn't it?

So, the first critical step to becoming an S corporation is to make an election. This is done by filing IRS form 2553, "Election by a Small Business Corporation" by March 15, the due date of the corporate tax return.

Second, what are the eligibility requirements to be an S corporation? They are spelled out in §1361:

1. Domestic (not a foreign corporation);
2. Not "ineligible" – ineligible includes insurance companies and other unique entities;
3. Only one class of stock, and profit distributions must be pro-rata;
4. The shareholders must be individuals, certain trusts, or ESOPs (employee stock ownership plans); shareholders cannot be a corporation or an LLC;
5. There can be no non-resident alien shareholders;
6. There is a maximum number of shareholders—under current law, that is 100 (formerly, it was 35).

Earlier I stated LLCs are a hybrid between a partnership and a corporation. Likewise, S corporations are a hybrid between a partnership and a corporation. The primary difference is that an LLC can choose how it is taxed; but an S corporation is taxed in a specific way. In fact, one of the ways an LLC can choose to be taxed is as an S corporation.

Well, how is an S corporation taxed? It differs from a C corporation in that it is a pass-through or conduit form of taxation, to avoid the double taxation of a C corporation. A C corporation is taxed on its net profits and the owners are taxed on the dividends distributed to them, but the C corporation cannot deduct the dividend payments. The good news under current tax law is these C corporation dividends are taxed at the favorable 15% rate. This rate may increase based on Congressional action.

An S corporation is only taxed on its net profits, which flow directly to the shareholders' individual tax returns. The S corporation files form 1120-S, but there is no tax due with that form. From that filing a K-1 is generated which reports the shareholder's pro-rata share of the S corporation's profit or loss. This information is reported on Schedule E of the taxpayer's form 1040.

For example, suppose a corporation has a profit of $300K, after paying the owner's salary (and we'll assume the salary is beyond the maximum amount for FICA tax). Here is the difference between double taxation and the single taxation of an S corporation:

	C Corp	S Corp
Profit	$300,000	$300,000
Corp. tax rate	39%	-0-
Corp. tax	$117,000	-0-
Dividend/profits to owner (after paying corp tax)	$183,000	$300,000
Tax rate on dividends/profits (married filing jointly)	15%	33%
Personal tax	$27,450	$99,000
Net after tax to owner	$155,550	$201,000

Thus, the difference due to double taxation is $201,000 – 155,550 = $45,450.

One major difference between an S corporation and a partnership is the pro-rata concept of profit/loss distributions. Partners in a partnership may choose what percentage of the income (profits) or

deductions (losses) each partner will receive based on their written partnership agreement regarding special allocations mentioned above. An S corporation must distribute profits or losses in the precise percentage of stock each shareholder owns.

ADVANTAGES

Perhaps the most unique and significant advantage of the S corporation entity is the opportunity to minimize FICA and Medicare taxes. This is possible because the salary paid to the owner(s) is separate from profit distributions, also known as dividends. The latter are not subject to FICA and Medicare taxation. Thus, owners can pay themselves a "reasonable" salary, from which FICA and Medicare are deducted. The dividends over and above the salary are taxed as ordinary income, but no FICA or Medicare taxes are deducted from dividends. Remember, for 2009, the maximum income subject to FICA is $106,800.

Here's an example, comparing the S corporation to a partnership (assume two partners/owners in each case, and the numbers below represent one owner's portion):

Business Gross Income	$200,000
Owner's salary	25,000
Other expenses	50,000
Profit	$125,000

PARTNERSHIP	
Profit	$125,000
Salary	25,000
S-E Income	$150,000
FICA Tax ($106,800 @12.4%)	$13,243
Medicare Tax ($150,000 @ 2.9%)	4,350
TOTAL	$17,593

S CORPORATION	
Profit	$125,000
Salary	25,000
FICA Tax ($25,000 @12.4%)	$ 3,100
Medicare Tax ($25,000 @ 2.9%)	725
TOTAL	$ 3,825

Tax Savings Benefit of S Corporation	
Partnership FICA & Medicare Tax	$17,593
S corporation Corp FICA & Medicare Tax	3,825
SAVINGS	$13,768

Keep in mind, in both entities, ordinary income taxes are paid on the full amount of the salary plus the profits; the tax savings are derived only from the FICA and Medicare tax.

Clearly, this strategy hinges on the interpretation of the word "reasonable" as it pertains to the salary. In a start-up, there is great risk and uncertainty. It is not unreasonable for the owner of a new business venture to be very cautious in controlling expenses, including his own salary. On the other hand, a business in existence for 10 years with consistent income in six figures that converts to an S corporation would have great difficulty convincing the IRS that a low salary was reasonable. As in most tax issues, the facts and circumstances are used to determine reasonableness.

You need to know that an ultra-low salary strategy is deemed by a few tax professionals to be aggressive. The IRS certainly looks at this for potential abuse, although it is not one of the "Top 9 Small Business Audit Triggers."[11] However, you need to be careful and not stretch the reasonableness too far.

There is a disadvantage associated with paying a low salary to the owner. Your ability to contribute the maximum amount to a deductible retirement plan is limited by your "compensation," which is defined as salary—the code expressly excludes S corporation dividends from the definition of compensation. Here is an example of the tax savings and retirement contributions based on a low salary or a high salary.

Minimize compensation: $25,000 per year salary

401(K) contribution:

$22,000 401(K) contribution by employee (age 50 or older)
$ 6,250 401(K) contribution by employer (25% of salary)
$28,250 total 401(K) contribution

Tax savings:

$ 9,323 savings on income taxes (assuming 28% federal and 5% state on $28,250)
$12,515 savings on payroll taxes (assuming $106,800 - $25,000 @ 15.3%)

$21,838 total tax savings

11 "Strategies: Top 9 small-business tax audit triggers" USA Today, April 3, 2009

Maximize retirement contributions: $130,000 per year salary	
401(K) contribution:	
$22,000 401(K) contribution by employee	
$32,500 401(K) contribution by employer (25% of salary)	
$54,500 total 401(K) contribution	
Tax savings:	
$17,985 savings on income taxes (assuming 28% federal and 5% state on $54,500)	
$-0- savings on payroll taxes	
$17,985 total tax savings	

Advantage of Minimize Salary strategy:	
Tax savings @ $25,000 salary	$21,838
Tax savings @ $130,000 salary	17,985
Advantage	$ 3,853

Actually, the payroll tax savings from keeping the salary low are even higher, because income subject to Medicare tax does not stop at wages of $106,800, as does FICA. The 2.9% Medicare tax is assessed on all compensation. So, for the $23,200 difference between the $130,000 salary in the second example and the $106,800 Social Security maximum wage base, the 2.9% Medicare tax would result in an additional cost of $673. Thus, the total advantage is $4,526.

Until recently, shareholders of an S corporation who owned 2% or more of the stock could not deduct 100% of their health insurance premiums. But under current law owners can deduct 100% of health insurance costs, up to the amount of earned wages (not profits, as with partnerships). If you have no salary income, you cannot deduct health insurance. In fact, the deduction is not taken on the corporate tax return (Form 1120-S). Rather, it is shown as income to each shareholder on their K-1, and the deduction is taken on line 29 of the 1040 form. This is subject to change in the future, so be aware.

Although some would consider this next point a disadvantage, it is actually an advantage; that is, the formality and legal process of setting up an S corporation. One of the problems with sole proprietorships and partnerships is the cavalier attitude the owners have with respect to keeping records and not conducting their business as a business. In fact, several of the items on the "Top 9 Small Business Audit Triggers"[12] have to do with sloppiness and poor records.

A corporation, in addition to the requirement to have a separate checking account (which many sole proprietorships and partnerships do not maintain), must have annual meetings and keep minutes. Setting up payroll is a complex and formal detail, but it does require the owner to treat the business as a real business. In any entity, when this is not done properly, it leads to trouble.

Limited liability is another advantage of an S corporation. Although LLCs can also provide limited liability, a general partnership does not have this feature. NOTE: the corporate shield of limited liability can be pierced if an S corporation does not follow the formal procedures mentioned in the previous paragraph. The formality is very important.

The opportunity to sell the business to a larger corporation or go public may not be applicable to you, but if that is a possibility, the S corporation is highly preferable to sole proprietorships, partnerships, or LLCs. This is due to a provision in the tax code allowing tax-free corporate mergers.[13] An S corporation can be acquired by (merged into) another corporation seamlessly and with no adverse tax consequences, although you will pay capital gains when you ultimately sell your stock. Similarly, going public is much easier if you are already a corporation which has elected S status. The S election can be easily revoked and thus the corporation quickly becomes a C corporation, which is then eligible to have its shares traded publicly.

S corporation stock can be owned by an ESOP. This can provide tremendous tax benefits, but is outside the scope of this discussion.

State taxation can also be reduced by use of an S corporation. Some states levy heavy taxes on other entities. For example, the state of California assesses a franchise tax of $800[14] on all entities for the privilege of doing business in that state. For S corporations, that's it. But for LLCs there is additional tax on gross revenue of up to $11,790[15] plus the $800 fee. So, in California, whether you make money or not, the LLC is subject to tax on its gross revenue (not net profits)!

12 ibid

13 I.R.C. § 368(a)

14 Cal. Rev. and Tax Code § 17941

15 Cal. Rev. and Tax Code § 17942

DISADVANTAGES

For fringe benefits, an S corporation is treated as a partnership[16], not a C corporation. A C corp can deduct payments for fringe benefits, such as medical insurance, from taxable income, and the benefit is tax-free to the owner. In an S corporation, the payment is treated as a distribution of taxable income to the S corporation owner (if you own 2% or more of the stock), and as an S corporation owner you may deduct the payment on your personal tax return, subject to the limitations on deductibility.

When an S corporation borrows money from a bank, this does not increase shareholder basis. But when a partnership or LLC being taxed as a partnership borrows money, it does increase shareholder basis. Increasing basis is important because it reduces taxes.

S corporations have one class of stock and all profits/losses must be distributed pro rata according to percentage of ownership. As mentioned above, partnerships can make special allocations of income and expenses; they are not required to be pro rata.

S corporations cannot be owned by other entities, except another S corporation in a Qualified Subchapter S Subsidiary election.

One of the little-known disadvantages of the S corporation has to do with removing assets from the corporation. In a partnership, a partner can have an asset distributed to him and there is no gain realized on that distribution. Not so with an S corporation; if an asset is distributed from the corporation to an owner, gain must be realized and tax paid. If the asset has been fully depreciated, its basis is zero, so the owner will be taxed on the entire fair market value of the asset at the time of transfer. This is true for any asset, including automobiles and computers.

The only time an S corporation is subject to double taxation is when you shut down the business; in the tax code, this is known as a liquidation.[17] The owner is taxed on the fair market value of assets received less the cost basis; the owner may be taxed again when you sell your stock, if it has any value. Partnerships and LLCs being taxed as partnerships avoid this because the partners or LLC members have outside basis.

In addition, an S corporation that was once a C corporation may have a built-in gains ("B-I-G") tax.[18] The B-I-G Tax requires a company to calculate the amount of unrecognized appreciation that existed at the time the S election was made. This is quite complicated, but if a C corporation becomes an S corporation, the company must compute the fair market value at the effective date of the S election as compared to the tax basis. The amount of unrecognized gain is determined for each asset. The net of unrecognized built-in gains and built-in losses is the company's unrecognized built-in gain. The B-I-G tax does not apply after the 10th year following the S election.

The most common assets that create built-in gains are accounts receivable and goodwill. The amount of the B-I-G tax is a deduction for the shareholders. It reduces each income item reported on Schedule K pro-rata.

Retirement Plans

IRA – same as Sole Proprietorship. Each owner may have their own IRA.

SEP – same as Sole Proprietorship. Yes, a S corporation may establish a SEP.

SIMPLE-IRA Plan – same as Sole Proprietorship.

401(k) Plan – The rules are the same as Sole Proprietorship. Generally, you should go with the SIMPLE-IRA plan unless you have more than 100 employees, or if most of the employees want to contribute more than the SIMPLE-IRA maximum of $11,500 plus the 50 and over catch-up of $2,500.

401(a) Profit Sharing (Defined Contribution) Plans – same as Sole Proprietorship

Defined Benefit Pension Plan – same as Sole Proprietorship

16 I.R.C. § 1372

17 I.R.C. § 331

18 I.R.C. § 1374

The Secret of the "C"

Regular C Corporations

Again, the general rule is, "Don't be a C corporation if you are eligible to be an S corp." Why? Double taxation, as we discussed in the last section.

A C corporation files form 1120 with the IRS and pays tax on its profits. Corporate tax rates are 15% on profits up to $50,000, and 25% on profits up to $75,000. Beyond that, the tax rate varies from 34% - 39%.

By contrast, in 2009 a taxpayer who is married filing jointly can have taxable income of up to $137,050 and still be in the 25% tax bracket.

The owner of a C corp will be paid a salary, which is deductible to the corporation and taxable to the owner. But what if the corporation wants to distribute profits to the owner? Here's the rub. If the corporation pays them to the owner in the form of a dividend, the corporation cannot deduct the dividend from its income and thus reduce its taxable income. However, the receipt of the dividend by the owner is taxable income.

One way around this is to pay a salary bonus to the owner at the end of the year, once the profit for the year is known. This can potentially "zero out" the profit so the C corporation will owe no tax, and thus avoid double taxation. However, it may not be possible to accurately estimate the profit in the final days of December, so this is not an exact method. In addition, as the C corporation grows in size and has more than one owner, this can become very impractical. Finally, a bonus is salary subject to FICA and Medicare payroll taxes.

Closely-held regular C corporations have attempted other ways to maximize allowable distributions to shareholders that did not result in double taxation of a dividend distribution. For example, interest paid by a C corporation to a shareholder on a shareholder loan to the corporation is deductible by the corporation. The shareholder is taxed at ordinary personal income tax rates on the interest income, but double taxation is avoided.

Similarly, rent paid by a corporation to a shareholder is deductible by the corporation. The shareholder owns a building personally and leases it to the business. The shareholder is taxed at ordinary personal income tax rates on the rent income received, but double taxation is avoided.

ADVANTAGES

C corporations have limited liability. A shareholder cannot be held personally liable for debts or activities of the corporation. Of course, many banks require the owners to personally sign a note before they will lend money to a small corporation.

Fringe benefits get the most liberal tax treatment in a corporation (see discussion on fringe benefits in the partnership section above). The corporation pays for benefits such as medical insurance and deducts the cost from taxable income. The owner does not get taxed on these benefits. This is not true with partnerships or S corporations.

The dividends received deduction is unique to C corporations. If a C corporation owns stock of another corporation and receives dividends, it can deduct 70% of the amount of the dividend received from taxable income. If the C corporation owns 80% or more of the other corporation, it deducts 100% of the dividends received.

There is no limit to the number of shareholders. This is an advantage over S corporations, but not over partnerships or LLCs. In addition, there can be many types of shareholders. It is possible to have voting and non-voting stock, common and preferred stock, etc. This presents many opportunities for sophisticated planning.

There is a unique tax advantage when small business stock is sold at a loss. Any gain on the sale of Section 1244 (small business) stock is taxed as a capital gain, but a loss is deductible as ordinary income.[19] This is in stark contrast to most other losses which are capital losses, which can only offset $3,000 of ordinary income per year.

Also, investments in certain "qualified small business stock" held for five years can qualify for a 50% reduction in the capital gains rate.[20]

C corporations also have more flexibility than other entities to choose a tax year other than a calendar year. This may be important for certain businesses.

19 I.R.C. § 1244

20 I.R.C. § 1202

DISADVANTAGES

The primary disadvantage of C corporations is double taxation, discussed previously.

Also, if a C corporation has a loss, that loss does not flow through to the owners' individual tax returns in the same tax year, as it does with partnerships and S corps. Rather, in a C corporation, the net operating losses (NOLs) are accumulated and carried back or forward in a rather complex tax calculation. NOLs can be advantageous because they can limit corporate tax in future (or past) years, but the shareholders do not get the immediate deduction as do the other entities.

Of all the entities, the C corporation is the most formal. There is complexity and cost in set-up and annual administration of the corporation—annual meetings with minutes, a board of directors, and other requirements. If a C corporation does not "act" like a corporation, the "corporate veil" of limited liability can be pierced, and the owners held personally liable for activities or debts of the corporation.

C corporations are also subject to the "accumulated earnings tax." If a C corporation does not distribute profits to the owners, but accumulates too much in retained earnings, it will be liable for a tax on these accumulated earnings. The tax is 15% on the accumulated taxable income.[21]

Tax exempt income does not retain its character, as with partnerships and S corps, when it is distributed to owners. In a C corporation a distribution of profits to owners is a taxable dividend, which is not deductible to the corporation.

21 I.R.C. § 531

There is double taxation on liquidation with respect to the distribution of assets to the shareholders. The shareholder receives payment in exchange for stock which can result in a gain.[22] In addition, the corporation recognizes gain or loss on property distributed.[23]

Retirement Plans

IRA – same as Sole Proprietorship. Each owner may have their own IRA.

SEP – same as Sole Proprietorship. Yes, a C corporation may establish a SEP.

SIMPLE-IRA Plan – same as Sole Proprietorship. Remember, a SIMPLE-IRA Plan may not be established if the employer maintains another qualified retirement plan. Also, related employers (businesses under common control) are treated as a single employer.

401(k) Plan
The rules are the same as Sole Proprietorship. Generally, you should go with the SIMPLE-IRA plan unless you have more than 100 employees, or if most of the employees want to contribute more than the SIMPLE-IRA maximum of $11,500 plus the 50 and over catch-up of $2,500.

401(a) Profit Sharing (Defined Contribution) Plans – same as Sole Proprietorship

Defined Benefit Pension Plan – same as Sole Proprietorship

22 I.R.C. § 331(a)

23 I.R.C. § 336

Summary and Conclusion

The selection of a business entity is important but complex. Many factors must be considered, both tax and non-tax.

Today, the LLC has become quite popular, and it is the entity of choice for many professionals. But the LLC in and of itself is not a new or different type of entity from a tax perspective. In most cases, an LLC is simply a partnership with the added benefit of liability protection. However, an LLC can elect to be taxed as an S corporation or a C corporation, so you must look into it further. Unless you want to make special allocations of income and loss items, or if you plan on contributing property (rather than cash) and receiving distributions of property in the future, there is no compelling reason to be taxed as a partnership. For real estate businesses, the partnership taxation concept is appropriate; for most other businesses, probably not.

In most cases, a new business should be formed as a Subchapter S corporation (also called a "Sub S" or S corporation). This is due to significant savings from FICA and Medicare taxes by setting the owner's salary reasonably low. In addition, the benefit of profits and losses passing through to the individual owner's tax return avoids double taxation. Unless the unique benefits of partnership taxation are necessary (special allocations or outside basis for distributions of property), an LLC should choose to be taxed as an S corporation.

Thus, the S corporation, or an LLC taxed as an S corporation, is the best choice for most businesses. One of the primary reasons for this recommendation, especially for start-up businesses, is the opportunity to minimize FICA and Medicare taxation. Plus, the S corporation does require a level of formality, which is a good thing. Too many businesses are run in a cavalier, informal manner which only invites trouble from the IRS.

The chart on the next page summarizes the advantages of the various entities.

Advantages & Comparisons

	Sole Proprietorships	Partnerships	LLCs	S Corps	C Corps
Simplicity	✔	✔			
Flow-through profits/losses (no double tax)	✔	✔	✔	✔	
Limited liability			✔	✔	✔
Special allocations of income and expense items		✔	✔		
Debt increases basis at entity level		✔	✔		
No realized gain on distributions of property	✔	✔	✔		
Tax-exempt income retains its character when passed through to owners	✔	✔	✔	✔	
Deductible losses limited to outside basis		✔			
Set low salary to reduce FICA & Medicare tax				✔	
Liberal tax treatment of fringe benefits					✔
Tax-free merger or go public				✔	✔
Formality – act like a business				✔	✔
Possibly lower state taxes	✔	✔		✔	✔
No double taxation on liquidations	✔	✔	✔		
Dividends received deduction					✔
Unlimited number and type of shareholders		✔	✔		✔
Ordinary loss on sale of small business stock					✔
Gain on small business stock held for 5 years – 50% reduction in capital gains tax					✔
Flexible tax year options					✔
Owners can deduct corporation's losses in current year	✔	✔	✔	✔	
Profits/losses must be distributed pro rata (no special allocations)				✔	✔
No Accumulated Earnings Tax	✔	✔	✔	✔	✔