<u>Business Owner's Indispensable Guide to Choice of Entity and Maximum Tax Savings, and Identifying Problems with Business Entities</u>

The selection of the appropriate business vehicle, S corporation, C corporation, LLC, partnership, or sole proprietorship, depends upon several factors. Most advisors automatically recommend the LLC taxed as a partnership as a knee-jerk suggestion. However, an S corporation can often save you thousands of dollars in Social Security taxes, depending on your specific situation. Almost always, a C corporation, sole proprietorship, or state law partnership are the least preferable business vehicles for the reasons detailed below. The Vicknair Law Firm will help you apply these factors to your particular situation.

<u>C corporations</u>

<u>Problems</u>. A C corporation is the default classification if your business is a corporation under state law. A C corporation is typically very expensive to operate because earnings of a C corporation are subject to "double taxation." "Double taxation" means that the C corporation is taxed first on its earnings, and then any income that is distributed to you as a dividend is taxed to you individually a second time. Typically, the best alternative to a C corporation is an S corporation, which is available by special election with the IRS. The primary issues with C Corporations are:

1. <u>You are subject to double taxation</u>. You will be taxed twice on the earnings of the C corporation.
2. <u>You need to draw full salary to avoid double taxation</u>. To avoid double taxation, you will need to draw full salary. But drawing a full salary usually equates to a high Social Security tax.
3. <u>You have high tax planning pressure</u>. In order to fully eliminate profit to avoid double taxation, your tax planner must be involved to a much greater extent than with other forms of doing business. This equates to higher professional fees and lower profit for you.
4. <u>You may be subject to the Louisiana Franchise Tax</u>. The Louisiana Franchise Tax is applicable to corporations (both C corporations and S corporations) doing business in Louisiana. The tax is levied on your corporation's capital reserve, and is typically a relatively minor tax for smaller corporations with few capital reserves. Nevertheless, you should consider the impact of this tax in your choice of entity.

5. <u>You are faced with reasonable compensation issues.</u> In order to avoid the problem of double taxation associated with C corporations, you would be required to effectively classify all residual income of the corporation as compensation (wages, bonuses, etc.). However, classifying all income as compensation has two damaging effects. First, all that additional income will be potentially subject to Social Security and Medicare taxes, and accordingly, you are making the trade off of additional Social Security and Medicare taxes to lower the tax on dividends. Second, if you pay all of your income in the form of compensation, the IRS may be able to re-classify the income as dividends if your compensation is not "reasonable," thereby exposing you and your corporation to additional taxes, interest and penalties.
6. <u>You cannot pass through losses</u>. With a C corporation, you cannot "pass through" the losses of the C corporation to your personal tax return, Form 1040. Rather, the losses can only be carried forward to future years, or backward to past years.
7. <u>C Corporations Were not Intended for Small Businesses</u>. C corporations are not intended for small businesses. Rather, they are intended for relatively large corporations that do not meet the strict requirements applicable to S corporations. Most often C corporations are intended for large publicly-traded corporations or their affiliates.

<u>**Solutions**</u>. The solutions can include making an S Corporation election which could provide you the following benefits:

1. <u>You are not subject to double tax</u>. An S corporation is not subject to double taxation on its earnings. Therefore, a election from a C corporation to an S corporation will potentially save the taxes paid on dividend distributions from the corporation to you.
2. <u>You can achieve significant Social Security and Medicare tax savings</u>. An election to be taxed as an S corporation can save significant Social Security and Medicare taxes. For purposes of the Social Security tax you must distinguish between compensation which is remitted to you for your services rendered to the S corporation, and the residual income of the S corporation after all expenses are paid (these expenses include your compensation). This is because your compensation is subject to the Social Security tax, which is currently 12.4% of compensation up to $106,800 (for 2010), and the Medicare tax, which is 2.9% of compensation (no cap). However, your net income from the S corporation is not subject to the Social Security tax nor the Medicare tax.

To illustrate, assume that your income from the corporation is $200,000, and the value of your services rendered to the corporation are $65,000. If you choose a tax partnership structure to avoid the "double tax" on C corporation income, your total Social Security and Medicare taxes will be $19,043.20, calculated as follows: $106,800 X 12.4% plus $200,000 X 2.9%. However, if you choose an S corporation structure to avoid the same "double tax" on C corporation income, and you pay yourself fair market value salary of $65,000, your total Social Security and Medicare taxes will be $9,945.00, calculated as follows: $65,000 X 12.4% plus $65,000 X 2.9%. Accordingly, the S corporation structure will save you $9,098.20 over the tax partnership structure (typically an LLC).

3. <u>You have much less tax planning pressure</u>. With a C corporation, there is a great deal of tax planning pressure, the goal of which is to eliminate or reduce the "double tax". These pressures result in additional costs to you and your business because a tax professional must be paid to perform this additional work.
4. <u>You can eliminate the Louisiana Franchise Tax if the entity "converts" to an LLC taxed as an S corporation</u>. The Louisiana Franchise Tax applies to all state law corporations, whether C corporations or S corporations, doing business in Louisiana. The tax is $1.50 for each $1,000 or major fraction thereof up to $300,000 of capital employed in Louisiana, and $3 for each $1,000 or major fraction thereof in excess of $300,000 of capital employed in Louisiana. You can avoid this tax and still retain the benefits of an S corporation election by "converting" to an LLC under state law, then electing to be taxed as a corporation, then electing S corporation status. Our firm can help you ascertain whether the Franchise Tax savings will outweigh the transactional costs of the state law conversion.
5. <u>You can pass through losses</u>. An S corporation is allowed to "pass through" its losses to you, thereby potentially reducing taxes on your personal income tax return, Form 1040.
6. <u>You can still have full corporate liability protection</u>. For purposes of liability protection, an S corporation is merely a tax construct, and provides precisely the same protection as a C corporation.

<u>S corporations</u>

Problems. As noted above, to be an S corporation, you need to make an affirmative election with the IRS to be taxed as such. Although the S corporation has many advantages, you need to monitor it very closely. Some of the problems with S corporations are:

1. You overpay Social Security and Medicare taxes. This is a very common problem. Many people with S corporations fail to take advantage of the potential Social Security and Medicare tax savings because they pay themselves a salary that is too high, or their tax advisors fail to alert them to the potential tax savings. Instead of paying a high salary, reduce your salary to a lower amount, which is still at fair market value, and save Social Security and Medicare taxes in the process.
2. You may be subject to high Louisiana Franchise Tax applicable to corporations. As noted above, corporations are subject to the Louisiana Franchise Tax. You can avoid this tax by converting to an LLC which is taxed as an S corporation.
3. Hard for you to maximize a retirement plan.
4. You cannot specifically allocate profits and losses. An S corporation cannot unevenly allocate it's profit and losses amongst the shares owned by the owners of the corporation. For example, assume two owner-shareholders in an architectural firm. Owner 1 designs office buildings, and Owner 2 designs churches. They agree that Owner 1 is to be allocated all income from his design of office buildings, and Owner 2 is to be allocated all income from her design of churches. Generally, this cannot be done with an S corporation structure, but can be achieved with a tax partnership, or LLC, structure.
5. You cannot have foreign ownership in an S corporation. One restriction on an S corporation is that you cannot have a foreign owner. Accordingly, ownership in the company must be monitored to avoid losing your S election.
6. You have a limited number of owners. Another restriction on an S corporation is that you cannot have more than 100 shareholders, and accordingly, the number of shareholders must be closely monitored to avoid losing your S election.

Solutions. Our solutions for S corporations can include, continuing the S corporation election, but:

1. Monitoring salary very closely to minimize Social Security and Medicare taxes. Your salary should be at fair market value so as to avoid Social Security and Medicare taxes on the excess.

2. Eliminating the Louisiana Franchise Tax if the entity "converts" to an LLC taxed as an S corporation. As mentioned above, a S corporation can avoid Louisiana franchise taxes by converting to an LLC taxed as an S corporation.
3. Choosing the best retirement plan for the S corporation.
4. Providing year-round tax planning, both for the corporation and you individually.

Sole Proprietorships / Schedule C Businesses

Problems. The sole proprietorship can be very expensive to operate from a tax as well as a liability perspective. The primary issues with Sole Proprietorships are:

1. You have high Social Security and Medicare taxes. This is because *all* of your earnings are potentially subject to Social Security and Medicare taxes.
2. You have a high audit risk. Because all business income and expenses for a sole proprietor are shown on Schedule C of From 1040, there is a significantly increased audit risk. This audit risk can be significantly reduced by reporting the income and expenses on a different form.
3. You have unlimited liability. The most damming aspect of a sole proprietorship is unlimited liability. If you are subject to a lawsuit, potentially all of your assets, both personal assets as well as business assets, can be subject to a judicial sale to satisfy the claims of a judgment creditor.
4. You cannot have a partner should you decide to have one. If you decide that you want a partner, a sole proprietorship will not suffice as a vehicle for reporting your income and expenses.
5. You cannot report continuing losses over a certain period of time. As a general rule, you can report business losses up to three of the last five years. If you report losses for greater than the allotted number of years, any losses may be presumed to be "hobby losses," and therefore not eligible to be offset against other income.

Solutions. You should consider incorporating and making an S Election so as to:

1. Significantly reduce your Social Security and Medicare taxes. As discussed above, you can reduce your Social Security and Medicare taxes by reporting only your fair market value income as compensation.
2. Lower your audit risk. You can lower your audit risk by reporting all of your income and expenses on a form separate from your Form 1040.

3. Achieve limited liability for you and your family. You can achieve limited liability by incorporating or becoming an LLC. This will be a significant step toward protecting your assets from lawsuits.
4. Allow you to get another partner, if desired.
5. Allow you to show recurring losses. You will be able to show recurring losses without being presumed to be generating "hobby losses."

Limited Liability Company / Partnership

Problems. The tax partnership (which is typically a state law LLC or state law partnership), can be very expensive to operate. The primary problems with the LLC / tax partnership form of business include:

1. High Social Security and Medicare taxes. As discussed above, you can incur higher Social Security and Medicare taxes if all of your income is reported as compensation under the "tax partnership" reporting mechanism.
2. If you are a state law partnership, then you have unlimited liability. Being classified as a state law partnership is a big no-no. This is because you can be liable for the errors and omissions of your partner, and potentially all of your assets will be subject to sale to satisfy the claims of a judgment creditor.
3. If you are an LLC, than liability protection is not any greater than with an S corporation or a C corporation.

Solutions. You should consider:

1. Making an S election so as to significantly reduce your Social Security and Medicare taxes. This point is discussed above.
2. If you are a partnership, converting into a corporation, and making an S election so as to achieve unlimited liability.
3. Securing the best retirement plan, considering your salary.

If you have any questions about starting a business, changing your choice of entity, or other tax or corporate law questions, feel free to call Ted Vicknair. You can also schedule a free 30-minute consultation with Ted, under no obligation. Please also see our 100% Money Back Guarantee [hyperlinked] covering our document preparation which gives our clients the maximum peace of mind.