Since 1963

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CHOOSING THE RIGHT BUSINESS ENTITY FOR YOUR BUSINESS

Is a Limited Liability Company right for you?

Now that you have decided to start a new business or buy an existing one, you need to consider the form of business entity that is right for you. Six separate popular categories of entities exist: proprietorships, general partnerships, C corporations, S corporations, limited partnerships, and limited liability companies. Each category has its own advantages, disadvantages, and special rules. **We often prefer a limited liability company.** To appreciate our preference, first you need to understand some of the advantages and disadvantages of the other entities.

Sole proprietorship: A sole proprietorship is the most straightforward but risky way to structure your business entity. Sole proprietorships are easy to set up. No separate entity must be formed. A sole proprietor's business is simply an extension of the sole proprietor. For federal income tax purposes, all business income, gains, deductions, or losses are reported on Schedule C of your individual Form 1040. State income tax returns and local municipal earned income tax returns use similar forms. Sole proprietors are liable for all business debts and other obligations the business might incur. This means that your personal assets (e.g., your family's home, savings, and investments) can be subjected to the claims of your business' creditors. *Do you want to expose your family to such risks?*

General Partnership: If two or more people are the owners of a business, then a partnership is a viable option to consider. In a general partnership, all partners have the capacity to act on behalf of one another to further business objectives. A partnership does file federal and state income tax information returns. The allocated income, gains, deductions, and losses of the partnership are usually reported on each partner's individual federal, state, and local income tax returns. The partnership entity is generally not subject to federal, state, and local income taxes. Each partner is personally liable for any acts of the others; and all partners are personally responsible for all of the debts and liabilities of the business! One partner with deep pockets could pay the debts caused by another partner with empty pockets. *Do you want this risk of loss, which could ruin your family?*

C Corporation: Corporations offer some advantages over sole proprietorships and partnerships, along with several important drawbacks. The two greatest advantages of incorporating are that corporations provide the greatest shield from individual liability and are the easiest type of entity to use to raise capital and to transfer ownership. A corporation may outlive its shareholders. **C corporations** are generally subject to federal and state corporate income taxes, state corporate capital stock or franchise tax, and state corporate loans tax. The US corporate income tax rates range from 15% to 35% and the Pennsylvania corporate income tax rate is 9.99%. Therefore, the distributed earnings (dividends) of your incorporated business may be subject to *double taxation*, corporate income taxes as well as individual income taxes. "Personal service corporations", such as lawyers and doctors, pay the 35% maximum corporate income tax rate starting on the first dollar of net profit! *What does this extra tax mean to you?*

S Corporation: All corporations are classified automatically as **C corporations**, which pay their own income taxes. The C corporation and its shareholders may elect **S corporation** status, which means the corporate income and losses are passed through to the shareholders similar to partnerships. The S corporation generally pays no corporate income tax. The shareholders pay income taxes on their allocations based only on their relative shares of stock, unlike with partnerships. *This eliminates the double taxation, but does not favor the high income tax bracket shareholders.* No complex allocation formulas are permitted as in partnerships. This means, high income tax bracket shareholders do not get any benefit over low income tax bracket

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shareholders! Losses may be passed through to S corporation shareholders only to the extent of their individual investments, loans, and accumulated previously taxed income retained in the business. Losses covered by mortgage loans signed by the corporation *but not individually cosigned by the shareholders may not be passed through to the shareholders* for deduction in their individual income tax returns. Those limited losses are suspended and deductible in future years, after the shareholders have invested or lent more money to the S corporation or it has profits. *Do you want these limitations?* The rules are very complex.

Limited Partnership: Limited partnerships were popular prior to the availability of limited liability companies. They were attractive alternatives to the S corporations, because they were more flexible and allowed more losses to be passed through. A general partner managed the business and had *unlimited liability* for the limited partnership's debts. The limited partners had limited liabilities; however, they were denied the option of participating in management. The limited partners were merely passive investors. Allocated losses were restricted to the amounts the limited partners invested and loaned to the limited partnership. Thus, limited partners were denied loss deductions, unlike general partners and limited liability company members. They were popular in "tax shelters" in the 1970s and 1980s. These were complicated with inherent limitations. Hence, they have lost popularity and have been replaced by limited liability companies.

Limited Liability Company: A limited liability company (LLC) is a hybrid of a partnership and a corporation. It has the best features of each and excludes their worst features! An LLC can be treated like a corporation for liability purposes and can be taxed as a partnership or a sole proprietorship. Income, losses, and other tax attributes may pass through to the owners (called "members") either pro rata or as allocated in the operating agreement. The limited liability company allows much more flexibility than a limited partnership or an S corporation. LLCs allow members to deduct losses covered by debts of the LLC, which the individual members *did not co-sign*, such as bank mortgage loans to the LLC. S corporations do not. Larger deductions and losses maybe allocated to members in higher income tax brackets. The allocation formulas can be very complex, granting privileges disproportionate to ownership percentage, income level, work effort, age, and capability! It is a fine way to steer income to children, parents, charities, non-voting members, etc. in lower income tax brackets. Unlike with salaries, the IRS may not challenge whether the allocation is fair or earned. The voting members may change the formulas frequently. We help our clients develop and manage those formulas to save income taxes and preserve wealth. We organize and manage the proper accounting and prepare the necessary tax forms and reports. LLCs have many more features and benefits, which we did not explain here.

The limited liability company form of entity is a good choice for almost any type of business venture. It is well suited for real estate investments, passive investments, and joint ventures between existing companies. It is usually suitable for professional organizations, medical service organizations, and for family businesses that want to keep control within the family. It also popular with huge partnerships, such as national real estate firms, investment groups, and national law firms. LLCs are replacing corporations in many initial public offerings.

The choice of entity selection is complicated but very important. Do you want the maximum tax savings, flexibility of income and ownership, and protection of your assets? An LLC is less complicated and less expensive to establish than is a corporation. Ongoing legal requirements are less than in a corporation. Would you like to change your entity type as your business grows? Keep your options open and plan your future. These decisions can make a major impact on your net after-tax income and wealth! The above advice is too general to apply automatically to your specific business. Meet with us for individual consultations about your entity selection and operation.

William N. Goodman, CPA has 44 years of experience in tax planning and reporting, since 1963. Goodman & Company, CPAs has over 200 years of combined experience specializing in businesses, having served over 5,000 clients.
Our accountants seek every advantage and provide you with leading edge tax strategies and concepts to save your taxes and increase your bottom line.

Call us today for a free consultation, 610-253-2745. ***Profit from our experience!***

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