Choosing a Business Entity

An Informational Resource Created by

MAINSTREET
Tax & Accounting

Plain English Edition

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Dear Entrepreneur:

We hope this guide is useful for you to better understand business entities. If you have heard countless testimonials for or against various business entities, or have tried to do your own research and now just feel confused, you are not alone.

There are two main reasons why selecting a business entity is normally difficult:

1. It involves legal and taxation issues that can be hard to understand (at first).
2. Lawyers and accountants have traditionally held opposing views on the matter!

Generally speaking, lawyers are pro LLC and accountants are pro S-Corp. This guide will help you understand why this opposition exists and where you can find some middle ground for your business without the confusion.

If at any point you need direction or assistance, MainStreet stands ready to help. We will help you understand the day-to-day, real life accounting habits you can adopt in small business without pulling you away from your business. You are welcome to call us toll free at 1-877-871-7901 or email us questions at support@msftaxes.com. Visit www.msftaxes.com for additional tools and resources.

We look forward to continually working with you in the future.

Sincerely,

The MainStreet Team

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TABLE OF CONTENTS

INTRODUCTION

Business entities are tools. Like other tools, business entities only become effective when you use them properly and for the purpose for which they were created. You have probably witnessed the disaster that can result when a tool was misused, such as an automobile or industrial accident. Entities are tools that can provide great legal protection and tax relief for business owners; however, if misused or misunderstood, they can result in a disaster, with wreckage far more expensive to fix than a crumpled automobile. Entities must be matched to the business model that best supports the legal and taxation structures associated with them. They must also be carefully maintained based on the requirements associated with each entity.

Properly selecting a business entity should be done with guidance from experienced professionals with both legal & accounting experience. To ensure that our advice is unbiased and accurate, MainStreet has partnered with lawyers and other legal professionals in order to guide you to the entity(s) that will provide you with both the legal and tax benefits right for your particular business.

Liability Protection

Business entities are designed to act as walls between personal assets and business creditors. This protective wall is called the “corporate veil” and protects business owners from losing their homes, vehicles and other personal belongings to their business creditors. While there are certainly many entrepreneurs who must risk personal finances to get into business, such as mortgaging a home or using personal property as collateral on a business loan, there is far more uncertainty if all your belongings are at risk in every business relationship you create. Without an entity’s liability protection, business owner’s personal and business assets are indistinguishable, like a giant piggy bank with all of your personal and business resources mixed up inside. In the event that the company is responsible for paying damages, nothing is left off the table. Business entities separate personal and business liability such that only the business belongings are at risk. Business owners can ensure that the protection of their corporate veil remains intact by complying with all requirements of their particular entity and by maintaining separation between personal and business finances.

Do not underestimate the level of exposure you carry on a daily basis and the lengths people will go to get money from you and your business. You, like most entrepreneurs, probably do not expect to be sued; however, even honest, trustworthy business owners can be found liable for damages when they themselves did not do anything wrong. Employee misconduct, product defects, accidents involving company vehicles and other unforeseeable issues can still put legal responsibility on you as the business owner. In the event your business becomes responsible to pay damages greater than you are able to pay through insurance or cash, the right business entity will protect your home, vehicle(s) and other personal assets that are not owned by the business from being taken.

Small Business Taxation

The taxation and terminologies between various business entities vary and will be explained with each section; however, almost all of the significant differences in taxation relate to how the owner is taxed on their portion of the company's profits. Some business entities are designed to reduce these taxes for their owners while other entities do nothing to reduce these taxes.

ENTITY DESCRIPTIONS

In this guide, we will discuss the most commonly used business entities, namely, Partnerships, Corporations (C-Corp's), and Limited Liability Companies (LLC's). We will also describe a popular tax adaptation available to Corporations and LLC's known as "s-election." While Sole Proprietorship is not considered an entity itself, we will also discuss the pros and cons associated with operating a company without an entity structure.

Sole Proprietorship

Sole Proprietorship is a lack of a business entity. You do not "organize" a Sole Proprietorship; you simply start doing business without an entity. Hobby business owners, 1099 sales reps and anyone else operating their own side business are considered Sole Proprietors if they have not created any other entity, regardless of whether they have a business license or any other necessary certifications. Sole Proprietors may operate under a registered business name, called a DBA (Doing Business As), which is registered within their State. In a Sole Proprietorship, even if personal and business finances are separated between different bank accounts, and recordkeeping is done flawlessly, personal and business finances are legally indistinguishable. All personal and business assets are exposed and at risk. In today's society, it is extremely dangerous and even foolish to operate a viable and successful business as a Sole Proprietor.

Because a Sole Proprietorship is not an actual entity, the company's profits are simply reported on the owner's personal tax return as self-employment income. As part of a standard 1040 individual tax return, there is a specific form, known as a Schedule C, to report self-employment income. Total revenue is reported in addition to the company's expenses. The resulting profit is then subject to self-employment tax.

Self Employment Tax

Self-employment tax represents the Social Security and Medicare taxes (FICA) normally withheld from a wage earning employee's paycheck. When a W-2 employee gets a paycheck, 7.65% of their earnings is deducted for FICA and their employer pays an additional 7.65% on the same wages. When an individual is self employed, they are responsible for paying both the employee and employer portions of FICA on their earnings, a total of 15.3% of their net profit. The traditional formula* for self-employment tax is as follows:

$$\text{Self-employment tax} = 15.3\% \times .9235 \times \text{Net Profit}$$

Self-employment tax is calculated along with your regular income tax in the spring. If you normally get a refund, the self-employment tax will be deducted from that amount. If you normally owe additional taxes in the spring, the self-employment tax will be added to it. Self-employment tax can be greatly reduced by certain entities; therefore, it is not advisable for profitable businesses to remain Sole Proprietorships.

Due to the lack of legal liability protection, as well as self-employment tax, a Sole Proprietor is not an ideal entity for any profitable business venture.

*Temporary tax reductions have been made to Social Security which affects the SE tax formula

Partnerships: General & Limited

A Partnership is formed by two or more owners who share the profits of their joint business according to an agreed percentage of ownership in the company. Partners can create a Partnership Agreement which lays out basic terms of the relationship, including percentage of ownership. In terms of legal liability protection, a General Partnership is no different than a Sole Proprietorship in that they do not provide legal protection between personal assets and business creditors.

The difference between a Sole Proprietor and a General Partnership is that partners assume "mutual agency" for the actions of other partners, including contractual obligations. This means that each owner is not only responsible for their own mistakes, but can also be held personally liable for the actions or misconduct of their business partners!

Limited Partnerships and other variations can provide limited protection to certain partners based on their level of involvement in the company. A Limited Partner is a silent partner, such as an investor, and is only liable up to their level of contribution into the company. For example, if a Limited Partner contributed $20,000 into a business as a silent owner and the other partner created a company liability for $1,000,000, the Limited Partner would only lose the original $20,000 he had contributed to the company, whereas the other partner would be at risk of losing personal property just as a Sole Proprietor if he was unable to pay in full.

Partnerships are "pass-through entities," this means that all profits and losses flow to the respective partners and are not taxed at the company level. Like a Sole Proprietorship, Partnerships are subject to self-employment tax. Each partner is responsible to pay self-employment tax on their percentage of the annual profits, regardless of whether the money was actually passed on to the partners or reinvested in the company. Partnerships file a separate tax return for their business on IRS Form 1065 which simply reports the revenues, expenses and profits of the company and splits the profits between the owners listed on the return. Once the business return is completed, each owner is given a K-1, similar to a W-2 that employees receive. The figures on the K-1 are then used when filing your personal income tax return and reported your earnings from the Partnership as self-employment income, subject to self-employment tax.

Partnerships are risky and generally not recommended. Not only are you as legally vulnerable as a Sole Proprietor, but you are also responsible and liable for the actions of your partners. Given that your profits are also subject to self-employment tax, Partnerships are arguably one of the worst entity choices for entrepreneurs given the availability and benefits of alternative structures.

Corporation (C-Corp)

A Corporation (C-Corp) operates as a stand-alone entity from its owners (called shareholders). This separation means that the corporation acts as a completely independent unit. Shareholders do not assume personal liability for the C-Corp assuming all finances are kept separate and corporate regulations are followed.

All corporations are required to hold certain annual meetings, such as shareholder and board of director meetings. They are also required to keep minutes of those proceedings in their corporate records. In at least one of these meetings, officers must be nominated and elected annually. Corporations are also required to create corporate resolutions for financial actions, such as incurring debts or opening credit cards/bank accounts, and keep a copy of these resolutions in their corporate records. By failing to comply with any number of these requirements, corporations can jeopardize their legal protection by not matching "substance" with "form."

Corporate ownership is transferred via the sale of stock. C-Corps are able to offer various classes of stock. C-Corps are often used when wanting to raise significant capital to fund large ventures and are the primary organization when a company makes a public offering of stock.

C-Corps are not pass-through entities. Profits of the company are taxed on the corporate level using IRS Form 1120. Profits can be kept in the company or paid to the shareholders. Profits can be paid to the shareholders via two methods: payroll and dividends. Losses are kept at the corporate level and cannot be passed onto shareholders.

Payroll wages are subject to FICA taxes, 7.65% from the company and another 7.65% from you as the payroll recipient. As the employee and employer, you will ultimately pay 15.3% on your earnings just as a Sole Proprietor, the main difference being that the taxes will be paid in two parts, one from the business and the other from your paycheck.

Dividends are payments of profit to shareholders from the company; however, they are not deductible as an expense to the business. This means that as an owner, you will pay taxes on the profits at the corporate level, then again on a personal level when the dividend has been paid to you. Paying taxes twice on the same income (double taxation) it what makes C-Corps unfavorable for most small business owners.

C-Corps can be advantageous in specific tax planning scenarios such as working with limits of depreciation when purchasing capital assets. Individuals and companies are given limits as to how much depreciation they can claim on their assets in a given year. Because C-Corps are independent entities, each one is given their own limit. This allows companies making investments of $250K+ the ability to purchase the equipment through multiple C-Corps, lease the equipment to their operating company, and be able to depreciate multiple times more than they otherwise could. For example, a single company purchasing $1,000,000 worth of equipment may only be allowed to write of $250,000 in depreciation in the year it was purchased; however, if four C-Corps were organized to each purchase $250,000 worth of equipment and lease it back to the operating company, each C-Corp would be allotted their own $250,000 limit and the entire $1,000,000 of equipment could be depreciated in a single year. If you are not purchasing equipment over the depreciation limits, this strategy would not be effective.

C-Corps are powerful tools when used properly, but remember, they are not favorable for most small business owners due to their taxation. In most cases where C-Corps should be used for small businesses, it is favorable for the owners to begin with a pass-through entity and transition to the C-Corp at a later date when it will provide the maximum benefit. Too often, entrepreneurs create C-Corps with intentions of attracting investors or "going public," yet they do not achieve those goals for 1-2 years down the road, if at all. In those situations, any losses incurred by the business (which usually come in years 1-2) are lost to the owners and cannot be used to reduce their individual tax liabilities.

S-Corporation (S-Corp)

An S-Corporation, or S-Corp, is a C-Corp that has been modified into a flow-through entity for taxes. This change is very favorable for small business owners. It allows owners to pay FICA taxes (15.3%) on a "fair & reasonable salary" in place of self-employment tax (also 15.3%) on their entire net income (This will be further explained in a following section of this guide). All S-Corps begin as C-Corps and file a document (Form 2553) to make the "s-election." The election is designed to provide a corporate veil to small business owners without the double taxation disadvantages of a traditional C-Corp. S-Corps file taxes on IRS Form 1120S.

Similar to Partnerships and LLC's, all profits and losses pass through the S-Corp to the shareholders; however, unlike Partnerships and LLC's, S-Corp shareholders can select their own 'fair and reasonable' salary subject to payroll taxes (FICA) in place of paying self-employment tax on their entire net income. S-Corps are extremely popular among small businesses and traditionally recommended by CPA's for their superior tax structure. S-Corps are required to comply with all of the corporate regulations associated with C-Corps including meetings, minutes and corporate resolutions. For firms looking for investors, S-Corps can have 100 unsophisticated, unrelated investors and can issue only one class of stock.

Limited Liability Company (LLC)

A Limited Liability Company is an extremely user friendly entity and quickly becoming the most popular entity for small business owners. LLC's are easy to manage. They provide a strong legal veil between personal and business assets without requiring compliance to a long list of corporate regulations. In addition to their ease of operations, they are governed by an Operating Agreement that can be customized to each company. Attorneys favor and recommend LLC's more than other entities due to their flexibility and liability protection unhindered by corporate regulations. LLC's are allowed 35 unsophisticated, unrelated investors and issue units of ownership in place of stock.

For taxes purposes, LLC's are pass-through entities. All profits from an LLC are taxed on the owner's individual tax return(s) and not taxed on a company level. LLC owners are called members. Members can be classified as either 'passive' or 'non-passive.' Generally speaking, entrepreneurs are non-passive; they are involved in the daily operations of their companies and are working to find clients, fulfill orders and make profit. Non-passive members who actively manage the company are called managing members. Managing members are required to take a “fair & reasonable guaranteed payment to manager” which compensates them for their work just as though they were hired as an outside manager. Guaranteed payments to managers are subject to self-employment tax. Once expenses have been paid for the company, including the guaranteed payment to managers, the remaining profits are split among all members of the LLC, including the managing members, according to their percent ownership in the company.

Profits paid to passive members who do not directly engage in operational activities are not subject to self-employment tax. This means that silent partners or LLC’s used solely for passive investments, such as a rental property are not charged self-employment taxes on their earnings.

Unlike Partnerships and Corporations, there is no tax return specific to LLC’s. An LLC owned by a single member is classified as a “disregarded entity” for taxation, meaning the owner will report their business on a 1040 Schedule C as though they were a Sole Proprietor. An LLC with multiple owners files taxes as a Partnership on a 1065 where all non-passive members are subject to self-employment tax. Unless the LLC is “s-elected” with the IRS, which will be explained next, an LLC only provides a legal shield and does not provide any tax benefit to the owner(s).

S-Elected Limited Liability Company (S-LLC)

An S-LLC provides the legal advantages of an LLC, yet the taxes are filed on an 1120S, receiving the tax benefits of an S-Corp. In this type of organization, rather than paying self-employment tax on their net income, members are only required to pay FICA taxes on a “fair and reasonable” salary that they select, just like an S-Corp. A fair and reasonable salary can be selected by using industry standards for a particular position of management in the company, or by getting information from their local Department of Workforce Services. In some cases, the salary could be selected as a percentage of the profit, perhaps 30-50% of the profit. Profits that are not paid to the owner as a salary can be transferred to the owner as distributions, not subject to payroll or self-employment taxes. Distributions are not deductible as an expense to the company or the shareholders, but simply act as a way for owners to move money from their business to their personal accounts.

While taxed as an S-Corp, an S-LLC is not required to have the same meetings & documentation requirements of an S-Corp. For all liability issues, the entity is treated as an LLC. For all tax issues, the entity is treated as an S-Corp. For the average entrepreneur, the s-elected LLC is far superior to any other entity option for both legal and tax purposes.

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WHEN SHOULD YOU CREATE AN ENTITY?

In terms of legal liability, it is ideal to have an entity in place before you ever start operating your business, whether profitable or not; however, this really becomes a matter of risk and comfort. Most entrepreneurs wait to create their entity until they are more vested in the company. It is not uncommon for hobby entrepreneurs, for example, to move on to other things after they experience a few months without profit. In that case, it's best to not have to worry about compliance or separate tax returns. Others plan to invest their time and resources over a much longer period of time and want to "start off right." Organizing an entity strictly for legal liability protection is much like buying earthquake insurance, you hope to never need it, but you buy it for peace of mind. Also, the purchase is made based on the risk level of the buyer and often neglected until the buyer feels like they have extra cash and can afford the extra comfort.

Break Even Point

Unlike liability protection, tax benefits of an s-elected entity are quantifiable. First off, companies are only taxed on their net profit; therefore, it is not necessary for a company without profit to have an s-elected entity. A regular LLC, especially if owned by a single member, does not require a separate tax return and is very easy to report on your personal income taxes. If a company will not be profitable for a full year, it is better to delay the s-election until the following year. Once organized, an s-elected entity can save a business owner approximately 8-9% of their net income that would have been paid in self-employment tax. Those savings obviously become more and more significant as the company grows. Once a company is s-elected, it is required to file an additional tax return and submit regular payroll reports/deposits. That being said, it only makes sense to s-elect if the savings are higher than the costs associated with having an additional return filed and payrolls processed. A breakeven point can be determined for each individual company, but they vary based on the type of entity currently owned, number of owners and the service provider's fees. See the following example:

Break Even Point Example

A single owner of an existing LLC wants to know if and when they should s-elect their LLC. They currently pay for their preparation and filing of their personal income taxes (single owner LLC is included in those personal taxes). Using MainStreet's pricing, over the course of a year, the owner would only pay a total ≈$660 for the s-election, business tax return and payroll processing, including submission of quarterly & year-end payroll reports. Using the $660 figure, the business owner should s-elect their LLC when they believe their profits are going to exceed $7,400 each year. It is at this breakeven point that the s-election will save enough to pay for the extra tax return and payroll. Any profit earned above $7,400 will result in savings back in the pocket of the business owner. If the company is expected to make less than $7,400/year, it is recommended that they maintain a simple LLC and pay the self-employment tax on their profits.

NOTE: LLC's have a 75 day window to s-elect. If that window is missed, you have the ability to s-elect each year from January 1st to March 15th for that coming year. It is best to call MainStreet or another skilled small business accountant to see if/when you should s-elect.

UNDERSTANDING THE SAVINGS OF AN S-ELECTED ENTITY

S-elected entities reduce taxes by paying FICA on a fair & reasonable salary in place of self-employment tax on net income. Here is a breakdown of how those savings are calculated:

Self-Employment Tax = Net Profit x .9235 x 15.30%

FICA = Fair Market Salary* x 15.30%

Annual Savings = Self-Employment Tax – FICA

*The fair market salary is selected by the business owner and their accountant. A salary should be selected that can be defended with documentation, such as an industry comparison or a report from the Department of Workforce Services. Salaries as low as 25-40% of net profit are regularly defended in audits when some form of documentation is available.

Savings for Different Income Levels

Net Income	Estimated Fair Market Salary	Self-Employment Taxes for Sole Proprietor/1099 Rep†	FICA paid on Market Salary†	Annual Savings
$35,000	$12,000	$4,945	$1,836	$3,109
$65,000	$22,000	$9,184	$3,366	$5,818
$95,000	$32,000	$13,423	$4,896	$8,527

† Based on 2009 SE tax formula and a fair market salary of ≈33% net income.

CONCLUSION

We hope this guide has given you additional insight into business entities and why S-LLC's are an ideal entity for most small business owners. If you have any questions as you continue to pursue your business, please contact us at support@msftaxes.com. Thanks and good luck!