

Choosing Your Business Entity

By David A. Solitare

This article summarizes the benefits and drawbacks of incorporating versus forming a limited liability company (“LLC”). While a complete analysis of every difference is beyond the scope of this article, I will discuss the major factors, and perhaps mention some other issues in passing.

Corporations

The primary advantage to incorporating a business is limited liability. While unincorporated individuals and partnerships are unprotected from claims of clients, creditors and others, corporate shareholders’ liability is limited. Unless the shareholder personally guarantees an obligation of the corporation, the shareholder will not be liable on it, so long as the corporation jumps through the hoops required by law. That is, if the business is carried on in the name of the corporation, its funds are not commingled with those of the shareholder, it observes the corporate formalities of minutes, bylaws and so forth, files tax returns and officer statements, etc., only its assets, and not those of the shareholders, will be liable to claims of creditors of the business.

The second advantage of doing business in the corporate form is that tax rates on net income in certain ranges may be lower than the rates on individuals. However, this advantage is probably eliminated by existing tax cut legislation. Furthermore, it is likely outweighed by the fact that if there are cash profits at the corporate level, and you wish to pass them to the shareholders (as dividends), to some extent they may be taxed twice. The specter of double taxation will deter many businesses from incorporating if they both expect significant profits and desire to distribute those profits to the shareholders currently. Of course, your accountant will do his best to minimize the corporation’s tax profits.

To avoid double taxation, the corporation will have to spend money on, for example, your salary, your pension plan and other employee benefits, etc., so that ideally at the end of the year little net income will remain. That is, unless the business is making so much money that you cannot avoid paying the double tax.

S Corporations

Another way to minimize double taxation is to elect S corporation status. In a nutshell, the profits of an S corporation are reported on its shareholder’s tax return; income is not taxed at the corporate level. S corporation pass-through treatment is most useful in three situations:

1. The business incurs losses useful as a deduction to the shareholder
2. The business has excess cash (after paying a healthy but reasonable salary and pension contribution) and wants to distribute it to the shareholders
3. The corporation has appreciating assets (such as real estate) which would be double taxed on liquidation.

Nevertheless, in real estate ventures, and other businesses or investments where leverage is important, I discourage the use of the S corporation, for tax reasons. The rule is that shareholders cannot take a

tax deduction for their share of corporate expenses without sufficient basis in their investment. “Basis” is a tax term meaning the amount of cash and other assets you contribute to the venture. Concurrently, S corporation shareholders cannot receive basis in nonrecourse debt, which is a major attribute of most real estate ventures. Because real estate financing typically relies solely on the property itself as security for repayment of the debt, it is said to be “nonrecourse” with respect to the property’s owners. Finally, to get around this limitation, the shareholders must lend money to the corporation directly; a guaranty of or cosigning the obligation does not work.

A corporation or other entity can provide many benefits to its employees. One popular benefit is a medical expense reimbursement plan, which reimburses employees for medical expenses not otherwise covered by insurance. The advantage to such a plan is that while non-self employed individuals may deduct such expenses only to the extent they exceed 7.5% of their adjusted gross income, the corporation can deduct the payments in their entirety. Additional benefits that a corporation may offer to its employees include a health and accident plan, a cafeteria plan, and nonqualified deferred compensation.

The major disadvantage of any business entity is the cost and additional administrative burdens:

- ◆ Your corporation must have its own checking account.
- ◆ Corporate formalities must be observed, and filings must be made.
- ◆ There will be additional legal and accounting fees as a result. The cost of incorporating will include filing fees, minute book, stock certificates, corporate seal, and legal fees for articles of incorporation, bylaws, initial minutes, preparation of filings, etc.
- ◆ You can expect additional annual legal fees for corporate maintenance.

Limited Liability Companies

On the other hand, for many new entities, and real estate ventures in particular, the form of choice is the LLC. If the LLC meets certain criteria, it is taxed as a partnership for tax purposes and also provides the limited liability of a corporation. You could say it offers the best of both worlds without the drawbacks of either.

S corporations have three primary drawbacks, which LLCs avoid:

1. The S corporation is limited to 75 shareholders, none of which can be foreigners, domestic corporations, or co-owners of partnerships.
2. An S corporation may not own more than 79 percent of another corporation.
3. The S corporation has less flexibility in allocating items of profit and loss among the investors than does an LLC.

The biggest drawback of the LLC is its initial cost. Every LLC should have an operating agreement, which contains all of the tax provisions applicable to partnerships. The other drawback of using an LLC in a multijurisdictional setting is that a few states do not yet recognize the LLC as an entity, which could affect its members' limited liability if the LLC does business in those states. This should not be a problem where the nature of the business places it in a specific California location.

Finally, you should be aware of the state tax differences between an S corporation and an LLC. Unlike the IRS, California taxes an S corporation's net earnings at 1.5%, with an \$800 annual minimum. On the other hand, LLCs pay a flat \$800 annual tax, plus a fee based on the company's gross income less cost of goods sold. There is no fee if gross income is less than \$250,000. The fee is \$900 if gross income is less than \$500,000, \$2,500 if less than \$1 million, \$6,000 if less than \$5 million, and \$11,790 if income exceeds \$5 million. Your accountant can help you determine the direction and extent to which this factor will affect your business.

Entity Formation and Capitalization Action Items:

1. Select a name for the entity. I would also urge you to consider picking alternate choices, in case the name is rejected by the Secretary of State. This can happen where the Secretary of State's office feels the name you select is too similar to the name of an existing entity. If a web presence is significant to your business model, confirm the availability of your desired web address.
2. If you want to use a corporation, confer with your accountant on the advisability of taxing the corporation under Subchapter S of the Internal Revenue Code.
3. Consider who should own the stock or LLC interests, and in what percentages.
4. If you use a corporation, decide who will fill the offices of President, Secretary, Treasurer, and any other positions you want. The same person can hold any or all of these offices. Also, decide who will sit on the Board of Directors. You need at least as many directors as there are shareholders, unless you have at least three directors. If you use an LLC, decide whether all members will be managers, or less than all.

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