Inc.

Everything you need to know to run your business in today's economy

A MONTHLY GUIDE TO POLICIES, PROCEDURES, AND PRACTICES

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REMOVE BOOKLET ALONG DOTTED LINE

HOW TO: CHOOSE THE RIGHT LEGAL STRUCTURE

Legally speaking, it's easy to start a company. A firm is by default a sole proprietorship or partnership unless its founders opt for another structure. Such a business is not distinct from its owners, and its income is reported on their tax returns.

And therein lies the key drawback of these basic forms: You have unlimited liability for your business's debts. You are personally liable for deals your partners make, even if you have an agreement that limits individual authority. And a mistake can cost you not just the company but everything you own.

So if you are starting a business, or you already run one but haven't thought strategically about its legal structure, you need to take this matter seriously. For limited liability protection—limited, that is, to what you have invested in your company—the choices come down to a limited liability company or a corporation. The decision is more complicated than it may seem: What the government leaves in one pocket, it takes from another. So sit down with a lawyer and accountant to weigh the options in light of your individual tax situation.

Keep in mind that liability protections are not absolute. Creditors may be able to pierce the corporate veil that separates a company from its owners' personal assets in cases of fraud, when the entities are inextricably linked, or when the company fails to adhere to the basic legal and reporting requirements.

STRUCTURING YOUR BUSINESS

1. Compare Options

The principal decision is whether you want your company to pay taxes on profits before they are distributed to owners or you want the profits to flow straight through to the owners' individual tax returns.

Limited liability company.
This structure essentially melds a partnership with the limited liability protection offered by a corporation. The LLC is a recent innovation—most states didn't recognize it until the mid-1990s—but because of its flexibility, lawyers have come to recommend it for most small companies. Only a few states put a limit on the number of owners (called members), which can usually include corporations, other LLCs, and foreign entities. Many states allow individuals to form LLCs, too.

How it works: Like a partnership, an LLC is a pass-through entity, meaning that profits, losses, credits, and deductions flow through to members' tax returns. An owner can use losses to offset other income, but only up to the amount he or she invested, which is called the basis. You can't, in other words, use a small investment to shelter a lot of income. (An LLC can choose to be taxed like a corporation without a formal change of structure, but this shouldn't be done lightly, because the decision is irrevocable.) In an LLC, unlike a corporation, income can be distributed unequally among members—the LLC could, for example, grant cash investors first dibs on profits, ahead of partners who contributed sweat equity.

Watch out for: LLC members can't distinguish between income earned as salary and passive investment income, so profits are subject to Social Security and Medicare taxes on top of income taxes.

Subchapter C corporation.
This is the basic type of American corporation, but relatively high tax rates make it unpopular among small companies. Because its shares can be freely traded among an unlimited number of owners, the C corp is the most tax-efficient vehicle for taking a company public. It is also the best vehicle for a tax-free merger in a stock swap.

How it works: The corporation files its own tax return and pays tax on its income. When profits are distributed as dividends to shareholders, they are subject to further tax—a double tax, some argue—on their individual returns. However, because the corporate tax rates for income below $75,000 are lower than the individual tax rates, some experts recommend a C corp for small growing companies that reinvest their profits. Unlike an LLC, a C corp can distinguish between active and passive income and pay employment taxes only on the salaries of the active shareholders.

Subchapter S corporation.
The S corp long reigned as the way to avoid the C corp's double taxation, but the arrival of the more flexible LLC has diminished the S corp's star. Ownership in an S corp is restricted to no more than 100 U.S. shareholders (a family can count as a single shareholder), with one class of stock. Normally, an S corp cannot be owned by another company or own one. Still, it remains a good choice for companies that can't legally organize as LLCs (such as banks or insurers) or would face higher taxes as LLCs, which is the case in California.

How it works: In S corps, income flows through to the individual shareholders, and federal tax is paid at the owner level. (Most states follow suit, but a few tax S corps at the company level in certain cases.)

Watch out for: S corps generally cannot deduct the cost of benefits provided to employee-owners holding more than 2 percent of the company. And while S corp owners currently enjoy the C corp's distinction between active and passive income, the IRS is trying to close that loophole for S corps, warns Jonathan Karp, an attorney and CPA with the Los Angeles law firm Reish, Luftman, Reicher & Cohen.

2. Anticipate Your Exit

Choosing a corporate structure isn't just about minimizing your current tax burden; it's also about looking ahead. If, for example, you anticipate a public offering or merger, it will be most tax effective to do so as a C corp, says Karp. If you anticipate selling the business outright, an S corp or LLC is a better vehicle. That's because buyers typically prefer (for tax and liability reasons) to structure a deal as a sale of assets, not as a sale of corporate stock. And a sale of

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assets translates into a higher tax burden for the seller of a C corp, because the profit is considered ordinary income to the company and is therefore taxed twice. By contrast, the owner of a pass-through entity like an S corp will usually pay only individual capital gains tax on the asset sale.

An LLC is a better option in the event that you simply dissolve the company. The IRS considers an LLC's assets to belong to its members, so when a business is dissolved and its property distributed, the IRS does not recognize a taxable event. Instead, the transaction officially occurs when the individual sells those assets. When a corporation is terminated, on the other hand, the IRS does view the distribution of assets to owners as a taxable event.

In some states, LLC members may not sell their stake without the consent of other members. A corporation shareholder, by contrast, can sell his or her stake without such approval—assuming there's no prior agreement to the contrary.

Regardless of the form you choose, consider drafting a buy-sell agreement that determines how partners can cash out. It is not cheap; Karp charges from $5,000 to $10,000 to draft one. But it can head off serious trouble. At the outset, "nobody is planning on retiring, getting disabled, or getting divorced, so the agreement is more likely to be fair and impartial," says Karp. If you wait until later, it becomes harder to negotiate.

And if you don't accurately anticipate your exit strategy? You may be able to change structures. See "Conversion Factors," next page.

CONVERSION FACTORS

Once a sole proprietorship or partnership becomes a corporation, it can't revert without great tax consequences. Apart from that, you have flexibility when it comes to changing the legal structure of your business and can, with some limitations, go from an S corp to a C corp and back.

What are the limitations? The IRS generally frowns on conversions that are obviously intended to avoid tax on transactions. For instance, a C corp that sells an asset that has appreciated in value cannot take the "S" election simply to avoid capital gains tax. (For the first 10 years, an S corp is liable for a special "built-in gains" tax when selling appreciated assets.) And a company that switches to S-corp status and revokes it can't do it again for five years.

Go corporate. Karp recommends making the transition to a C corp in the tax year prior to the year in which, say, you plan to go public or merge. A good rule of thumb is to allow at least six months, and ideally more than a full year, between the changeover and the transaction.

Wait for the new year. If you change your business entity in the middle of the year, you will have to file two tax returns, says Gail Rosen, a CPA in Martinsville, New Jersey. That will cost you more in accountant fees.

Switching to an LLC. It is easy to change a sole proprietorship or partnership into an LLC. Depending on the state, you file either a conversion form or new articles of organization, pay fees, and transfer authorities and IDs. In some states, partnerships also have to publish a notice of termination in the local paper.

NOTES:

DOING THE PAPERWORK

LLC: After choosing a unique name (which must end in a variation of *Limited Liability Company*), you file articles of organization with your state. Many states allow you to do so online; others provide a template to use. Though not required by law, an operating agreement that defines the basic rights and responsibilities of the LLC's members is also crucial.

Corporation: Incorporation begins by selecting a name and filing articles of incorporation, which in most states simply entails completing a registration form. (Filing fees vary by state, from $100 to $1,000.) Then, the founders must appoint directors and draft the company's bylaws, which stipulate how the business will operate. Finally, the new corporation must deliver stock certificates to its shareholders.

Resources

The plain-English legal publisher **Nolo.com** offers much information on business entities in its Nolopedia. See "Ownership Structures" on its Business & Human Resources page.

Visit **Inc.com's** Start-up Resource Center for a how-to guide on business formation. You will find articles from the pages of *Inc.* and other sources.

The National Association of Secretaries of State (**nass.org**) offers a Contact Roster with links to each state; you can find detailed business-structure information and forms and instructions, and often submit paperwork online.