

BUSINESS ENTITIES: ADVANTAGES AND DISADVANTAGES

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In last month's article we discussed the choices available for business entities and this month we will look at some of the advantages and disadvantages of these entities. An in depth discussion is prohibitive here and we will limit this review to C Corporations, S Corporations and Limited Liability Companies. (LLC's can be taxed either as partnership or corporation.) It must be emphasized this article discusses only the obvious advantages/disadvantages and your own situation should be reviewed by a tax/business professional based upon your particular factual situation.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA") became effective in 2003. This act revised the corporate income tax rates so that corporate rates are no longer significantly lower than individual rates and are, in fact, higher in some situations. However, JGTRRA also reduces the tax rate on "qualifying dividends" received by individuals through December 31, 2008 to a maximum of 15%. Since the original proposal was to eliminate tax on dividends, JGTRRA's impact on the entity choice is not as significant as anticipated. If the "dividend exclusion" had been adopted, S corporations (with a single level of taxation of income) would have diminished considerably. But with C Corporations earnings still subject to two levels of taxation S Corporations are relevant in some situations. In reality the client and professional must now study the facts and prospects for income more carefully.

The S Corporation: The major difference from a C Corporation is a single level of taxation passed through to the individual owners. You can obtain this same status by using a Limited Liability Company. So what are the S Corporations advantages over a C Corporation? Primarily it is the lower tax consequences to owners. These can be illustrated as:

1. Losses generated during the startup phase may be passed through to the owners.
2. Pre-JGTRRA C corporation rates were often considered preferable to higher individual rates. This is not necessarily true for 2003 through 2008 and the S may be preferable under certain situations.
3. When it is desirable to distribute earnings to the owners, an S Corporation pass-through status could be preferable. Without S status the distributed corporate income will be taxed at both levels – corporate and individual. However, one must consider the use of qualifying dividends from the C Corporation.
4. In considering a sale of the business an S Corporation may be preferred with its single level of tax (hopefully capital gain) when selling stock or the assets.

So how does the S Corporation compare to the LLC which is also a pass through entity. The LLC offers the limited liability of the S corporation and pass-through taxation with none of the S corporation restrictions on ownership and operations. Thus,

disadvantages of operating as an LLC would evolve around particular facts and circumstances of the parties and their preference of one form over the other.

Here is a list of some of the advantages/differences the LLC over the S Corporation.

1. Restrictions on Ownership. S corporations can have only one class of stock. Shareholders must be natural persons, and either U.S. citizens or resident aliens. An S corporation may have no more than 75 shareholders.

2. Special Allocations. S Corporations may not specially allocate tax attributes to its shareholders. Attributes pass through pro rata and this restricts the type of debt the corporation issues and can hamper efforts to shift control of family-owned businesses. The result is passive investments are more difficult to structure.

3. Deductibility of Losses. S corporations differ in the ability to obtain tax basis from its share of the entity's liability. This, in turn, determines the extent of losses that may be deducted by the owners, and their ability to receive operating distributions tax free. S corporation shareholders do not share in the entity liabilities and basis is limited to the cash actually invested. However, an LLC member and a limited partner increase their basis by the allocable share of entity liabilities. Also when an S Corporation distributes appreciated property trigger the gain passes through to the shareholders.

The Limited Liability Company: Previously we discussed sole proprietorships and it is important to remember that the one owner LLC is treated for tax purposes in the same manner. Hence profits are reported on your individual 1040 tax return as a part of Schedule C and self employment taxes must be paid. One must remember that this usually forces one into making quarterly estimated tax payments and that the self employment tax may have consequences beyond that of social security taxes. Also it is important to note that in both a single owner and multiple owner LLC all profits are taxed to the owners even though not distributed.

LLC's with multiple owners are treated as partnerships for IRS purposes unless they elect corporate treatment under IRS Form 8832. Hence the LLC files IRS Form 1065, Partnership Information Return and each owner is given a Schedule K-1 showing each owners income/loss and is attached to their respective 1040's.

In determining your choice of business entity, you should keep in mind the following disadvantages to the use of an LLC: In the legal/tax arena the forming and operating of an LLC is more uncertain because of the lack of guidance from established case law and regulations. This may be more theoretical than real. Although we are primarily concerned with Georgia law a recent trend is to form the business entity in other "friendlier" jurisdiction. Other states may not recognize all of the rights and privileges afforded to an LLC in Georgia. If the LLC has one or more members who are non-residents of the LLC state, it must file a list of members and consents with its annual state tax return. In some jurisdiction when a non-resident member fails to consent to the forming state's tax jurisdiction, the LLC must pay the tax attributable to

the non-consenting member's distributive share of LLC income. Finally, the members of an LLC may have implied authority to act on behalf of the LLC and bind the LLC, e.g. signing of deed of trust (mortgage). Consequently, as emphasized last month, your operating agreement is very important and should be considered carefully

The "C" Corporation: We have already discussed the S Corporation and its pass through benefits and discussed the JGTRRA and how it still requires one to consider both the C and S Corporation with their separate and distinct advantages/disadvantages. If anything, JGTRRA has forced the professionals to examine the choice of the S versus the C more carefully. Now we will spend our time on the C versus the LLC.

Looking first to the disadvantages of an LLC Relative to "C" Corporation one must consider the issues of retained earnings and fringe benefits.

1. Retained Earnings. If your business intends or may retain substantial earnings you may prefer the corporate structure. However, with the JGTRRA changes one must carefully consider and weigh the options and consequences. Additionally you should consider and study the projections for your entity and calculate the pro forma after-tax performance before making a decision.

2. Fringe Benefits. For an investor starting and expecting a business to continue in existence as opposed to being a single project the issue of fringe benefits can be controlling. An LLC taxed as a partnership cannot provide many of the fringe benefits that a "C" Corporation can. Members are not "employees" for purposes of the fringe benefit rules. See, e.g., IRC 5105(9) relating to accident and health care plans and IRC #79 relating to group term life insurance. If the LLC provides members with fringe benefits, the cost must be included in the member's gross income. Some states also allow more favorable retirement plans/benefits for C's so you must check your state of origin carefully.

SUMMARY: One of the most important and threshold issues in starting a new venture is the choice of business entity. The first decision is making the choice is whether a pass through is desired. If not, the C Corporation is probably your entity. However, if pass through is desired along with limitation of liability (who would not seek this), you are now ushered to either an LLC or an S corporation. There are some situations whether the business is passive and no significant liability attaches (very rare indeed in today's world) and then you might choose a general partnership.

In most situations the LLC will probably dominate where one previously used either the S Corporation or the limited partnership and in some situations also where one used the C Corporation. This is true even in light of the advantages extended to C Corporations by JGTRRA. One must carefully consider all factors. But the avoidance of the entity level tax and the pass-through of the character of the income and/or the availability of losses to offset income from other sources, will prove advantageous in most cases. When the owners decide to sell or transfer the business to successors, they

will be no corporate level tax and the proceeds of sale will generally qualify for capital gain treatment at the member or shareholder level.

Still, the "C" corporation does have its advantages in the benefit area, particularly with respect to the availability of nontaxable fringe benefits and asset protected retirement plans. Hence, as stated repeatedly, one must carefully consider long term goals in electing the choice of business entity. My clients generally prefer to continue using the "C" corporation in circumstances where a "C" corporation was formerly used.

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