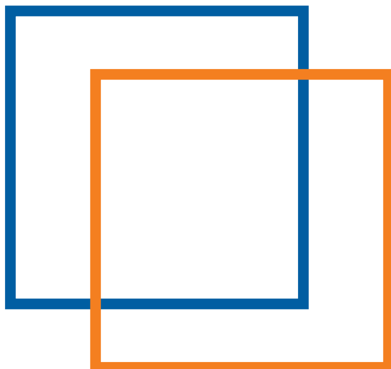
Clarifying Taxes So You Take Control of Your Money

Business Entities

The Guide to Choosing the Right Entity for Your Business



Copyright 2020 Bradford Tax Institute

BRADFORD TAX INSTITUTE

Table of Contents

All About Limited Liability Companies (LLCs) 1

Should You Operate Your Business as a Partnership
(or an LLC Taxed as a Partnership)? 9

Beware of the Dark Side When Considering the C Corporation 16

Is the S Corporation the Best Tax-Deduction Entity
for Your Business? 21

Choosing the Right Entity for a Newly Acquired Business (Part 1) 28

Choosing the Right Entity for a Newly Acquired Business (Part 2) 33

Choosing the Right Entity for a Newly Acquired Business (Part 3) 41

Five of Our Popular Articles 48

All About Limited Liability Companies (LLCs)

Limited liability companies (LLCs) are a popular choice of entity for small businesses and investment activities.

Reason. LLCs have legal and federal income tax advantages that we will explain here.

LLC owners are called members.

- Single-member LLCs have one owner, although spouses who jointly own an LLC in a community property state can elect treatment as a single member LLC for federal income tax purposes.
- We will call LLCs with two or more members multimember LLCs.

Key point: LLCs are not corporations. But LLCs can offer similar legal protection to their members (owners).

Here are the most important things to know about LLCs.

LLCs Offer Legal Protection

Using an LLC to conduct a business or investment activity *generally* protects your personal assets from LLC-related liabilities—similar to the legal protection offered by a corporation.

As you know, liabilities can arise from simple things—like the Federal Express guy slipping on the banana peel someone left on your front steps—or in seemingly endless and complicated ways if you have employees.

Key point. As a general rule, no type of entity (including an LLC) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts.

Tortious acts are wrongful deeds other than by breach of contract—such as negligent operation of a motor vehicle resulting in property damage or injuries. The issue of liability protection offered by an LLC is a matter of state law. Seek advice from a competent business attorney for details.

Single-Member LLC Tax Basics

Single-member LLC businesses owned by individuals are treated as sole proprietorships for federal income tax purposes unless you *elect* to treat the single-member LLC as a corporation.

In other words, the *default* federal income tax treatment for a single-member LLC business is sole proprietorship status.[1] Under the default treatment, you simply report all the single-member LLC's income and expenses on Schedule C of your Form 1040.

If the single-member LLC business activity generates net self-employment income, you will report that on Schedule SE of your Form 1040.

Rental. If the single-member LLC activity is a rental activity, you report the rental income and expenses on Schedule E of your Form 1040.

Farm or ranch. You report the numbers for a farming or ranching activity on Schedule F.

Simple. You don't need to file a separate federal income tax return for the single-member LLC. And other things being equal, simple is good.

Three key points

1. The big federal income tax advantage of operating as a single-member LLC is extreme simplicity.
2. The big non-tax advantage is liability protection, under applicable state law.
3. As mentioned, you can elect to treat a single-member LLC as a corporation for federal income tax purposes, but we don't recommend that, for reasons we explain later.

Multimember LLC Tax Basics

Multimember LLCs are treated as partnerships for federal income tax purposes unless you *elect* to treat the LLC as a corporation.

In other words, the *default* federal income tax treatment of a multimember LLC is partnership status.[2] Under the default treatment, you must file an annual partnership federal income tax return on Form 1065.

From the Form 1065 partnership return, the LLC issues an annual Schedule K-1 to each member to report that member's share of the LLC's income and expenses. The member then takes those taxable and deductible amounts into account on the member's own return (Form 1040 for a member who is an individual).

The LLC itself does not pay federal income tax. This arrangement is called *pass-through taxation*, because the income and expenses from the LLC's operations are passed through to the members who then take them into account on their own returns. (The same pass-through taxation concept applies to entities set up as "regular" partnerships under applicable state law.)

Partnership Taxation Advantages for Multimember LLCs

Before the Tax Cuts and Jobs Act (TCJA), multimember LLCs treated as partnerships for federal income tax purposes were often the preferred choice of entity for business and investment activities with more than one owner—mainly because of the favorable federal income tax treatment of partnerships and partners.

Those favorable partnership taxation rules are still around after the TCJA, so let's review how they work for an LLC treated as a partnership for tax purposes and for the LLC's individual members, who are treated as partners for federal income tax purposes. Here goes.

Pass-Through Taxation

As explained earlier, your share of the LLC's taxable income, gains, deductions, losses, and credits are passed through to your personal Form 1040 under the partnership taxation rules, with the resulting federal income tax consequences at your personal level.

Deduct LLC Losses on Form 1040 (within Limits)

You can deduct LLC losses passed through to you on your personal return, subject to various federal income tax limitations. The limitations can include

- the passive loss rules,
- the at-risk rules,
- the excess business loss disallowance rule, and
- the LLC membership interest basis limitation rule.

Qualified Business Income Deduction

Thanks to the TCJA, the qualified business income (QBI) deduction is potentially available to individual LLC members for 2018-2025. The deduction can be up to 20 percent of QBI passed through to you from an LLC.[3] At higher income levels, hurdles and limitations apply. The Section 199A QBI deduction will expire at the end of 2025 unless Congress extends it.

Basis from LLC Debts

Under the partnership taxation rules, you receive additional tax basis from your share of LLC liabilities for purposes of determining the amount of passed-through LLC losses you can deduct.[4] This is a significant tax advantage. It allows you to deduct passed-through LLC losses in excess of your investment in the LLC membership (ownership) interest—subject to various federal income tax limitations.

Basis Step-up for Purchased LLC Interest

If you purchase an LLC membership (ownership) interest from another member (owner), you can step up the tax basis of your share of LLC assets to fair market value, under the partnership

taxation rules. The basis step-up minimizes taxes for you when the LLC later sells appreciated assets or converts them to cash.[5]

Tax-Free Transactions with the LLC

The partnership taxation rules give you much greater flexibility to make tax-free transfers of assets (including cash) between you and the LLC, compared to operating as an S or C corporation.[6]

Special Tax Allocations

Thanks to the partnership taxation rules, LLCs can make special (disproportionate) allocations of taxable income, tax deductions, and tax losses among the members.

For example, a 50 percent high-tax-bracket member (you) could be allocated 80 percent of the LLC's depreciation deductions while the 50 percent low-tax-bracket member (the other guy) is allocated only 20 percent of the LLC's depreciation deductions. Later on, the high-bracket member (you) could be allocated more of the LLC's income and gains to compensate for the earlier special allocations of depreciation deductions.

Partnership Taxation Disadvantages for Multimember LLCs

Partnership taxation is not all good news. Keep the following two important tax *disadvantages* in mind when evaluating the wisdom of operating as a multimember LLC that will be treated as a partnership for tax purposes.

1. Exposure to Self-Employment Tax

You may owe self-employment tax—consisting of the 12.4 percent Social Security tax component and the 2.9 percent Medicare tax component—on most or all of the income passed through to you by an LLC.

At higher income levels, you may also owe the 0.9 percent additional Medicare tax. In contrast, if you operate as an S or C corporation, Social Security and Medicare taxes (FICA tax) are owed only on amounts paid out as salary to you and the other members (owners). This factor favors operating as a corporation, and it can be an important factor.

2. Unfavorable Fringe Benefit Tax Rules

Compared to C corporations, multimember LLCs treated as partnerships for tax purposes cannot provide as many tax-free fringe benefits to their members (owners). This factor favors operating as a C corporation, but it's usually not a terribly important factor.

For instance, say your multimember LLC treated as a partnership for tax purposes pays health insurance premiums for you and the other members (treated as partners for tax purposes), for

services rendered to the LLC. The LLC treats the premiums as deductible guaranteed payments made to you and the other members.[7]

In turn, you and the other members must report the insurance-generated guaranteed payment as income on Form 1040. Usually, you can then write off the insurance amount on your Form 1040 as a self-employed health insurance deduction.[8]

Because the guaranteed payment income and the self-employed health insurance deduction offset each other, you get no net fringe benefit write-off. In contrast, if you operate as a C corporation, the corporation can deduct the cost of health insurance coverage provided to employee-shareholders, and the coverage is a tax-free fringe benefit for the employee-shareholders.

Key point. The unfavorable partnership fringe benefit taxation rules that apply to multimember LLCs treated as partnerships for tax purposes and their members also apply to S corporations and their shareholder-employees. Strange but true![9]

C Corporation Option Deserves Consideration

The TCJA permanently installed a flat 21 percent corporate federal income tax rate for tax years beginning in 2018 and beyond.

Before the TCJA, the conventional wisdom was that, for tax reasons, most small business activities should be conducted using a

- sole proprietorship,
- single-member LLC treated as a sole proprietorship for tax purposes, or
- pass-through entity (multimember LLC treated as a partnership for tax purposes, a partnership, or an S corporation).

These choice-of-entity options were attractive mainly because (1) they avoided the pre-TCJA 35 percent federal income tax rate paid by profitable C corporations and (2) they avoided (and still avoid) the double taxation issue that still afflicts C corporations even after the TCJA.

That was then. This is now. In the post-TCJA world, we must compare the flat 21 percent corporate federal income tax rate with the federal income tax rates that individuals pay on income from a single-member LLC treated as a sole proprietorship for tax purposes or income passed through from a multimember LLC treated as a partnership for tax purposes.

For 2020, the maximum individual rate is 37 percent, but it's scheduled to increase to 39.6 percent after 2025. Obviously, 21 percent is a much lower rate than 37 percent or 39.6 percent. But consider the following potential negatives of C corporation status.

Double taxation. The C corporation double taxation issue still exists, although it has been toned down by the flat 21 percent corporate federal income tax rate.

Double taxation occurs when a C corporation is taxed once on its income at the corporate level and again at the shareholder level when shareholders receive taxable dividends paid out by the corporation.

But double taxation is not an issue for a C corporation that retains all or almost all of its profits to finance growth. Double taxation is also not an issue for a C corporation that pays out all or almost all of its income to shareholder-employees in the form of deductible salaries and fringe benefits.

No QBI deduction. A C corporation shareholder cannot claim the QBI deduction based on the corporation's income. That said, the QBI deduction is scheduled to disappear after 2025, if it does not disappear sooner.

Losses. If a primary tax goal is deducting losses from your venture on your personal return, operating as a C corporation is a bad idea, because C corporation losses cannot be passed through to the shareholders.

Appreciating assets. As in the past, it's generally still a bad idea to hold valuable assets that are likely to appreciate (such as real estate and intangibles) in a C corporation. If the assets are eventually sold for substantial gains, it may be impossible to get the profits out of the corporation without double taxation.

In contrast, gains from selling assets held by an LLC treated as a partnership for tax purposes will be taxed only once at the member (owner) level.

Electing to Treat the LLC as a Corporation for Tax Purposes

As stated at the beginning of this article, you have the option of *electing* to treat a single-member LLC or multimember LLC as a corporation for federal income tax purposes. You do that by filing IRS Form 8832, *Entity Classification Election*, to change the default classification of the single-member LLC or multimember LLC to the new classification as a corporation.

If your desire is to have your LLC treated as an S corporation, it can elect S corporation status directly using IRS Form 2553, or it can elect C corporation treatment on Form 8832 and then S corporation treatment on IRS Form 2553.

While there may be valid non-tax reasons for electing to treat an LLC as a corporation, we think tax reasons generally dictate against taking that step.

If you conclude that there are tax advantages to electing corporate status, why not just *actually* incorporate your operation in the first place? That's simpler. Keeping your tax matters simple is generally good policy.

Electing corporate status from the LLC could have unintended tax consequences. For example, you can potentially collect federal-income-tax-free gains from selling stock in a qualified small business corporation (QSBC). But you must own shares and hold them for over five years to

cash in on this super-favorable deal.[10] Can an LLC membership (ownership) interest count as QSBC stock for this purpose? Apparently not. It's not stock.

If you are looking for the QSBC stock break, just set up as a corporation in the first place.

Here's another example: a special federal income tax break allows you to annually deduct up to $50,000 of losses from selling eligible small business stock, or $100,000 if you're a married joint filer, and treat the loss as a tax-favored ordinary loss instead of a tax-disfavored capital loss.[11]

Can an LLC membership interest count as eligible stock for this purpose? Apparently not. It's not stock. Avoid the problem—set up as a corporation in the first place.

Don't Overlook State-Specific Factors

Sometimes the choice-of-entity question is decided based on state-specific issues. If we live in different states, what works for thee might not work for me. Do your homework to understand all the state legal and tax consequences for making a final decision about whether to operate as an LLC.

Key point. Under some state laws and/or applicable professional standards (such as state bar association rules), LLCs may be prohibited from operating certain types of professional practices.

Takeaways

Single-member LLCs offer liability protection plus super-simple federal income tax treatment.

Multimember LLCs taxed as partnerships offer liability protection and might be preferred for tax reasons, particularly if you desire to use special allocations of income and expenses.

When compared with the C corporation, the LLC offers the possible advantage of the Section 199A deduction.

But don't use the LLC if you plan to operate as a C corporation, because you would not qualify for favorable Section 1244 stock losses or Section 1202 tax-favored capital gains. If the goal is the C corporation, start with the C corporation.

The big downside to the LLC is the self-employment tax. It's something you have to weigh against the advantages you gain with the LLC.

---

[1] Per the so-called check-the-box entity classification regulations found in Reg. Sections 301.7701-1; 301.7701-2; 301.7701-3.

[2] Ibid.

[3] IRC Section 199A.

[4] IRC Section 752 and related IRS regulations.

[5] IRC Sections 743; 754.

[6] Under the partnership taxation rules, appreciated assets can often be transferred back and forth between members and LLCs with no adverse federal income tax consequences, thanks to IRC Sections 721; 731.

[7] Rev. Rul. 91-26; IRC Section 707(c).

[8] IRC Section 162(l).

[9] IRC Section 1372.

[10] IRC Section 1202.

[11] IRC Section 1244.

Should You Operate Your Business as a Partnership (or an LLC Taxed as a Partnership)?

Changes included in the Tax Cuts and Jobs Act (TCJA) force you and other small-business owners to reconsider whether a new venture should be conducted as a pass-through entity or as a C corporation.

Pass-through entities include partnerships and multi-member LLCs that are treated as partnerships for tax purposes.

LLC owners are called "members," and a multi-member LLC means an LLC with more than one member. For the rest of this article—unless we say otherwise—when we refer to LLCs, we will be talking about multi-member LLCs that are treated as partnerships for tax purposes.

So what should you think about the advisability of operating a business as an LLC or a partnership in the post-TCJA world? Good question. Please keep reading.

Multi-Member LLC Option Still Looks Good in Common Scenarios

Before the TCJA, LLCs were often the preferred small-business entity choice, mainly because they can take advantage of the favorable federal income tax rules for partnerships. We summarize those rules below.

Operating as an LLC also generally protects your personal assets from exposure to business-related liabilities. Such exposure can include everything from a lawsuit filed by the FedEx guy who slips on your ice-covered steps to the seemingly endless variety of liabilities that can be caused by the actions or inactions of employees.

Key point. No type of entity (including an LLC) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts. Tortious acts are wrongful deeds other than by breach of contract—such as negligent operation of a motor vehicle resulting in property damage or injuries.

The issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for full details.

Partnership Taxation Advantages

The generally favorable partnership tax rules, which apply equally to multi-member LLCs treated as partnerships for tax purposes, can be summarized as follows.

You Get Pass-Through Taxation

Your share of LLC taxable income items, gains, deductions, losses, and credits are passed through to your personal return. You then pay taxes at the personal level. You don't have to worry about the double taxation issue that can potentially haunt C corporations.

You Can Deduct LLC Losses on Your Personal Return (within Limits)

You can deduct LLC losses passed through to you on your personal return, subject to various limitations. These can include the passive loss rules, the at-risk rules, the excess business loss disallowance rule, and the ownership interest basis limitation rule.

You May Be Eligible for a QBI Deduction

Thanks to the TCJA, the qualified business income (QBI) deduction is potentially available to individual LLC members. The deduction can be up to 20 percent of QBI passed through to you from an LLC. But limitations apply at higher levels of personal income. The QBI deduction will expire at the end of 2025 unless Congress extends it. And it could go bye-bye much sooner, depending on political developments.

You Get Basis from LLC Debts

You receive additional tax basis from your share of LLC liabilities for pass-through loss deduction purposes.[1]

You Get Basis Step-Up for Purchased Interests

If you purchase an LLC membership interest from another member, you can step up the tax basis of your share of LLC assets, which minimizes taxes for you when the LLC sells those assets or converts them to cash.[2]

You Can Make Tax-Free Transactions with the LLC

As an LLC member, you have much greater flexibility to make tax-free transfers of assets (including cash) between yourself and the LLC than you would if you were an S or C corporation shareholder.[3]

You Can Benefit from Special Tax Allocations

LLCs can make special (disproportionate) allocations of taxable income, tax losses, and other tax items among the members. For example, a 50 percent high-tax-bracket member (you) could be allocated 80 percent of LLC depreciation deductions, while the 50 percent low-tax-bracket member (the other guy) is allocated only 20 percent of the depreciation deductions.

Later on, the high-bracket member (you) could be allocated more of the LLC's gains from selling depreciable assets to compensate for the earlier special allocations of depreciation.[4]

Partnership Taxation Disadvantages

Partnership taxation is not all sweetness and light. There are a couple of important disadvantages to consider.

More Exposure to Self-Employment Tax

You may owe self-employment tax—consisting of the 12.4 percent Social Security tax component and the 2.9 percent Medicare tax component—on most or all of the income passed through to you by an LLC.

At higher income levels, you may also owe the 0.9 percent additional Medicare tax.

In contrast, if you run your business as a corporation, Social Security and Medicare taxes hit only the amounts paid out as salary to you and the other owners. This factor favors operating as a corporation, and it can be an important factor.

Unfavorable Fringe Benefit Tax Rules

Compared with C corporations, multi-member LLCs that are treated as partnerships for tax purposes cannot provide as many tax-free fringe benefits to their members (like you). This factor favors operating as a C corporation, but it's usually not an important factor.

Key point. The unfavorable partnership fringe benefit tax rules that apply equally to multi-member LLCs treated as partnerships also apply to S corporations.[5]

Partnership Taxation Compared to S Corporation Taxation

Like LLCs treated as partnerships for tax purposes, S corporations also offer the advantage of pass-through taxation. But the partnership taxation rules (which apply equally to multi-member LLCs treated as partnerships for tax purposes) are more favorable and more flexible.

For instance, you as an S corporation shareholder do not receive any loss-deduction basis from S corporation debts, except for loans that you personally make to the corporation.

- And there is no step-up in the basis of S corporation assets if you buy shares from another shareholder.
- And you have limited flexibility to engage in tax-free transactions with the S corporation.[6]
- And you cannot benefit from special tax allocations, because all S corporation tax items must be allocated to shareholders strictly in proportion to their stock ownership percentages.

Recommendation Regarding Multi-Member LLCs Taxed as Partnerships

Most advisors agree that the multi-member LLC treated as a partnership for tax purposes is the best entity alternative for businesses with several owners if pass-through taxation is desired, such as with a service business where there is no need to retain significant amounts of earnings within the business.

If there is an earnings retention need, the C corporation is probably a better choice. More on the C corporation option later.

Key point. Under some state laws and/or applicable professional standards (such as state bar association rules), LLCs may be prohibited from operating certain types of professional practices.

Limited Partnership Option May Not Work for You

Limited partnerships are obviously treated as partnerships for federal income tax purposes, with the generally favorable partnership taxation rules explained earlier in the context of multi-member LLCs treated as partnerships for tax purposes.

Limited partners are generally not exposed to liabilities related to the partnership or its operations. So, you generally cannot lose more than what you've invested in a limited partnership—unless you guarantee partnership debt.

So far, so good. But you must also consider the following disadvantages.

You Need a General Partner

Every limited partnership must have at least one general partner, and that general partner is theoretically exposed without limitation to all recourse liabilities of the partnership.

But a general partner can be an LLC or an S corporation owned by one or more of the limited partners. That way, even if the general partner entity loses its shirt to partnership liabilities, the economic loss is limited to the general partner entity's capitalization.

The limited partners (including those who own the general partner entity and effectively run the partnership) are protected against losing more than what was invested in their limited partnership interests. Still, having to set up a separate entity to function as the general partner is an unwelcome complication.

Limited Partners Can Lose Their Liability Protection

Under applicable state law, limited partners can potentially lose their limited liability protection by becoming too actively involved in managing the limited partnership. Therefore, limited partnerships may be unsuitable for activities where all or most of the owners are heavily involved in the business (such as a professional practice).

Recommendation Regarding Limited Partnerships

Most advisors agree that multi-member LLCs taxed as partnerships, when available, are far superior to limited partnerships.

General Partnership Option Is Generally a Bad Idea

General partnerships are obviously treated as partnerships for federal income tax purposes, with the generally favorable partnership taxation rules explained earlier.

But the good news basically ends there, because partners of a general partnership are personally liable (without limitation) for all debts and obligations of the partnership.

The liability of general partners is "joint and several" in nature. That means any one of the general partners can potentially be forced to make good on all partnership liabilities. That partner may be able to seek reimbursement from the partnership for payments in excess of his share of liabilities. But that depends on the ability of the other partners to contribute funds to allow the partnership to make such reimbursement.

Note that general partners are jointly and severally liable for partnership liabilities related to the tortious acts and professional errors and omissions of the other general partners and the partnership's employees.

In addition, general partners are personally liable for their own tortious acts and professional errors and omissions.

Finally, under applicable state law, each general partner usually has the power to act as an agent of the partnership and enter into contracts that are legally binding on the partnership (and ultimately on the other partners).

For example, a partner can enter into a lease arrangement that is legally binding on the partnership. For this reason, it is critical that the partners have a high degree of trust in one another. If that is not the case, a general partnership is inadvisable.

Recommendation Regarding General Partnerships

General partnerships can be a reasonable entity choice when there are two or more co-owners (all of whom have a high degree of trust in each other), pass-through taxation is desired, and liability concerns can be managed with insurance. In the real world, these three conditions don't coincide very often.

With the TCJA, the C Corporation Option Deserves Consideration—but Beware of Tax Traps

The TCJA permanently installed a flat 21 percent corporate federal income tax rate for tax years beginning in 2018 and beyond.

Before the TCJA, the conventional wisdom was that most businesses should be conducted as pass-through entities (such as LLCs and partnerships), because that avoided both the 35 percent federal income tax rate that formerly applied to profitable C corporations and the double taxation issue that still afflicts profitable C corporations when they pass out dividends to shareholders.

Now, thanks to the TCJA, you must compare the 21 percent corporate federal income tax rate with the individual tax rates that LLC members and partners must pay on taxable income passed through to them. Currently, the maximum individual rate is 37 percent, but it's scheduled to increase to 39.6 percent after 2025. Obviously, 21 percent is a much lower rate than 37 percent or 39.6 percent. But consider the following potential negatives:

- The C corporation double taxation issue still exists, although it has been toned down by the 21 percent corporate rate. As in the past, double taxation is not an issue for a C corporation that needs to retain all of its profits to finance growth.
- There's no QBI deduction possibility for C corporation shareholders. That said, the deduction is scheduled to phase out after 2025.
- If a primary tax goal is deducting losses from your venture on your personal return, operating as a C corporation is a bad idea, because C corporation losses cannot be passed through to the shareholders. So, in this case, you should operate as an LLC or a partnership.
- As in the past, it's generally still a bad idea to hold valuable assets that are likely to appreciate (such as real estate and intangibles) in a C corporation. If the assets are eventually sold for substantial gains, it may be impossible to get the profits out of the corporation without double taxation. In contrast, gains from selling assets held by an LLC or a partnership will be taxed only once at your personal level. So, operate as an LLC or a partnership if this is an important issue.[7]

Takeaways

Limited and general partnerships, in addition to LLCs taxed as partnerships, can still be advisable now that the TCJA is in effect, after evaluating the factors we've mentioned. But the LLC option will almost always be the preferred choice when compared with the limited and general partnerships.

C corporations are more attractive with the TCJA, but the tax negatives we've mentioned come along for the ride.

To add some extra uncertainty to the mix, consider these questions.

- Is the 21 percent corporate rate really permanent? Only as long as our beloved DC politicians don't change their minds. And the 2020 general election is lurking on the horizon.
- Will the current 37 percent maximum individual rate really last through 2025? Ditto.

- Will the QBI deduction really last through 2025? Ditto.

Place your bets, and keep your fingers crossed!

You are now well informed on the tax aspects of operating as an LLC or a partnership versus operating as a C corporation. But as a business owner, we recommend that you seek professional advice before pulling the trigger on your choice of entity for a significant venture.

> SIDEBAR: Don't Overlook State Taxation Factor
>
> Sometimes the choice-of-business-entity question is decided based on state tax issues.
>
> What works for me might not work for you if you live in another state. For example, LLCs are generally attractive from federal income tax and liability protection perspectives.
>
> But Texas LLCs are subject to the state's corporate franchise tax, which is similar to an income tax. In Colorado, meanwhile, LLCs are not subject to any entity-level state income or franchise tax. Do your state tax homework before making a final decision for your venture.

---

[1] See IRC Section 752 and related IRS regulations.

[2] IRC Sections 743; 754.

[3] Appreciated assets can usually be transferred back and forth between members and LLCs with no adverse tax consequences thanks to IRC Secs. 721 and 731.

[4] To make valid special allocations, you must comply with the so-called substantial economic effect rules outlined in IRS regulations. It can be done!

[5] IRC Section 1372.

[6] When assets are transferred from an S corporation to a shareholder, it must be determined whether the transaction is shareholder-employee compensation subject to employment taxes, or a distribution, or something else. Distributions of property (other than cash) generally are treated as if the corporation sold the property to the recipient shareholder for fair market value (FMV). See IRC Section 311(b) via Section 1371(a) 2018. The corporation must recognize taxable gain to the extent the property's FMV exceeds its basis, and must allocate the gain to the shareholders in proportion to their stock ownership per IRC Section 1366.

[7] Under current law, gains from selling LLC or partnership assets will usually be taxed at a maximum federal rate of 23.8 percent or at 28.8 percent for real estate gains attributable to depreciation deductions. The rates include the 3.8 percent net investment income tax. Note that it's not necessary for assets held by a C corporation to appreciate for double taxation to occur. Depreciation deductions lower the tax basis of property, so a taxable gain results whenever the sale price exceeds the depreciated basis.

Beware of the Dark Side When Considering the C Corporation

The Tax Cuts and Jobs Act (TCJA) makes the idea of operating your business as a C corporation more attractive than before.

Reason. The TCJA created a flat 21 percent corporate federal income tax rate. That low rate applies equally to garden-variety C corporations and to personal service corporations.

Compare the 21 percent corporate rate to the 37 percent maximum federal income tax rate for individual taxpayers, and you can see why the C corporation status seems golden.

But there's more to the story. C corporations face tax issues that don't affect sole proprietorships, single-member LLCs treated as sole proprietorships for tax purposes, and pass-through entities (partnerships, multimember LLCs treated as partnerships for tax purposes, and S corporations).

Here's what you need to know about the potential tax negatives of running your business as a C corporation.

Conventional Wisdom Then and Now

Before the TCJA, conventional wisdom dictated that you should conduct most small and medium-sized businesses via pass-through entities because that avoided the dreaded double-taxation issue that haunts C corporations.

The double-taxation threat still exists, but the 21 percent corporate rate lessens the danger. So, after the TCJA, conventional wisdom is not so cut-and-dried.

- Pass-through entity status is still advisable in some circumstances (such as when a business will incur losses or will pay out most or all of its profits to its owners every year).
- C corporation status is also advisable in some circumstances (such as when your business needs to retain most or all of its profits to finance growth).

Also, C corporation status looks better if you believe that our beloved D.C. politicians

- will probably allow the current 21 percent corporate tax rate to stay in place, and
- will almost certainly raise personal income tax rates sooner or later (probably sooner).

Paying a 21 percent tax rate is better than paying 37 percent or higher. Right? Yes, but beware of the C corporation tax caveats covered in the rest of this article.

Double Taxation of Corporate Dividends

Say you run your business as a C corporation. The business is successful, and your corporation builds up a hefty amount of earnings and profits (E&P).

While lots of E&P (a tax accounting concept similar to the financial accounting concept of retained earnings) indicates a financially healthy operation, it also creates tax concerns when you try to get money out of the company.

Double Taxation of Dividends Explained

To the extent your C corporation has current or accumulated E&P, non-liquidating corporate distributions to shareholders (like you) count as taxable dividends.[1]

Since the current federal income tax rate on dividends received by individuals cannot exceed 23.8 percent (the 20 percent maximum rate plus 3.8 percent for the net investment income tax, or NIIT), dividends paid while the current rates are in force will be taxed relatively lightly.

But it could be a different story in future years if lawmakers increase the tax rates on dividends. Back in the day, dividends were taxed as ordinary income—at the higher rates. There's no guarantee we won't go back to the past in terms of how lawmakers will tax dividends in the future.

If that happens, C corporations won't be nearly as attractive as they are under the current tax rate regime.

Accumulated Earnings Tax Can Be Assessed If Dividends Are Not Paid Out

You might ask: "Can't my C corporation avoid the double-taxation problem simply by *not* paying dividends?" Answer: that may not work.

When your C corporation retains a significant amount of earnings rather than paying them out as double-taxed dividends, there's a risk of the IRS hitting the company with the dreaded accumulated earnings tax.

Accumulated Earnings Tax Explained

The accumulated earnings tax is a corporate-level tax assessed by the IRS, as opposed to a tax that is paid voluntarily with your company's corporate tax return.

The IRS can assess the accumulated earnings tax when (1) the corporation's accumulated earnings exceed $250,000, or $150,000 for a personal service corporation, and (2) the corporation cannot demonstrate economic need for the "excess" accumulated earnings.

When the accumulated earnings tax is assessed, the rate is the same as the maximum federal rate on dividends received by individual taxpayers (currently 20 percent).[2]

But if in the future dividends are once again taxed at ordinary income rates (as was the case back in the day, before the Bush tax cuts), the accumulated earnings tax rate would skyrocket accordingly. Reverting to the ordinary income treatment of dividends would not be good for the C corporations of the world.

Key Point. The whole idea behind the accumulated earnings tax is to discourage the strategy of not paying out corporate dividends to avoid double taxation. With the accumulated earnings tax, the feds achieve double taxation via the back door.

Zeroing Out Corporate Taxable Income with Compensation Paid to Shareholder-Employees Is Not Foolproof

Okay, so you now understand that C corporation dividends are potentially subject to double taxation, and that not paying dividends could trigger the dreaded accumulated earnings tax.

"So," you ask, "why not just pay out all or nearly all of my C corporation's annual profits as tax-deductible compensation to me (and other shareholder-employees, if any)?" That way, you avoid double taxation because your corporation's taxable income is zeroed out (or nearly so).

You'll have to pay personal income taxes on the compensation, but that's okay, because the current federal income tax rates are pretty low by historical standards. Great idea! But . . .

The zero-out strategy works only as long as the purported compensation paid to the shareholder-employee(s) is "reasonable." If the purported compensation exceeds what's deemed reasonable, and if the IRS discovers this during an audit, the IRS can reclassify some or all of the purported compensation as double-taxed disguised dividends.

Needless to say, the issue of what constitutes reasonable compensation has been the subject of much litigation between the IRS and taxpayers.

Taxpayers have tended to win when

- almost all of the corporation's income is derived from the personal efforts of the shareholder-employees (such as with a medical or dental practice); or
- the claimed compensation deductions did not reduce the corporation's income beyond the point where a hypothetical independent investor in the company would be dissatisfied with his or her rate of return; or
- current compensation was set at high levels to make up for earlier years when the corporation did not have the funds to fully compensate the shareholder-employee(s), such as with a company that has only recently advanced beyond the cash-short start-up phase.

Case in Point

In a 2016 decision, the Tax Court upheld IRS-assessed additional taxes and penalties against a law corporation that claimed compensation deductions for purported year-end bonuses paid to shareholder-employees. The purported bonuses were found to be disguised dividends.

The claimed bonus deductions completely eliminated the corporation's book income, even though the corporation had income from substantial invested capital.

So, the corporation failed the aforementioned hypothetical independent investor test, which indicated that the purported bonuses were not reasonable compensation. Other factors supported the finding that the purported bonuses were disguised dividends.[3]

Takeaways

- In the right circumstances, operating your business as a C corporation rather than as a pass-through entity can be a tax-smart move.
- But be aware of the tax caveats surrounding C corporation status.
- When evaluating the C corporation option, consider the possibility of future unfavorable changes to the federal income tax regime.
- Do a side-by-side comparison of the after-tax results when considering the C corporation versus your current operating entity.

SIDEBAR: C Corporation Status Still a Bad Idea If Your Venture Involves Assets Likely to Appreciate

Even with the 21 percent tax rate, you still generally don't want to have a C corporation hold significant assets that are likely to appreciate—such as real estate and valuable intangibles. If the corporation eventually sells the assets for substantial gains, you may be unable to get the profits out of the corporation without double taxation.

In contrast, if you hold appreciating assets in a pass-through entity such as an S corporation or a partnership, gains on sale will be taxed only once, at your personal level—probably at a maximum rate of 23.8 percent or 28.8 percent for gains attributable to real estate depreciation deductions.[4]

Example

Your solely owned C corporation needs a new building.

You set up a single-member LLC owned solely by you to buy the property and lease it to your corporation. After a few years, the property is sold for a $500,000 gain. The entire gain will be taxed on your personal return.

Part of the profit will be taxed at a maximum rate of 25 percent under current law (the part of the gain that's attributable to depreciation deductions). The rest of the gain will be taxed at a

maximum rate of 20 percent under current law. You may also owe the 3.8 percent NIIT on both parts of the gain.

Assume you pay a total of $130,000 to the feds for capital gains tax and the NIIT. There's no federal income tax at the single-member LLC level, so your after-tax profit is $370,000 ($500,000 - $130,000). To keep things simple, we will ignore any state income tax hit.

Now let's see what would happen if your C corporation buys the same property.

The $500,000 gain will be taxed at the 21 percent corporate rate under current law. The corporation pays the $105,000 federal income tax bill ($500,000 x 21 percent) and distributes the remaining $395,000 ($500,000 - $105,000) to you. We will ignore any corporate state income tax hit.

The $395,000 will almost certainly constitute a dividend that will be taxed at 20 percent under current law. We assume you'll also owe the 3.8 percent NIIT on the $395,000 dividend. The tax at your personal level is $94,010 ($395,000 x 23.8 percent).

So, you will net only $300,990 after paying federal income taxes at both the corporate and personal levels ($500,000 - $105,000 - $94,010).

Compare the $300,990 with the $370,000 that you would receive under the leased-from-the-single-member-LLC leasing alternative. With the leasing alternative, your after-tax cash is 23 percent higher. That's a big difference in your favor!

Key Point. It's not necessary for assets held by a C corporation to appreciate for double taxation to occur. The conclusion in the preceding example would be the same if the entire $500,000 gain was caused by depreciation (although the tax bill would be a bit higher under the leased-from-the-single-member-LLC alternative due to the 25 percent maximum rate on unrecaptured Section 1250 gains). Depreciation lowers the tax basis of the property, so a tax gain results whenever the sale price exceeds the depreciated basis.

---

[1] IRC Sections 301(a); 301(c); 312(b); 316(a).

[2] IRC Sections 531-537.

[3] *Brinks Gilson & Lione A Professional Corporation v Commr.*, T.C. Memo 2016-20.

[4] The maximum federal rate on so-called unrecaptured Section 1250 gains (long-term gains attributable to real estate depreciation) is 25 percent, or 28.8 percent when you tack on the 3.8 percent NIIT.

Is the S Corporation the Best Tax-Deduction Entity for Your Business?

The question: Is the S corporation better than the sole proprietorship, the single-member LLC, and the C corporation as the tax-deduction choice of entity for your business?

This is the fourth article in our series on choice of entity, which began with the November 2011 issue.

In this article, we explore the tax-deduction advantages and disadvantages of the S corporation.

What Is an S Corporation?

The S corporation is a creature of federal tax law wherein you first form a corporation or an LLC and then elect taxation as an S corporation.[1]

Thus, your legal entity is the corporation or LLC, but your taxable entity is the S corporation.

For federal tax purposes, your S corporation is a pass-through entity, meaning that the corporation's income, deductions, and tax credit items are passed through to you, the shareholder, on a Schedule K-1.

For some business owners, this is the best of both worlds: liability protection with personal taxation.

Special Rules

To elect S corporation status, the LLC or corporation must[2]

- be a domestic corporation (including an LLC, which can file an S election without having to formally file a "check the box" election);
- have 100 or fewer shareholders;
- have no shareholders other than U.S. citizen individuals, resident alien individuals, estates, certain types of trusts, and certain types of tax-exempt entities; and
- have only one class of stock.

Violations. If your LLC or corporation violates any of the above, it loses its S corporation status.

The good news is that as a one-owner or husband-and-wife-owned business, your odds of having a problem with the S corporation election rules are about nil.

The real question is: Does your choice of entity as an S corporation put more after-tax money in your pocket?

Advantages and Disadvantages

As with all operating entities, you will find advantages and disadvantages. But there is one sure way to drill down on which entity gives you the best tax deductions.

That "sure way" is to do a numbers check where you identify the cash advantage or disadvantage and what causes the difference. You should do this before forming the S corporation and then every five to ten years or so to ensure that your situation continues to benefit from your choice.

In general, the S corporation has three basic advantages and nine disadvantages.

Advantage 1. Save on Payroll Taxes

When you operate your business as an S corporation, you are both a corporate employee and a shareholder.

As an employee, you receive a wage or salary to compensate you for work you perform.

As a shareholder, you receive distributions (think corporate dividends) to reward you for your intelligent investment decision in your S corporation.

Your wage or salary incurs the FICA and Medicare tax on earnings of up to $137,700. For earnings in excess of $137,700, your wage or salary incurs the Medicare tax only.

The Medicare-only rate is 2.9 percent, and it applies once your wage or salary exceeds $137,700.

Now that you know the payroll taxes, you can look at the strategy of lowering your wages and increasing your distribution because lower wages reduce payroll taxes.

Example. Say that before you consider your salary, your S corporation earns a net income of $100,000. If you take the $100,000 as salary, you and your corporation pay at least $15,300 in payroll taxes.[3]

But let's say you take $38,000 as salary and the balance as a profit distribution. Presto! You and the corporation save at least $9,486 in payroll taxes.

Of course, the payroll tax savings depend on your salary being reasonable.

Let's look at another example. Say the S corporation income before your salary is $200,000. By giving you a salary of $120,000 and a distribution of $80,000, you and the corporation save only $4,515 on payroll taxes. Your savings here are at a far lower rate because you save on the Medicare tax only.

Thus, with respect to the strategy of lowering your salary, answer these two questions:

- How much do you save in payroll taxes?
- Can you justify the lower salary as reasonable?

If the answer to both questions is yes and the savings are substantial, then the S corporation is a choice of entity for you to consider.

Advantage 2. Split Taxable Income

This strategy might be for you if you gift money to a person who is in a lower tax bracket than you and that person is not your child, who can trigger the Kiddie Tax.

Here's how this works: Say you are in the 35 percent tax bracket and you want to give money to your dad, who is in the 10 percent tax bracket.

If you want your dad to have $10,000 in his pocket, you have to either

1. earn $15,385, pay taxes of $5,385 in your 35 percent bracket, and then gift the remaining $10,000 to your dad, or
2. give your dad a percentage ownership in your S corporation so the corporation can distribute $11,111 to him, on which he pays $1,111 in taxes (10 percent times $11,111), leaving him with $10,000.

Note. You had to earn $4,274 more to make a gift with your after-tax money compared to gifting a percentage of your S corporation to your father ($15,385 minus $11,111).

The downside to this strategy is that now your father owns part of your corporation. How do you get that ownership back? It's highly probable that you will inherit the stock when your father passes. But it's obvious that you need to think about this.

How about your children? The Kiddie Tax destroys the income-splitting strategy for children who are under age 19 or who are under age 24 and in college, because for these children, the law taxes unearned income over $2,200 at the parent's rate.[4]

Advantage 3. No Double Taxation

You no doubt cringe when you see the words "double taxation."

But here's good news: Double taxation isn't what it used to be, because corporate dividends are taxed at only 15 percent and the tax bracket of a C corporation is now a flat 21 percent.

Thus, with C corporation income of $500,000 as an example, your combined corporate and individual tax rate is only 33.75 percent.[5]

When you combine the various factors, it's likely that the S corporation avoids the double taxation you would face with a C corporation.

As we mentioned earlier, to find the after-tax benefit of choosing the S corporation over another choice of entity, you need to consider the three advantages listed above and the nine disadvantages that follow.

Disadvantage 1. Extra Tax Return and Legal Fees

Unlike the Form 1040 Schedule C of a proprietorship, the S corporation tax return includes a balance sheet in addition to the required K-1 pass-through information. To ensure that you get the right numbers in the right spots of your S corporation tax return, you should use a professional tax preparer.

Your S corporation is a corporation, and that means you also need corporate paperwork. To get this right for both tax purposes and legal protection, you should use a lawyer.

Thus, the first disadvantage of choosing the S corporation rather than a proprietorship is the extra cost of tax returns and corporate compliance.

Disadvantage 2. Possible Extra State Income, Franchise, or Similar Taxes

Depending on where you live, your state may require your S corporation to file and pay a state income, franchise, or similar tax.

This can seem unfair when the state's levy of an additional tax on the S corporation does not generate an offsetting deduction for you on your personal taxes.

Disadvantage 3. Extra Paperwork

The balance sheet we mentioned in disadvantage 1 creates extra paperwork on your part. In many cases, this makes double-entry bookkeeping more appropriate, and that's harder than simply keeping a checkbook or using Quicken.

The S corporation also creates extra tax-related paperwork each time you take money (or any other asset) out of the corporation, because you must treat each withdrawal in one of three basic ways:

1. as a salary or bonus paid to you in your capacity as a corporate employee,
2. as a distribution of corporate earnings paid to you in your capacity as a corporate shareholder, or
3. as proceeds from a loan made by the corporation to you.

If you treat the withdrawal as salary or bonus money, you'll have to deal with employment taxes, employment tax forms, and W-2s.

Distributions create adjustments in the retained earnings section of your balance sheet.

Loans create a need for loan documents, an interest rate, and (preferably) a repayment schedule backed up by actual payments on your part.

Comparatively, you face little extra tax-related paperwork when you run your business or practice as a single-member LLC or proprietorship.

Disadvantage 4. Trapped Assets

The assets owned by the S corporation are not your assets. They are S corporation assets. You may not take them from the S corporation without triggering a taxable action, in most cases adverse to you and/or the S corporation.

With the single-member LLC and the proprietorship, you have far more ability to take assets without triggering a taxable action.

One area of concern for all businesses is recapture. If you are thinking of converting an asset to personal use or making a lot more personal use of an asset, make sure you know the recapture rules.

Disadvantage 5. Value in Case of Death

If you own a single-member LLC or a proprietorship when you die, the individual assets such as real estate, patents, copyrights, and customer lists get marked up to fair market value for your date of death or alternate date. In general, the markup means lower taxes for your heirs.[6]

If you own an S corporation when you die, the value of your S corporation stock is marked up to fair market value. That value could be far different from the value of the individual assets. Further, proving the value of the stock is more difficult and expensive than identifying only the value of the assets.

Disadvantage 6. Medical Mistreatment

Tax law and the IRS do not grant much in the way of tax breaks for health insurance or other medical expenses to the S corporation's more-than-2-percent owner or his or her spouse.

(Note: The attribution rules make the spouse own exactly what the shareholder owns. Thus, if the husband owns 100 percent of an S corporation, the wife also owns 100 percent.)

Disadvantage 7. No Medical for Spouse without Payroll Taxes

The single-member LLC and the proprietorship can compensate the employee-spouse solely with a Section 105 medical reimbursement plan, and those plan benefits are not W-2 income.

The S corporation owner's spouse does not qualify for this benefit because, as we mentioned above, the attribution rules give the spouse the same ownership interest as the owner-spouse.

Disadvantage 8. Payroll Taxes on Hiring Your Children

The single-member LLC and the proprietorship pay no FICA, Medicare, or employment taxes on the employment of the owner's under-age-18 children who work for the parent. Similarly, the children pay no payroll taxes on wages earned working for the parent.

The S corporation gets no such break. When children are employed by the S corporation, both the S corporation and the children are subject to payroll taxes.

Depending on the earnings of the child, the payroll tax can take close to 20 percent of the wage, and of course, this affects the financial benefits of hiring the child.

Disadvantage 9. Impact on Retirement Contributions

If you are going to use a 401(k) or other type of defined contribution plan for retirement, you need to know that the S corporation produces a lower contribution because the contribution is based on salary, which you likely lowered to save self-employment taxes. It works like this: lower salary, lower contribution to retirement.

If you operate as a single-member LLC or as a proprietorship, you base your defined contributions on net income—a higher number, and thus a larger contribution to your retirement plan.

What to Do

If you need liability protection, you can get that with the LLC, the C corporation, or the S corporation. The next question is: Which of the three choices puts the most after-tax money in your pocket?

The S corporation has advantages and disadvantages, as do all taxable entities.

Since your choice of entity stays with you for some time, you should engage a tax professional to help you with the tax side of this question. The money you pay now for this help will pay dividends for many years.

---

[1]IRC Section 1361(a)(1); The LLC can elect to be taxed as (1) a C corporation, by filing IRS Form 8832 with the Internal Revenue Service, or (2) an S corporation, by filing IRS Form 2553.

[2]IRC Section 1361(b); Reg. Section 301.7701-3(c)(1)(v)(C); Starr, Smith, and Sobol, 730-3rd T.M., S Corporations: Formation and Termination V, C.

[3]FICA and Medicare taxes are 15.3 percent for 2020.

[4]IRC Section 1(g)(2); Rev. Proc. 2011-52; the $2,200 is a combination of the minimum standard deduction ($1,100) and up to $1,100 taxed at the child's rate before application of the parent's rate.

[5]The way this works is that you first pay the income tax and then the dividend tax. For example, say your C corporation earns $500,000 net and pays taxes of $105,000 at the 21 percent rate. It then pays a dividend to you of $425,000, on which you pay $63,750 in taxes, leaving you with $331,250. On the $500,000 of income, you and your C corporation paid a combined corporate and dividend tax of 33.75 percent, or $168,750.

[6]IRC Section 1014(a).

Choosing the Right Entity for a Newly Acquired Business (Part 1)

When you buy a business, one of the first things to consider is the legal form you will use to own and operate the activity.

The choices range from a sole proprietorship to a corporation.

If the business you are buying will become part of an existing entity (such as an existing LLC or corporation), you may not need the information in this article. Otherwise, please keep reading.

The Sole Proprietorship Option

Before reflexively moving on to other entity choices, give some consideration to using the sole proprietorship form of doing business instead of a liability-limiting entity such as a corporation.

Sometimes it is wiser to stick with the simplicity of the sole proprietorship option and buy sufficient insurance against liability claims. That said, we advise getting legal advice on that issue.

A sole proprietorship is not actually a legal entity, because there is no legal distinction between the sole proprietorship and its individual owner (you). You and the proprietorship are one and the same for state-law purposes. Ditto for federal income tax purposes.

The big attraction of sole proprietorship status is administrative simplicity. Because a sole proprietorship is owned by a single individual and is not considered a separate entity (for either legal or tax purposes), there are no federal income tax complexities.

You as the owner simply file Schedule C (for a business activity), Schedule E (for a rental activity), or Schedule F (for a farming or ranching activity), along with Schedule SE (to calculate your self-employment tax bill, if you owe that tax), with your Form 1040 to reflect the business's activity for the year.

But as soon as a business begins to generate significant income and wealth for you, the use of a liability-limiting entity (corporation, LLC, LLP, or limited partnership) is highly advisable.

Why? Because a sole proprietor's personal assets are exposed, without limitation, to any and all liabilities related to the business.

The liabilities can include everything from a lawsuit filed by the FedEx guy who slips on ice-covered steps to the seemingly endless variety of liabilities that can be caused by the actions (or inactions) of employees.

Recommendation

The sole proprietorship may be the preferred form of doing business under the following circumstances:

- There is only a single owner.
- Adequate liability insurance is available at an acceptable cost, or the major liability exposures are from the owner's practice of a profession (a problem that is generally not "cured" by using a liability-limiting entity).
- Minimizing administrative expenses and paperwork is a major objective.
- You as the owner do not currently wish to deal with the issue of how future transfers of ownership interests (for estate planning, succession planning, or other reasons) will be accomplished.
- You as the owner do not currently wish to deal with the issue of how additional equity capital might be raised in the future.
- The newly acquired business is currently small enough that operating as a sole proprietorship is still a rational choice in light of the above considerations.

Key point. When available, the single-member LLC option is almost always preferable to the sole proprietorship option, because a single-member LLC offers liability protection to its owner (you). In contrast, a sole proprietorship offers none.

The Single-Member LLC Option

The single-member LLC is a one-owner entity that is also a liability-limiting entity. The single-member LLC owner is called a member.

Thanks to IRS regulations, the existence of a single-member LLC is generally ignored for federal tax purposes. In other words, a single-member LLC is treated as a so-called disregarded entity for most federal tax purposes (except in the relatively rare cases where corporate tax status is elected for the single-member LLC).[1]

- When you use a disregarded single-member LLC to conduct a business activity, you report the tax information on Schedule C of your Form 1040, and you complete Schedule SE to calculate your self-employment tax bill. In other words, the federal income tax treatment of the single-member LLC is exactly the same as for a sole proprietorship.
- When you use a disregarded single-member LLC to operate a rental operation, you report the tax information on Schedule E.
- When you use a disregarded single-member LLC to operate a farming or ranching operation, you report the tax information on Schedule F.

You get the idea. In any of these cases, there is no need for a separate federal income tax return for the single-member LLC activity.

In contrast, setting up a solely owned S or C corporation for the same activity will necessitate filing a separate federal income tax return for the corporation (and likely a separate state return as well).

In addition, all transactions between a solely owned S or C corporation and its shareholder (you) must be carefully characterized and structured to avoid adverse tax outcomes. For example, when a shareholder withdraws cash from the corporate business:

- Is the withdrawal compensation (subject to employment tax issues)?
- Is the withdrawal a dividend (subject to possible double taxation with a C corporation)?
- Is the withdrawal a loan (subject to documentation requirements and possibly the tricky below-market loan rules)?

All such complications are avoided with a disregarded single-member LLC, because transactions between the entity and the owner (you) have no income tax significance. Why? Because tax law considers the transactions inside a proprietorship to be between you and yourself; therefore, tax law ignores them.

While a disregarded single-member LLC is effectively invisible for federal tax purposes, it is nevertheless respected as a separate liability-limiting entity for state-law purposes.

The single-member LLC protects your personal assets from business-related liabilities, as long as you comply with the applicable LLC statutes. This liability protection is similar to that offered by a corporation.

Key point. Generally, no type of liability-limiting entity (including a single-member LLC) will protect your personal assets from exposure to liabilities related to your own professional malpractice or tortious acts. (In a nutshell, tortious acts are wrongful deeds other than by breach of contract. An example of a tortious act is negligent operation of a motor vehicle resulting in injuries or property damage to others.)

That said, the issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for any specific questions on the subject.

Single-Member LLCs Are Separate Tax-Paying Entities for Some Purposes

While federal tax law generally ignores their existence, disregarded single-member LLCs are required to pay certain federal excise taxes and most federal employment taxes in their own names as if they were corporations.

If your disregarded single-member LLC has employees other than certain of your children and your spouse, you must adhere to the corporate federal payroll tax rules for withholding and payment of Social Security, Medicare, and FUTA taxes; the rules for federal income tax withholding from employee paychecks; and related tax reporting obligations such as filing Forms W-2 to report employee wages and filing Forms 941 to report and pay federal payroll taxes.

The single-member LLC should obtain and use its own employer identification number (EIN) for federal payroll tax purposes.[2]

You, as the disregarded single-member LLC's owner, are not considered to be an employee of the single-member LLC for federal payroll tax purposes.[3] Instead, you are considered self-employed and must therefore include any net self-employment income from the single-member LLC in your self-employment tax calculation on Schedule SE. You file Schedule SE with your Form 1040.

Key point. If you use your disregarded single-member LLC to hire your under-age-18 child, his or her wages are not subject to Social Security or Medicare taxes.[4]

Recommendation

When available, the disregarded single-member LLC is generally the best choice for a single-owner business because it

- provides liability protection,
- is not subject to double taxation, and
- is very simple from a tax compliance standpoint.

That said, before concluding that disregarded single-member LLC status is the no-brainer choice for your newly acquired business, be sure to carefully examine the state tax implications.

For example, Texas single-member LLCs are subject to the state's corporate franchise tax, while sole proprietorships are not. California imposes a minimum tax on single-member LLCs.

Key point. Some state LLC statutes do not permit single-member LLCs to be used for certain types of businesses (e.g., professional practices). Some professional standards and licensing bodies prohibit operating as a single-member LLC.

When single-member LLC status is unavailable (for whatever reason), S and C corporations are the only remaining liability-limiting options for a single-owner business.

Stay Tuned for More

Next, we will cover the C and S corporation options for owning and operating your newly acquired business.

Takeaways

When starting a new business by buying the assets of an existing business, you need to consider the operating entity.

The sole proprietorship is your easiest entity for tax purposes. If you would like the ease of the sole proprietorship and the safety of liability protection, you can achieve both with the single-member LLC.

When available, the disregarded single-member LLC is generally the best choice for a single-owner business because it

- provides liability protection,
- is not subject to double taxation, and
- is very simple from a tax compliance standpoint.

---

[1] See the so-called check-the-box entity classification rules found in Reg. Sections 301.7701-1; 301.7701-2; 301.7701-3.

[2] Reg. Section 301.7701-2(c)(2)(iv)(B).

[3] Reg. Section 301.7701-2(c)(2)(iv)(D).

[4] IRC Sections 3121(b)(3)(A); 3306(c)(5); Reg. Sections 31.3121(b)(3)-1; 31.3306(c)(5)-1.

Choosing the Right Entity for a Newly Acquired Business (Part 2)

When you buy a business, one of the first things to think about is the legal form you will use to own and operate the activity. The choices range from the sole proprietorship to corporations.

But if you will acquire a new business and make it part of an existing entity (such as your existing LLC or corporation), you may not need to read this. Otherwise, please continue on.

Previously, we covered the sole proprietorship and single-member (one-owner) LLC options. In this analysis, we cover three corporate alternatives.

1. The S Corporation Option

S corporations can potentially be used for a one-owner business or for a business with several owners. The S corporation has strong advantages if you can tolerate the tax-law restrictions.

Advantages

Liability protection. By operating as an S corporation, your personal assets are generally protected from exposure to business-related liabilities under applicable state law. Such exposure can include everything from a lawsuit filed by the FedEx guy who slips on ice-covered steps to the seemingly endless variety of liabilities that can be caused by the actions or inactions of employees.

Key point: Unfortunately, no type of entity (including an S corporation) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts. Tortious acts are wrongful deeds other than by breach of contract—such as negligent operation of a motor vehicle resulting in property damage or injuries. The issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for more information.

Pass-through taxation. With an S corporation, your share of the business's taxable income items, deductions, and credits are passed through to your personal return. You pay taxes at the personal level on your share of the corporation's profits. There generally is no corporate-level tax, so you don't have to worry about the double taxation issue that can potentially haunt C corporations.[1]

Chance to minimize Social Security and Medicare taxes. Operating your newly acquired business as an S corporation may offer opportunities to minimize Social Security and Medicare taxes. This is done by having the corporation pay you a modest (but reasonable) salary.

You and your S corporation pay Social Security and Medicare taxes on the salary. Your share of the S corporation's remaining taxable income (after deducting amounts paid as salary) is not subject to Social Security or Medicare taxes, whether you leave the money inside the corporation or take it out via cash distributions.[2]

In contrast, if you operate your business as a sole proprietorship, as a single-member LLC treated as a sole proprietorship for tax purposes, or as a partnership or multi-member LLC treated as a partnership for tax purposes, you generally owe Social Security and Medicare taxes (via the self-employment tax) on your share of the entity's business income, whether you take it out via cash distributions or leave it inside the entity.[3]

Disadvantages

Tax-Law Restrictions. S corporations are subject to a number of tax-law restrictions that do not apply to other business entities.

For example, an S corporation can't have more than 100 shareholders (not likely to be a problem for you), and the shareholders can be only individuals, estates, and certain types of trusts.

Non-resident alien individuals are not allowed to be shareholders. These restrictions preclude having foreign shareholders, foreign corporate shareholders, and foreign partnership and LLC shareholders.

Also, an S corporation can have only one class of stock. If there are several shareholders, the S corporation must allocate taxable income items, deductions, and credits strictly in proportion to stock ownership.[4]

Partnership Tax Rules Are Better. The partnership tax rules, which also offer the advantage of pass-through taxation, are more flexible than the S corporation tax rules. Note that LLCs with more than one owner (multi-member LLCs) are automatically taxed under the beneficial partnership rules if they don't opt for taxation as a corporation. We will cover the partnership and multi-member LLC options in a future article.

Recommendation

S corporations may be the preferred option in the following circumstances:

- You have a major concern about, and want to limit your exposure to, business-related liabilities that are not covered by insurance.
- You want the advantage of pass-through taxation and the opportunity to minimize Social Security and Medicare taxes.
- The S corporation restrictions are not a major concern when you consider future plans to add new owners or transfer ownership interests to others for estate planning, family tax planning, or business succession planning purposes.
- You cannot operate your business as a single-member LLC, multi-member LLC, or limited liability partnership (LLP) due to state-law restrictions or professional standards.

Key point. Assessing the attractiveness of the S corporation option involves balancing the advantages of reliable liability protection for you as an owner and pass-through taxation against the tax-law restrictions. Most tax advisors agree that single-member LLCs, multi-member LLCs, and LLPs—when available—are superior to S corporations.

But if you will be the sole owner and you want to avoid the double-taxation threat, the S corporation option is the only alternative to the sole proprietorship option in situations where single-member LLC status is unavailable (for example, due to state-law restrictions).

2. The "Regular" C Corporation Option

By "regular" C corporation, we mean an incorporated entity that is not an S corporation.

Advantages

Liability protection. By operating your newly acquired business as a C corporation, your personal assets are generally protected from exposure to business-related liabilities under applicable state law.

Key point. As explained earlier, no type of entity (including a C corporation) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts.

Flat corporate income tax rate. C corporations pay a flat federal income tax rate of only 21 percent on all taxable income. Compare that to the federal income tax rates on individual taxpayers, which can be as high as 37 percent.

Bottom line. A C corporation will pay no more than 21 percent to the Feds.[5] That 21 percent rate is significantly lower than the maximum individual rate of 37 percent.

Tax-favored fringe benefits. When you are employed by your C corporation, you are allowed to give yourself a number of tax-free fringe benefits, including the following:

- Accident and health insurance coverage.
- Medical expense reimbursement plan.
- Contributions to health savings account (HSA).
- Disability insurance coverage.
- Up to $50,000 of group-term life insurance coverage.

The corporation deducts the costs of providing these tax-free benefits. But for the benefits to be tax-free to you, you must meet the applicable qualification rules. Pass-through entities such as S corporations, LLCs, and LLPs are more limited in their ability to offer tax-free fringe benefits to owners.

Disadvantages

The key disadvantage of C corporations is that they are potentially subject to double taxation. The two most common ways that double taxation can rear its ugly head are:

1. **Double taxation of dividends.** If the corporation has accumulated earnings and profits (which are already taxed at the corporate level), nonliquidating distributions to shareholders are treated as dividends and are taxed again at the recipient shareholder level.[6] The good news: the current maximum federal income tax rate on qualified dividends received by individuals is "only" 20 percent, and that rate applies only to folks in the 35 percent federal income tax bracket and above. Most folks pay a 15 percent rate. Higher-income shareholders also may owe the 3.8 percent net investment income tax on dividends.
2. **Double taxation on stock sale gains.** When a C corporation earns taxable income (which is taxed at the corporate level), the retained income increases the value of the stock, which creates a bigger taxable gain for shareholders when they sell their shares. As a result, the retained income is effectively taxed twice. The good news (just as with dividends): the current maximum federal income tax rate on long-term capital gains recognized by individuals is "only" 20 percent, and that rate applies only to folks in the 35 percent federal income tax bracket and above. Most folks pay a 15 percent rate. Higher-income shareholders may also owe the 3.8 percent net investment income tax on stock sale gains.

Other unfavorable tax rules. Other negative aspects of C corporation taxation apply in the following circumstances:

- When the corporation incurs tax losses, such losses cannot be passed through to the shareholders, so the losses never do any tax-saving good unless the corporation has positive taxable income that can offset the losses.[7] In contrast, pass-through entities (sole proprietorships, S corporations, LLCs, LLPs, and partnerships) can pass through tax losses to their owners who can then deduct them on their personal returns—subject to various tax-law restrictions.
- The C corporation has no tax-favored long-term capital gains rates, the corporation gets no current deduction for corporate net capital losses (it can carry the losses back three years or forward five years), and corporate tax-exempt income eventually gets taxed in the form of dividends or stock appreciation.[8]

When C Corporation Tax Rules Are Harmless or Even Favorable

Thankfully, C corporations can often avoid the double-taxation threat by zeroing out (or nearly zeroing out) corporate taxable income with deductible payments to or for the benefit of shareholder-employees—like you. Such payments can be for salary, fringe benefits, interest on shareholder loans, and rent paid for property that is owned by the shareholders and used by the corporation. When corporate taxable income can be zeroed out (or nearly so), the double-taxation threat is not applicable.

Even when zeroing out income is impossible, the favorable graduated corporate tax rates can make C corporations attractive compared to pass-through entities.

Specifically, this is the case when the business intends to indefinitely retain all earnings to internally finance its growth. Here's why. Pass-through entities may have to distribute up to 37 percent of their taxable income just so their owners can pay their personal federal income tax bills on passed-through income.

In contrast, the federal rate on a C corporation's retained income is only 21percent. This is still well below the 37 percent maximum rate for individual taxpayers.

Key Point: The use of a C corporation can maximize your newly acquired business's current cash flow by minimizing payouts to cover your current personal income tax bills. But you must remember that the cost of this current tax benefit is potential double-taxation problems that may crop up in later years.

Recommendation

C corporations may be preferred to pass-through entities (sole proprietorships, S corporations, LLCs, LLPs, and partnerships) when the benefits of pass-through taxation are not required because the graduated corporate rates counteract the ill effects of double taxation, or because your venture's income can be zeroed out (or nearly so) with deductible payments to or for the benefit of the owner(s).

Empirical evidence shows that C corporations are still being formed to operate capital-intensive and growth businesses, such as manufacturing and high-tech ventures. Such businesses typically need to retain all earnings to finance capital expenditures and growing receivable and inventory levels. Operating as a C corporation maximizes cash flow by minimizing current outlays for federal income taxes.

And for very successful businesses, the C corporation format lays the groundwork for going public. In contrast, if your newly acquired business will distribute most or all of its cash flow to the owner(s), you should probably operate the venture as a pass-through entity to prevent the dreaded double taxation threat from coming into play.

3. The Qualified Small Business Corporation Option

Qualified small business corporations are a special category of C corporations (meaning corporations that are not S corporations). As a qualified small business corporation shareholder, you can potentially qualify for:

1. a 100 percent federal income tax gain exclusion break when you sell your shares (meaning you owe no federal income taxes on gains from selling them) and
2. a federal income tax gain rollover break (meaning you can roll over proceeds from selling your qualified small business corporation shares tax-free into newly acquired shares of a different qualified small business corporation).

When qualified small business corporation status is available, it can contradict the conventional wisdom that operating as a pass-through entity (sole proprietorship, S corporation, LLC, LLP, or partnership) is the best tax strategy for a small business operation. Here is the story on qualified small business corporations, starting with the gain exclusion rules.

100 Percent Gain Exclusion Break

Thanks to legislation enacted in late 2015, a 100 percent federal income tax gain exclusion (within the limits explained below) is potentially allowed for sales of qualified small business corporation shares that are acquired any time after September 27, 2010. But the qualified small business corporation stock must be held for more than five years for the gain exclusion break to be available.[9]

In any tax year, the amount of qualified small business corporation stock sale gain that can be excluded is limited to the greater of:

- 10 times the shareholder's tax basis in the shares that are sold or
- $10 million reduced by the amount of gain that was excluded in prior tax years ($5 million for shareholders who use married filing separate status).

In effect, the second limitation is a lifetime limit on the gain exclusion break, but the limit is big enough that the gain exclusion break is still a great deal when available.

Gain Rollover Break

There is also a gain rollover break for profitable sales of qualified small business corporation shares.[10]

Under the rollover break, the amount of gain that you must recognize for federal income tax purposes is limited to the excess of your qualified small business corporation stock sales proceeds over the amount that you reinvest in new shares of a different qualified small business corporation. We will call such shares "replacement stock."

You must acquire the replacement stock during a 60-day period beginning on the date of the sale of the original qualified small business corporation shares. The amount of gain that is rolled over reduces the basis of your replacement stock.

Working this rule. The gain rollover break allows you to sell qualified small business corporation shares on a wholly or partially tax-deferred basis without meeting the five-year holding period rule. Then you can potentially take advantage of the 100 percent gain exclusion break when you sell the replacement stock.

Eligibility Rules for Gain Exclusion and Gain Rollover Breaks

To qualify for the 100 percent gain exclusion break and/or the gain rollover break, the stock must meet the following requirements:

- You must have acquired the stock upon its original issuance in exchange for money or property contributed to the corporation or through gift or inheritance.
- The issuing corporation must be a qualified small business corporation on the date of the stock issuance and during substantially all the time that you own the stock.

Qualified small business corporation definition. The following requirements must be satisfied for a corporation to be a qualified small business corporation:

- It must be a C corporation.
- It cannot own either (1) real property with a value that exceeds 10 percent of its total assets, or (2) portfolio stock or securities with a value that exceeds 10 percent of its net worth.
- Its assets cannot exceed $50 million on the date of the stock issuance.

Active business requirement. The corporation must also satisfy an active business requirement to be a qualified small business corporation.

This requirement is satisfied if either: (1) the corporation is a specialized small business investment company licensed by the Small Business Administration (unlikely) or (2) at least 80 percent (by value) of the corporation's assets are used in the active conduct of a qualified business.

Qualified businesses do *not* include:

- The performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other business where the principal asset is the reputation or skill of one or more of its employees.
- Banking, insurance, leasing, financing, investing, or similar activities.
- Farming.
- Production or extraction of oil, gas, or other natural resources.
- Operation of a hotel, motel, restaurant, or similar business.

Recommendation

Qualified small business corporations are treated as "regular" C corporations for all other legal and federal tax purposes. So all the other advantages and disadvantages of C corporation status (explained earlier in this article) apply equally to qualified small business corporations.

For example, qualified small business corporations must pay the standard corporate tax rates. But as explained earlier, taxable income can be reduced (often to zero) by making deductible payments to provide salaries and fringe benefits to shareholder-employees (like you).

A C corporation that meets the definition of a qualified small business corporation may be the preferred entity choice in the same circumstances in which "regular" C corporations are preferred.

These circumstances were explained earlier in this article.

In many situations, including the difficulty in simply selling the stock in a small corporation, the qualified small business corporation tax breaks should be considered a bonus rather than a primary reason for choosing to *not* operate your newly acquired business using a pass-through entity (sole proprietorship, S corporation, LLC, LLP, or partnership).

Takeaways

When buying a business with the idea that you will put that business into a new legal entity, you have much to consider. This article (part 2) gives you insights into the:

1. S corporation
2. C corporation
3. Qualified small business corporation

The part 1 article published last month gave you insights into the proprietorship and the single-member LLC taxed as a proprietorship.

Each of the entities has its place and purpose. If you are in the process of starting a new business or buying a new business, you should spend a few minutes reading both the part 1 and part 2 articles.

---

[1] IRC Section 1366.

[2] See Rev. Rul. 59-221 and *Paul B. Ding*, TC Memo 1997-435, *aff'd*. 9th Cir. 1999.

[3] IRC Section 1402.

[4] IRC Sections 1361; 1366.

[5] IRC Section 11(b)(1).

[6] IRC Sections 301; 312; 316; 317.

[7] IRC Section 172.

[8] Sections 11; 1212.

[9] IRC Section 1202.

[10] IRC Section 1045.

Choosing the Right Entity for a Newly Acquired Business (Part 3)

When you buy a business, one of the first things to think about is the legal form you will use to own and operate the activity. The choices range from sole proprietorships to corporations.

But if the new business that you acquire becomes part of an existing entity (such as your existing LLC or corporation), you already made a choice. You can use this article to see whether that's a good choice for you.

We covered sole proprietorships, single-member (one-owner) LLCs, and three corporate options in Parts 1 and 2. In this analysis, we cover multi-member LLCs and partnerships.

The Multi-Member LLC Option

Multi-member LLCs are popular because they combine the best legal and tax characteristics of corporations and partnerships.

Specifically, a multi-member LLC can offer limited liability protection to all its owners (referred to as members) while being treated as a partnership for federal tax purposes. The generally favorable partnership tax rules are summarized later in this article in our coverage of the general partnership option.

Advantages

Liability protection. When you operate as an LLC, state law generally protects your personal assets from exposure to business-related liabilities. Such exposure can include everything from a lawsuit filed by the FedEx guy who slips on ice-covered steps to the seemingly endless variety of liabilities that can be caused by the actions or inactions of employees.

Key point. Unfortunately, no type of entity (including an LLC) protects your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts.

Tortious acts are wrongful deeds other than by breach of contract—such as negligent operation of a motor vehicle resulting in property damage or injuries. The issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for more information.

Pass-through taxation. Multi-member LLCs are treated as partnerships for federal income tax purposes—unless you elect to have the LLC treated as a corporation.

We covered the corporate tax rules in Choosing the Right Entity for a Newly Acquired Business (Part 2). In this article, we examine the multi-member LLC operating as a partnership for tax purposes.

When you are in a partnership, your share of the business's taxable income items, deductions, and credits is passed through to your personal return. You pay taxes at the personal level on your share of the LLC's profits. Generally, you have no entity-level federal income tax, so you don't have to worry about the double taxation issue that can potentially haunt C corporations.[1]

Disadvantages

Fewer tax-free fringes for owners. Compared with C corporations, multi-member LLCs that are treated as partnerships for tax purposes cannot provide as many tax-free fringe benefits to owners. The fringe benefit rules for multi-member LLCs are essentially the same as the rules for S corporations.[2]

More exposure to self-employment tax. You may owe self-employment taxes—consisting of the Social Security tax component and the Medicare tax component—on income passed through to you by the LLC. In contrast, if you run your business as a corporation, Social Security and Medicare taxes apply only to amounts paid as salary to you and the other owners.

Key point. Under some state laws and/or applicable professional standards (such as state bar association rules), LLCs may be prohibited from operating certain types of professional practices. But when permitted, LLCs are a good choice.

Recommendation

Most advisors agree that the multi-member LLC is the best entity alternative for businesses with several owners if pass-through taxation is desired (such as with a service business where there is no need to retain significant amounts of earnings within the business entity).

Not surprisingly, empirical evidence shows that multi-member LLCs are seldom formed to operate capital-intensive and high-growth businesses, such as manufacturing and high-tech ventures. Such businesses typically need to retain all earnings to finance capital expenditures and growing receivable and inventory levels. These businesses are most often operated as C corporations in order to maximize cash flow by minimizing current outlays for federal income taxes.

Because multi-member LLCs allow all members to fully participate in management without risk of losing limited liability protection (which can happen with a limited partnership), they are ideally suited for closely held entrepreneurial businesses.

Multi-member LLCs may be the best choice for business and investment ventures in the following circumstances:

- There will be more than one owner.

- Pass-through taxation is desired.
- The advantages of partnership taxation are significant compared to the alternative of S corporation taxation, or the entity cannot qualify for S corporation status.
- The activity can be operated as an LLC under state law and applicable professional standards.

Limited Liability Partnership (LLP) Option

LLPs are a relatively new type of entity that can be particularly useful for the operation of professional practices. LLPs are formed and operated pursuant to state LLP statutes.

In some states, LLPs are in essence a special form of general partnership. Like general partners, LLP partners in these states remain personally liable for the general debts and obligations of the LLP (contract liabilities). Contract liabilities include bank loans, lease obligations, vendor accounts payable, etc. But LLP partners are generally not liable for the professional errors and omissions of the other LLP partners and employees.

In most states, LLP partners are not personally liable for the LLP's contract liabilities unless the liabilities are expressly guaranteed by the partners. In such states, LLPs offer "LLC-like" liability protection to their partners (owners).

In all states, an LLP partner generally remains personally liable for his or her own tortious acts and professional errors and omissions (and possibly for errors and omissions of other individuals who were or should have been supervised by that partner).

Key point. The issue of LLP partners' exposure to liabilities related to professional errors and omissions is a matter of state law. Consult an attorney regarding specific questions.

The major advantage of LLPs is the ability to offer pass-through taxation without being affected by the various restrictions applying to S corporations (such as the dreaded one-class-of-stock rule). In addition, LLPs enjoy the other tax advantages that partnerships have over S corporations (covered later in this article).

Recommendation

LLPs are probably the best entity choice for professional service ventures when

- there are several owners,
- pass-through taxation is desired without having to deal with the hassles of S corporation status, and
- LLPs are afforded LLC-like liability protection under applicable state law.

Key point. In many cases, professional practices can be operated as C corporations and avoid the double taxation problem by "zeroing out" corporate income with deductible payments to or for the benefit of the owners. But this is not foolproof.

When the zeroing-out strategy is possible, C corporations are possibly a better choice than LLPs when LLPs are not afforded LLC-like liability protection.

General Partnership Option

The partners of a general partnership are personally liable (without limitation) for all debts and obligations of the partnership.

The liability of general partners is "joint and several" in nature. That means any one of the general partners can potentially be forced to make good on all partnership liabilities. That partner may be able to seek reimbursement from the partnership for payments in excess of his or her share of liabilities. But that depends on the ability of the other partners to contribute funds to allow the partnership to make such reimbursements.

Note that general partners are jointly and severally liable for partnership liabilities related to the tortious acts and professional errors and omissions of the other general partners and the partnership's employees. In addition, general partners are personally liable for their own tortious acts and professional errors and omissions.

Finally, under applicable state law, each general partner usually has the power to act as an agent of the partnership and enter into contracts that are legally binding on the partnership (and ultimately on the other partners).

For example, a partner can enter into a lease arrangement that is legally binding on the partnership. For this reason, it is critical that the partners have a high degree of trust in one another. If that is not the case, a general partnership is inadvisable.

Differences between Partnership and S Corporation Tax Rules

While both partnerships and S corporations benefit from pass-through taxation (where taxable income items, deductions, and credits are passed through to the owners and reported on their personal returns), there are some significant differences between the partnership tax rules and the S corporation tax rules. Most of these differences are in favor of partnerships. They include the following:

- Partners can receive additional tax basis for loss deduction purposes from entity-level liabilities, whereas S corporation shareholders can receive additional tax basis only from loans made by them to the corporation.[3]
- A partner who purchases a partnership interest from another partner can step up the tax basis of his or her share of partnership assets, which minimizes taxes for the purchasing partner when the partnership sells assets or converts them to cash.[4]
- Partners and partnerships have much greater flexibility to make tax-free transfers of assets (including cash) among themselves than do S corporations and their shareholders.[5]
- Partnerships can make disproportionate allocations of income, tax losses, and other tax items among the partners. In contrast, all S corporation pass-through items must be allocated among the shareholders strictly in proportion to stock ownership.[6]

Recommendation

General partnerships are probably the best entity choice when

- there are two or more co-owners, all of whom have a high degree of trust in each other;
- pass-through taxation is desired;
- LLC, LLP, limited partnership, and S corporation statuses are unavailable or unworkable; and
- liability concerns can be managed with insurance.

The Limited Partnership Option

A limited partnership is a separate legal entity (apart from its limited partners) that owns its assets and is liable for its debts. Therefore, the personal assets of the limited partners are generally beyond the reach of partnership creditors. This is the nontax selling point of limited partnerships.

But limited partners still are personally responsible for partnership liabilities resulting from their own tortious acts.

Advantages

Obviously, limited partnerships are treated as partnerships for federal income tax purposes (a favorable attribute), and limited partners are generally not exposed to liabilities related to the entity or its operations. So limited partners generally cannot lose more than what they have invested in the partnership.

Disadvantages

Must have a general partner. Every limited partnership must have at least one general partner, and that general partner is theoretically exposed without limitation to all recourse liabilities of the partnership.

But a general partner can be an LLC or S corporation owned by one or more of the limited partners. That way, the general partner entity can lose its shirt to partnership liabilities, but the economic loss is limited to the general partner entity's capitalization.

The limited partners (including those who own the general partner entity and effectively run the partnership) are protected against losing more than what was invested in their limited partnership interests.

Limited partners can lose liability protection. Another potentially significant negative factor is that limited partners can lose their limited liability protection by becoming too actively involved in managing the limited partnership. As a result, limited partnerships are not suitable for

activities where all partners are heavily involved in the business (for example, professional practices).

In some cases, this problem of being too actively involved can be avoided by having an LLC or corporation owned by the limited partners function as the general partner. Check with a competent business lawyer on this issue.

Key point. Generally, no type of liability-limiting entity (including a limited partnership) will protect the business owner's personal assets from exposure to liabilities related to his or her own professional malpractice or tortious acts. In a nutshell, tortious acts are wrongful deeds other than by breach of contract. An example of a tortious act is negligent operation of a motor vehicle resulting in injuries or property damage to others.

The issue of liability exposure is a matter of state law, and you should seek advice from a competent business attorney for any specific questions on the subject.

Recommendation

Limited partnerships can be attractive in the following circumstances:

- There are at least two co-owners.
- Pass-through taxation is desired.
- LLC status is unavailable.
- Qualifying as an S corporation would be unworkable.

Key point. Most advisors agree that multi-member LLCs, when available, are superior to limited partnerships. But when pass-through taxation is desired, limited partnerships are perhaps the second-best choice when workable.

The State Taxation Factor

More and more, the choice of business entity question is decided based on state tax issues. What works for one might not work for you if you live in a different state.

For example, LLCs are clearly "wonderful" from federal income tax and liability protection perspectives. Texas allows both single-member and multi-member LLCs, but both are subject to the state's corporate franchise tax (which is similar to an income tax).

Colorado also allows both single-member and multi-member LLCs, and neither is subject to state taxation. So in the Lone Star State, you see professional practices set up as LLPs rather than as LLCs because of the state-tax disadvantage of LLC status.

In Colorado, there is no state-tax disadvantage to LLC status, so LLCs are often chosen for professional practices in that state.

Takeaways

As we said at the beginning, one of the first things to think about when buying a business is the legal form you will use to own and operate the activity.

In this article, you saw how the partnership in one form or another can offer advantages over the corporate form.

Keep in mind that once you form the entity that you will use, you likely are going to use that form for a long time. This means you want to get this right at the beginning.

And getting this choice of entity right at the beginning likely means you should get good professional advice.

---

[1] The partnership tax provisions are found in IRC Sections 701-777.

[2] IRC Section 1372.

[3] IRC Section 752 provides the partnership rules. IRC Section 1366(d)(1) and Reg. Section 1.1366-2 allow S corporation shareholders to increase their tax basis for loss deduction purposes by the principal amount of bona fide loans made to the corporation.

[4] IRC Sections 743; 754.

[5] Appreciated assets can usually be transferred back and forth between partners and partnerships with no adverse tax consequences, thanks to IRC Sections 721; 731. In contrast, when assets are transferred from an S corporation to a shareholder, it must be determined whether the transaction is shareholder-employee compensation subject to employment taxes, a distribution, or something else. Distributions of property (other than cash) generally are treated as if the corporation sold the property to the recipient shareholder for fair market value (FMV). See IRC Section 311(b) via IRC Section 1371(a). The corporation must recognize taxable gain to the extent the property's FMV exceeds its basis and must allocate the gain to the shareholders in proportion to their stock ownership per IRC Section 1366. But if basis exceeds FMV, the loss generally cannot be recognized. See IRC Section 311(a) via Section 1371(a).

[6] IRC Section 1366.

Five of Our Popular Articles

Two Correct Ways to Deduct Your Home Office with a Partnership

With the COVID-19 experience, you and your partners may be doing a lot of work from home or even working from home primarily. Is the home-office deduction in the mix? If so, because you are a partner, your options for getting a tax benefit for your home-office deductions are tricky. But no worries, we'll tell you about the two options to use and two options to avoid.

Beat the Unfair $10,000 SALT Cap with a C Corporation

The Tax Cuts and Jobs Act's $10,000 cap on your state and local tax deductions probably took cash out of your wallet—especially if you have a profitable S corporation. A C corporation can make your state income taxes on your net business income 100 percent deductible. When should you make the move to a C corporation?

10 Proven Tax Reduction Strategies for the Self-Employed

We took a deep dive into the hundreds of strategy articles that apply to the self-employed and pulled out 10 that you should spend time with.

How to Deduct Medicare as a Business Expense

When you are in business for yourself, you have options when it comes to creating tax deductions for your health insurance. The tax rules treat Medicare as health insurance, and that means you have options for how to create your tax deductions for Medicare.

Q&A: What Are My S Corporation Election Options?

Because of the Tax Cuts and Jobs Act, more businesses are looking at the S corporation election. But you have to make a timely election to get the tax benefits. This article helps you with both a "timely" and a "late" election.

Interested in a free trial? CLICK HERE. You'll get a no-obligation 7-day FREE trial during which you can read, not only the articles mentioned above, but all of our helpful tax-saving tips. This trial is absolutely free and there are no strings attached.