Borroni CPA

CHOOSING A BUSINESS ENTITY

I. Sole Proprietorship

a. May sell or transfer the business assets
    i. Goodwill can be written off over 15 years

- **Advantages**
    - Can employ family members
    - Can deduct health insurance
    - Can convert to LLC or corporation without triggering a taxable event
    - Only required registration is a trade name in locality
    - Cannot deduct fringe benefits

- **Disadvantages**
    - Liability – personal assets are at risk
    - Need insurance
    - Profits are subject to income tax & self-employment tax

- **Tax Considerations**
    - Deduct ½ self-employment tax
    - Losses are deductible
    - Accrual or cash basis
    - Cannot deduct your own salary
    - SEP IRA or other retirement plan limited to income or $54k
    - Section 199A pass-through deduction is available
        - Deduction of 20% of qualified business income
        - Phased out for income MFJ $315-415k for specified service trade (based on reputation or skill

II. General Partnership

a. Two or more owners
b. Cash or accrual method
c. Share liability with other general partners
    i. Use non-recourse debt
d. General partner may be LLC or corporation

III. Limited Partnership

a. Must have at least two partners; one general partner
b. Liability is limited to investment for LP
    i. Liability of general partner is unlimited
c. Must not participate in management
d. State typically requires a certificate of limited partnership
e. Formal registration not required

    i. Written partnership agreement recommended
    ii. Succession issues, distribution of profits, etc.

- **Disadvantages**
  - Must use calendar year
  - Partners taxed on fringe benefits
  - Partners' earnings subject to FICA

- **Tax Considerations**
  - Avoid double taxation
  - Can deduct losses up to basis
  - Section 754 election – adjust asset basis upon sale, death of partner, etc.
  - Partnership is nontaxable entity
  - Partnership files separate return (Form 1065)
  - Individuals receive K-1 and file Schedule E
  - Section 751 "hot assets"
    - Unrealized receivables, inventory, recapture items
    - Allocation to those items in sale treated as ordinary income
  - Inclusion of both capital contributed & a share of entity's debt in partner's basis

IV. Limited Liability Company

a. Hybrid; Limited liability and pass-through taxation
b. Created by filing a Certificate of Formation
c. Can be considered "disregarded entity" and treated as sole proprietorship

- **Tax Considerations**
  - Can be taxed as partnership or C or S corporation
  - LLCs with multiple members are generally taxed as partnerships

V. C Corporation

a. Certificate of incorporation is filed with State
    i. Name directors
    ii. Registered agent
    iii. Issue stock/par value
b. Limited liability
c. Centralized management
d. Continuity of life
e. Personal service corporation is subject to a flat 21%
    i. Distribute "dividends" to owners as compensation
    ii. Used to avoid liability

- **Advantages**
  - May have more than one class of stock

- Can choose fiscal year
- Most shareholder fringe benefits may be deducted by corporation

- **Disadvantages**
  - Must use accrual method of accounting
  - Double taxation; earnings taxed at corporate level & shareholders taxed again
  - Losses are not deductible by shareholders
- **Tax Considerations**
  - Formation is tax-free event
  - Double taxation
  - Certain fringe benefits to shareholders are deductible by corp
  - May be subject to accumulated earnings tax
    - Personal holding company tax
    - AMT
  - Disposition - Seller prefers to sell the stock of the corporation
    - Buyer prefers to purchase the assets rather than the stock
      - Buyer pays tax on assets
    - Seller has ordinary gain
  - Seller's goodwill is an asset in sale
    - Win/win for buyer & seller
    - Cannot have non-compete

VI. S Corporation Treatment

a. May have only one class of stock
b. Shareholder shielded from liability
c. No non-resident alien shareholders
d. Shareholders may only be individuals or S corp
e. if C corp converts to S corp, C corp attributes continue for 5 year
f. Must file an S corp election (form 2553) with the IRS

- **Tax Considerations**
  - Election is made to have corporation's profits & losses pass thru to shareholders
  - **Shareholder is not subject to self-employment taxes**, accumulated earnings tax or Personal Holding Company tax
  - For losses, shareholders can only deduct up to basis without consideration of recourse debt, etc.
  - What constitutes "reasonable compensation" may be an issue if wages are too low
  - S corporation items may not be specially allocated to various shareholders

C corporations are separately taxable entities. They file a corporate tax return (Form 1120) and pay taxes at the corporate level. They also face the possibility of double taxation if corporate income is distributed to business owners as dividends which are considered personal income. Under Section 2017 Tax Cuts and Jobs Act corporate rate reduced to 21%.

The corporate structure limits each owner's personal liability for the corporation's business debts to the amount invested in the company by the shareholder. C corps can have an unlimited number of shareholders, have more flexibility to provide employee benefits and may offer stock options to employees.

An **S corporation** is considered a "pass-through entity" which means the income is reported and taxed on the owners' personal tax returns. The highest individual tax rate for 2018 for married filing jointly is 37% based on income in excess of $600,000. S corporations are restricted to no more than 100 shareholders and offer greater flexibility in setting salaries for employee/owners to minimize Social Security and Medicare taxes.