# Revisiting Entity Choice for Small Business Owners

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Recent changes and proposed changes in federal tax laws may affect the important decision about which entity to choose when starting a small business. Reduction in the rate of tax on dividends to 15 percent has lessened the impact of double taxation of corporate income under Subsection C of the Internal Revenue Code. The Treasury Department's recent statement of support for proposals that reduce complexity in tax laws governing Subchapter S may make that entity choice more appealing than those taxed under complex partnership laws.[1] This article will provide an overview of several business entity forms from tax and legal perspectives.

## Most Popular Business Forms In Recent Years

Since 1986, when individual income tax rates were significantly reduced, S Corporations have grown in popularity. They are not the most popular business form, however. As of the year 2000, S Corporations accounted for less than 8 percent of non-farm business with gross receipts under $250,000. Most small businesses (79 percent) were sole proprietorships and the remaining 13 percent were C corporations, partnerships, and limited liability companies.[2]

## Benefits of Incorporation

Historically, the reason for choosing the corporate form over sole proprietorship or partnership has been to gain limited liability for business debts for the owners

[1] US Treasury, Statement of Gregory F. Jenner before House Ways and Means Subcommittee on Select Revenue Measures, 6/19/2003, treas-taxes@lists.treas.gov, P.1

[2] Ibid. p.2

(shareholders.) In most cases, their losses are limited to their investments in the company.

Shareholders must be careful to maintain the corporate formalities and avoid using the corporation as an "alter ego". If business funds are co-mingled with personal funds, no annual meeting is held, no corporate minutes are maintained, or in other ways the corporate form is disregarded, creditors may seek to "pierce the corporate veil" in order to access the shareholders' personal assets to satisfy corporate debts.

In closely held corporations, shareholders still have some flexibility in retaining earnings for future business growth rather than paying dividends. If the stock increases in value, the new capital gains rate of 15 percent will lessen the tax bite on gains when the stock is sold. If dividends are desirable, the new preferential rate of 15 percent for shareholders effectively reduces the double taxation for those in higher individual tax brackets.

If shareholders work for the business, their salaries, if not unreasonable, can qualify as a deduction on the corporate return.

If the corporation is not thinly capitalized, shareholders' loans to the company can create interest deductions on the corporate return.

## Subchapter S Election

Shareholders who expect the business to grow larger and more profitable in the future may prefer to incorporate under state law, then elect Subchapter S tax treatment during start-up years when losses are expected. The losses can be passed through to the shareholders' individual tax returns, providing immediate tax savings that can be used to invest in the company. As the business grows and becomes successful, the shareholders can revoke S Corporation status and revert to being taxed at the corporate level under Subchapter C if tax rates are more favorable at the corporate level.

According to the Treasury Department, S corporations account for more than 37 percent of non-farm businesses with gross receipts over $1 million and more than 25 percent of non-farm businesses with gross receipts over $50 million.[3]

In 1996, major reforms were made in tax treatment of S corporations The purpose of these reforms was to move the S corporation tax treatment closer to that of partnerships.[4]

Congress once again is considering changes in the tax treatment of S corporations. In his June 19, 2003 statement before the House Ways and Means Subcommittee on Select Revenue Measures, the Treasury Department's Deputy Assistant Secretary for Tax Policy, Gregory F. Jenner, commented on proposed changes. He pointed out that between 1996 and 2000, growth in S corporations exceeded that of limited liability companies. "We believe this is due in no small measure to the complexity of the partnership system compared with S corporations," he noted. Jenner went on to reiterate Treasury's basic goal of preserving the relative simplicity of Subchapter S while increasing flexibility to businesses choosing that form.[5]

A few of the proposed changes to taxation of S corporations that the Treasury Department does not oppose include:

(1) Allow shareholders of an S corporation to obtain full benefit of a charitable contribution of appreciated property by the corporation.

[3] Ibid. p.2

[4] Ibid. p.1

(2) Allow S corporation shareholders to transfer suspended losses on a divorce.

(3) Permit an electing small business trust (ESBT) to claim an income tax deduction for any interest incurred to purchase S stock.

(4) Eliminate earnings and profits earned by a corporation as an S corporation prior to 1983.

(5) Allow charitable contribution carryforwards and foreign tax credit carryforwards to offset the corporate-level tax on built-in gains.[6]

The Treasury Department does oppose proposals to increase the number of permissible S corporation shareholders from 75 to 150 because they believe that would increase complexity of this business form.[7]

Limited Liability Companies

This relatively new business form developed in the U.S. as a result of the growth of international trade with Germany and Latin America, where organizational forms were available that combined limited liability, separate legal entity, conduit treatment similar to partnerships, dissolution on an owner's death, and controlled admission of new owners.[8] Subchapter S did not allow nonresident aliens as shareholders, so U.S. businesses began lobbying state legislatures to pass structures similar to those in Germany and Latin America that would be accessible to nonresident aliens. The result is the limited liability company

[5] Ibid. p.3

[6] Ibid. p.3

[7] Ibid. p.7

[8] Murphy and Higgins, *Concepts in Federal Taxation* 2004 Edition, p. 561.

Limited liability companies have some corporate characteristics, including an unlimited number of members, limited personal liability for members, and flexible design structure. They do not enjoy public trading. They do, however, enjoy a centralized management structure and unlimited life of a sort. They have the partnership tax advantages of loss pass through and no double taxation. Another advantage is the simplicity of the form. For example, limited liability companies do not have to hold formal board meetings with detailed minutes. Members must endure the loss limitations inherent in filing an individual tax return. They may also be subject to alternative minimum taxes.[9]

While care must be taken in drafting the document known as the "operating agreement" which governs a limited liability company, flexible statutes allow members to insert any rules they would like. They must be careful to spell out everything in order to satisfy state law and the Internal Revenue Service. There are no limits on the number of investors and no limitation on the types of individuals or organizations that are allowed as members.[10]

Partnerships

A partnership usually is defined as "the association of two or more persons for business." Next to sole proprietorship, a partnership may be the simplest form of business entity.

A contract to form a partnership may be written or oral. Not having a formal written agreement may be an unwise decision. When differences of opinion crop up,

[9] What are Limited Liability Companies?, *Free Advice,* Retrieved May 3, 2003 from http://business-law.freeadvice.com/partnership/limited_libility.htm.

friendships and family relationships can suffer serious harm. If lawsuits are involved, the court must rely on one partner's word against the other partner(s), although equality is assumed.

The contract, whether written or oral need only include these five elements:

1. Exhibit an intention to form a partnership.
2. A contribution of property, labor, or skill.
3. An objective of benefit to all partners.
4. An objective to make a profit.
5. Fulfillment of all requirements inherent in a contract.[11]

When preparing a written contract, it is wise to include additional items such as listing what each partner contributed, how distributions will be made and in what proportion, how long the partnership is intended to last, and how it will be dissolved.[12]

Characteristics of a partnership include joint ownership of property, joint participation in business management, and joint obligation regarding debts of the partnership. Any contract entered into by a partner binds all partners. If that contract cannot be fulfilled, each and every partner is obligated to the full extent of his or her business and personal assets. Most partnerships are limited in size to twenty partners by the Companies Act. Some organized professions are exempt from this limitation.[13]

[10] Glossary Terms, *The Limited Liability Company Website,* Retrieved May 4, 2003 from http://www.llcweb.com/Glossary.htm.

[11]Partnership - Nature, *Business Entities - Partnership*, Retrieved May 3, 2003 from http://www.spotlight.co.za/counsellorPartnership-Nature.htm.

[12]Partnership – Formation, *Business Entities - Partnership*, Retrieved May 3, 2003 from http://www.spotlight.co.za/counsellorPartnership-Formation.htm.

[13]Partnership - Nature, *Business Entities - Partnership*, Retrieved May 3, 2003 from http://www.spotlight.co.za/counsellorPartnership-Nature.htm.

In a general partnership, all partners are "jointly and severally liable" for all debts. In other words, they are equally but totally responsible for all debts. There is no protection against the loss of the personal assets of any of the partners. Each partner is known to be associated with the partnership and have full decision-making and management authority.[14]

There are several circumstances that cause a partnership to come to an end. A written contract may state a length of time or specific date for termination. When a partnership has been formed for a specific venture and that venture is completed, the partnership ceases to exist. If one partner dies or retires, remaining partners may choose to end the partnership or form a new partnership. Partners may come to an agreement to end the partnership. In the case of insolvency of the partnership or one of the partners, the partners may terminate the partnership. A court may order termination of a partnership.[15]

## Summary

In today's complex and litigious business environment, the prudent businessperson should seek competent tax accounting and legal advice before making a decision on business entity. There is no "one size fits all." Personal circumstances, types of business activities, plans for future growth, all must be considered before taking the first step in forming a business.

[14] Hinson, Chris, The Difference Between a Partnership and a Limited Partnership, Alllaw, Retrieved May 3, 2003 from http://www.alllaw.com/articles/business_and_corporate/article12.asp.

[15] Partnership – Formation, *Business Entities - Partnership*, Retrieved May 3, 2003 from http://www.spotlight.co.za/counsellorPartnership-Formation.htm.

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