tax IMPACT

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Ensuring your business structure is the right one

Selecting the right business structure — C corporation, S corporation, limited liability company (LLC), partnership or sole proprietorship — for your business is a complex decision that requires you to consider a number of interrelated tax, liability and administrative factors.

There's no one right answer because it depends entirely on your circumstances, which may change over time. That's why it's essential to periodically review your business structure. Here's an overview of some of the factors that will affect whether you keep your current structure or, if needed, elect a new one.

What are your options?

For many businesses, the entity choices come down to three options: C corporation, S corporation or LLC, because all three limit their owners' exposure to personal liability for the company's debts and obligations. (The limited liability partnership is a variation of the LLC and is used by professional firms in some states.) Note that no business entity can shield an owner from the consequences of his or her own actions, such as malpractice, slander, sexual harassment or an automobile accident.

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General and limited partnerships have become less common since the creation of LLCs. Why? LLCs offer most of the flexibility of a partnership combined with the liability protection of a corporation.

For a one-person business, a sole proprietorship is the simplest entity to set up and operate, but it offers no protection against personal liability. A one-person business can establish itself as a single-member LLC, which for tax purposes is disregarded. The single-member LLC activity is reported on the member's individual income tax return just as it would be for a sole proprietorship.

Which has the greatest flexibility?

LLCs have certain advantages. They're relatively easy to set up, have few restrictions and require little in the way of corporate formalities. Members have flexibility in the allocation of profits and losses.

S corporations have certain limitations. They can't have more than 100 shareholders (though most members of the same family are treated as a single shareholder) or more than one class of stock. Also, eligible S corporation shareholders are limited to individuals, certain trusts and tax-exempt organizations, and employee stock ownership plans.

What are the tax considerations?

The biggest disadvantage of a C corporation is double taxation. Profits are subject to corporate income tax at the entity level and then to personal income tax when they're distributed as dividends to the shareholders. To the extent the corporation is able to distribute profits in the form of salaries and bonuses, however, the deduction for wages paid eliminates double taxation. Keep in mind that there are restrictions on what is considered reasonable compensation.

Like partnerships, S corporations and LLCs are "pass-through" entities, which means that all of the company's profits and losses are passed through to the owners, who report their shares on their personal income tax returns. (Sole proprietors also report business profits and losses on their personal income tax returns, using Schedule C.)

Despite double taxation, C corporations offer some tax advantages. For example, C corporations may be able to deduct employee benefits for owners, such as health reimbursement plans and long-term care insurance, that may not be available to S corporations and LLCs.

Additionally, due to the graduated tax rates of a C corporation, a business may be able to build up and retain capital at a lower current tax rate than it would with an LLC or S corporation. For instance, the C corporation pays tax at a 15% rate for the first $50,000 of profit. An owner of an LLC or S corporation is taxed on net profit, which could push the owner into a tax bracket higher than 15%.

When it comes to self-employment taxes, S corporations may have an advantage over LLCs, because S corporation profits aren't subject to self-employment tax. LLC members, unlike S corporation shareholders, may be subject to self-employment taxes on their entire profits. However, S corporations must pay reasonable salaries to owner-employees.

Changing your business entity

Even if you select the optimal structure when you start your business, a different entity type may become desirable as your company grows and changes. If you decide to go public, for example, you may need to convert your limited liability company (LLC) or S corporation to a C corporation.

It's relatively easy, from a technical standpoint, to convert one type of entity into another, provided you meet the eligibility requirements (such as the 100-shareholder limit for S corporations). Keep in mind that certain conversions may have tax implications.

For instance, converting an LLC into a C corporation or S corporation is generally a tax-free transaction. The reverse can have a different outcome: Converting a corporation into an LLC may generate a tax liability, because the conversion is treated as a deemed liquidation of the corporation.

Meanwhile, converting a C corporation into an S corporation is fairly simple. Depending on your circumstances, however, the conversion may generate tax because of the built-in gains tax. This is a separate corporate-level tax levied on certain dispositions held by an S corporation on the conversion date; it's applicable for the 10-year period following the entity change.

Certain conversions may have other tax implications or requirements, such as compliance with state laws, so it's critical to plan carefully and consult your tax and legal advisors before making any changes.

What about financing?

It may be more difficult for S corporations to attract equity investors because of limits on the number of shareholders and their inability to issue preferred stock. Outside investors often insist on preferred stock because they get priority over common stockholders in the payment of dividends and liquidation of assets. LLCs can have an unlimited number of investors and have a great deal of flexibility to create different types of interests to meet investors' needs.

All types of business entities have access to bank loans, but banks may be more likely to ask for personal guarantees from S corporation shareholders, LLC members and partners.

Choose wisely

Choosing an entity type for your company is a complex process and the issues discussed here are just a few you need to consider. But with planning and expert tax advice you can ensure you have the right structure for your needs. ◎

The home sale exclusion may be more limited than you think

The capital gains tax exclusion for home sales may be the best-known provision in the tax code. It's also widely misunderstood because many people assume they can sell their homes tax-free. Plus, a recent tax law change further limits the exclusion for certain sellers.

Eligibility requirements

To qualify for the home sale exclusion, you must own and use the home as your principal residence for at least two years during the five-year period preceding the sale. In addition, you can't use the exclusion more than once every two years.

If you qualify, you can exclude up to $250,000 ($500,000 for joint filers) in capital gain from income. On the other hand, ineligible taxpayers who have owned their home for more than one year will be taxed on their entire gain at the long-term capital gains rate (currently 15%); meanwhile, those who have owned their home for one year or less will be taxed at their short-term capital gains rate, which is equal to their ordinary income tax rate and may be as high as 35%.

If you sell your home before you meet the two-year threshold because of certain circumstances, you're entitled to a prorated exclusion.

If you sell your home before you meet the two-year threshold because the primary reason is for a change in employment, health issues or other unforeseen circumstances, you're entitled to a prorated exclusion. "Unforeseen circumstances" that might cause you to move prematurely include condemnation or other involuntary conversions, natural disasters, acts of war or terrorism, death, divorce or multiple births (twins, for example).

Keep in mind that it's the maximum exclusion that's prorated, not your gain, so you can still exclude your entire gain if it's within your prorated exclusion.

Reduced exclusion for conversions

Previously, it was possible to convert a nonqualified residence — such as a rental property or vacation home — into a principal residence, live in it for at least two years and then sell it at a gain without incurring any tax liability. The Housing Assistance Tax Act of 2008 (HATA) made this strategy less desirable. Now, if you convert a rental property or vacation home into a principal residence, the amount of gain you can exclude is reduced by any period of nonqualified use prior to the conversion.

Let's look at an example. Teri and Richard buy a home in June 2009 for $500,000 and rent it out for two years. In June 2011, they move into the home and use it as their principal residence for another two years, selling it in June 2013 for $900,000. Previously, Teri and Richard

would have been able to exclude their entire $400,000 gain. Under HATA, because their use of the home was nonqualified for two of the four years they owned it, the gain they can exclude is reduced by 50% to $200,000.

Note that the new rule applies only to periods of nonqualified use beginning on or after Jan. 1, 2009. Also, you can still take a full exclusion if the nonqualified use occurs *after* you use the home as a principal residence, provided you meet the other tests for the exclusion.

Avoid surprises

The home sale exclusion is a valuable tax break, but it's not always available. To avoid unpleasant tax surprises, be sure you know the tax implications before you sell. ◎

Succession story

Estate planning for family business owners

If you own a family business, chances are that a substantial portion of your wealth is tied up in it. To protect that wealth for your family, it's important that your estate plan address succession planning.

Unfortunately, many families invest a lot of time, energy and resources into building successful businesses but pay little attention to how their companies will make the transition from one generation to the next. According to a 2008 study by Campden Research, *Protecting the Family Fortune*, a majority of affluent family business owners "are not implementing succession plans, don't have asset protection strategies and are not updating estate plans, leaving their professional and personal interests vulnerable." Campden Research is a research organization that focuses on family business issues.

Failure to address succession is risky: According to the study, only 15% of family businesses survive past the second generation. To improve your odds and protect your family's wealth, consider strategies to ensure your succession is successful and the tax impact is minimized.

Ownership vs. management succession

Ideally, from a management perspective, you'll have an obvious successor, such as a child who is active in the business and has the skills and temperament necessary to assume a leadership role. However, if several children or other family members are competing for the job or if a nonfamily member is best suited to take the reins, conflicts could occur. By allowing family members to participate in the succession planning process, identifying a successor well in advance and explaining your decision to those affected, you can help ensure a smooth transition.

Another thorny issue is how to divide your wealth between family members who work in the business and those who don't. If you want to divide your estate equally among your children or other family members and you have significant nonbusiness assets, you can leave the business to those who are active in it while still treating everyone fairly.

For family business owners whose wealth is tied up in the business, equal isn't necessarily fair. A child who

has spent years helping you grow the company may object to sharing control with family members who weren't involved. One way to share the wealth without diluting management control is to give voting stock to children working in the business and nonvoting stock to the rest.

A tax-efficient transition

From a tax perspective, succession planning is critical because the way you transfer the business to the next generation can have significant gift and estate tax implications. Even though the estate tax is set to be repealed in 2010, it's scheduled to return in 2011 at higher levels than before. Congress is unlikely to let that happen, but it's still best to be prepared for some level of estate tax.

It's possible that the most effective way for you to minimize estate taxes is to begin transferring business interests during your lifetime. With proper planning, you'll be able to remove these assets from your estate today without negative gift and estate tax consequences, and avoid gift and estate taxes on any future appreciation in value.

In planning the transition, you need to balance the benefit of reducing transfer taxes against your desire to maintain management control and your need to continue to receive income from the business.

If you're comfortable relinquishing control over the business, the simplest strategy is to begin making regular gifts of ownership interests, taking advantage of the $13,000-per-recipient annual gift tax exclusion and the $1 million lifetime gift tax exemption (the current limits in 2009).

Tools for transferring ownership

There are several other tools you can use to transfer business interests to your family at a low tax cost, including:

Family limited partnership (FLP). This strategy involves forming a limited partnership to own the business and transferring limited partnership interests to your children or other family members. By retaining a small general partnership interest, you retain management control while removing most of the business's value from your estate. Because limited partners have scant control over the partnership, their interests are entitled to valuation discounts for gift tax purposes. Another advantage of an FLP is that it provides liability protection for limited partners.

An FLP is a powerful tool, provided you can do without the income associated with the transferred interests. Also, they're complex entities, and they must be structured and operated carefully in order to avoid an IRS challenge.

Self-canceling installment note (SCIN). For those who can't afford to give their businesses away, another option is to sell it to family members. By using a self-canceling installment note (SCIN), you can even provide for the buyers' payment obligations to terminate on your death without adverse tax consequences. This strategy can be risky, because you need to charge a premium as compensation for the possibility that the buyers won't pay the full purchase price. But if you have reason to believe that you won't reach your normal life expectancy, a SCIN can provide your family with a tax-free windfall.

If you're comfortable relinquishing control over the business, the simplest strategy is to begin making regular gifts of ownership interests, taking advantage of the annual gift tax exclusion and lifetime gift tax exemption.

Employee stock ownership plan (ESOP). An ESOP is a qualified retirement plan similar to a 401(k) plan except that it's required to invest primarily in the company's stock and often the company stock is its sole investment. The business makes tax-deductible contributions to the plan, which can be used to buy some or all of your stock. This can be a tax-efficient means of transferring stock to employees, whether family members or others. At the same time, it enables you to remove some of your equity from the business, so you can finance your retirement or create a source of liquidity to provide for family members outside of the company.

Secrets to succession

There's no one right way to plan for family business succession. It depends on your particular circumstances and goals. But one thing is certain: To ensure that your business is among the 15% that survive to the third generation, you need to have a plan that addresses the tax impact of transferring your ownership interests to the next generation. ◎

tax TIPS

If you don't ask …

State and local governments recognize the advantages of attracting new businesses and encouraging existing companies to expand. They know that this sort of growth brings new jobs, increases tax revenues and provides countless other benefits for their communities.

Most governments offer a variety of tax credits, deductions, grants and other incentives to businesses that invest within their borders. Some of these incentives are statutory so, if you qualify, you simply claim the tax benefit on your company's income tax return. However, in many cases, the most valuable incentives are discretionary — you need to negotiate them with a local taxing authority or economic development agency.

If you're planning to relocate or expand your business, it pays to approach municipalities or local government agencies about location-based incentives. They may offer you real or personal property tax breaks, sales and use tax breaks or other incentives that — unlike income tax breaks — provide your business with immediate benefits whether you're profitable or not. ◎

Seller beware

If you sell products on eBay or other online auction sites, be sure your tax house is in order. A relatively unknown provision of the Housing Assistance Tax Act of 2008 requires banks and other processors of credit card transactions to file 1099s reporting a merchant's annual gross payment card receipts. Similar paperwork must also be filed by companies that process online payments, such as PayPal.

The new rules don't take effect until 2011, and there's an exception for merchants with less than $20,000 in gross sales and fewer than 200 transactions per year. If your online sales are significant or there's a chance that your casual sales will grow into a profitable business down the road, it's important to report all income. ◎

There's no place like home

Many investors assume that municipal bonds are tax-free. Although that's true for federal tax purposes, it's not always the case for state income tax purposes. Most states exempt home-state municipal bonds from income tax, but many states tax interest on out-of-state bonds. A recent U.S. Supreme Court case, *Department of Revenue of Kentucky v. Davis,* upheld the constitutionality of this practice.

Municipal bonds typically earn lower returns than comparable corporate bonds. But to compare apples to apples, you need to compute a municipal bond's taxable-equivalent yield. If you're in the 33% federal income tax bracket, for example, a municipal bond earning 4% is equivalent to a taxable bond earning 5.97%. To make a fully informed decision about municipal bond investments, however, you should also find out whether your state treats home-state bonds and out-of-state bonds differently. ◎

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