

WHAT IS THE BEST ENTITY?

By Garrett Sutton, Esq. and Kathy Spitzer, Esq.

It's probably the most frequently-asked question that we hear from entrepreneurs, both experienced and those just getting their feet wet. So, we've put together this report to help you make that selection. Hopefully this information will allow you to make a more informed decision about the entity that is right for your business. But don't despair if you don't see your business fitting into any of the models set out below -- we also offer a service where your business structure is reviewed and you are provided with our opinion as to the best entity in your situation. And, because in many cases, the company structure you choose will be based on how it will pay taxes, our top-level review will have your business plan run past a CPA, to make sure all of your options are reviewed. We can also review your existing business structure and offer our suggestions for maximizing your strategy. A review of entities follows:

Sub-Chapter "S" Corporations ("S Corp")

An S Corp is a great entity for a beginning business that:

- will provide a service;
- does not have significant start-up costs;
- will not need to make major equipment purchases before beginning operations;
- will make a sizable amount of money without a great deal of effort and expense; and
- expected growth of no more than 75 shareholders, who will all be people who living in the United States or who file a U.S. Resident tax return.

An S-Corp is structurally the same as a C corporation (i.e., it has officers, directors and shareholders), but with one key difference. An S Corp files an election with the IRS, called a Form 2553, that provides it with a flow-through tax structure as found in entities such as partnerships and limited liability companies. That means, the company's income (and corresponding expenses, write-offs and deductions) will flow through to its shareholders, and be split among them according to each shareholder's ownership percentage. The S Corp's taxes will actually be paid by its shareholders, at their individual tax rates, and in proportion to their individual ownership percentages.

From a taxation standpoint, an S Corp is a great fit for a company that offers a service, because in many cases the revenues can be split and paid to the shareholders in two categories: salary and passive earnings. A flow-through tax structure means that the profits and corresponding losses, deductions and expenses are divided up among the shareholders, in proportion to their ownership percentages, and reported on each shareholder's personal income tax return. Therefore, if your income from an S Corp is split into two streams, salary and passive, each stream will be taxed differently. Your salary stream will be subject to both income tax and payroll taxes such as medicare and social security. However, the passive income stream will be subject only to income tax. So, by taking a reasonable salary from the S Corp your tax bracket would be lower than if you were take your entire share of the earnings as salary, and the remaining share would flow through to you as passive income, and would also be taxed at this lower rate.

An S Corp is also a great entity for businesses with low start-up costs, that do not have to purchase a significant amount of assets to begin operations. For example, buying a working laundromat would be an excellent choice for an S Corp. You are purchasing a turnkey business - it's already operating, and you aren't going to be laying out significant cash to get it up and running. So, you will have a pretty good income stream immediately, and that income stream can best be disbursed to you and your partners, if any, through the S Corp structure. Two other great matches for an S Corp are network-marketing and Internet-only businesses. In each case, the business is likely to have no storefront, low operating costs, and probably doesn't maintain a warehouse. Most network marketing and Internet-only businesses drop-ship from their suppliers directly to the end consumer when they are delivering products at all. Again, as these can be high-income, low cost operations, they work great in the S Corp structure.

Here's another reason we suggest S Corps for many service-oriented businesses -- To avoid being characterized as a Personal Service Corporation, or "PSC" by the IRS. PSCs are C corporations that are classified by the IRS as providing a service, such as consulting, to the general public. Now, as you may know, the United States government, in an effort to boost the economy and keep business working, assesses C corporations with a pretty low initial rate - 15% on earnings up to \$50,000. That's quite a bit lower than you would pay personally, if you were receiving that same \$50,000 as salary. And, that 15% rate is also lower than you would pay if your business was an S Corp. So, to head off the anticipated

revenue drain, the IRS closed that loophole by designating C corporations that provide services to be PSCs. The additional tax rate for PSC earnings can be a flat 35% or the regular C Corporate plus 15% of the corporation's undistributed personal holding company income. That maybe higher than you would pay through your S Corp, if you took a reasonable salary and the rest as passive income. And, it's enough, in many cases, to make the difference between going S Corp and C Corp.

A downside to S Corps is the limitation on who can be a shareholder, and what kind of shares it can issue. There can be no more than 75 shareholders in total, and no-one may take their shares in anything other than their personal names (or in their living trust). So, forget transferring your S Corp shares into an irrevocable trust, limited partnership or children's trust. And, you can't have any non-U.S. resident shareholders, either. Everyone who holds shares in an S Corp must file a U.S. resident tax return. And, you can only have one class of shares, which can be confining, especially if your plans include taking your company public or looking for outside investors. If you breach any of these requirements the IRS will strip your company of its S Corp status, and automatically turn it into a C Corporation, which may have a negative tax consequence.

Another downside is asset treatment. Both C and S Corps are not great vehicles if your business will hold appreciating assets, such as land, buildings, stocks, bonds, etc. The tax on them upon sale will be much greater if held in a corporation than if held in a limited liability company or a limited partnership. This is further explained in the book *How to Use Limited Liability Companies & Limited Partnerships*, written by Garrett Sutton and available at www.successdna.com.

The steps to create a C or S corporation are the same. Articles of Incorporation are prepared and filed, Bylaws are prepared, directors are elected by the shareholders, officers are elected by the directors, and shares are issued to the shareholders. This may sound difficult but we will be there to guide you through it all.

The S Corp Declaration, that Form 2553 we mentioned above, should be filed within 75 days of the incorporation date, so don't delay if this is how you see your company proceeding. If you don't file within that 75 day period, the IRS can deny you S Corp status for a full year, meaning that your first year of operations will be conducted at C Corporation tax rates.

The shareholders, directors and officers of the company must remember to follow corporate formalities. They must treat the corporation as a separate and independent legal entity, which includes holding regularly scheduled meetings, conducting banking through a separate corporate bank account, filing a separate corporate tax return, signing all documents related to the business in their official capacity, and filing corporate papers with the state on a timely basis. If these steps are not followed, a business creditor may be allowed to "pierce the corporate veil" and seek personal liability against the officers, directors and shareholders. Adhering to corporate formalities is not at all difficult or particularly time consuming. In fact, if you have our affiliate handle the corporate filings and preparation of annual minutes and direct your accountant to prepare the corporate tax return, you should spend no extra time at it with only a very slight increase in cost. The point is that if you spend the extra money to form a corporation in order to gain limited liability it makes sense to spend the extra, and minimal, time and money to insure that protection.

Regular, or "C" Corporations ("C Corp")

A C Corp is a great entity for a beginning business that:

- wants to retain earnings, rather than disbursing them each year;
- may have large start-up costs and expects to have losses in the first few years;
- wants to look for outside investors, and may even plan on going public;
- wants to have multiple classes of stock and sell stock to anyone, anywhere in the world;
- wants the option of providing its owners with tax-free benefits, as well as its employees;
- may have very high-income owners.

C Corps came of age in England in the 1500's, as the Crown's answer to Fate and Mother Nature. At that time, most business ventures were operated as general partnerships. As general partnerships, these business ventures also featured unlimited liability of each partner, one of the key reasons general partnerships should be avoided. So, that new three-masted schooner you and your partners purchased, outfitted and sent on a trade mission to China for silk and pepper had better not sink, or you and your partners would be personally answering to the bank that loaned your business the money to buy the ship, the creditors that provided you with trade goods to outfit your ship, or to your families, if it came from your own pocket.

Unfortunately, both Fate and Mother Nature intervened frequently, and the losses were staggering. In an attempt to keep business moving, the English government invented the Corporation, which existed as its own entity, distinct and separate from each shareholder who had invested into it. The partners (now called shareholders) were liable only for the money they invested. Creditors now had only the Corporation to sue, and not the shareholders - so if the Corporation had no assets (or it did, but they were resting at the bottom of the ocean) those creditors were out of luck. (And thus the insurance industry was born, but that's a different story.) The "C" in C Corp is an IRS code section as is the "S" in S Corporations.

Because C Corps exist as their own entity, a C Corp will file its own tax return. As we explained earlier, a C Corp's earnings will be taxed at a relatively low rate on the first \$50,000 in taxable income. But you must be aware that forming one or more C Corps and putting a portion of your money into each company, with the idea that each C Corp will fit into the lower, 15% tax bracket won't work. If you wind up owning more than 50% of one or more of those companies you have formed to disburse your wealth, the IRS will tag all of those companies as being part of a control group, and ramp their taxation rates back up towards a 38% rate. Control group status only applies to C Corps though, so be careful to plan a proper mix of entities into your wealth-planning structure.

A C Corp has the widest range of deductions and expenses allowed by the IRS, especially in the area of employee fringe benefits. A C Corp can set up medical reimbursement and other employee benefits, and deduct the costs of running these programs, including all premiums paid. The employees, including you as the owner/shareholder, will also not pay taxes on the value of those benefits. This is not the case in a flow-through entity, such as an S Corp, LLC or LP. In each of those cases the entity may write off the costs of the benefits, but any employee/shareholder who owns more than 2% of the entity will pay taxes on the value of their benefits received. So, if having the maximum deductions and all of the employee fringe benefits on a tax-free basis is important to you, a C Corp may be your entity choice.

C corporations are great for a business that sells products, has a storefront and employees, and may or may not have a warehouse where it keeps its inventory. C Corps don't work well businesses that want to hold appreciating assets, such as real estate, because of the tax treatment on the sale of these assets.

But the most often-cited disadvantage of using a C Corp is the "double-taxation" issue. Double-taxation happens when a C Corp has a profit left over at the end of the year and wants to distribute it to the shareholders, as a dividend. The C Corp has already paid taxes on that profit, but once it distributes the profit to its shareholders, those shareholders will have to declare the dividends they receive as income on their personal tax returns, and pay taxes again, at their own personal rates.

There are many things you can do to avoid the double-taxation scenario. Structure the C Corp so that there are no profits left over -- use all of the write-offs and deductions allowed by the IRS to reduce the C Corp's net income. Offer great benefit plans! Pay higher salaries to yourself and the other owner/employees than you would if you were using a flow-through entity such as an S Corp. Yes, you will have to pay payroll taxes and personal income taxes on those monies, but you would pay personal taxes on dividends paid to you anyway. And it may be that in the big picture, the savings on one side outweigh the additional taxes paid on the other side.

The decision as to what entity is best for you really does, in so many cases, hinge on taxes, and that is why, with any corporate-related decision, you are wise to seek the advice and assistance of a good CPA.

Some quick things to note on C Corps:

- They can have an unlimited amount of shareholders, from anywhere in the world.
- For Nevada and Wyoming corporations, officers and directors can reside anywhere in the world;
- They can have several different classes of shares.
- They are the most widely recognized business entity in the world, and are the premier entity for going public.
- In Nevada and Wyoming, nominee, or stand-in, officers and directors can be utilized and bearer shares can be issued, adding extra levels of privacy.

Limited Liability Companies ("LLCs")

An LLC is a great entity for a beginning business that:

- wants to invest in assets that will appreciate over time;
- is intended to be an estate-planning vehicle to transfer wealth to the next generation;
- wants its owners to hold their interests in the names of other entities or trusts;
- wants to be able to sell ownership interests all over the world;
- wants to provide its owners with flow-through taxation;
- wants to divide up the profits and losses in ratios other than strict ownership percentages;
- wants to protect its assets from creditors;

LLCs are one of our favorite entities to use. They provide both the limited liability protection found with corporations, as well as the flow-through taxation of a partnership. They allow you to divide up profit and loss allocations among the owners in varying ways -- and not based strictly on ownership percentages, as is required in C and S Corps. Ownership may be held by individuals, corporations or trusts, and there are no restrictions on where owners live. Annual Meetings are not required but are strongly recommended, both as a good method of communication between the Managers and the Members, as well as establishing that the LLC is a distinct, stand-alone entity. That last point is important, as when corporate formalities are not followed creditors may attempt to pierce the veil of protection of LLCs as well as corporations.

In an LLC, the owners are called "members" and instead of stock, they receive "membership interests" based on the value of assets or services contributed by each member. LLCs can either be governed collectively, by all of its members, or by one or more Managers, who are voted in by the Members and who carry out the day to day functions and business of the LLC. Managers can also be members, or they can have no ownership rights in the LLC at all. Manager may be individuals or entities. An LLC governed by a Manager or Managers is, not surprisingly, known as a "Manager-managed" LLC, while a collectively-governed LLC is called a "Member-managed" LLC. The rules by which the LLC is governed are set out in its Operating Agreement, which is signed by all of the owners.

One of our favorite ways to use LLCs is in connection with real estate investing. Properties held in an LLC are easy to transfer, and incur less tax on a subsequent sale than would be assessed if that same property was held in a C or S Corp. LLCs work well for family asset based entities, where the goal is to increase the family wealth, plan for the future, and maximize tax savings. You can put other things into an LLC, such as day-trading accounts, stock and bonds, insurance policies and annuities.

One of the greatest things about using an LLC is the asset protection aspect, especially in Wyoming and Nevada. Under Wyoming and Nevada law, any creditor who attempts to collect a judgment against someone holding their assets in an LLC is barred by law from seizing the LLC's assets. That creditor must use a procedure called a "charging order" to recover any monies they are owed. Under a charging order, a creditor receives the right to collect distributions from the LLC when (and if) profits are distributed, but that creditor does not receive the right to vote, or have any impact or control over the daily operations of the LLC. That makes you a much smaller target for litigation-minded individuals.

Limited Partnerships ("LPs")

Like LLCs, LPs are a great entity for most of the same reasons. They are particularly excellent for use as an estate planning vehicle, because properly structured, they allow parents to transfer wealth to their children tax-free, while maintaining complete control over the assets and the day-to-day operations of the LP. This control continues even after majority ownership has passed, on paper, to your children.

This is because an LP has two types of partners: (1) a general partner who is actively and personally responsible for managing the partnership and (2) limited partners who are passive owners, with no management rights. The general partner can be an individual or another entity, and has broad powers to obligate the LP and manage its daily operations. However, unlike any of the other entities we have discussed, a general partner remains personally liable for the debts incurred by the LP. So, for protection purposes we tend to recommend that you use a C Corp, S Corp or an LLC to serve as the general partner, thus insulating you personally from liability.

A limited partner is 'limited' to ownership of his or her limited partnership interests, and has absolutely no control over how the entity operates. Limited partners receive passive profit distributions from the LP. The distributions are taxed at each limited partner's individual personal income tax rate.

LPs can be a great way for parents to transfer their assets to their children. Using an aggressive gifting strategy, parents can pass along ownership of assets to their children and provide their children with an income stream that will be taxed at their children's individual tax rate. How to employ a gifting strategy is discussed in detail in Garrett Sutton's book, *How to Use Limited Liability Companies & Limited Partnerships*, available through www.succesdna.com.

LPs can be an excellent choice for a family with children who may not be mature or capable enough of making good financial decisions. Because limited partners cannot interfere in the daily LP operations, even though they may have majority ownership of the LP assets, the children cannot remove or sell assets from the LP. Even though the general partner may have as little as 2% of the LP interests, it still retains complete control over the LP's operations. This can be a great way to save your kids from themselves.

Another good reason to use LPs in an estate planning situation has to do with the law. Because LPs have been around much longer than LLCs, the law around how they operate is much more settled. It is very difficult for limited partners to wrest control from the general partner, no matter how high their ownership percentage. Generally speaking, for a general partner to be removed from control takes a finding of fraud or serious misdoings by the general partner.

An LP is governed by a formal Limited Partnership Agreement. Because an LP provides a great deal of flexibility, the written limited partnership agreement can be drafted to tailor the business and family planning requirements of any situation. There are very few statutory requirements that cannot be changed or eliminated through a well drafted limited partnership agreement.

The same great asset protection and charging order procedure we outlined in the LLC section also applies to LPs. If you are sued personally and you own LP interests, a creditor cannot reach into the LP and seize its assets. However, if the LP is sued directly, its assets could be subject to seizure and sale. If you are intending to use an LP to own and operate rental real estate, then make sure you put a comprehensive insurance policy in place to protect you and the LP's assets from potential claimants.

We hope this overview has been helpful. For further information, or to arrange a consultation with one of our attorneys, please call 1-800-700-1430.

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Taxation: Nevada and Wyoming

A common misperception is that by forming an entity in Nevada or Wyoming you won't have to pay any income tax on the entity's profits, no matter where you are located.

First of all, business entities pay federal income tax, regardless of where they are. Secondly, they pay state taxes generated in a state where business is conducted.

However, depending on the type of business, Nevada or Wyoming is an excellent place to form your entity. Both states have minimal tax obligations and reporting requirements, great flexibility in company operations and excellent privacy protection. For example, if you operate a company that provides consumer goods and merchandise, forming your entity and warehousing your products in Nevada can reduce or eliminate state tax obligations.

How much you can reduce or eliminate depends on the type of entity you use and where you live. For example, if you have a flow-through Nevada entity such as an S corporation or an LLC and you live in New York, your profit distributions will have to be reported on your income tax return and will be subject to New York taxes. Operate that same entity as a C corporation however, and it would not pay state income tax on its profits. But, anything being distributed to you either by way of salary or dividend would be subject to New York taxes.

In many cases, from a strictly tax-oriented point of view, you won't save money by forming a Nevada or Wyoming entity, because you will be required to register that Nevada or Wyoming entity in your state of operation and its earnings will then fall under that state's taxation laws. Use the "*substantial nexus*" (or physical presence) constitutional test to determine whether or not your entity will be required to pay state sales, income or other taxes.

If, for example, you have employees in the state or own property there and collect rents in the state then your Nevada or Wyoming entity will be required to register to do business in that other state, and its earnings will be subject to that state's income tax laws and regulations. However, United States Public Law 86-272 prohibits states from taxing businesses where activity in that state is limited to soliciting sales of tangible personal property, provided that all orders are sent to a separate state for approval and all goods are shipped into the state via common carrier. So, for example, if you have an Internet website selling goods all over the United States and shipped from Nevada, your entity may beat the substantial nexus test. Be careful though - you will be considered an employee (thus failing the test) if your involvement in the entity is not passive (i.e., you do nothing but let the checks come in). And, even though you may beat the substantial nexus test, it applies only to state income taxes, and does not apply to sales/use taxes or any other state taxes.

If your entity fails the substantial nexus test, you have two options. You can either form a Nevada or Wyoming entity and register it to do business in another state, or you can form your entity directly in the state where it will be considered doing business. There are some great benefits to forming an entity in Nevada and Wyoming, as follows:

Privacy. Nevada and Wyoming do not provide shareholder information to the IRS. Nevada also allows the issuance of "bearer" shares, allowing for maximum anonymity and privacy. In addition, nominee officers and directors can be provided to further enhance privacy. Nevada law is very protective of the corporate veil and will rarely breach it and attack the owners personally where companies are in good standing and have maintained minimal corporate formalities, such as the preparation of annual minutes.

Flexibility. Directors, officers, shareholders, managers, members, general and limited partners do not have to live in or hold meetings in Nevada or Wyoming. Foreign nationals may own and operate Nevada or Wyoming corporations from outside the United States (with the exception of S corporations). Telephone meetings for directors and shareholders are permitted. One person may hold all director and officer positions, and directors and officers do not have to be stockholders. Corporate bylaws can be made or expediently changed by Directors. These and other favorable features of Nevada and Wyoming corporate law provide for great corporate flexibility and ease of maintenance.

Favorable Capitalization. Nevada allows you to issue shares for cash or services provided to your entity. Nevada also allows you to issue shares for services *yet to be* provided, unlike many other states. A Nevada company may purchase, sell, hold or transfer shares of its own stock, another benefit not available in all states.

Low Annual Maintenance Costs. Nevada and Wyoming have minimal reporting and annual maintenance fees. The Nevada Secretary of State requires that a \$125 List of Officers and Directors be filed once per year along with a \$100 business license fee, for an annual fee of \$225. Wyoming's annual fee is \$50. As such both states are excellent low cost locations for asset protection

Things You Cannot Do With A Business Entity

There are some things that you cannot do with business entities, and which are illegal in most states. The three major illegal uses for business entities are as follows:

1. Fraudulent Conveyance. A fraudulent conveyance is a transfer of assets made intentionally, or found to be intentional, in an attempt to avoid creditors, spouses or judgments. If you have already been served with court documents, or anticipate that you may be sued, or may be the subject of divorce proceedings, you cannot transfer your personal assets into a business entity to avoid having them seized.

For example, you hold a duplex in your own name and a tenant is injured when the roof collapses. The tenant retains an attorney and you receive a letter notifying you that the tenant is claiming damages against you for his injuries. You had been meaning to transfer title of the duplex to your LLC, and decide that now would be a good time. Unfortunately, the matter does not settle and when it goes to trial, the tenant's attorney makes a claim that you fraudulently conveyed the duplex into the LLC to protect it from a valid claim. In addition to finding you at fault for the tenant's injuries, the Court also rules that by transferring the duplex into the name of the LLC after you had been notified of the tenant's claim, you have committed a fraudulent conveyance. The Court rules that the duplex must be transferred back into your name, and the tenant allowed to attach their judgment against it. The Court also fines you for your attempt to avoid the judgment by conducting the transfer in the first place.

2. Medicare Fraud. Medicare fraud occurs when individuals transfer assets into the name of a business entity in order to reduce their personal income or conceal their assets to pass income and net worth tests for Medicare eligibility.

For example, your parents are retired, and living on a small, fixed pension. They also hold several real estate properties, which have a combined value of \$1.5 million. Your father's health is failing, however, and your mother is anticipating that his medical expenses are about to increase dramatically. Although your parents live on a fixed pension and qualify for Medicare on that basis, by adding in the value of their real estate holdings, they become ineligible. Your mother is wondering how she will keep up your father's medical expenses on their pension, and is anticipating having to sell at least one of the properties to make sure there is enough money to cover them. You feel that if your parents formed a Limited Partnership with a corporate general partner, and transferred all of their real estate holdings into the Limited Partnership, the assets would no longer be in their name. Without having the assets in their name, they could then report their pension income on their Medicare application and qualify for benefits. This type of transaction is considered fraudulent and is prohibited.

Medicare fraud is a federal offense, which can result in severe monetary penalties.

Please bear in mind however, that there is a difference between Medicare fraud and proper estate planning. Estate planning is a strategy to minimize the tax burden on your estate, and to ensure that you are able to transfer a maximum amount of wealth to your heirs with a minimum tax payment to the federal and state governments. The best way to avoid a possible claim of Medicare fraud is to make sure that estate planning begins early, and while everyone is in good health.

3. Money Laundering. Money laundering happens when the proceeds of crime are funneled through a business entity in order to create the appearance of legitimate income. For example, a drug ring forms an LLC to purchase real estate properties. The members use a regular corporation as the Manager of the LLC, and use the proceeds from sales of drugs to purchase their membership interests in the LLC. The LLC then takes the money received from its members and purchases luxury real estate on Martha's Vineyard.

This is money laundering, which is a criminal offense at both state and federal levels. Parties convicted of money laundering can face jail, monetary penalties and the seizure and sale of assets bought with the proceeds of crime.