Tax and Financial Newsletter from "The Power of the Dual View"

Efficient taxation can be highly dependent on selecting the proper legal entity to operate your business. This **Tax and Financial Newsletter** details some rules for determining whether to operate as an LLC (Limited Liability Company), S-Corporation, or regular corporation (C-Corporation). The tips herein are carefully considered from Paul's 38 tax seasons as an attorney or C.P.A. Assisting Paul is Theresa Ruth, C.P.A. She is starting her 8th tax season with us. Her knowledge of complex accounting issues and solutions further ensures that our clients have the newest technologies in accounting systems to support the various business entities.

BUSINESS ENTITY SELECTION

There are generally three legal entities to consider for operating a business: (1) Limited Liability Companies; (2) S-Corporations; or (3) C-Corporations. LLCs and S-Corporations are similar with three crucial differences: (1) debt basis issues; (2) profit distribution rules; and (3) labor taxes. This newsletter highlights many of the "ideal" circumstances for each entity and general rules about when to avoid one of the three.

THE S-CORP AND LLC CONCEPT

An LLC, like a corporation, is a creature of state statutes. Taxation of each is primarily driven by federal tax laws. As such, an LLC or corporation is organized pursuant to state laws, but federal law controls the income taxes. Therefore, it is possible to have an LLC that is taxed as an S-Corporation.

Ideal Circumstances for LLCs

- Real estate holdings with third parties; and LLCs are good for personal real estate holdings for creditor protection.
- Owners desiring to withdraw money from their company other than by ownership percentage or salaries.
- Owners personally guaranteeing company debt provides tax basis for deductions, but the personal guarantee for an S does not provide basis.
- Different types of owners exist, such as trusts, aliens, estates, etc.
- When liquidating the company, the owner desires to retain some of the assets.
- Joint ventures or short-term ventures between companies or individuals.
- Holding passive investment assets such as stocks, bonds, and raw land.
- LLCs are good for Estate Planning because they allow family members to own minority positions.
- Professional businesses (doctors, architects, lawyers, etc.) with more than one professional. These are known as Professional LLCs (PLLC); and each professional has a separate S-Corporation that owns part of the PLLC.
- Oil and gas companies are typically LLCs for profit-splitting flexibility, but net profits from LLC working interests increase self-employment taxes.

✓ ***Tax Tip!*** An LLC is the default entity when no one structure seems preferable; then let circumstances develop, and make a change if warranted.

✓ ***Tax Tip!*** Convert a sole proprietorship LLC to a partnership LLC (99:1 perhaps?) to save taxes to take advantage of Oklahoma's pass-through entity state income tax deduction.

Reasons Not to Operate as an LLC

- Self-employment taxes can be high, especially for manager-owners where capital is significant in generating profits.
- Minority owner and distributions to pay for income taxes are not required.

✓ ***Tax Tip!*** A single member LLC that elects S can likely reduce audit risk, likely decrease the labor tax, and can elect to pay Oklahoma income taxes by the business which can yield lower federal and state income taxes at the individual level.

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Ideal Circumstances for S-Corporations

- Desire to reduce payroll taxes or self-employment taxes.
- Desire to split profits among owners based on stock ownership.
- Operating trades or businesses, especially for the sole owner or when a few owners exist.
- Foregoing tax basis for loan guarantees to defer deductions due to expectations of being in higher tax bracket in subsequent years.

✓ ***Tax Tip!*** If circumstances develop and an S is a better option, it is easy to switch from LLC to S, but not the other direction.

Reasons Not to Operate as an S-Corporation

- No tax basis increases for owners who guarantee the business debt.
- Desire to split profits other than stock ownership.
- In certain circumstances the S election can be inadvertently revoked, such as an owner transferring their stock to an ineligible trust for their children.
- In the very small setting, desire to avoid paying employee-shareholder wages.
- At times, real property held by S-Corporations can cause tax problems.
- Can't have two different classes of stock. Thus, classes of stock with different distribution provisions are not allowed.
- Companies that are formed for passive investment purposes versus operating assets in a trade or business.
- Could have more than 100 shareholders.

Ideal Circumstances for C-Corporations

- Regular corporations are experiencing a resurgence because of the recently enacted 21% federal tax rate compared to the old rates that were as high as 39%.
- Owners withdraw all the profits through salaries or other benefits.
- Company has significant fringe benefits.
- Profits after owners' salaries are relatively low, and the cash flow is typically reinvested in inventory or non-deductible expenditures.
- Owner desires to "distance" his or her personal taxes from that of the company.
- Passive investors who will receive dividends are taxed at preferential rates.
- Companies owned by §401(k) plans.
- Publicly traded companies and widely held private companies.

Reasons Not to Operate as a C-Corporation

- Owners would like losses to flow to shareholders.
- Tax problems can result from "excessive" salaries to the owners.
- Double taxation issues, especially when selling the assets of the business.
- Owners of S-corporations, unlike C's, get an increase in their stock tax basis for non-distributed taxable income.
- I disagree that cannabis businesses should be C-Corporations due to personal tax liability exposure.

✓ ***Tax Tip!*** If your business is a C-corporation, consider electing S status if contemplating a sale in five+ years or so.

CONCLUSION

The legal entity you choose for your business will impact how much you pay in taxes. The decision will also affect profit distributions, personal liability, and other crucial, long-term components of business success including taxes when the business is sold. Thus, consider the above tips; they have been developed from specific circumstances. Nevertheless, subtle differences and fact patterns do exist. So please contact our team of tax, accounting, and legal pros to help with organizing and operating an efficient tax solution for your business, including how to pay the least taxes upon selling or purchasing your business.