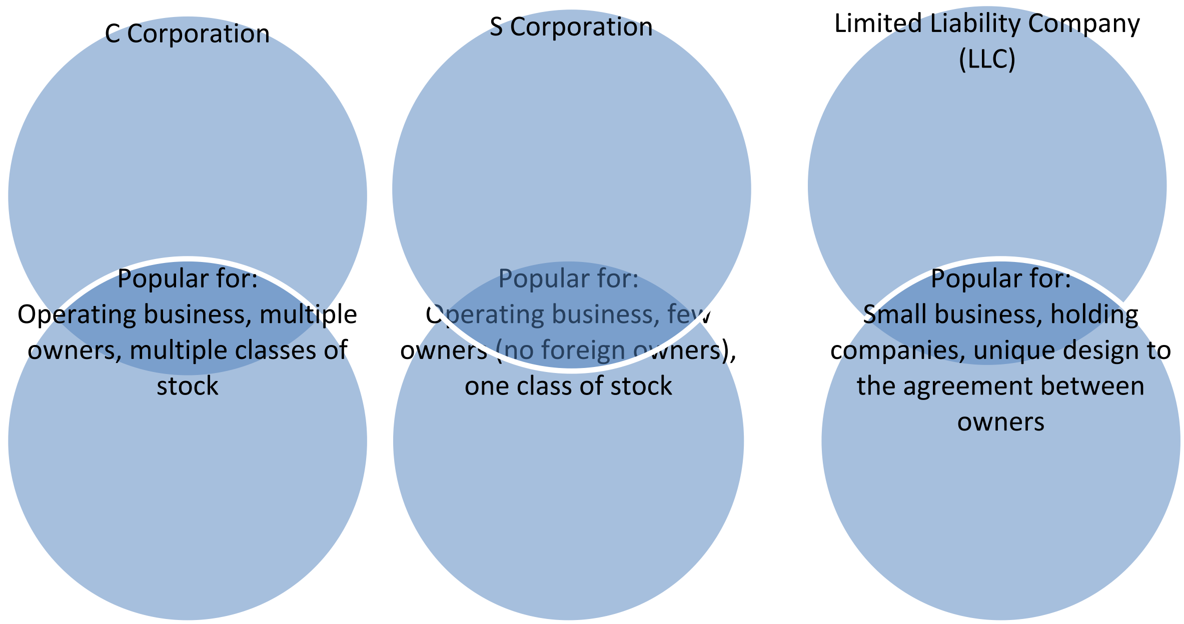
Choice of Entity - 2015 Review BHW Hot Topics Article 2015 - 5

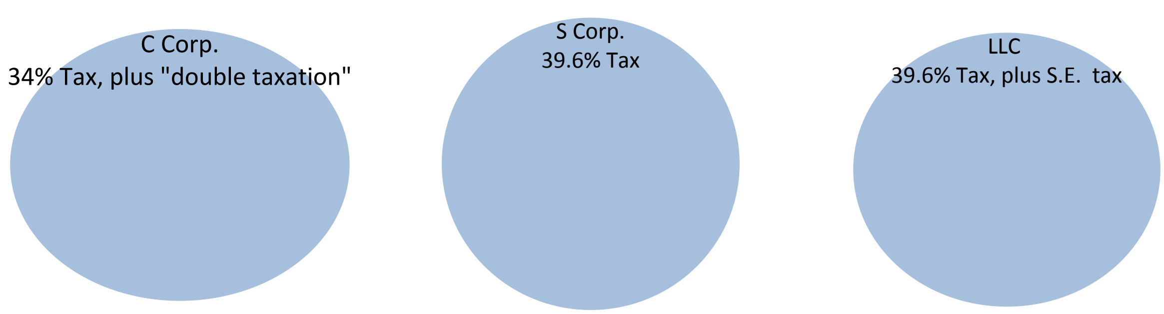
We often guide clients through **'Choice of Entity'**. The choice is not simple, for new entities or for existing entities. The popular choices are:



Income tax issues

Startup businesses usually prefer LLC or S Corporation, to enable startup losses to be allowed at the individual tax level. Some startups know they will quickly want multiple classes of stock, and choose C Corporation. No business intends to lose money, for long. After the startup period, a change in entity choice may be desirable.

The income tax system does not clearly favor one choice. While C Corporations have a top federal tax rate of 34% (35% for some), they also cause "double taxation". The retained earnings will typically become subject to a second level of tax, at the individual owner level, when distributed to owners or when realized as gain on sale or liquidation. S Corporations and LLCs have a top federal tax rate of 39.6%, taxed at the owner level, and potentially another 3.8% for tax on 'net investment income'.



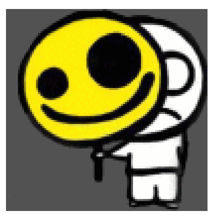
The direct comparison of 34% versus 39.6% seems to favor the C Corporation. Then, the analysis of potential double taxation effect and other factors favor the other choices. Then, the analysis of self-employment (SE) tax may result in favoring the S Corporation over LLC.

C Corporation tax rates start at 15% and are effectively 22.25% on the first $100,000. If the owner is at the 39.6% tax rate and $100,000 of entity income could be taxed as a C corporation at 22.25%, the direct annual tax savings as a C corporation is $17,350. That is "CHC", cold hard cash, retained in the corporation year by year as the income is earned.

Then, the double taxation effect comes along in a future year, and the owner asks, "Why did you ever let me be a C Corporation"? Answer: You wanted the annual CHC. Cash was king.

Single member LLCs

A single member LLC may be a "DE", acronym for Disregarded Entity. An LLC owned by a married couple may be a DE, or may elect to be treated as a tax partnership and file partnership income tax returns. Even that choice is not simple. Choosing to be a disregarded entity does not spare the LLC from the need to keep complete and accurate accountings. We often find it more efficient for the LLC to file the partnership tax return and have the tax information flow concisely from entity to owner.


"Disregard me, please".

Everyone would like to be "disregarded" when it comes to income tax! However, being a DE means only Disregarded as an Entity for income tax entity purposes. That puts the activity into status as reportable for income tax purposes just like the owner had performed the activity without the entity. That may be Schedule C for a business, Schedule E for a rental, Schedule F for a farm, etc. Or, reported on numerous schedules, for an LLC with numerous types of activities.

Limited liability

Having entity accountings and tax filings helps preserve the entity sanctity, when claimants want to "pierce the LLC veil". It should not matter, under state law, but in a practical sense it may. In discovery, production of the entire tax return of the owners adds information to the argument that the entity should also be disregarded by the court, to let the claimants pursue the owners. Or, simply puts private information in the hands of others. The practical argument of "you can afford to pay me" sometimes goes further than it should, regardless of actual rights.

The more an LLC acts like it is not an entity, such as not having an operating agreement and not following state law about maintaining the entity and doing business as an LLC, the more likely a claimant can pierce the LLC veil.

We sometimes see LLCs be formed with the best of intentions that certain assets, liabilities or activities will be within the shelter of the LLC entity, but the actual steps of transfer of the assets, liabilities or conducting business under contracts in the name of the LLC do not happen. The shell was formed, but remained an empty shell.

Likewise, in loan transactions, the lender will want annual accountings and tax returns of the LLC. When they discover that the entity is "disregarded", the lender will want the complete tax return of the owners. Again, private information gets reviewed. The lender may be more inclined to require personal guarantee of debt.

ID theft issues

In 2015 there is an increase in identity theft cases. That is one reason to prefer an LLC or Corporation over an unincorporated business. Giving out your social security number to more places exposes it to more risk of theft. IRS instructions for Form W-9 state a preference for disregarded entities to use the SSN of the owner. Our preference is the opposite, to use the EIN of the entity, keeping the SSN private whenever possible.

State LLC laws

The State of Washington LLC laws will change effective January 1, 2016. The requirement to have a written operating agreement is changing, as are some provisions for fiduciary duties of the LLC manager, such as the details of the duty of loyalty. The changes may make the LLC choice less desirable, because owners, managers, and investors want a higher level of certainty about such matters. They do not want to be sued. Corporate articles, bylaws, state corporate law and employment law may provide greater certainty.

Kell Rabern of BHW says, "Operating an LLC without a good operating agreement is a train wreck about to happen, crashing into a courtroom". Kell also says that the "check-the-box" tax election, to treat an LLC like an S Corporation for income tax purposes, does not transform it into a corporation under state law and does not assure bypass of self-employment tax. Adding, "A wanna-be S Corporation is not the same as a real S Corporation".

Employment matters

We often see confusion within LLCs that employ LLC members. The handling of payroll and employee benefits may become confused and mistaken. The IRS and state agencies may object to LLC members being on payroll like employees. And, at the same time, the matter of nondiscriminatory health insurance looms as an issue for which clarity is important.

Summary

Recent developments may render LLCs less popular for operating businesses, with working owners and employment issues. LLCs will remain popular for holding companies, holding real estate and other types of assets.

New entities should choose carefully. Existing entities may change the Choice of Entity. BHW can assist with the business planning, tax elections and tax reporting. Legal counsel is advisable for the other aspects of entity structure, asset and liability transfers, and business agreements.