According to Form: Choosing the Right Business Entity

by Nancy Opiela

In a classic example of a small-business owner operating in the wrong business entity, a bridge builder doing business as a sole proprietor recently came to see Ellwood Jones of Capital Region Financial Group LLC in Folsom, California. "He never thought about asset protection," says Jones. "Like the majority of manufacturers and contractors we work with, he was most concerned with meeting payroll and staying afloat in a difficult environment. Needless to say, we sat down and talked about the asset protection a corporation could offer."

Conversations like this one are taking up more time, notes Chris Caswell, J.D., CFP®, of Christopher K. Caswell, P.A., in Sarasota, Florida, who has been advising small-business owners for two decades. "Years ago, there were fewer factors to consider when counseling clients on choosing a small-business entity," he says. "Today's matrix of factors is getting larger for all types of entities. We need to discuss asset protection, estate planning issues, and self-employment tax."

Grace C. Wellwerts, CFP®, CLU, of Rocky Mountain Planning Group Inc. in Avon, Colorado, asks questions such as these in a small-business entity fact-finding session: What kind of business is it? Is the business going to own real estate? Do you expect a loss during the start-up phase of the business? What are your projected long-term profits? In addition to health insurance, what benefits do you plan to offer employees and take advantage of yourself? Do you anticipate family members becoming involved in the business?

Another driver in more time spent considering entity selection is an approach advocated by Keith Newcomb of Full Life Financial LLC in Nashville, Tennessee; he encourages his clients to look at their business in the context of their overall life. Explains Newcomb, "Stepping back and looking at the business as a mere component of a lifetime—and beyond—financial plan simplifies the decision process for entity selection and entity creation. That tends to reveal the client's ultimate objective, including how they envision the evolution of their long-term role in the business, up to and including an exit strategy. There are lots of creative ways to use entity selection to help propel clients toward the achievement of their goals and the fulfillment of their personal life mission."

To help with the selection of entity, Newcomb performs what he refers to as "discrete optimization." He explains, "With each decision we're considering, I run the numbers and then we look at various combinations to see which is the best all-around entity option. This process puts the choices in black and white for clients and provides a framework for objective comparison."

Not surprisingly, planners say there's no one-size-fits-all for business entities. Different motivations result in different business-entity selections, just as different personal goals inform unique asset allocations. And continuous changes in tax law and case law make any decision made today a moving target. These disclaimers aside, we asked planners to discuss the pros and cons of various business entities and to identify trends in their recommendations.

Square One: Asset Protection

Richard S. Kahler, CFP®, ChFC, CCIM, of Kahler Financial Group LLC in Rapid City, South Dakota, notes that as liability insurance gets more expensive for less coverage, asset protection is becoming more of a critical factor for entity selection. "I just had a client get out of medicine because his liability insurance quadrupled," he says. "One of the first things sole proprietors can do to help themselves liability-wise is to incorporate to protect their personal assets. That way, a claim against your company has nothing to do with your personal assets. Incorporating provides another layer of complexity, giving you protection for your home."

Kahler says clients in a general partnership with others are liable for their partners' negligence. "A general

partnership is one of the worst entities out there," he says. "I can't think of many reasons to be in a general partnership, unless it's a partnership of corporations or LLCs."

Kahler stresses, however, that while the LLC goes a long way to protect personal assets if an employee or a partner is negligent, the entity may not afford protection if the LLC owner is personally negligent.

Caswell agrees. "There is a current belief that LLCs are the best asset protection vehicles because statutes in various states limit remedies available to creditors of members of an LLC. But I'm uncomfortable recommending an LLC as an asset protection vehicle to a single-member LLC."

Caswell's fear is based on a case out of Colorado where a bankruptcy court found a creditor could attach the interests of a single-member LLC. "There's a lot of discussion on the various listserves as to whether this decision is an anomaly or a trend," he says. "I feel judges have the power to unwind or overcome any asset protection vehicle that we create if they have the sense that what we've created is unfair. Judges can find a way to create remedies that the statutes don't always provide."

Getting back to the virtues of the LLC, Kahler says the entity works particularly well for real estate holdings, noting that by moving holdings out of your name, the LLC can often function in place of a family limited partnership. "When it comes to owning real estate, the number-one rule is, don't own anything in your own name," he says. "Good asset protection means maintaining a low profile and you can't do that if your name is splattered all over the public record. In my town, you can go to the county courthouse, put in names of several high profile individuals and print out a list of 20 or so properties owned by these individuals. That makes them a sitting duck for a lawsuit."

Kahler's rule number-two in asset protection is to avoid a high concentration of assets in any one entity. "If you transfer all your property to one LLC, the LLC is often just as open to losing everything in a judgment as you, as an individual, are. So, you have to use a lot of entities. Let's say you own a dozen rental properties and they are all in one LLC. If there were a lawsuit and judgment against one of the properties, it would be a judgment against all 12 properties. Obviously, you would be better off with 12 LLCs. That way, if you had a lawsuit against one LLC and lost, the most the LLC could lose is what it owns, the one property. You have insulated the other 11 along with your personal assets. Of course, that also means an increased amount of complexity. All of a sudden, you have 12 tax returns."

Kahler also recommends having the multiple entities in different jurisdictions. "It amazes me how many wealthy people turn a blind eye toward asset protection. They embrace the very innocent belief that insurance is enough," he says. "It's the planner's job to convince them that ugly things can happen when you get in front of a jury, especially if you're perceived as having deep pockets."

Finally, if a small-business owner is shouldering a large amount of personal debt, Newcomb says the LLC can afford additional asset protection. "It might be a real surprise to some sole proprietors that their personal creditors can attach their business," he says. "But if you're an LLC, in some states it's impossible for a personal creditor to attach your business. If I were going into business with somebody who had a large amount of personal debt, I'd want to make sure we had an appropriately structured LLC in the right state."

Ellwood Jones cautions that proper entity selection is not the be-all and end-all for asset protection. Perhaps more important, he says, is diversification. "The average small-business owner has 85 percent of their net worth in the business and 90 percent of their income comes from the same business, so our goal is to help these clients find ways to diversify, meet their personal financial obligations, and grow their business. When we're talking about managing risk, our first response should be to get them to diversify," he says.

Still, it's likely the increasing need for asset protection will result in the formation of more LLCs. In fact, both Kahler and Caswell are recommending the LLC more often. Says Caswell, "LLCs are not so much the steak, but

the sizzle. Everybody wants one. Once, it was 80/20 in my business with start-up businesses forming an S corp versus those becoming an LLC. Now it's closer to 50/50. But an S corp may be preferable for one-person companies, since some states require that an LLC have at least two members."

Adds Kahler, "I prefer the LLC in almost every situation when compared with the S corp, except for the ability S corps offer to take out dividends that are not subject to FICA tax."

The Tax Tail Shouldn't Wag the Dog

Kahler says a new client, an architect starting her own firm, is an ideal candidate for an S corporation because of those very tax savings. "She would initially set a very low salary and at some point be able to pay dividends to herself. The dividends, of course, are not subject to FICA. So she wouldn't be paying the 15.3 percent that she'd pay as a self-employed individual."

Kahler notes, however, that the amount of dividends that can be paid is a gray area for the Internal Revenue Service. "Some clients ask why they can't take everything as dividends and avoid FICA altogether," he says. "We know very clearly, however, that the IRS would challenge that position, and the client taking everything as dividends would lose. On the other hand, you could take everything out as salary and issue no dividends, and the IRS would be very happy with that. Anything in between is in a gray area. There's nothing legislated about what a client's salary should be."

When measuring the benefits of an S corporation, Kahler has evaluated whether his clients would be better off paying the FICA, or not paying the FICA and investing their savings on their own. He explains, "In the calculations I've run over the years, most often the person is better off not paying the FICA and investing what they would have paid. But if the business owner is just going to spend what they don't pay in taxes, you could argue that they'd be better off paying the FICA. For the most part, people who are setting up an S corp have the discipline to save."

Grace Wellwerts notes that a common mistake business owners make is not realizing that because an S corporation is a pass-through corporation, the net income, including dividends, is taxed to the owners as ordinary income. "Although you are not paying FICA on those dividends, or distributions, they are taxed at your income tax rate," which could be much higher than the new dividend rate, she says.

Because using the dividends feature of the S corp to lower FICA is so appealing, John Scherer, CFP®, of Trinity Financial Planning in Madison, Wisconsin, whose clients are mainly in the construction field, generally recommends the LLC, but selects the option of being taxed as an S corporation. "The tax preparer must fill out one form to elect to have the LLC taxed as a corporation, and then a subsequent form to elect sub-S status," he explains.

Continues Scherer, "I had one business owner who was being taxed as a partnership LLC. The husband and wife were each paying self-employment tax. I suggested they look at an S corp. Their accountant had figured that she and her husband would save $500 a year and that making a change wouldnÕt be worth the hassle because they were so close to retirement. That seemed wrong to me, so my client interviewed several other CPAs and was told that the savings would be much more substantial than that—and, more importantly, that they could keep the existing corporate structure in place and just elect to be taxed as an S corp. They switched CPAs and she called last year just before tax day to tell me that they saved almost $15,000 in taxes."

A potential drawback to using the dividend feature of the S corporation to reduce FICA taxes is that by keeping your salary at a low level, you limit the contributions you can make to a qualified retirement plan.

Unlike an S corporation, a C corporation is not a pass-through entity, so there may be additional advantages to taking dividends that are no longer taxed at the ordinary income tax rate. Explains Kahler: "It's important to

explain to clients that the C corp has its own tax rate—15 percent on the first $50,000, 25 percent on the next $25,000, and 34 percent on anything over $75,000. This entity can be very effective for companies with profits of $75,000 or less."

To use the C corporation most effectively, Kahler says the business owner needs to have some discretionary cash flow. "If the business is hand-to-mouth, everything has to come out as salary and there's nothing that can be left in there to be taxed at the lower dividend rate."

The drawback in the tax arena is that C corporations involve double taxation for business owners—that is, the company pays taxes and then owners pay taxes on dividends issued. Therefore, rather than take dividends out of a C corporation, often the strategy is to expense any profits left in the corporation. "We can get into hours of creative ways to dispense with profits in a C corp," says Kahler. "An easy example is a financial planner who practices out of his house. For the corporation to own the house would be within the limits of the law. Corporations can require employees to live at corporate headquarters."

Kahler notes a final wrinkle with the C corporation. "You might conclude that if you can only have $50,000 in a C corp taxed at 15 percent, that you should simply form additional C corps, but that doesn't fly with the IRS; they will make you file a consolidated tax return," he explains. "But a husband and wife each can have their own C corp as long as they follow some very strict rules. They can't have anything to do with each other's C corp."

Big Picture: From Estate Planning to Fringe Benefits

While an S corporation might be your first choice for a variety of tax issues, if your client is interested in transferring wealth to the next generation tax efficiently, he or she probably shouldn't be operating an S corporation. Explains Chris Caswell: "S corps are very limited in terms of the types of shares that can be issued; it all has to be common stock. Although they call for voting and nonvoting shares, all shareholders need to be treated in accordance with the percentage of shares they own. You can't give preferential treatment with super-majority voting rights, for example."

Newcomb has run into an estate planning roadblock due to the limited number (35) of shareholders an S corp allows. "I was working with a group of eight or nine business owners ready to transfer the business on to the next generation. In this case, there were at least eight sets of children, so as they went down the family tree, they ran out of headroom well before they got to the grandchildren."

In addition to allowing unlimited shareholders, the LLC allows business owners to pass on more value through discounting, notes Newcomb. What's more, an owner can make tax-free contributions of appreciated property to an LLC to distribute to members. "With an S or C corp the gain is recognized at the time of distribution of the appreciated asset as if it were sold at fair market value. With an LLC, you could contribute the asset to the LLC and not have adverse estate tax consequences for the recipient," he says.

Another benefit with an LLC is that the basis steps up for the buyer. "The buyer of an LLC gets an adjusted basis that reflects their purchase price. In terms of cost basis, I'd rather buy an LLC," says Caswell.

While it's difficult to look at entity selection through a multi-generational lens, fringe benefit pros and cons have become easier to evaluate—and somewhat of a secondary issue. Although accountants often tout the C corp for its more favorable deductibility of fringe benefits and allowance of charitable deductions, new laws have leveled the playing field, shaking the C corporation's status as benefit king. The biggest factor in this shift is that health insurance premiums, once 100 percent deductible only to the C corp, can now be fully deducted by the LLC and S corp.

Scherer notes, however, that a remaining drawback of an LLC or S corp is that cafeteria (Section 125) plans and

medical expense reimbursement plans (MERPs) are not available to the owners, whereas with a C corp those benefits are available to owners.

Planning Long Term: Flexibility Is Key

The popularity of LLCs can be traced largely to the entity's flexibility, which is essential given the certainty of tax law changes, new case law, and changes to the client's business itself. Explains Keith Newcomb, "At some point, business owners approach an inflection point where the need for cash flow to cover major league personal expenses such as funding insurance, the education of children, the home, or other properties begins to shift toward the need for a different kind of support: resources to provide for retirement income, healthcare expenses, and wealth preservation and transfer issues. Their business entity may or may not be suited to these changing needs.

"At that point, I may suggest converting the business into a provider of retirement benefits, directing what might have been paid out as taxable income or profit to the owner into providing benefits, the cost of which are tax deductible to the business. For example, we might use the C corp to provide long-term care insurance in a more tax-favored way."

Newcomb refers to a recent case of a married couple who had sold a family business in the late 1990s. The wife had retired from a large corporation with a large lump- sum severance payment, plus a lot of company stock in her 401(k) plan. The husband was working as a sole proprietor managing the family's real estate holdings and providing consulting services.

Explains Newcomb, "By the time they came to me, they had sold the main business outright, and part of the outcome of the deal was the creation of an S corp that held notes payable by the new business owner. The S corp was to pay a substantial distribution in either 2003 or 2004 that, according to the accountant, could not be avoided or delayed.

"As a side note, the S corp also held assets that were ideal for that S corp to sell to a pre-existing trust that had been established through the will of the client's late mother for added current income tax and potential future transfer tax benefits. The couple also retained personal ownership of several pieces of commercial property, some being used by the business they had sold, all of which produced strong rental and lease income."

Newcomb recommended that the couple put the real estate holdings into a newly created LLC with multiple classes of membership units. "In addition to offering liability protection, the LLC would provide a vehicle for future wealth transfer via lifetime gifting of nonvoting units," he explains.

Because the husband's business pursuits were producing a strong, reliable cash flow, Newcomb also recommended the creation of a C corp to house the husband's real estate management and consulting activities. "The C corp could provide lifetime LTC benefits to him and his wife," he says. "We also considered using the C corp to fund a defined benefit pension plan for them. The design of each is to stack as much of the unneeded cash flow into pre-paid future benefits in a tax-favorable way."

If the C corp income continues to grow, Newcomb says they may look into employing certain investments that produce tax credits in the C corp, which are now being used by this client at the individual personal level. "The credits are limited in personal use, but unlimited when used by a C corp," he notes.

Finally, Newcomb recommended that the couple use their unusually high, and unneeded, income influx (from the S corp distribution, the wife's large cash severance payment, and the strong cash flow of the husband's business) to pre-fund their philanthropy through another newly established entity: a private foundation. The result was current-year income tax savings well into six figures, and future savings as well, along with liability protection and flexibility.

"Through creatively reviewing existing entity selection, and proactively establishing new entities where appropriate, substantial income tax, transfer tax, and long-term community benefits were put into place that serve the client, his family, and the community well," concludes Newcomb.

Working Together

In closing, planners say it's important that clients understand the responsibility that comes with forming a corporation; that is, they have to treat their business like a business entity, not their personal checkbook. Here again, the LLC offers more flexibility because it doesn't require an annual meeting, so although business owners of LLCs still must file with the state, they need not worry about keeping their minutes up.

It's also important for clients to realize that sometimes, the best business entity is no entity at all. Says Grace Wellwerts: "Often a client will want an S corp because they've heard about it, but in some situations they shouldn't be incorporated at all. If you are self-employed, a sole proprietor filing Schedule C, you really want to weigh how much you will save by incorporating. If you're not making that much, the FICA savings might be outweighed by the added cash flow and administrative hassles. Recently, a retired executive decided that the hassle wasn't worth the savings. You also have to look at what you'd be sacrificing or gaining in terms of funding a retirement account."

Precisely because there are no easy answers when it comes to entity selection, planners advocate a meeting of the minds with the client's CPA and attorney. Says Newcomb, "Bringing different ideas together enables us to come up with a better solution for the client than we could have done on our own. I hear some people refer to these professional meetings as 'going the extra mile.' But getting to the core of what's best for the client is really part of the first mile."

Rick Kahler concludes that in spite of the field's complexity and ever-changing nature, entity selection is a topic planners should regularly discuss with clients, with the primary driver being asset protection. Concludes Kahler, "Asset protection planning doesn't have to be exotic, but it's essential to get something in place. You don't want your business-owner client to end up on the stand and field the question, 'Didn't your planner talk to you about the asset protection that would have been available to you by incorporating?'"

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