

Right tax structure could energize slumbering business

"Happy New Year" may be the most positive phrase in the English language. For those whose fortunes were less than desired, the New Year is an opportunity to close the books and start anew. New Year's resolutions are a time-honored tradition. They also can be useful business tools.



Expert Opinion

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What New Year's resolution did you make for your business? Whether you're already in business or thinking of that next bright idea, the start of a new year presents an opportunity to re-examine your business structure or choose a new one.

Many closely held businesses, sole proprietors included, operate their corporate structures like bears in hibernation.

As winter arrives and foods become harder to find, bears go into hibernation. In today's economic climate (a bear market), winter may seem longer than ever before. Just as bears get through winter and food shortages by going into a dormant state, businesses may go into hibernation when they find it difficult to get the information they need for sustenance.

But when bears get hungry, they begin their next hunt. So do businesses as they quest for more efficient tax structures.

Tax reforms that were enacted in 2001 and take effect in 2003 make choosing the right business structure more important than ever.

Issues of limited liability, tax treatment (such as the recognition of income and the deductibility of expenses) and corporate governance drive the analysis of appropriate corporate structures for most businesses.

S, C OR LLC?

Closely held businesses have traditionally operated as either sole proprietorships, general partnerships or

some variety of limited liability entity, such as a C corporation, S corporation or limited liability company (LLC).

Traditionally, C Corporations have been considered less desirable for the closely held business. Their profits are subject to double taxation, once at the corporate level and when paid out as dividends.

However, C corporations in the past had a decided advantage over LLCs and S corporations: full deductibility of the shareholders' medical expenses and the exclusion from income of those expenses by the shareholders.

Owner/employees of C Corporations deduct the full value of their health insurance premiums, a benefit denied to owners of S corporations and partnerships.

Non C corporation business owners/employees holding more than 2 percent of the shares in the company were only permitted a portion of the deduction (60 percent in 2001, and 70 percent in 2002).

Tax reform has since leveled the field, providing full deductibility to the non C corporation owners/employees as well, beginning this new year.

In the past few years, LLCs have been hyped by many in the legal and accounting community as the "honey pot" of business entities.

LLCs provide limited liability to their owners, and are generally treated as flow through entities (i.e., partnerships) for tax purposes. Closely held businesses have gravitated towards LLCs, because of the purported ease of administration and flexibility.

In doing so, owners of closely held business may slumber through their tax returns and miss out on tax benefits innate to the S corporation.

A combined tax rate of 7.65 percent – 6.2 percent for old-age, survivors, and disability insurance (OASDI) and 1.45 percent for hospital insurance (Medicare) – is imposed on both employer and employee, or 15.30 percent of the total compensation derived.

But unlike owners of C corporations and LLCs, the owners of S corporations have the potential to limit their exposure to the self-employment tax by reducing their salary and taking a portion of the entity's profits as a distribution.

While owners of S corporations must take a "reasonable salary," the definition of reasonable can be as fluid.

S corporation shareholders/employees who reduce their salary from \$88,000 to \$44,000 and take a \$44,000 distribution, reduce their overall self-employment tax by approximately \$6,500.

S Corporations, however, have limitations in their own right.

Restrictions on the number of shareholders (75), classes of ownership (1) and owners (individuals, exempt organizations and certain trusts and estates) provide substantial limitations on their use.

Running awry of these restrictions is much like waking a sleeping bear—the Internal Revenue Service can revoke that business' S election and treat the enterprise as a C corporation.

Hibernating bears survive on the energy they accumulated as fat. Few closely held businesses have the luxury of accumulating excess funds. Those that do rarely desire to spend any more on taxes than the legal requirement.

If your business has already "cut the fat," the right choice of entity could just sweeten your very own honey pot.

WHAT ABOUT THE IRS?

Self employed individuals, as well as the Owner/Employees of S corporations and LLCs are required to pay a self-employment tax on their entire share of the entity's income.

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