“NAVIGATING THE MAZE: UNDERSTANDING THE FINANCIAL IMPLICATIONS OF COMMON BUSINESS STRUCTURES”

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ABSTRACT

Students and entrepreneurs alike, struggle with the challenging, yet crucial need to project the financial implications of undertaking a new business venture. In the current economic environment financial organizations and investors are more closely scrutinizing financial plans before extending credit. This paper will focus on the difficult choice of what legal form to choose when setting up a new business and the some of the resulting differences in financial statement presentation. In addition the impact on owners’ wealth will be examined as a result of entity choice.

INTRODUCTION

Many call the United States the land of opportunity. This is exemplified by the large number of “legal” immigrants into the United States on a yearly basis. According to the Department of Homeland Security over one million people legally immigrated to the U.S. in 2007 (Monger, 2008). The free-enterprise structure of the United States economy allows individuals the right to open their own business. Along with this privilege comes the risk of failure which is a real possibility due to the sluggish U.S. Economy. So never before has the need to accurately project the financial impact of an owner’s investment in new business been more important.

Often one of the first decisions made by “new business” owners is the legal form of the business organization. Many new businesses choose their legal structure before start-up costs are estimated and profits or losses have been projected. The timing of this decision is often premature before a clear financial projection has been developed. Certainly the amount of capital needed to start a business will influence the decision on business form, as well as, the impact on the individual owner’s personal taxes.

This paper will focus on three of the more common forms of legal structure: C Corporations, S Corporations and Limited Liability Companies (LLCs) because they all provide some degree of protection from personal liability. According to the Internal Revenue Service in 2006 there were approximately 3,825,000 S Corporation tax returns filed, 2,773,000 partnership returns and 2,454,000 C Corporation returns. Of the partnership returns filed Limited Liability Companies accounted for 79% of the total, clearly the most popular form of partnerships. In addition, S Corporations and LLCs

experienced growth between 2005 and 2006 of approximately 5% and 4% respectively, while C Corporations declined by approximately 1.6% (SOI Tax Stats - Partnership Statistics by Sector or Industry, 2004) . Two commonly used forms of business entities, the Sole Proprietorship along with the General Partnership, provide no protection from personal liability so it is best to avoid their use. Maybe the use of one of these two organizational structures would be OK if you are 12 years old and running a lemonade stand in your front yard, but keep in mind, there is always someone waiting to sue because they choke on a lemon seed or found an ant in their cup. The simplest plan can often become your biggest nightmare.

OVERVIEW AND TAXATION

A C Corporation is taxed as a separate legal entity from its owners. A C corporation offers owners (referred to as shareholders) limited liability and the ability to easily transfer their ownership shares to others. Profits from operations of a C corporation are taxed based on a progressive tax structure; in other words the tax percentage increases as the amount of income increases. The progressive structure flattens out and appears to be a flat tax rate of 34% between earnings of $335,001 and $10,000,000 and again at $18,333,334 and up, at a flat tax rate of 35%. A shareholder will only pay tax at the individual level if they receive dividends from the Corporation. Since these dividends are paid from earnings already taxed at the corporate level and then again when earnings are distributed to shareholders this double taxation is seen as a disadvantage of a C Corporation.

"An S Corporation is a regular corporation under state law that meets certain requirements and has elected to be taxed under a pass-though system similar to partnerships" (Doran, 2004). Instead income of the S corporation is taxed at the individual shareholder level at their own individual tax rate. Much like C corporations, ownership of S corporations is in the form of stock which makes the transfer of ownership very easy. However S Corporations can only have 100 shareholders and all shareholders must by U.S. citizens or resident aliens; therefore, the limitations on the number and type of shareholders does limit the pool of available buyers. Taxable income of the S Corporation is allocated to the owners based on ownership percentages and reported on their individual tax returns. As the income flows to the individual shareholder it is important to point out that the income and expenses maintain their own identity. Capital gains and charitable contributions are examples. Capital gains will appear on the individual's 1040 Schedule D and charitable contributions will be on the 1040 Schedule A to maintain their special tax treatment. Dividends paid to owners of an S corporation as nontaxable.

"In 1980 a new form of business entity was introduced in the United States, the Limited Liability Company (LLC) and since 1997 every state has a statue authorizing LLCs" (Doran, 2004). According to guidance in Practice Bulletin 14 provided by the Accounting Standards Executive Committee, LLCs have the following characteristics:

"An LLC is an unincorporated association of two or more persons

Its members have limited personal liability for the obligations or debt of the entity

It is classified as a partnership for federal income tax purposes" (Committee, 1995)

The LLC form of organization offers several advantages, such as a more flexible ownership structure and allocation of profits, losses, income and credits without concern about entity liabilities or the degree of participation in management.

FINANCIAL REPORTING: OWNERS INVESTMENTS

The key difference in financial statement presentation due to the choice of entity is the equity section of the balance sheet or statement of financial position. C and S corporation equity sections are very similar. Owners are referred to as shareholders and the amounts invested by shareholders are recorded in stock accounts and kept separate from the earnings of the corporations. Payments to shareholders take the form of dividends. LLC owners are referred to as members; therefore the equity section in the statement of financial position should be titled "members equity." According to Practice Bulletin 14, if more than one class of members exists, each having varying rights, preferences and privileges, the LCC is encouraged to report the equity of each class separately within the equity section. If the LLC does not report the amount of each class separately, it should disclose these amounts in the notes to the financial statements. In addition the AcSEC recommends that the presentation of the equity section of the statement of financial position should be similar to a partnership which does not maintain separate accounts for invested capital and earnings. Finally S and C Corporations show changes in equity in a separate statement. An LLC may show changes in members' equity in a separate statement combine with the statements of operations or include in the notes to the financial statements. Payments to members take the form of distributions.

SPECIAL ISSUES: WAGES, FICA TAX AND FRINGE BENEFITS

Additional guidance is needed regarding the taxation of wages, self employment tax and fringe benefits before we can analyze the impact of business entity choice on the owners' wealth. Shareholders who are also an employee of a C Corporation will be

treated like any other employee of the company. Their wages will be subject to Federal Insurance Contributions Act (FICA) taxes and any fringe benefits received will not be taxable to the employee as long as all discrimination rules are met.

Since 2005 the IRS has sent out reminders that a reasonable salary must be paid to shareholder-employees (SE) of S corporations. The IRS warns that it can reclassify as salary any distribution to shareholders. There are no published criteria currently from the IRS on what a reasonable SE salary or salary range might be. The IRS goal is to collect Federal Insurance Contributions Act (FICA) taxes on the salaries and Federal Unemployment Tax Act (FUTA). Several suggestions include examining comparable wages within its industry by consulting trade publications. "The salary should also consider the SE's experience and skill, the geographic region, customer base, numbers of employees and time committed to the corporation" (Jewell, September 2007). In other words, if you are the accountant of the Corporation and receive $70,000 as an employee, which is similar to that of other Corporations for that position, the pass-through income will be exempt from FICA tax. On the other hand, if you receive only $20,000 as the accountant when other Corporations are paying $70,000 you could find your pass-through income subject to FICA Tax. Disguised distributions such as a loan to the shareholder or perhaps a distribution of property can also be reclassified as salary (Jewell, September 2007). Employee fringe benefits, received by a 5% or more owner of an S Corporation, will be included in taxable income by the taxpayer. There are some exceptions such as employee discounts, de minimis benefits and contributions to retirement plans.

Now the confusion starts. It appears as the tax code is written that payments made to members of a LLC who perform services for the LLC will be treated as a Partnership. Under the rules of a partnership all pass-through income will be subject to FICA Tax. However, Section 1402(a)(13) of the Internal Revenue Code states, "there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments…to that partner for services actually rendered to or on behalf of the partnership" (Internal Revenue Bullentin 2006-51). So now the question becomes is a member of a LLC to be compared to a limited partner of a partnership? In 1997 the IRS proposed, Reg. Sec. 1.1402(a)-2(h) (5) to help clarify the FICA tax question. As things go in the world of the tax code, the proposed regulation to help clarify the question of SE tax created more confusion. The proposed regulation still stands and currently the best strategy is to treat a member of a LLC as a limited partner of a partnership. Therefore it is reasonable to subject wages (guaranteed payments) of the member of the LLC to the FICA tax and not to the flow through income.

EXAMPLE OF TAX EFFECTS ON PERSONAL INCOME TAXES FOR COMPANY INCOME

A and B has started a company and are looking at the effects on their personal income tax returns under both a company that is a Flow through entity (S Corporation or Limited

Liability Company) and a C Corporation. Both A and B invest $60,000 each, giving each 50% ownership in the company. A and B each receive an annual salary of $25,000 which is considered normal for the position that they have in the company; therefore, any distribution of taxable income will not be subject to Social Security Tax.

In analyzing the impact on A and B's individual tax returns, the following assumptions are made. Both owners are Married Filing Joint with no dependents and will itemize their deductions. The income from the new business is projected to be $60,000; therefore A and B will each report $30,000 of the taxable income for the Flow Through entities based on their ownership percentage and a nontaxable distribution of $10,000. If a C Corporation legal structure was chosen, the salary will be the same $25,000 each and dividends paid to the owners will be $10,000 each. The taxable income of $60,000 from the C-Corporation will be paid by the Corporation on its Form 1120. The tax on the Form 1120 will be $10,000 based on the current corporate tax tables. The big difference in the two individual tax returns is income from other sources. A's spouse has a very large salary and they have a lot of investment income from other sources therefore their AGI is much higher.

The table shown below illustrates the impact on owners A and B's individual tax returns without any income from the new business in the first column and then the impact related to the business income under a flow-through entity or a C corporation.

Mr. and Mrs. A

	Before Any Business Income	With Flow-Through Income	With C-Corp Dividends
Adjusted Gross Income	$356,072	$385,615	$366,072
Itemized Deductions	$19,854	$19,263	$19,654
Exemption Deduction	$2,357	$2,266	$2,266
Taxable Income	$333,861	$364,086	$344,152
Tax Before AMT	$87,801	$97,888	$89,397
Alternative Minimum Tax	$2,037	$2,290	$2,641
Tax Before Credits	$89,838	$100,178	$92,038
Marginal Tax Rate	33%	35%	33%
Effective Tax Rate	26.90%	27.50%	26.80%

Mr. and Mrs. B

	Before Any Business Income	With Flow-Through Income	With C-Corp Dividends
Adjusted Gross Income	$83,787	$114,053	$93,787
Itemized Deductions	$13,297	$13,297	$13,297
Exemption Deduction	$6,800	$6,800	$3,800
Taxable Income	$63,690	$93,726	$73,690
Tax Before AMT	$8,769	$16,279	$10,269
Alternative Minimum Tax	$0	$0	$0
Tax Before Credits	$8,769	$16,279	$10,269
Marginal Tax Rate	15.00%	25.00%	15.00%
Effective Tax Rate	15.30%	18.40%	15.30%

As you can see from the example of the A's and B's personal taxes A will pay more taxes than B on the same amount of additional income. If the company is a flow-through entity A will pay $10,340 additional tax and B will pay $7,510; therefore it costs A $2,830 more dollars than B on the same amount of additional income. Looking at the C-Corporation example A will pay $700 more than B on the additional income.

Now, let's look at the actual effect on A and Bs personal wealth. They invested $60,000 each and they want a five percent return on that investment, which is a reasonable return based on current market conditions. The projected return on their $60,000 equates to $3,000. It is very important to have a target for the return on investment because if a dividend or distribution is never paid, the money invested in the business would have been better off in a CD or even obtaining employment with an existing business. The cash dividend or distribution to the owners should be enough to cover the additional taxes on each owner's share of income and expected return on their investment.

	A – Flow through	B – Flow Through
Cash received:		
Cash Distribution	(10,000)	(10,000)
Cash needed:		
Taxes on Income	$10,340	$ 7,510
Return on Investment	3,000	3,000
Total cash	$13,340	$10,510
Cash Shortfall	(3,340)	(510)

As the previous example illustrates, the personal wealth of both owners is negatively impacted under the flow through option. They received $10,000 but it is not enough to cover the tax on the additional income and to leave them with the $3,000 return on their $60,000 investment.

	A – C Corporation		B – C Corporation	
Cash Dividends		$10,000		$10,000
Less Return on Investment	3,000		3,000	
Less additional Tax	2,200		1,500	
Less half of Corp Tax				
(Reduction of equity)		5,000		5,000
Impact on Wealth	(200)		500	

With a C Corporation the impact on the owner's wealth is much more favorable. Owner A has a slight negative impact of $200 while owner B actually has a projected increase in wealth of $500. It appears that both owners would be better off than as a Corporation. This positive impact is possible due to the current tax laws which allow dividends paid by C Corporations to be takes at 15% for individuals in the 25% of higher tax bracket and 5% for individuals in the less than 25% tax bracket. The lowest individual tax bracket is 25% so the flow through income would always be taxed at a higher rate.

Conclusion

In addition to fulfilling life-long dreams, most business owners expect to earn a return on their investment over time. There are various ways that this can be accomplished; however individuals forget to complete several reasonableness tests that can be quickly reviewed to assess the soundness of the financial investment. First evaluate the amount of cash on hand shown on the balance sheet. If the amount of cash exceeds the amount necessary to cover three months of expenses consider increasing increase distributions to owners. Also make sure dividends or distribution payments are sufficient to cover the individual tax liability and provide an adequate return on the owner's investment. Finally review the capital structure of owner investment versus outside borrowing. Ensure the return to the owners of the business is reasonable compared to the interest rate being paid to outside lenders. This paper discusses some of the key difference in three popular choices for business entity form and illustrates the potential impact on an owner's individual wealth. The C Corporation is an option worth considering due to the current tax laws which allow dividends to be taxed at rates lower than individual tax rate used on the 1040 and the ability to deduct one hundred percent of fringe benefit costs. With frequent changes in the tax code this challenging issue will continue to require time and attention to make the best decision possible.

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