

CHOOSING BEST SMALL-BUSINESS STRUCTURE TOUGHER CHOICE THESE DAYS

Small-business owners have more factors and choices to consider than they once did when choosing the best business structure for their company. Yet many owners casually pick off the shelf “what everybody else is doing” instead of what’s best for them, caution financial planners.

Before choosing a business structure, such as a sole proprietorship, S or C corporation, partnership, LLP, or LLC, owners should reflect on their business in the context of their overall financial life and ask themselves a series of questions. For example, is the business your primary source of personal wealth and daily cash flow, or is it a side business? Do you expect the business to pay for your retirement? Do you want it to provide other financial benefits? Do you want to pass it on to family members or sell it to existing employees or outside buyers?

The answers to these questions figure importantly into the decision, along with other key factors such as what type of business it is, current tax laws, and regulations such as workman’s compensation. Here are four major issues to consider when choosing a business entity.

Asset protection. Buying liability insurance remains critical in providing asset protection for a business, but choosing the right business structure is becoming increasingly important as the chances for lawsuits increase and the cost of liability insurance climbs. It’s also important if you’re starting a business that could amass substantial debt.

If the risk of lawsuits and creditors is a major concern for you, you’ll likely want to incorporate such as a C or S corporation, or form a limited liability partnership or limited liability company. These structures generally shield your personal assets from business creditors, unlike a sole proprietorship or general partnership (where even your personal assets are vulnerable to claims against your partner). Or vice versa: depending on state law, some business entities may shield your business assets from claims by your personal creditors.

LLCs have become especially popular in recent years as an entity for protecting personal assets from business creditors. But some planners caution that LLCs may not shield the personal property of a single LLC owner. In fact, some states don't allow single-member LLCs. In such cases, an S corporation might be a better choice.

Income taxes. From a federal income-tax perspective, sole proprietorships, partnerships, and LLCs are about the same – all are “pass through” entities in which all taxable income is passed directly through to the owner(s) and taxed on their individual tax returns.

An S corporation is also a pass-through entity, but the owner can set a relatively low salary (how low is a “gray area”) and take out the rest of the profits as distributions. There is no FICA tax on these distributions, though they are taxed at the owner's ordinary tax rates. Minimizing salary in favor of distributions often works best, however, if the owner invests what he or she would have paid in FICA taxes. On the other hand, maximizing distributions may reduce what you are allowed to contribute to a retirement plan.

A C corporation is taxed on the corporate level first, and issued dividends are taxed at the shareholder's level, though generally at a maximum of 15 percent. Despite the double taxation, a C corporation can still be a good tax choice, say planners, particularly where profits are less than \$75,000. That's because they are taxed at rates lower than the top individual rates. But to work most effectively, the business needs to have some discretionary cash flow, say planners.

And don't overlook the potential impact of state taxes on your entity choice. The impact can be different from that of federal taxes.

Fringe benefits. Recent tax laws have reduced the advantages of incorporating and taking tax deductions for fringe benefits and charitable giving. In particular, the 100 percent deduction for health insurance premiums now allowed to LLCs and S corporations has undermined the fringe-benefit role of C corporations. Still, fringe benefits remain a factor to consider when choosing structure, especially if you want a cafeteria plan.

Estate planning. Certain business structures are more ideal than others for owners wanting to pass the business on to heirs. A C corporation, for example, can pass on shares of stock with preferential treatment, whereas an S corporation can't. LLCs and limited partnerships also have estate planning advantages.