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THE STATE OF YOUR BUSINESS STRUCTURE

DIFFERENT ENTITY TYPES HAVE VARYING TAX IMPACT

Have you ever wondered how your year end tax planning might differ if your company operated under a different business structure? Although the variances among most of the major entity types aren't drastic, they're notable enough to make reviewing the state of your business structure a worthwhile endeavor. Let's take a look at the fundamental tax impact of each of the major entity types in use today.

Corporations

Traditionally, many companies didn't start life as a corporation but rather as a sole proprietorship. In fact, the sole proprietorship may still be the most common entity type, if only because so many small businesses begin this way. Its tax treatment is relatively simple: The owner reports business profits and losses on his or her personal income tax return — for income *and* self-employment tax purposes.

But sole proprietors are held personally liable for their companies' debts and obligations, which can bring great risk. So many sole proprietors reach a point where they incorporate their businesses to better protect themselves and gain some tax advantages.

Incorporation has long come in two types: the C corporation and the S corporation. Both have a maximum federal tax rate this year of 35%, and individual owners of either generally aren't subject to self-employment taxes.

But these two business structures have different tax bases. A C corporation must pay taxes on profits at the corporate level, and then shareholders pay tax at the personal level when they receive dividends or upon liquidation (so-called "double taxation"). S corporations, on the other hand, are "pass-through" entities, meaning the company's profits and losses pass through to the shareholders, who report the income (or losses) on their personal returns.

Being a pass-through entity has long been viewed as an advantage for the S corporation structure — and it certainly can be. But S corporations are limited to a maximum of 100 shareholders, which can inhibit efforts to attract equity investors.

And a C corporation may be able to mitigate the negative effects of double taxation via wage and benefits deductions.

Partnerships

Of course, not every company follows the sole-proprietorship-to-corporation formula. Many businesses begin as — and stay — partnerships between two or more individuals. Again, two types tend to dominate here: general and limited.

> ***LLCs took off in popularity largely because they allow flow-through taxation yet provide greater protection against liability for debts and obligations than partnerships.***

A general partnership is similar to a sole proprietorship in that partners retain personal liability for the company's debts. In a limited partnership, the limited partners face liability only up to the amount of their investment. The general partners, however, have the power to make strategic business decisions for the partnership and do assume personal liability for the business's debts.

Like corporations, the partners of both general and limited partnerships currently face a maximum 35% tax rate. And, in either case, a partner is taxed based on his or her allocable share of the partnership's income, whether distributed or not. That income flows through from the company to the partner's personal return. Only general partners are subject to self-employment taxes.

The latest on LLCs

For tax purposes, a limited liability company (LLC) is treated as a partnership as well. But this entity type has enough legal differences that it's typically considered a business structure unto itself.

Depreciation breaks an option for any entity type

No matter what your business structure, a couple of tax breaks that are particularly important to consider this year are the Section 179 expensing deduction and bonus depreciation.

The Sec. 179 deduction allows you to expense, rather than depreciate, a specified dollar amount of qualified new or used asset acquisitions in a given year. For 2011, that amount is an impressive $500,000. But it's scheduled to drop to $125,000 (indexed for inflation) in 2012. So there are big tax savings in the offing if the circumstances are right for your business to make qualifying asset purchases this year. Various limitations apply and, for 2011, the deduction starts to phase out dollar for dollar when total asset acquisitions for the tax year exceed $2 million.

Bonus depreciation allows you to simply claim an extra percentage of depreciation on a qualifying asset. This year, that percentage couldn't get any bigger: You can deduct 100% of the cost of eligible assets acquired and placed in service this year (or by Dec. 31, 2012, for certain long-lived and transportation property). For 2012, bonus depreciation is scheduled to drop to 50%. And after Dec. 31, 2012, it's currently scheduled to be eliminated. Various limitations apply here as well — notably that the property acquired must be new, not used.

As is the case for S corporations and partnerships, LLCs are pass-through entities and thus the maximum income tax rate this year is also 35%. Individual owners are generally subject to self-employment taxes if not treated as limited partners.

LLCs took off in popularity largely because they allow flow-through taxation yet provide greater protection against liability for debts and obligations than partnerships do — while coming with fewer

restrictions and administrative formalities than corporations have. They're also fairly easy to set up.

One interesting issue involving LLCs that's arisen of late is how owners under this business structure should be treated under the passive activity loss (PAL) rules. Created to limit the use of tax shelters, these rules prohibit taxpayers from offsetting losses from passive activities (such as limited partnerships or rental properties) against nonpassive income (such as wages, interest, dividends and business income).

Up until recently, the IRS generally treated LLC owners as *limited* partners for purposes of the PAL rules. But, just this year, the U.S. Tax Court and the U.S. Court of Federal Claims ruled that LLC owners should be treated as *general* partners. This facilitates their ability to deduct business losses. To qualify, however, owners must establish that they "materially participated" in the LLC per a series of seven tests. (Ask your tax advisor for details.)

Reasons to review

Over time, you may find that your current structure no longer suits the size or nature of your business. Or you might want to divide your company into separate entities or form a joint venture with another business. These are just a few of the reasons to stay up on the advantages and risks of these various business structures. Changing entity type typically isn't easy and may trigger tax consequences, so be sure to discuss the possible ramifications with your tax advisor. ❐

MANAGE YOUR WEALTH WITH GIFT TAX PLANNING

When you read about gift taxes, it's probably most often in association with estate planning. But those interested in smartly managing their wealth need a gifting strategy — both for estate planning purposes and for minimizing the taxes they and their loved ones could face in the here and now.

Looking to the future

Making lifetime gifts is particularly attractive for assets you expect will appreciate significantly in the future, such as stock, real estate or interests in a closely held business. By transferring these assets to family members while values are low, you can minimize transfer tax and remove future appreciation from your taxable estate.

Plus, the gift tax exemption is $5 million through 2012. So, if you can afford to do so, you may want to give as much as possible up to that amount before Jan. 1, 2013. Also consider your $13,000-per-recipient annual gift tax exclusion ($26,000 if splitting gifts with your spouse).

Of course, the income tax impact must be factored into any gift tax strategy. Under current law, when your heirs *inherit* assets, their tax basis is generally "stepped up" to the assets' current fair market value, minimizing or eliminating capital gains taxes in the event of a sale. But gifted assets don't enjoy a stepped-up basis, which means that, if the assets appreciated in value while you held them and the recipient sells them, he or she may have significant income tax exposure.

Forming an entity

Transferring interests in a family business or other closely held company using a family limited partnership (FLP) or a family limited liability company (FLLC) may be a wise gifting strategy. In a typical arrangement, you form a limited partnership or LLC to own your business (or your interest in a business) and then transfer limited partnership interests or nonmanaging LLC interests to your children or other family members. By maintaining a small ownership interest and acting as general partner or managing member, you retain the right to manage the business indefinitely.

FLPs and FLLCs offer important benefits. They can provide family members with an ownership stake without giving up managerial control, and can offer some protection from creditors' claims against limited partners or nonmanaging members.

In addition, valuation discounts can allow you to minimize or even eliminate gift taxes when you transfer a minority interest in the business.

The IRS frequently challenges FLPs and FLLCs. So to avoid undesirable tax consequences and even penalties, it's critical to structure and manage your FLP or FLLC properly.

Exploring a trust

Trusts are another gifting option to explore. When you establish certain trusts — such as grantor retained annuity trusts and charitable lead annuity trusts — your children or other beneficiaries receive a "remainder interest."

To avoid undesirable tax consequences and even penalties, it's critical to structure and manage your FLP or FLLC properly.

In other words, at the end of the trust term, after the annuity payments have ceased, whatever is left in the trust is distributed to your beneficiaries. When you fund the trust, you make a taxable gift equal to the present value of this remainder interest.

To calculate the remainder interest, the IRS assumes that the trust assets will grow at the Section 7520 rate in effect during the month the trust is funded.

The lower that rate, the smaller the remainder interest and, therefore, the smaller the gift. If, and to the extent, the trust's growth and earnings outperform the Sec. 7520 rate, your beneficiaries will reap the benefit of that excess growth and earnings without any additional gift tax cost to you.

By setting up and funding these types of trusts now, you may be able to lock in a low interest rate, making it possible to transfer a significant amount of wealth while minimizing gift taxes.

Forging a path

These are just a few basics to consider when devising a strategy for minimizing taxes when gifting. The nature of your wealth, as well as your goals for yourself and your loved ones, will help forge the right path for you. ❒

Moneylines: News Briefs for Businesses

High gas prices inspire IRS to raise mileage rates. If you and your employees are logging business-related driving time in the second half of this year, you may be in line for some tax relief. To counter rising gas prices, the IRS has increased the optional standard mileage rate from 51 cents per mile to 55.5 cents per mile for business use of an automobile July 1 through Dec. 31, 2011. (The rate for use of an automobile as a medical or moving expense also has gone up for this period, from 19 cents to 23.5 cents.)

Fraud study findings: It's not what they take, it's what they cause. You may assume the worst part of a fraud incident would be the money stolen. But a recent study by Javelin Strategy & Research of small business owners and self-employed persons found that, of the $8 billion in fraud losses that occurred in 2010, $5.43 billion wasn't directly from theft. Rather, it was from the out-of-pocket costs caused by the crime, such as insurance payouts, legal expenses and lost customers.

What's your company afraid of? The top four concerns of retailers, according to the *2011 BDO RiskFactor Report for Retail Businesses* compiled by BDO USA LLP, are: 1) U.S. economic conditions, 2) supplier/vendor concerns, 3) competition/consolidation, and 4) increased regulation at federal, state and local levels. Even if you're not a retail company, you might use these results as a launching point to consider your own top challenges. For instance, is the economy still a significant risk? Or is it time to come out of a defensive stance and more aggressively compete for customers?

TAX-CONSCIOUS INVESTOR LOOKS INTO QSB STOCK

Emily has always enjoyed keeping her portfolio balanced and reading up on what's hot in the investment world. As year end nears, however, her enthusiasm tends to change to concern — namely about what her tax bill may look like. So, as she does every year, Emily recently paid a visit to her financial advisor to discuss the latest capital gains rules.

Her advisor, as always, commended Emily for being so diligent about looking into the tax impact of her investments. Knowing that she'd long held an interest in investing in small businesses, he had a particularly interesting bit of tax planning news to share.

An exclusion of note

Emily's advisor began by explaining that a tax break is available that applies to the sale of qualified small business (QSB) stock. (Under the tax code, a QSB is defined as, among other things, one engaged in an active trade or business that doesn't — at the time the stock is acquired — have assets exceeding $50 million. Other limitations apply.)

From past experience, Emily knew she could usually exclude up to 50% of her capital gain from the sale of QSB stock as long as she'd held it for more than five years. But this usually resulted in only a slight tax savings over other long-term capital gains because a 28% rate applied to the taxable portion of QSB stock gains.

Her advisor complimented her knowledge but remarked that this is where the interesting news comes in. For QSB stock acquired after Sept. 27, 2010, and before Jan. 1, 2012, Emily

would be able to exclude 100% of her gain. (For stock acquired after Feb. 17, 2009, and before Sept. 28, 2010, there's a 75% exclusion rate.) She still would be required to hold the stock for more than five years, and additional requirements apply.

Greater good

Emily's advisor emphasized that Emily must buy the QSB stock by Dec. 31, 2011, to garner the future 100% gain exclusion — unless Congress extends the break.

Plus, there's a potentially greater good that could come from this type of investment. One of the reasons lawmakers created the exclusion was to encourage investment in small businesses. The hope is that, as these companies have an easier time raising capital, the economy as a whole will benefit.

More to discuss

Of course, Emily's investment-related tax planning didn't end here. Although she was grateful to her advisor for raising her awareness of the 100% exclusion, she knew there were many other valuable strategies that the two could discuss as well. ❐

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