

Gero & Evaul

Certified Public Accountants and Consultants
A Partnership of Professional Associations

Dear Clients & Friends,

Proper entity selection is crucial to the success of any business venture. The selection of one particular entity or another has varying ramifications. The following is a general discussion of some of the various entity structures that are available to businesses and some of the differing tax and other related issues associated with these different entity types.

One of the more obsolete forms of conducting business is through a *sole proprietorship*. This type of entity is easily created and has relatively few administrative regulations (aside from those that may be imposed by the industry you are conducting business in). There is no separate income tax return required to be filed, rather the profits or losses are filed with the individual's Form 1040 on an attached Schedule C. There is no legal distinction between the owner of the business and the business itself. A major disadvantage of the *sole proprietorship* is the fact that the owner has unlimited liability. Another drawback of this form of ownership is that all profits accrue to the owner subject to regular income taxation as well as self-employment taxation (up to the applicable limits). The self-employment tax is approximately 15.3% on the business profits which is on top of the ordinary income tax rates assessed on the individual.

One of the more popular forms of entity selection in recent years is that of a *Limited Liability Company (LLC)*. Besides the catchiness of having LLC behind your business name, this type of structure offers many advantages. *LLC's* offer limited liability to their members. One of the important things to note is the flexibility associated with the *LLC*. An *LLC* can take on various forms for tax purposes. It can be a sole proprietorship (as mentioned above, but with limited liability protection for the owner), it can be taxed in the form of a partnership, it can be taxed in the form of a corporation (S-Corporation or C-Corporation), and can be even termed a disregarded entity for tax purposes. This terminology means that the entity owning the *LLC* will report the income and expense from the *LLC* on their applicable tax return. For IRS purposes *LLC's* that are created with more than one member will be taxed as a partnership and those with only one member will be considered a disregarded entity taxed as a sole proprietorship. To elect taxation as corporation (whether single member or multi-member) the *LLC* will need to file "Form 8832, Entity Classification Election" with the IRS. Furthermore if the *LLC* wishes to be taxed as an S-Corporation the applicable Form 2553 will have to be filed and the requirements associated with this entity classification will have to be met, as discussed later. Please note an *LLC* is a relatively new entity created by state statutes. The IRS did not create a new tax classification for the *LLC* when it was created by the states; instead IRS uses the tax entity classifications it has always had for business taxpayers: corporation, partnership, or sole proprietor.

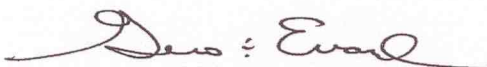
The *general partnership* is one of the oldest forms of joint business ownership, but in essence is one of the least widely used (unless in the form of an LLC or LLP). This could be due to the fact that the *general partnership* form of ownership is generally misunderstood by the typical entrepreneur and also

there is unlimited liability to its partners. To circumvent this unlimited liability issue for the partners many people set up LLC's or Limited Liability Partnerships (LLP), or have their wholly owned corporations own their interest in the general partnership. These different structures are still taxed as partnerships for tax purposes. The partnership and its various forms (LLC, LLP, LLLP, and so on) is not a separate distinct taxpaying entity for federal income tax purposes. The income or loss created from the partnership flows through to the individual owners for tax purposes. The partnership offers great flexibility to the individual partners in regards to the sharing of profit and losses and related distributions. A multitude of things about a partnership and their various flexibilities can be written, but we want you to finish reading this newsletter so we will cut off here. Please contact our office if you would like more information on the partnership structure.

Another popular form of business ownership is that of an *S-Corporation*. This form of ownership offers the joys of limited liability for its shareholders. As opposed to its counterpart, the *C-Corporation*, it also is generally not subject to double taxation. The income or loss from this entity flows through to the individual shareholders. To add to the taxation benefits associated with an *S-Corporation*, in some states (Florida included) it is not subject to the state income tax regimes. Due to this favorable treatment the IRS requires various tests that must be met for an entity to be classified as an *S-Corporation*. In general these tests include the timely filing of Form 2553 with the IRS, only one class of corporate stock, no more than 100 shareholders, shareholders cannot be foreign persons or entities, and it must be a domestic corporation. Based on these requirements, the fact that distributions must be taken in proportion to the shareholders ownership interest, and limits on obtaining basis to deduct flow through losses to the shareholders some strategies (based on other circumstances as well) would favor business ventures to form an entity taxed as a partnership for tax purposes (LLC, LLP, etc.).

This is a general discussion of some of the various entities that can be utilized when an individual(s) is looking at starting a business venture. There are various other forms of entity structures that were not discussed in the aforementioned article. In order for you to obtain a more in depth understanding of the various types of entities that can be created and how they relate to your particular situation we highly recommend you contact our office for a discussion. Each business situation is unique and therefore requires a sophisticated plan to obtain the most advantageous results. The idea of running a successful business can be a very overwhelming process in itself. Please contact our office to help alleviate the matters related to creating a proper structure and to help ensure the proper building blocks for your businesses future success.

Sincerely,

A handwritten signature in cursive script, appearing to read "Gero & Evaul".

Gero & Evaul