Alabama Entities: Understanding Structures and Recognizing Planning Opportunities

Corey W. Jenkins, J.D., LL.M.
Lanier Ford Shaver & Payne P.C.
2101 West Clinton Ave., Suite 102
Huntsville, AL 35805
256-535-1100
cwj@LanierFord.com

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Overview

- Types of Entities
- Formation Requirements
- Tax Considerations
- Risk Exposure
- Conclusions

Types of Entities:

- Sole Proprietorship
- Partnership
- C corporation
- S corporation
- LLC

Formation Requirements

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Sole Proprietorship

- Any business operated by one individual
- Vast majority of businesses
- No express formation requirements
- Default business organization
- Managed by Sole Proprietor

Partnership

- General Partnership – More than one individual acting to accomplish common endeavor. Management depends on the agreement of the partners or, without such agreement, state law.
- Limited Partnership – Requires formal agreement and certain filing requirements. Management depends on Partnership Agreement.

C Corporation

- File Certificate of Incorporation
- By-Laws determine how Corporation is operated
- Shareholders own the C Corporation
- Shareholders elect board of directors
- Board of directors appoint officers
- Officers run the Corporation

S Corporation

- A C corporation that qualifies as a small business corporation and makes an election with the Internal Revenue Service
- S Corporation must:
  - Be owned by no more than 100 United States' individuals
  - Have one class of stock

LLC

- Must file Certificate of Formation
- Different management structures
- Company Agreement

Certain Determinative Factors

- Taxes
- Risks

What taxes?

- Federal and state income tax
- Employment taxes
  - Social Security
  - Medicare
  - Unemployment taxes (federal and state)

Sole Proprietor, Partnerships, S Corporation, LLC

- "Pass-through" entities
- LLC may be disregarded or taxed as partnership or corporation depending on ownership and certain elections with the IRS

C Corporation
Double Taxation

- Corporation pays tax on its income
- Shareholders pay tax when Corporation pays dividends

Example

- A Corporation earns $10,000 in year 1. If the Corporation is subject to a 40% tax, Corporation will owe $4,000 in taxes and have $6,000 remaining to distribute. If the shareholders are taxed at 20%, will pay $1,200 in tax. Out of $10,000 that was earned, the shareholders will only see $4,800.
- The effective tax rate is 52%

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Example #2

- With single taxation, an individual that earns $10,000 and is taxed at 40% will have $6,000 after taxes as opposed to $4,800 with the C corporation.

Withholding Taxes

Employment Taxes

- Paid on income associated with “employment”
- To the extent an individual earns income that is not attributable to “employment,” not subject to employment taxes

Sole Proprietorship and General Partnership

- Pay Self Employment Taxes
- 15.3 % paid by the Sole Proprietor or by the General Partner
- Generally receive deduction for half of Self Employment Taxes paid

LLC

- Depends on whether Manager Managed or Member Managed
- Guaranteed Payments

Corporation

- Only subject to employment taxes to the extent you are paid as part of being employed.

S Corporation

- Employment Taxes Depend on character of payments.
- Planning opportunities
- Risk of audit

Risk Exposure - Liability

Sole Proprietorship

- Unlimited exposure to liability

Partnership

- Depends on type of partnership
  - General Partnership – unlimited exposure
  - Limited Partnership – General partner has unlimited exposure, Limited Partner's liability generally limited to investment

LLC and corporations

- Exposure to liability generally limited to investment
- Insurance

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Utilizing Multiple Entities

- The “submarine scenario”
- Consolidated Groups
- Single Member LLC’s
- Series LLC’s

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Potential Challenges: Piercing the Corporate Veil

- Alter ego
- Separate operations
- Honoring corporate formalities

Conclusion

Sole Proprietor

- Ease of formation
- Sole owner controls everything
- Sole owner gets all profits
- Relatively easy to sell, but sale may create many taxable events

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Sole Proprietor

- Unlimited liability
- Business terminates upon death of owner
- Less available capital
- Long-term financing difficult to obtain

Partnership

- Ease of formation.
- Opportunity for financial contributions from others.

Partnership

- Exposure to liability
- Business likely terminates upon death or withdrawal of partner
- Long-term financing difficult to obtain
- Difficult to sell a partnership interest

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C Corporation

- Limited liability for shareholders
- Easy transfer of ownership
- Deaths of shareholders have little or no effect on operation of business
- Easier to secure capital
- Necessary for publicly traded companies

C Corporation

- Double taxation
- Extensive government regulations and required reports
- Highly regulated
- Requires legal and accounting services

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S Corporation

- Limited liability for shareholders
- Easy transfer of ownership
- Deaths of shareholders don't affect business as much
- Easier to secure capital
- No double taxation
- Employment tax advantages for highly profitable businesses

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S Corporation

- Limited number of shareholders
- Shareholders generally must be individuals and be residents of the United States.
- Traps → Inadvertent terminations
- Must pay taxes with or without distributions

Limited Liability Company

- Limited liability for members
- No double taxation
- No limit on number of members
- Planning opportunities

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Limited Liability Company

- Death of members can create problems with management of business
- Estate planning more difficult
- Tax traps

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Questions?

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