Structuring Your Business to Maximize Tax Benefits

The Types of Business Entities

- **Sole Proprietorship**
  - Owned and operated by a single individual
  - Owner is personally responsible for all debts and liabilities
  - Pass-Through Taxation (Entity)
    - Profits and losses are reported by the Sole Proprietor on their individual tax return
  - Non-registered, unincorporated

- **Partnership**
  - Owned and operated by two or more individuals who share the profits, losses, and responsibilities
    - Liabilities are unlimited amongst all ***general*** partners
      - ***Limited*** partners have limited risk, but usually limited decision-making abilities
  - Profits and Losses:
    - Partnerships distribute profits and losses among the partners according to the agreed-upon terms outlined in the ***Partnership Agreement***
  - Pass-Through Taxation:
    - Profits and losses of the partnership are "passed through" to the partners, who report them on their individual tax returns
      - *The partnership itself does **not** pay income tax*

- **Limited Liability Company (LLC)**
  - Owned by one or more members (can be individuals, corporations, or other entities)
  - Members are ***not*** personally liable for the debts, obligations, and legal liabilities of the LLC
    - Personal assets are separated & protected from business-related claims
  - LLC's are a ***Pass-Through Entity***

- **Corporation**
  - A legal entity that is separate and distinct from its owners (shareholders)
  - There are different types of Corporations:
    - **C Corporation**
      - Allowed unlimited number of shareholders
      - Offers ***limited liability*** protection
      - Double Taxation: the corporation pays taxes on its profits, and shareholders pay taxes on dividends received on their own personal tax returns

        - Allowed to issue different classes of stock to shareholders
        - Allows for flexibility in ownership structure and attracting investors

    - **S Corporation**
        - Pass-through entity
            - Corporation does not separately report its profit/losses
        - Limited to 100 shareholders
        - Offers ***limited liability*** protection
        - Shareholders must be U.S. citizens or residents, certain trusts, estates, or eligible tax-exempt organizations
        - Allows only for a ***single class*** of stock

- **Limited Liability Partnership (LLP)**
    - Personal liabilities are ***separated*** from the liabilities of the LLP
    - Used by professional service firms (law firms, accounting firms, consulting firms, etc.)
    - LLP's shield individual partners from the debts/misconduct of other partners
        - Each partner is only responsible for their own actions
    - Pass-through entity

When and How to Mix Dividends with W2 Pay

- Reasonable salary as defined by the IRS

- Playing the Game
    - Compensate self "reasonable" salary
    - Take what's leftover from company's profits, and take some of it as dividends

- Paying FICA taxes on W2 portion
    - Social Security + Medicare = 15.3% in taxes
    - Employer pays ½ & Employee pays other ½ of that 15.3%
    - If you're self employed, you'll be paying the whole 15.3% amount

- How to minimize that taxation?
    - Take a reasonable salary for your industry & position
    - Take rest of profits and take them as a dividend
        - The $ taken on dividends will then "avoid" that 15.3% tax hit
        - Will only be taxes as ordinary income on individual tax return

- The FICA Tax Conundrum
    - Your Social Security payment in retirement is based on how much you put ***into*** the Social Security system
    - Do you plan on relying on the payments, or not?
        - That will determine your decision

Fallacies of Business Credit

- At first, your business' credit is based off your ***personal*** credit
    - Unless you have established business credit (it takes time), you will be asked to personally guarantee any loans, contracts, etc.

- First, established a viable business

- Personal assets will be leveraged in order to obtain a loan from lending institutions

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Maximize Business Expenses or Business Profitability?

- Two ways to run a business:
    - Personal Income *or* Business Attractiveness

- Personal Income:
    - Expensing as much as possible to reduce taxes on income
    - Trying to reduce business profit as low as possible

- Business Attractiveness:
    - Writing off as little as possible in maximize business profits
    - Making potential buyers want to buy out your business

Business Structure & Saving for Retirement

- If you're an owner/operator:
    - Traditional/Roth IRA
    - SEP IRA
    - Solo 401(k)
    - Defined Benefit Plan

- If you have employees:
    - Limited on the types of retirement vehicles you can use
    - 401(k)
        - Matching contributions
        - Pension
    - SIMPLE IRAs

<u>Tax Savings First, Investments Second</u>

- *The Biggest Yield for Your Effort:* **Tax Savings**
    - Less taxes = More money towards investments
    - More contributions into your investments means there's less pressure to earn high yields on those investments every year
        - ***Less risk!***

<u>When to Plan Your Exit Strategy</u>

- <u>Developing a Sellable Business</u>
    - ***Don't*** put your name on the front door
    - What buyers will want:
        - Client book
        - Reputation
        - Profitability
    - The business needs to be able to operate ***without*** the owner
    - Start the preparation process as soon as possible!

- <u>Negotiation & Who to Bring Along</u>
    - Attorney
    - CPA
    - Financial Advisor

- <u>Types of Sales, Payments, Earnouts, etc.</u>
    - Each is taxed differently and each should be considered in a sale/purchase

    - **<u>Asset Sales:</u>** *Physical assets and things of value, such as a client list*
        - Client lists are typical sold as a zero basis, long term capital gain
        - Physical assets are subject to depreciation recapture and typically sold for replacement value with the tax treatment as long-term capital gains. Taxes may subject the seller to ordinary income rates on the proceeds.

- **Stock Sale:** *Dissolution or continuance of the LLC, S-Corp, or C-Corp will have great impact on taxation and liability*
  - Liabilities will follow the owner
  - The purchaser will not (likely) be able to expense the portion allocated to a stock sale, but the seller may be able to calculate long term cap gains. This is the contentious aspect of a transaction due to the opposing interests.

- **"Blue Sky":** *Typically related to the marketing (branding) power of the entity*
  - Taxed as ordinary income

- **Most business sales will result in a component ratio of the three items listed above**
  - The ratio will apply throughout the sale period (payments) and be carried to both parties' tax returns
  - Tax and legal advice are critical to be sure the ratio fits the deal for each party

- **Non-compete and non-disclosure agreements**
  - Should be included in every business transaction
    - Must be compliant to state and Federal laws
    - Language should be well defined and considerate of likely challenges/issues (plan the divorce before the marriage!)

- **Extended sales**
  - Note carry: *The seller functions as a bank (financier)*
    - Default risk
    - Possible liability risks
    - Contract may not be as durable as a single payment contract
    - Default actions must be well defined and enforced

  - Earnout: *The seller is retained to sustain and/or grow the business*
    - Typically designed to with incentives to the seller to encourage focus on business growth
    - Often accompanied by complicated contract(s) with defined metrics
      - A well qualified, experienced attorney is vital to be sure as little is left to interpretation as possible
      - Non-compete and non-disclosure agreements are nearly always a component of the contract