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Part II: Deciding between the Limited Liability Company and the S Corporation

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Introduction

Last month, we examined the selection of which entity to choose from based on the perspective of the proprietor through the lens of the Limited Liability Company. To recap last month's conclusion:

"Limited Liability Companies are becoming more popular. This is because most business owners want a limit on liability, single layer taxation, want to limit the formalities and still enjoy the protections. The LLC is definitely worth consideration."

While the LLC has some big advantages, the S Corporation is not out of the race yet. This month we examine the S Corporation.

Subchapter S Corporation

To begin with, the self employment tax is 15.3% for those who are self employed and encompasses both Medicare and Social Security taxes. Profit (not salary or compensation paid) from an S Corporation is not subject to self employment taxes. Normally when a person is employed by an employer, their employer pays half of the tax subjecting the employee to only paying half of the full tax. When one is self employed, they must pay the full tax by themselves. Under the use of a Subchapter S Corporation, salary (not profit) is subject to self employment tax. However, if the salary is deemed insufficient, the IRS can reclassify the profits as a salary subjecting them to self employment taxes.

Continued on page 2

A CASE STUDY

Trustees Liable for Taxes

A District Court ruled that trustees of an estate were liable for unpaid estate taxes. In the fact pattern, the estate came about when the decedent died in 1992, leaving behind large insurance policies and a hotel. The insurance policies were immediately paid out through the estate, leaving only the hotel as the last remaining asset.

The estate managed the hotel in order to make estate tax payments to the IRS until it eventually defaulted in 2005. Needless to say, the IRS pursued collection options. One problem occurred; by the time the IRS pursued the estate, the estate was insolvent and essentially bankrupt. The IRS then brought the matter to court, in which the District Court ruled that the trustees and the Distributees were liable for the taxes.

Continued on page 3



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This is in contrast to LLCs. While operating under an LLC, both salary and profits are generally (but not in all cases) subject to self employment taxes. For people with incomes below the social security maximum threshold amount, this can result in a significant amount of money being put into self employment taxes. That being said this can be good or bad depending on your retirement planning needs and expectations.

Since S Corporations are flow through entities, losses can be deducted. This also holds true for the LLC. However, this is in contrast to C Corporations in which shareholders cannot deduct losses. If an S Corporation is experiencing losses, the owner will recognize the loss on his or her income statement leading to a lower tax liability. However, there is a limit. You cannot deduct amounts that exceed your investment and loans to the company.

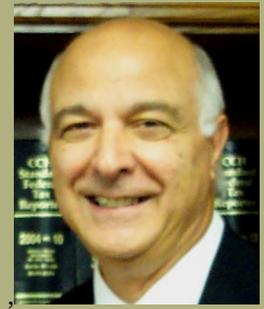
During operation of an S corporation, profits are taxed only at the shareholder level as opposed to C Corporations, which are taxed twice. Just like with the LLC, the profit, not the distributions are taxed. This can be good or bad depending on the situation.

When winding up the affairs of the entity and dissolving the business, profits are taxed once. As stated above, all businesses eventually close their doors and their assets are sold at one point or another. With an S corporation this transfer is only taxed at the shareholder level.

Of less importance, the franchise fee and start up filing fees that S Corporations pay are substantially less than that of LLCs. Generally, S Corporations will cost in the area of \$50 per year in fees and LLCs generally cost \$300 - \$500 per year.

Conclusion

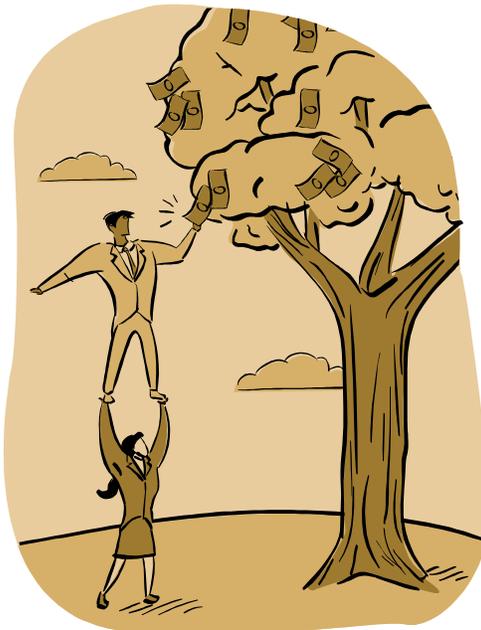
There is no one "be all, do all" separate entity for the business man or woman. Each entity has subtle differences which can make a substantial difference to the business owner. When deciding which entity type to go with, consider tax and legal aspects to the full extent necessary. The Center is well adept to providing, setting up and maintaining entities such as those discussed above. Call The Center for these and all of your other financial, legal, and tax planning needs.



Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- While the LLC has some big advantages, the S Corporation is not out of the race yet.
- Profit (not salary or compensation paid) from an S Corporation is not subject to self employment taxes.
- There is no one "be all, do all" separate entity for the business man or woman.



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A CASE STUDY CONTINUED:

Editor's Comment: While many people are eager to get their inheritance and spend it in a manner they see fit, it is important for both the Trustees and the Heirs to realize that they are both liable in the event the estate defaults. An early distribution, like in this case, can cause a domino effect. Here, since distributions were made early, the heirs would have been foolish to refuse the early distribution because had the estate defaulted, the IRS would have seized that money first, leaving that heir out their inheritance. In this case, the cash in the estate was distributed, taxes were being paid, then the default occurred. Word to the wise; do not make early distributions until the estate taxes have been paid in full to the IRS.



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ESOP Can Be A Win-Win-Win for You, Your Company And Your Employees

Employee Stock Ownership Plans (ESOP) have been around for 35 years, and many well known, national companies have them, but many misconceptions still exist, such as: (1) Employees will directly own the company's stock [FALSE], or (2) Employees will directly ratify everything from executive compensation to capital spending plans [FALSE], or (3) Employees will have complete access to all of the company's trade secrets and financial data [FALSE].

Today, there are over 10,000+ ESOP's in the US covering 10.5 million employees (10% of the US private workforce). Total assets owned by ESOP companies is approximately \$675 billion. Well-known examples of ESOP companies include Proctor & Gamble, Anheuser Busch, Sherman Williams, United Airlines, and Publix.

Creating an ESOP trust to purchase your shares in your company can have many advantages for the Seller, the Company, Management and Employees. For example:

Advantages for Selling Shareholder(s)

- Liquid market for shares at fair market value
- Tax deferred (or tax free) sale of company stock
- Qualify for lower capital gains tax rates when paid
- Achieve full or partial liquidity
- Partial sale allows for retaining voting control
- Diversification of assets and net worth

Advantages for Employees

- Provides tax deferred retirement plan
- Equity participation may increase productivity
- Employees build wealth without personal investment

Advantages for Management

- Ensures smooth transition of ownership
- Provides increased ownership opportunities
- Enhances overall morale throughout company

Advantages for Company

- Tax deductible contributions to the ESOP
- Tax deductible dividends paid on ESOP stock
- Provides substantial tax savings
- Ability to use pre-tax dollars to repay debt

Legacy Advisors Group has experience working with ESOP financial advisors, bankers, attorneys, appraisers, etc., and can help you decide if an ESOP is right for your company. To learn more about ESOPs and qualify for a FREE, preliminary feasibility study, contact me at mertel@lmaallc.com

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Frequently Asked Questions...



Q: Now that the Supreme Court has upheld The Patient Protection and Affordable Care Act, how will this affect my business in the years to come?

A: First off, the PPACA is a law that is workable for business owners to deal with. It requires business and tax planning like most laws do, but the law is manageable. Of most immediate concern is the 3.8% additional tax on incomes above \$250,000. While many people do not earn this level of income, those buying and selling their businesses should be cognizant of this additional tax as it typically causes their income to spike.

Q: I would like to set up a Subchapter S Corporation. How do I do this?

A: You must first file articles of incorporation with your respective state. Once this is done, IRS Form 2553 must be filled out to make the Subchapter S election.

Q: Where is the best place to store estate plan documents?

A: The best place to store estate plan documents is in a secure location that others know of and that is easily accessible. Storing the documents in a safe deposit box that a friend knows of can be a good place as long as that friend knows where to get the keys. Hiding documents in a book or in a safe that no one has the combination for renders the documents useless to both you and those that are trying to help you.

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