Legacy M&A Advisors LLC

M&A UPDATE®

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File Articles of Incorporation or Articles of Organization?
The Letter S v. The Acronym LLC Part II

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Introduction
Last month, we examined the selection of which entity to choose 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, minimum 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/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.

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.

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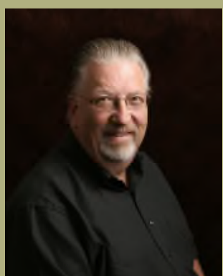

Mike Ertel is a Certified M & A Advisor and a Principal Broker with Legacy M&A Advisors, LLC, a full-service M & A Advisory firm with an office in Tampa, Florida specializing in representing sellers and buyers of small- to mid-sized companies. Prior to joining Legacy M&A Advisors, LLC, Mike's business career spanned 30+ years with Fortune 500 and Fortune 1000 Companies, with senior management roles in Marketing, Operations and Logistics. Mike also served as President, COO of a mid-sized Manufacturing company headquartered in Tampa. Mike also holds a BS in Electrical Engineering and an MS in Industrial Administration, both from Purdue.

A CASE STUDY

Being a Real Estate Professional

The Tax Court rejected a taxpayer's claim that he was a real estate professional. The taxpayer owned 7 properties. He additionally owned two other businesses.

One was a mortgage application processor, the other business sold health drinks. His real estate endeavor lost money year by year. As part of his tax strategy, he would take the losses on his personal tax return to reduce his overall tax liability. The IRS reviewed his tax return and took the position that this passive loss should not be allowed on his tax return.

The taxpayer took the time to catalog all of his time spent dealing with the properties. In total for the year in dispute, he performed more than half time services and above 750 hours (or so he claimed) on the properties as required.

The Tax Court viewed the evidence and arguments and ruled against the taxpayer. What was particularly damaging was that a management company was managing the properties for him. In the eyes of the Court, this, combined with the fact he was processing mortgage applications full time, would have made it impossible to fulfil the time requirements (at least half time/750 hour) for any given year. Therefore, no passive expense deductions were allowed.

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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 pay in the area of $50 per year in fees and LLCs can pay $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.

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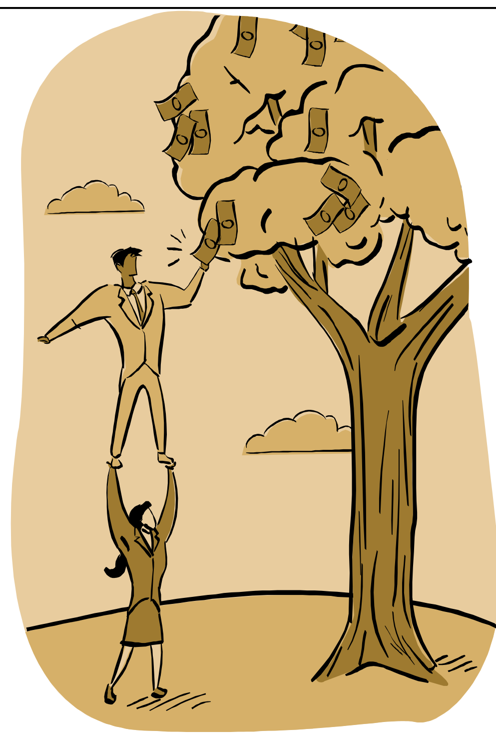
Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure 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

- **Profit (not salary/compensation paid) from an S Corporation is not subject to self-employment taxes.**
- **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.**
- **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.**



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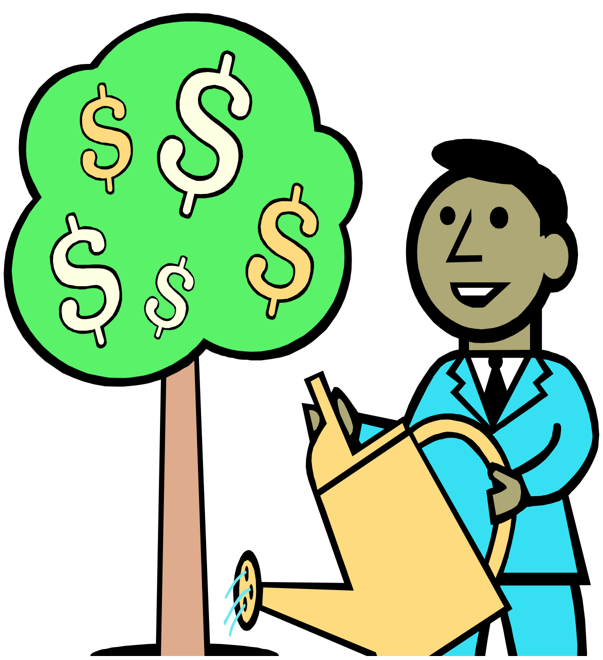
A CASE STUDY CONTINUED:

Editor's Comment: A lot of people are tempted to take a passive loss deduction when it is simply not appropriate. If you take this deduction you must be able to substantiate your position with the IRS. If you do not substantiate your position, you're open game for the IRS and they will not hesitate to remove the deductions. This brings an unexpected tax liability to you, the taxpayer at often some of the most inopportune moments in your cash flow. Also, it gives the IRS another in road to review more tax returns creating a snowball effect. Bottom line, either substantiate your position or be prepared for a potential large outlay of cash.



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Ten ESOP Fables – Debunked, Part I

There are many misconceptions about ESOPs today, sometimes in the business press, and sometimes by professionals from various fields. With all this misinformation and misconceptions about ESOPs, it can be difficult – if not impossible – for the average business owner to make an informed decision about whether setting up an ESOP makes sense for himself, his company, and his employees.

This is the first in a series of articles that will attempt to dispel ten common misconceptions, or fables, about ESOPs.

ESOP Fable #1: It would be easier just to sell my company to a third party.
Business owners often hold the belief that "When the time comes to retire, I will simply sell my company to an interested buyer."

Unfortunately, it's not that easy. Finding a qualified buyer who is ready, willing and able to pay a fair price for a privately held business can be a daunting task even in good economic times, and next to impossible in bad economic times. In the worst of times, even an otherwise qualified buyer may require the seller to carry back a substantial portion of the purchase price as a seller's note. The entire business brokerage industry devotes most of its energies to simply finding qualified buyers for willing sellers. Finding such a buyer generally involves advertising the business for sale, interviewing potential buyers, weeding out the unqualified prospects, and negotiating a selling price and other terms.
Even if you have been approached in the past by parties expressing interests in buying your company, getting an actual commitment to purchase can often be disappointing. Many of these "interested parties" cannot afford to acquire your business at a fair price, and/or are hoping to acquire your business at a substantial discount from its fair market value.

Herein lies one of the key benefits of selling your company to an Employee Stock Ownership Plan. There is no need to find a qualified buyer, or to otherwise put your company on the market. Setting up an ESOP actually creates a buyer for your stock. Furthermore, the ESOP will pay fair market value for your stock, in cash. And consummating the sale can take considerably less time than a typical third-party sale, often in less than 120 days. Moreover, an ESOP is typically ready, willing and able to acquire more of your stock if and when you're ready to sell more of your stock.

Next month's article with tackle: ESOP Fable #2: ESOPs are only applicable to very large corporations
As ever, if you know of a business owner who's thinking of selling or buying a business and who might benefit from a ***free***, ***confidential***, consultation with us, have them contact me directly.

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Frequently Asked Questions…

Q: Is an S corporation required to pay quarterly estimated tax?

A: An S corporation must make installment payments of estimated tax if the total of the following taxes is $500 or more: 1) built-in gains, 2) The excess net passive-income tax, and 3) The investment credit recapture tax.

Q: If an employee claims more than 10 allowances on their Form W-4, does the employer have to report this to the IRS?

A: In the past, employers routinely had to send the IRS any Form W-4, claiming more than 10 allowances or claiming complete exemption from withholding if $200 or more in weekly wages was expected. <u>The requirement no longer exists.</u>

Q: How do you determine if a worker is an employee or an independent contractor?

A: There are three basic categories of factors that are relevant to determining a worker's classification:

1) **Behavioral control (whether there is a right to direct or control how the worker does the work),**
2) **Financial control (whether there is a right to direct or control the business part of the work), and**
3) **Relationship of the parties (how the business and worker perceive the relationship).**

If all three elements are substantially met, generally the worker is an employee. If not, the worker can be classified as an independent contractor. But be careful, you are liable for unpaid withholding taxes if you get this classification wrong!