



Starting A Business

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Starting a business can be one of the most exciting and terrifying experiences in your life. You can make the experience less painful – and more profitable – if you get professional help before you start your business. You can't escape taxation but you can minimize the tax bite by anticipating and planning.

Choosing A Business Entity

First, and most importantly, you have to decide how your business will be structured. Will it be a corporation, a partnership, or another type of business entity?

How much of your money and personal assets are you willing to risk in the business? If the business isn't profitable, creditors, including the IRS, can come after you. This is the reason why the choice of business entity is so important. Depending on how you structure your business, you can shield some or all of your personal assets.

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You also have to think about the tax consequences of your choice of business entity. Different businesses are taxed differently. If you incorporate your business, the corporation pays taxes (unless you elect special "S corp" tax treatment). But if you operate your business as a partnership, you and your other partners pay the taxes.

Here's a look at some common business entities. We all know the names – sole proprietorship, corporation, partnership – but if you're serious about starting a business, you have to know and carefully weigh the pros and cons

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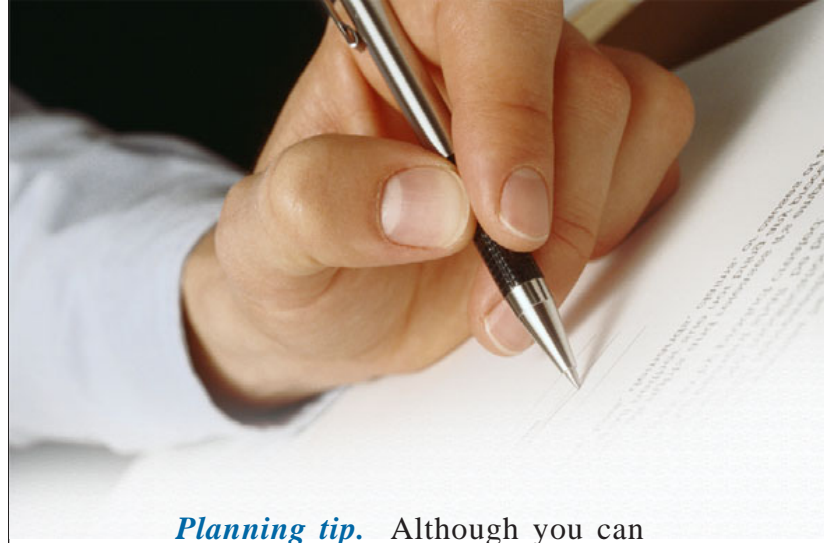
of each type of business.

Sole proprietorships. Where there is only one owner and he or she is willing to risk all of his or her personal assets to satisfy the liabilities of the business, a sole proprietorship may be appropriate. While the business activities of the owner are, for accounting and tax purposes, separate from the owner's other income, a sole proprietorship is not an "entity" separate from its owner.

Because sole proprietorships are conducted by individuals, the income of the business is taxed just as individuals are taxed.

Sole proprietors also have to think about capital gains tax. Generally, sales of long-term capital assets used in the business will be taxed at the capital gains rate. The maximum capital gains rate is 15 percent for individuals. There are lower rates but they are exceptions reserved for lower-income individuals.

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Planning tip. Although you can switch from one business entity to another, it's easier—and a lot less expensive—to get it right in the first place. Nevertheless, not a single year should pass in your business—whether it is brand new or it's been around for years—in which you do not question whether the type of tax entity you use continues to be appropriate. This evaluation should take place not only from the perspective of your business operations but also from the perspective of your ownership interest in that business.

Sole proprietorships also could be subject to the alternative minimum tax (AMT). The AMT is a parallel tax system that was intended to be paid by only the very wealthy. Today, more middle income people are paying AMT because it was never indexed for inflation. Calculating AMT liability is complicated and you must get help from a tax professional.

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Partnerships. If two or more people are starting a business, a partnership is a simple way to get the business off the ground. A **general partnership** is a partnership of the “old-fashioned” kind. All of the partners are entitled to participate in the operation of the business and all are liable for the full amount of any portion of the partnership’s debts. The partnership generally does not compute or pay taxes. Rather, income “passes through” to the partners. Thus, the tax rate of each partner depends upon his or her own level of income.

Corporations. You don’t have to be a million dollar business to be a corporation. Anyone can incorporate a business. Unlike sole proprietorships and partnerships, corporations have to follow more state laws about the number of shareholders, issuing stock, holding meetings, and so on. Corporations also are taxed differently from sole proprietorships or partnerships. Corporations, except for S corporations, are taxed at the entity level. Income distributed to the owners out of any after-tax profits in the form of dividends is taxable again to the owners.

Corporations are distinct legal entities. Ownership interest is divided into shares. Corporations have perpetual duration. The shareholders generally are not liable for any debts of the corporation beyond the value of their investments. However, lenders and other creditors sometimes ask owners of small corporations to assume personal liability for loans and other transactions.

C Corporations. Corporations taxed at the entity level are referred to as “C corporations” or regular corporations. The name comes from the title of a subchapter of the Internal Revenue Code.

C corporations compute and pay taxes based on their own operations, with no reference to the income or losses of the shareholders. Corporate federal tax rates are as follows:

- (1) 15 percent on the first \$50,000 of income;
- (2) 25 percent on \$50,001-\$75,000;
- (3) 34 percent on \$75,000-\$10 million; and
- (4) 35 percent over \$10 million.

New Manufacturing Deduction.

In 2004, Congress created a new deduction for U.S. manufacturers. The “manufacturing deduction” is one of the most generous tax breaks in a long time. It’s not just for traditional manufacturers like auto and steel makers. Almost every business that makes something qualifies for the deduction. The deduction can be claimed by partnerships and proprietorships as well as corporations.

For 2005 and 2006, the deduction is three percent of taxable income from production activities *or* three percent of taxable income, whichever is less. Over time, the deduction rises to nine percent by 2010.

The government wants the new deduction to be widely available to U.S. businesses. That’s why it is not just limited to traditional manufacturers. Some of the other businesses that qualify for the deduction include construction, farming, software development, motion picture production, and many other businesses. There are also special rules to make it easier for small businesses to qualify for the deduction. There is one very important exception. Restaurants generally do not qualify.

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Hybrid C corporations. Hybrid C corporations are C corporations, but they do not have all of the rights of C corporations. Frequently, these corporations are taxed at the maximum *individual* tax rate. Examples are:

- ***Personal holding companies:*** A “personal holding company” is a corporation that: (1) has at least 60 percent of adjusted ordinary gross income for the tax year characterized as personal holding company income, and (2) at any time during the last half of the tax year, more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by five individuals.
- ***Personal service corporations:*** A personal service corporation is one that furnishes personal services performed by employee-owners. Employee-owners are those who own, directly or indirectly, more than 10 percent of the outstanding stock of the corporation on any day during the company’s tax year.

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- **Qualified personal service corporations:** A qualified personal service corporation is exempt from the general prohibition against use of the cash method of accounting by corporations. However, a qualified personal service corporation is not entitled to utilize the graduated tax rates available to other corporations.

Passthrough entities: A business entity (other than a general partnership) that insulates the owners from most liability, yet pays no tax (or very little) is called a passthrough entity. All income and deductions are “passed through” to the owner and taxed on the owner’s individual income tax return each year.

Caution: The IRS can recast transactions that attempt to use the passthrough rules for tax avoidance purposes.

Examples of passthrough entities are:

- **S corporations:** S corporations are popular because income is taxed at the shareholder level. The shareholders have the same protection from liability as shareholders of a C corporation. An S corporation passes most of its income and loss items to the shareholders. Thus, the corporate tax rates do not apply, and each shareholder is subject to his or her individual tax rate. The S corporation itself is liable for a small number of taxes.
- **Limited partnerships:** These are partnerships that have two classes of partners. One or more general partners run the business operations and are fully liable for any partnership debts. Limited partners are discouraged by law from running the partnership’s business and are liable only for the amount they invested in the partnership. Income generally passes through to the partners.

- **Limited liability partnerships (LLPs):** These operate like a traditional limited partnership, but the general partner also has limited liability.
- **Limited liability companies (LLCs):** These resemble both limited partnerships and corporations. They provide limited liability to members, but also permit members to conduct the business affairs of the limited liability company. Like a partnership, a limited liability company passes income through to members.

Trusts: Although usually formed to protect assets for a child or other dependent, beneficiary trusts also are used for business purposes. The donors of the trust place business assets “in trust,” and the trust operates a business or owns an investment. This form generally provides limited liability for the donors and beneficiaries. Trusts, however, do not pay the same tax rates that apply to individuals. Trusts are also subject to the AMT.

One exception: If the trust is set up as a passthrough or grantor trust, income will be taxed to the owner at the owner’s rate and the trust entity will be ignored.

Factors Affecting Entity Choice

There is no blanket rule that determines what entity is right for your business. However, identifying the existence or absence of certain key factors can go a long way in making the right decision.

Factor #1: Contribution of property and services to the entity

One of the most important considerations in entity choice is the tax treatment of your contribution of property and services to the new business.

- **Corporations:** Contributions of property to a corporation (S or C) need not be a taxable event. When a corporation is organized, the value of the issued stock is usually the same as the value of the property transferred to the corporation. The tax law calls this non-recognition of gain or loss.

Caution. Non-recognition is not provided for the contribution of services for an equity position in a corporation. Therefore, if one of the shareholders provides the money and the other the labor, the contribution of money will be a tax-free event, while the shareholder who contributes his or her labor will recognize compensation income in the value of the stock received in return.

- **Partnerships and passthrough entities:** The contribution of cash or property to a partnership or other type of passthrough entity is generally a nontaxable event. The partnership rules prevent the transfer of gain or loss between partners when property with a “built in” gain or loss is contributed.

Caution. The contribution of services to a partnership or other passthrough entity can be tax-free, but not always. The tax rules are complicated and the IRS doesn’t always apply them consistently, especially if your business is a limited liability company.

Factor #2: Limitations on investors’ and owners’ rights to participate in management

Who is going to manage your business? Do you want centralized management; that is, will a few key people be charged with the day-to-day conduct of affairs, while the rest of the investors remain “silent?” Will everyone who invests want a say in the operation of the business?

Corporations, both S and C, have centralized management. Investors’ rights are governed by state law. The conduct of the business is divided between the officers and the directors of the corporation.

Centralized management is possible in a partnership or passthrough entity. For example, a limited liability company can have centralized management if the members appoint certain members to run it or if they hire managers. Generally, however, there are no specific restrictions on management of passthrough entities.

Factor #3: Restrictions on investors

The S corporation, unlike the other business entities, has restrictions on who may invest. These restrictions limit the utility of S corporations.

Shareholders. Not everyone can be an S corporation shareholder. Only the following individuals, estates and trusts are eligible S corporation shareholders:

- (1) Individuals other than nonresident aliens;
- (2) Estates, including the estate of an individual in bankruptcy;
- (3) A qualified Subchapter S trust (QSST);
- (4) A voting trust that is a subpart E trust and is created primarily to exercise the voting power of stock transferred to it;
- (5) A trust to which stock is transferred according to the terms of a will;
- (6) An electing small business trust; and
- (7) Retirement trusts and charitable organizations.

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Planning tip. A partnership is not permitted to hold stock in an S corporation. The partnership's ownership of the stock is not attributed to the individual partners for purposes of qualifying as an S corporation. Beneficial ownership is the controlling factor for purposes of determining whether a partnership is a shareholder. Thus, an S corporation in which a partnership is a nominal shareholder will not be disqualified if the facts show that the individual partners are the true owners of the stock.

Caution. The maximum number of S corporation shareholders is 100. Even an accidental or temporary excess in the allowable number of shareholders can terminate your S corporation. However, of great advantage to some family businesses, all family members can elect to be treated as one shareholder. As a result, large family businesses (especially those that have a number of generations) can retain S corp status without precluding employees or others from having an equity stake.

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Factor #4: Types of stock interests

C and S corporations have different restrictions on the types of stock permitted. Generally, C corporations can have a variety of interests attached to various classes of shares. An S corporation binds all investors to the same enterprise. Therefore, it is difficult to direct specific items of income or loss to specific shareholders. The outstanding shares must be identical regarding the rights of the holders in the profits and assets of the corporation. In other words, each share must confer identical rights to distribution and liquidation proceeds. Differences in voting rights, however, are permitted.

Factor #5: Debt and equity

Because S corporations and pass-through entities treat the entity's debt to its owners under the partnership rules, both debt and equity can be used to capitalize the venture. An owner's contribution to the entity, whether debt or equity, becomes part of the owner's basis in the entity.

The capitalization flexibility provided under the partnership rules comes at a price. The accounting for S corporations and passthrough entities is complex and technical. This complexity also may lead to valuation problems on the sale of the owners' interests.

Start Up Costs

Once you've decided what entity is right for your new business, your next step is managing start-up costs.

You need to maximize the tax savings from:

- Research costs;
- Advertising;
- Salaries and wages of employees-in-training;
- Travel;
- Expenses of lining up customers, suppliers and distributors; and
- Fees paid to consultants for professional services.

You might assume that all start-up expenses are deductible as business expenses in the year you pay them, but this is not true. These expenses are not considered to be business expenses because they are not incurred by a going business. Instead, unless you make the proper tax elections you may need to wait years to recoup those costs while still being taxed on your business profits.

Qualified start-up expenses include *any* amount that is paid or incurred in connection with:

- Investigating the creation or acquisition of an active trade or business (investigatory expenses are costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business), or
- Creating an active trade or business (business start-up expenses are costs incurred subsequent to the taxpayer's decision to establish a particular business and prior to the time the business actually begins operating), or
- Any activity engaged in for profit and for the production of income before the day on which the active trade or business begins and in anticipation of such activity becoming an active trade or business.



Planning tip. You want to be sure that you get the maximum tax benefit you can from all of these expenses. To do so, you need to coordinate the expenses with the starting date of the business and properly make the necessary elections. If you are expanding an existing business rather than starting a new one, you may be able to deduct the expansion costs currently. Sometimes this depends on whether a new line of business is considered part of your old business or must be treated as an entirely new business.

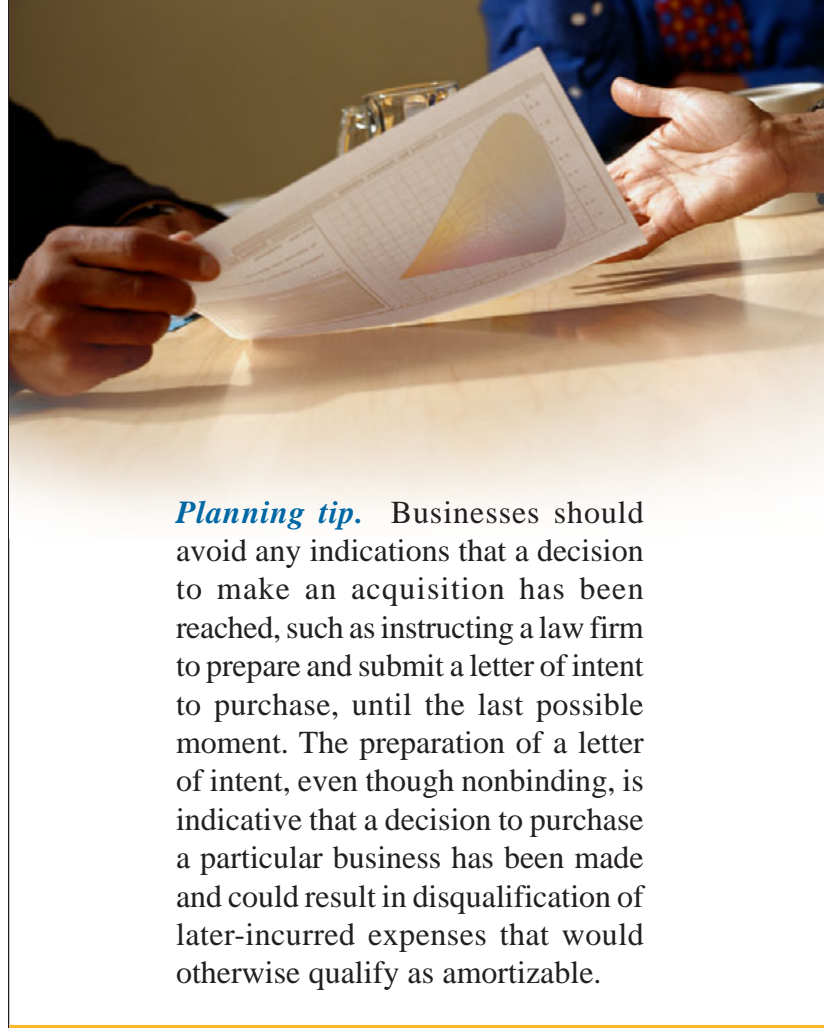
Comment. Business owners can deduct up to \$5,000 in start-up expenses. This helps smaller businesses. The remainder of any start-up expenses, however, will have to be amortized over a 180-month period.

Who owns the deduction? Another complication with start-up expenses is that they are amortizable only by the person who incurs them. If your new business is going to be a sole proprietorship, that won't be a problem. However, if the venture is to be a corporation, you can't personally deduct the costs you incur before incorporation. Those costs are part of your investment in the corporation's stock. You may want to contribute the funds to the corporation and let the corporation incur the expenses so that it can amortize them.

Profit-Motive

When you start a business, you are not expecting to lose money. But depending upon the type of business, you may have losses over the first few years of operation until things start humming. One danger in starting a business is that the IRS will invoke the "hobby loss" rule.

Deductions attributable to an activity not engaged in for profit, like a hobby, are limited to the amount of gross income derived from the activity. That means that income that you have from other sources can't be offset by your new business's losses. This can make or break your fledgling business. The best way to avoid these harsh "hobby-loss" rules is to start collecting proof simultaneously with starting your business.



Planning tip. Businesses should avoid any indications that a decision to make an acquisition has been reached, such as instructing a law firm to prepare and submit a letter of intent to purchase, until the last possible moment. The preparation of a letter of intent, even though nonbinding, is indicative that a decision to purchase a particular business has been made and could result in disqualification of later-incurred expenses that would otherwise qualify as amortizable.

Profit-motive. Most businesses start out small, so small that the IRS may question whether you are really serious about making money. In IRS-speak, an activity not engaged in for profit is any activity that does not constitute a trade or business, or an activity that is not engaged in for the production or collection of income. What this really comes down to is a determination based on the presence or absence of a profit motive. You must have a good faith expectation of making a profit and you must be prepared to prove it.

No one says that you can't enjoy your business. And you can still have a qualifying profit motive for an activity that has little chance of making a profit. But in determining your intent for tax purposes, more weight is given to objective facts than to your subjective testimony of business intent.

Nine factors. Courts often use nine factors to test if an activity is engaged in for profit:

- (1) Manner in which the taxpayer carries on the activity;
- (2) Expertise or experience of the taxpayer's advisors;
- (3) Time and effort the taxpayer expends on the activity;
- (4) Expectation that the assets used in the activity may appreciate in value;
- (5) Success of the taxpayer in carrying on other similar or dissimilar activities;
- (6) Taxpayer's history of losses from the activity;
- (7) Amount of occasional profits earned from the activity;
- (8) Taxpayer's financial status; and
- (9) Elements of personal pleasure or recreation derived from the activity.



Planning tip. If you are starting a new business, the IRS gives you the opportunity to elect to defer determination of whether the profit presumption exists until after the fourth tax year after the activity starts.

An activity is presumed to be for profit if it is profitable for three or more years in a period of five consecutive years. If the activity involves breeding, training, showing, or racing horses, the presumption applies if profits arise in two or more years within seven consecutive years. The IRS can rebut the presumption.

Conclusion

All the factors that go into the selection of the proper entity for your venture, as well as the strategies for maximizing your start-up deductions, are beyond the scope of this booklet. However, you are now acquainted with some of the major considerations. This familiarity will help make the first meetings with your tax advisor more productive and your business more profitable.