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CHOICE OF BUSINESS ENTITY[1]

Thank you for allowing us the privilege and opportunity to work with and for you in developing and implementing a plan of success for your business or prospective business. We enjoy designing winning strategies, which enable you to maximize wealth, minimize taxes, and care for loved ones®

This summary memo discusses, in general terms, the type of legal entities and structures which we offer to our clients. Please keep in mind that these are general recommendations and considerations and that we need to individually visit, in person or by teleconference, with each client regarding their particular circumstances, before we can recommend the best legal structure to address their liability, tax, and management concerns.

Without further delay, let us review the relevant considerations that we want to look at in picking the right entity for a client. Then, we can use this criteria to tour the Entity Showroom and choose the right "business vehicle" to accomplish each client's goals.

I. **LIABILITY EXPOSURE:** Every business activity generates risk and potential liability. No entity or legal structure can prevent someone from filing a lawsuit. However, a proper structured legal entity can protect your assets from seizure or attachment by potential claimants. When we talk about liability, we mean every type of foreseeable claim or cause of action that a person, including other companies and entities, could bring against you. We generally group these various claimants into the following classes of liability. As you read this list, ask yourself if you and your business has exposure to any of these types of liabilities.

A. **Tort Liability:** Tort liability comes from any type of injury to a person or a person's property, whether intentional or accidental. For example, if in the course of your business you are driving to a job site and you are hit by another driver who runs a red light, the driver has committed a tort against you. Other examples include assault, battery, trespass, or fraud.

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[1]The Groce Law Firm, Ltd. focuses its practices in the areas of business law and wealth transfer planning. The Groce Law Firm has clients throughout the United States from Florida to California and throughout the U.S., particularly in Texas and the Chicagoland area. Over the last thirteen (13) years, the Groce Law Firm has created hundreds of companies of all sizes and for a variety of businesses, from real estate development to washer and dryer repair. The Groce Law Firm develops individualized plans to help clients maximize wealth, minimize taxes, and care for loved ones®.

1. **Own Acts:** A person is always personally liable for their own torts. No company can prevent someone from suing and collecting against you for your own actions.

2. **Acts of Employees:** However, most entities can protect an employer personally from liability for the torts of their employees. For example, if an employee is the driver who runs the red light in the course and scope of their employment, the employer may also be liable. If the employer uses one of the many entity choices described later in this memo, they should be shielded personally from liability. In other words, the person who has been harmed may only be able to sue the employee personally as well as the company, but not the owners of the company.

B. **Contract Liability:** Contractual liability usually comes from a breach of contract. A breach of contract occurs when either party to the contract fails to perform any term of the contract without a legal excuse. Generally, the party who breaches the contract is liable for that breach. However, most businesses who operate through a separate entity have the entity sign the contract on behalf of the business. This allows the entity to absorb any contractual liability in the event of such a claim. In other words, only the entity will be liable on the contract, the owners of the entity will not.

C. **Employment Liability:** Employment liability arises out of the employment relationship. Generally, the employer is liable for certain injuries even though the employer did nothing wrong. This may include an injury to the employee in the scope and course of employment. This may also include the employer's responsibility for acts the employee performed in the scope and course of employment. For example, if your employee, on an errand for your business, hits a pedestrian, your business may be liable to the pedestrian for that injury. Employment liability also arises out of federal law, such as discrimination based on age, race, sex, religion, or any special handicap covered by the Americans with Disabilities Act, not to mention OSHA, EPA, and other type of governmental liability. By running a business through an entity, the business is generally liable for any of these type of claims, and not the owners, unless the statute creates special personal liability, such as the personal responsibility to withhold and pay payroll tax.

D. **Land Occupiers Liability (Slip and Fall Liability):** The responsibility of a person who owns or does business on land varies on a state by state basis. But generally, every state imposes liability on the owner or operator of a physical location to keep a location in a reasonably safe condition or to warn of any known conditions or dangers. For example, in a business setting, the business operator generally owes a duty to each customers who enter the business. This duty usually consists of a duty to warn of any potential defects in the premises (i.e. a broken step or a wet floor) and a duty to remedy the defect as soon as possible. In the event of a claim based on land occupier's liability, the business, or the entity through which it is operated, will be liable for any failure to warn or remedy if a duty existed.

E. **Product Liability:** Product liability comes from the responsibility of manufacturers, distributors and sellers of products to the public, to deliver products free of defects which could harm people or property and to make good on that responsibility if their products are defective. Types of product liability include faulty auto brakes, contaminated baby food, exploding bottles of beer, flammable children's pajamas or lack of label warnings, just to name a few. Generally, each state within the United States holds everyone in the "chain of commerce" responsible for defective products, including the manufacturer, distributor, and the seller of the product. By selling products through a company, a business owner generally avoids personal responsibility for any defective products.

II. **NUMBER OF PARTNERS:** Beyond protecting oneself from liability, a business owner needs to look at the number and type of owners of a business to determine the proper ownership structure. Different entities offer different benefits depending on the number and type of participation of the owners.

A. **Number:** For simple classification, we will break the number and participation of the owners into several groups:

1. **Sole-Proprietors:** Some businesses have a single owner, who does all of the work, and performs all of the services of the business. This is your typical "one-man show."

2. **Partnerships:** Other businesses function about like the one man show, except that two (2) or more people participate in the daily operation of the business, generally separating the duties and responsibility between the different people.

3. **Active and Passive Owners:** Other businesses have a distinction in the type of ownership. Some businesses have two types of owners, the workers and those people we will call the "money men." Generally, in these types of operations the workers actively participate and derive their living from the business, while the "money men" act more as passive investors. In these active and passive ownership situations, the tax code

recognizes this distinction. People who work in the business have to pay the self-employment tax on the income earned from the business, while the passive investors do not, but instead treat the money from the business as passive income.

III. **NET INCOME:** Beyond liability risk and the number of owners, the amount of money a business makes also affects the proper entity selection, because Uncle Sam and each state wants to take their cut of the money through federal, state, and local taxes. The more money a business makes, the more time, effort, and expense the business owner should give to making sure that they do not pay more taxes than they must. Judge Learned Hand, a Supreme Court Justice, once said that, "Taxes are a forced extraction and not a voluntary contribution and no one has a duty to pay anything more than must and everyone should take every deduction allowed by law." Generally, the first and best step in reducing taxes comes in choosing the proper business structure, which legally reduces federal income, self-employment, and estate tax as well as the various state and local income and franchise taxes. Almost all taxes are tied to revenue and most are tied to net income. Thus, to make a proper determination, we need to look at net income. Generally, when we discuss taxes, we look at the following types of taxes:

A. **Federal Income Tax:** We all know about the income tax that each American must pay on the income they earn. This income tax applies to income, other than capital gain from the sale of property, and is applied in brackets, starting at 10% and climbing to 35% based on the amount of income a person makes. Thus, the more you make, the more you have to pay. Most people feel that this bracketed tax system punishes those hard working Americans who get out of bed every day trying to make more and trying to obtain the American dream.

1. **Added benefit of LLC or LP:** In an LLC or Limited Partnership, the owners have the option to allocate the entity's income to the partners of their choosing. For example, if there are four equal partners in an LLC, the normal allocation would be each partner pays 25% of the tax. The partners, however, may agree to a special allocation, in which the tax is split in an unequal manner, such as one of the four partners paying all of the tax, two of the partners paying all of the tax, or so on.

B. **Federal Employment Tax (Self-Employment Tax):** The "employment tax" is the tax that must be paid on income earned from employment under the Federal Insurance Contributions Act. This tax only applies to income earned from employment, not for any other type of income (i.e. investment income, rental income, etc.). For people who own and operate their own business, we call this the "Self Employment Tax," generally abbreviated SE Tax. The employment tax does not apply to passive investors, or the "money men," who do not actively participate in the business. In reality, the Employment Tax contains two parts:

1. **Social Security Tax:** 12.4% of an employee's wages must be paid to the IRS for Social Security. If a person is self employed, that person must pay the entire 12.4%. If the person is an employee, the employee must pay 6.2% (which is withheld from the employee's pay check) and the employer must pay the other 6.2% of the employee's wages to the IRS. This 12.4% tax must be paid on all wages up to $94,200 (for the year 2006).

2. **Medicare Tax:** 2.9% of an employee's wages must be paid to the IRS for Medicare. Just like the Social Security tax, if a person is self employed, the person must pay the entire 2.9%. If the person is an employee, the employee must pay 1.45% (which is withheld by the employer) and the employer must pay the other 1.45% of the employee's wages to the IRS. This 2.9% tax must be paid on all wages earned.

C. **Corporate Income Tax:** C-Corporations, like individual people, must pay tax on income earned by the corporation for each tax year. The tax rates for that income range from 15% to 35%. Because a C Corporation as well as the owners have to pay income tax, most tax practitioners call this the "**double tax**."

D. **State Income or Franchise Tax:** This is a tax imposed by a state on a corporation or other business entity. The tax may be charged either on income earned by the corporation or business, or on the value of the assets owned by the corporation or business. These tax rates vary from state to state.

IV. **OTHER PLANNING NEEDS:** In addition to a business owners need to seek protection from liability, the number and type of investors in a business, and the desire to minimize income tax, a business owner may have other reasons for creating a business entity. The following list identifies a number of other considerations which affect business owners in the selection of the proper type of entity:

A. **Business Continuation:** Most people who have been in business for many years want to see their business continue. These business owners generally try to perpetuate their business by passing the ownership to family, loyal employees, or other shrewd business owners who will continue the traditions of the business. Depending on the people to whom a business owner desires to transition the business, the business owner may choose a different type of entity.

B. **Asset Protection:** Beyond protecting the owner's personal assets from liability, a business owner may also want to protect certain income generating business assets from the potential risk and liability of the business and the owner's personal liability. Many times, business owners create separate businesses structures to own and operate the equipment and assets totally independently of the business operations. In this structure, the business owner runs the business operations in one business and owns the assets in the other. If the income producing business comes under attack, this structure serves to protect the assets from the liability of the income producing business, enabling the business owner to simply start another business, the next day, without fear of losing the property.

C. **Estate Tax Protection:** Sadly, over 90% of family businesses fail to pass from one generation to the next because of the gift and estate tax, called the transfer tax, which taxes the owner on the transfer of the asset to the next generation, whether the transaction occurs during life or at death. Generally, an individual can only pass $1,500,000 worth of assets to one's heirs without paying estate tax, which starts at 18% and goes up to 47%. The bottom line is that most business owners, after paying income taxes their whole lives, wind up having to sell their assets to pay the estate tax at the time of death, if their business is worth more than $1,500,000. The good news, however, is that proper structuring can reduce or avoid this estate tax. If this is a concern, then we must develop a plan that integrates the business and estate planning.

V. **ENTITY COMPARISON:** Based on the above criteria, the following chart discusses the types of available entities and the purposes for which they are generally best suited. This chart serves as a general guide for framing a discussion of business entities. For the best option, we recommend that each client call us or another competent attorney to discuss business formation.