Avoiding collapse

How building the right form of entity reduces risks **Interviewed by Arthur G. Sharp**

One of the hardest decisions business owners have to make in business planning is their form of entity. Choices abound, such as a partnership, limited liability company (LLC), or sole proprietorship, and each has advantages and disadvantages, depending on the type of business.

Type notwithstanding, owners should not downplay the significance of choosing the entity that will best suit their businesses' needs. For owners, making the right decision means taking the time upfront to identify precise goals and objectives and partnering with the best qualified professional advisers to help them through the selection process. Bypassing these important steps can expose business owners to myriad risks that can lead to adverse conditions for them and their companies.

Smart Business spoke with Michael R. Milazzo, CPA, MBA, a partner with Skoda Minotti, to learn more about how the selection of an appropriate form of entity can enhance business owners' chances of success and improve their possibilities of selling their companies.

What is the connection between goals and objectives and the selection of an entity?

Form of entity has a large number of implications for a business. It affects legal liability, current taxation, the type of tax forms companies are required to file and owners' exit strategies. That's why it is important for owners to carefully think about why a specific entity is best for them, rather than just pulling a structure out of the proverbial hat.

If one entity selection doesn't work out, can owners change it?

Generally, a company can change its form of entity at any time. But, depending on the original form of entity, there could be significant tax consequences associated with a change. For example, if a business opens its doors as a C corporation, which is a taxpaying entity in itself, and changes to an LLC, which in most cases is not a taxpaying entity in itself, but a flow-through entity in which all the income flows through to the individual members on to their individual tax returns, there will be differences in how the entity is taxed. Moreover, there could be significant additional tax incurred by the C corporation from the change because the tax rules treat the change as a deemed liquidation of the C corporation. Nevertheless, companies do change entities frequently for a variety of reasons, such as to alleviate administrative burdens or to accommodate their future exit strategies.

Michael R. Milazzo, CPA, MBA
Partner
Skoda Minotti

Does a company's form of entity make a difference when it is involved in the buying or selling process?

Definitely. Consider the opposite forces that are at work in a typical M&A transaction. In most cases, buyers want to purchase assets because they want to limit their exposure to the target's liabilities and be able to write-off the excess purchase price via amortizable goodwill. On the other hand, sellers want to sell stock because they want to generate long-term capital gains, which are currently subject to favorable individual tax rates. As a result, the form of entity has a significant effect on the buying and selling process.

What it boils down to is that a flow-through form of entity (i.e., partnership, LLC, or S corporation) is generally better in the selling process because these entities are not subject to tax at the entity level. Therefore, it is possible to structure a transaction with a flow-through entity that satisfies the goals of the buyer and seller — amortizable goodwill for the buyer and long-term capital gain for the seller. The C corporation form of entity is not usually a favorable structure for an asset sale because the C corporation is subject to entity level taxes, and the individual shareholders are subject to tax again upon distribution of the funds from the sale. Owners who recognize the importance of form of entity early in their formation process can improve their exit strategies, which can result in increased after-tax proceeds from a sale.

What risks do entrepreneurs face when they do not devote the necessary time to selecting a form of entity in their business planning?

One significant risk is the potential for personal liability. Owners who offer products or services that can result in personal liability should be extremely careful in choosing a form of entity and must involve their corporate counsel in the decision. Likewise, owners of entities that are very profitable and choose C corporation status simply because it seems like a good choice at the time can run into problems when they try to sell. Again, buyers generally want to purchase assets. That means the C corporation seller can lose over 50 percent of the consideration just in taxes if the business is not structured properly on the front end. Consequently, the business owner may find herself in a position where she wants to sell the company, but finds that the tax ramifications are too high. That can happen when owners do not structure their businesses viably up front.

One of the best ways for business owners to avoid risks like these is to work closely with professional advisors when choosing a form of entity — and get them involved early in the business planning process. <<

MICHAEL R. MILAZZO, CPA, MBA, is a partner with Skoda Minotti. Reach him at (440) 449-6800 or michaelmilazzo@skodaminotti.com.

Insights Accounting & Consulting is brought to you by Skoda Minotti

© 2008 Smart Business Network Inc. Reprinted from the August issue of *Smart Business Cleveland.*