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# SELECTION OF BUSINESS STRUCTURE

Listed below is a general description of some of the pros and cons of different forms of business structure. It must be remembered, however, that every business transaction is unique and individual guidance should be obtained from an accountant and attorney before making a final decision as to which structure is best in a particular situation.

## SOLE PROPRIETORSHIP

### Pros

- Easiest to establish--least regulation
- No separate tax return for federal purposes (use schedule C of 1040) but some states require separate filing
- Generally don't have to register proprietorship with state, but want to do "doing business as" filing
- Must do quarterly estimated income tax payments to IRS and state
- No double taxation
- Taxed at individual rates, not PSC rates
- Maximum flexibility and control by owner
- No tax consequences to formation
- No Texas franchise tax

### Cons

- Personal liability for practice debts
- Inflexible ownership structure and transfer (i.e. never sell business, just assets
- Poor tax treatment of owner employee benefits (Medical insurance, group term life, unreimbursed medical expenses, group legal, disability)
- Capital infusion from owner contributions or loans only
- May have limited management expertise--won't be able to utilize skills and experience of others with vested interest in success of enterprise

PARTNERSHIP

Pros

- Usually don't have to register with state, but may want to do “doing business as” filing
- Much flexibility in how allocate income and expenses--does not have to be related to ownership %
- Flexible ownership and capital structure
- No double taxation
- Individual tax rates, not PSC rates
- Multiple owners may bring complementary skills and expertise
- Generally no tax gain/loss when money or unencumbered property contributed to partnership (gain recognition is possible when liabilities transferred exceed basis in property)
- No Texas franchise tax

Cons

- Jointly and severally personally liable for practice debts
- Can be responsible for each other's acts
- Must have partnership agreement (can be oral but should be written)
- Must file partnership return with IRS
- All income subject to self-employment tax even if partner not active
- Tax laws can be very complex
- Poor transferability of ownership interests--must find willing buyer and have approval of other partners
- Moderate degree of administrative complexity
- Poor tax treatment of owner employee benefits
- Capital infusion from owner contributions or loans only (but have more owners)
- Multiple owners can lead to disagreements

CORPORATIONS:

Corporation designations are different for state versus IRS purposes. For example, at the state level a veterinary practice may be a professional corporation (PC) but for tax purposes, it could be taxed either as a C corporation or an S corporation, depending on which was elected.

C CORPORATION

Pros

- Protection from general and creditor liability above investment in corporation (defined by state law--same as for S corp.)--owners may have to personally guarantee corporate debt, but limited liability would still apply to acts occurring in the ordinary course of the corporation's business--with PC, may gain protection against claims caused by negligence of other professionals in the corporation and may be protected from attachment of personal assets because of lawsuits other than malpractice--with all corporations, if owner personally involved in a transaction or incident, there may be personal exposure (i.e. malpractice) in spite of corporate format

- May not have to pay estimated quarterly taxes because draw salary
- Better tax treatment of owner employee benefits (Medical insurance, group term life, unreimbursed medical expenses, group legal, disability
- Flexible ownership and capital structure (different classes of stock available although preferred stock generally used only for estate planning purposes in small businesses)
- Can obtain capital by issuing stock, selling bonds, or obtaining loans
- Free transferability of ownership interests--true in theory but limited in small businesses because there is usually a small market for the stock and shareholders usually more interested in limiting transferability than in promoting it
- Amount of management skills/expertise available dependent on # of owners
- May force organization on practice
- Generally no tax gain/loss when transfer assets/liabilities to newly formed corp. solely in exchange for stock (gain recognized if transferred debt exceeds transferor's basis in property also transferred)
- If in 40% tax bracket and want to retain money in corp. for debt repayment, capital improvements, etc, may be better to accumulate at 35% rate

Cons

- Double taxation on profits taken other than as salary
- Double taxation when liquidate or sell assets(corporation taxed on sale of assets, then owners taxed on distribution)--not an issue if sell stock
- Personal Service Corporation with 35% flat tax (may be avoided in states where non-vets can be owners)
- Limited ability to generate tax savings with NOLs
- High degree of administrative complexity--more accounting and legal advice needed--minutes, state filings
- Loan interest for buy-in treated as investment interest with limited deductibility
- May have franchise or state taxes
- Multiple owners can lead to disagreements
- Dividends must be distributed on ownership interest (salaries to owner/shareholders do not have to be proportional on ownership interest)
- Texas franchise tax
- Can be a difficult structure to deal with in a sale—seller will almost have to sell stock (instead of assets) to avoid very high taxation and buyers generally want to

buy assets because of better tax advantages and reduced liability for prior actions of the business

S CORPORATION

Pros

- Protection from general and creditor liability (defined by state law--same as for C corp.)--owners may have to personally guarantee corporate debt, but limited liability would still apply to acts occurring in the ordinary course of the corporation's business--with PC, may gain protection against claims caused by negligence of other professionals in the corporation and may be protected from attachment of personal assets because of lawsuits other than malpractice--with all corporations, if owner personally involved in a transaction or incident, there may be personal exposure (i.e. malpractice) in spite of corporate format
- May not have to pay estimated quarterly taxes because draw salary
- No double taxation
- Interest on loan to buy shares deductible
- Free transferability of ownership interests with some exceptions--true in theory but limited in small businesses because there is usually a small market for the stock and shareholders usually more interested in limiting transferability than in promoting it
- Taxed at individual rates, not PSC
- Distributions not subject to payroll taxes as long as shareholders adequately compensated for services performed
- Amount of management skills/expertise available dependent on # of owners
- May force organization on practice
- Generally no tax gain/loss when transfer assets/liabilities to newly formed corp. solely in exchange for stock (gain recognized if transferred debt exceeds transferor's basis in property also transferred)
- Sub S status may be more advantageous in estate planning

Cons

- Distributions must be made on a per-share basis (proportional to ownership)--Dividends must be distributed on ownership interest (salaries to owner/shareholders do not have to be proportional on ownership interest)
- More limited capital sources--only one class of stock allowed, maximum 75 shareholders
- No corporate, partnership or nonresident alien shareholders allowed
- Calendar year or prepay the tax that shareholders defer if electing to report on fiscal year
- Can't take profit distributions in lieu of fair salary

- High degree of administrative complexity--more accounting and legal advice needed--state filings, IRS election
- Inflexible ownership and capital structure
- Poor tax treatment of owner fringe benefits
- Multiple owners can lead to disagreements
- Texas franchise tax

LLC--created under state law, available in all states, owned by members, combines tax advantages of partnership with liability protection of corporation, often more flexible than S corps though similar, LLC rules and characteristics vary by state

Pros

- Protection from creditor liability and acts of other partners (would still have malpractice exposure, but if using for real estate only, shouldn't have any malpractice problems)
- Flexible ownership and capital structure--no limits to number of members, members can be individuals, corporations, trusts, partnerships, other LLCs and other entities, different classes of ownership allowed (managing vs. non-managing)
- No double taxation
- Individual tax rates, not PSC (technically an LLC could be taxed as an S corp or a partnership/sole proprietorship; for practical purposes they are almost never taxed as an S corp)
- Distributions do not have to be proportional to ownership
- Can have large # of investors--may be easier to raise capital
- All owners can participate in managing business without losing limited liability protection
- Multiple owners and ability to be managed by non-owner may increase skills and expertise available

Cons

- All earnings subject to self-employment tax (as if unincorporated)
- Laws are new and relatively untested in non-tax matters (i.e. how much member liability actually limited)
- Some states don't let veterinary practices use LLC form
- Some states don't allow a sole owner to be a LLC
- Must pay estimated quarterly taxes
- If have more than one owner, must file a partnership return with IRS or can elect to be a C or S corp
- Must have operating agreement and articles of organization--usually minimal cost
- May have to pay state income tax or franchise tax—do have to in Texas

- Limited transferability of ownership interests--equity interest may be transferred but not necessarily all rights and attributes, depends on state law, may require affirmative vote of all members to continue if one member dies/withdraws
- Moderate degree of administrative complexity
- Poor tax treatment of owner employee benefits
- Variable tax and liability treatment in different states
- Multiple owners can lead to disagreements

LLP--special type of general partnership that exists in many states

Pros

- Protection from errors and omissions (malpractice) by other partners and employees, but still personally liable for obligations of entity, their own actions and actions of those one supervises
- Formation similar to creating a partnership but may have to file registration statement with formation fee
- Flexible ownership and capital structure
- No double taxation
- Individual rate taxation, not PSC

Cons

- All earnings subject to self-employment tax (as if unincorporated)
- Responsible for general liabilities of the partnership
- Difficult to transfer interests
- Moderate administrative complexity
- Poor tax treatment of owner employee benefits
- If have more than one owner, must file a partnership return with IRS or can elect to be a C or S corp