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Business Entities:

The Lasting Consequences of What You Choose

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The Lasting Consequences of What You Choose

Many dentists have questions about which type of business entity makes the most sense for their practice. The answer is not simple, because business entities vary considerably from corporate and recordkeeping requirements, to tax consequences, to levels of protection or exposure that they offer their shareholders.

The Main Purposes of Most Entities

Before discussing the nuanced differences between types of business entities, it is important to understand that there are really only two reasons why you would ever bother to set up a business entity at all:

- 1) ***To limit liability; OR***
- 2) ***To gain favorable tax treatment in some way***

THAT IS IT! There is literally no other reason. And both reasons can be very important. So let's begin with limitations on liability.

Limitation of Liability

To understand what Limitation of Liability really means, you need to understand different types of liabilities. For our purposes, we will discuss three main types of liabilities. These are: personal liabilities, business liabilities, and professional liabilities.

Personal Liabilities

A personal liability is something created by an individual. Think about a car accident as an example. The at-fault driver is personally liable for the injuries and property damage caused by the accident.

Some business entities are very good at protecting assets within the business from the personal liabilities of the people who own the entities. Other types of entities are not so good at providing protection. (I will discuss later how you can protect your business interests from potential personal liability.)

Business Liabilities

These are liabilities created by the business entity itself. A commercial lease is a good example. If you own an LLC that rents office space, the LLC is on the hook for a business liability. In other words, the LLC itself is responsible for satisfying the obligation. In the case of pure business liabilities, most business entities do create an effective barrier between the liability and personal assets. But that changes if you *personally guarantee* a business liability, like the commercial lease. A personal guarantee converts the obligation into both a business and a personal liability.

Professional Liabilities

Professionals like dentists, physicians, CPAs, and attorneys are personally subject to liabilities for the services they render in a professional capacity, even if the services are rendered through a business entity. That means a business entity cannot protect professionals from malpractice, negligence or other professional liabilities.

Consider this example: a dentist is running his practice through an LLC. If that dentist makes a huge mistake resulting in liability exposure of millions of dollars, the dentist is ***personally liable*** for that loss. In other words, the dentist's personal assets and the assets in the LLC are at risk. That is why it is critical to have BOTH malpractice insurance ***and*** some form of *personal asset protection* for your real assets.

Taxes

The second reason to set up a business entity is that some types have more favorable tax treatment than others. Taxation of businesses falls into three general categories:

- Corporate Level Taxation
- Disregarded Taxation
- Pass-Through Taxation

A *corporately* taxed business is itself taxed on income. This results in double taxation, as discussed more fully below. An entity with *disregarded* tax treatment "ignores" the income at the business entity level and reports it directly to the owners whom report and pay taxes on the business's income on their personal tax returns. *Pass-Through* taxation combines the elements of corporate reporting with pass-through taxes. In other words, the entity itself reports income, but the owners (not the entity) actually pay the taxes due on that income.

Below, we will discuss the three most common business entities used by Dentists, in addition to:

1. How each of these types of taxation apply
2. What liability protection applies to each

When Do You Need A Business Entity?

Assuming that you plan to grow a profitable business, the ideal time to create and start using a business entity is on **Day One**. That's because *legal entities gain strength with age*. It also makes sense for tax reasons. And this can make a big difference if you ever need your entity for liability protection.

From a tax perspective, it is smart to set up positive tax treatment sooner rather than later. For example, if you earn income as a sole proprietor, then all of your income (up to the required federal limit) is subject to self-employment tax. There is simply no wiggle room. Additionally, if you are a sole proprietor, then all of your assets are at risk regardless of whether personal, business, or professional liabilities are at issue. It just makes sense to have an entity from the start.

What Type of Entity Should You Use?

We are going to discuss three types of entities:

- Professional Corporations (PC)
- Corporations with Subchapter S elections (S-corporation)
- Limited Liability Companies (LLC)

Professional Corporations

Professional Corporations were once very popular because they received favorable tax treatment. Prior to 1986, owners of PCs could shelter more money from taxation than sole proprietors or partners could. However, since 1986, PCs have been taxed at a flat 35% rate. In short, the tax benefits have disappeared. Of course, a PC can opt to be treated as an S-corporation and avoid some adverse tax consequences. (See Section on Corporations below for more).

Professional Corporations still have some advantages over operating as a sole proprietor, but in most cases there are better, more efficient business entity alternatives. Despite that fact, some states actually require professionals to use PCs, so do some homework before deciding to incorporate as a PC or not.

Corporations (Standard C & Subchapter S)

Normal (Standard C) corporations are majorly disadvantaged from the standpoint of taxation because they are double taxed. The corporation itself is taxed on profits at a corporate tax rate (15%-39%), and then the shareholders are taxed on dividends that they receive from the corporation (currently 10%-35%).

Subchapter S of the Internal Revenue Code solved the problem of double taxation, at least insofar as it affects small business owners. By electing to be treated as an S-corporation, business owners can avoid double taxation. In effect, S-corporation income "passes through" the entity and is taxed to the S-

corporation shareholders as if they earned it individually, thus leaving just ONE LEVEL of tax on an S-corporation.

Another advantage of S-corporations is that the owners have the ability to characterize the company's income. Self-employment tax doesn't have to be paid on dividends distributed from an S-corporation, but it does have to be paid on wages. One might be inclined to characterize all distributions from an S-corporation as dividends, but the IRS is aware of that tactic and requires that "reasonable" wages be paid to the people running an S-corporation. For a high-performing practice, this could provide a significant tax savings, making this structure a favorite of CPA's and preferable to doing business as a sole proprietor from a tax standpoint.

Limited Liability Companies – Cream of the Crop

First, the really good news: almost all the advantages of the entities discussed above are available through Limited Liability Companies. LLCs can opt to be taxed as sole proprietorships (disregarded taxation), as partnerships, or as S-corporations (Pass-Through Taxation). So from a tax standpoint, they are the most flexible option.

They are also the most flexible option from the standpoint of corporate governance. S-corporations are often required to have three directors and/or corporate officers, and they must hold annual meetings and keep meticulous minutes.

LLCs, on the other hand, have a "decentralized" form of governance. One person can run the whole show as manager, or the members (i.e. the owners) can operate the business themselves and still maintain limited liability. It really is the best of all worlds.

Finally, LLCs offer the best form of protection from personal liability for your business assets. Let's look at an example of how that works:

Example 1: An entrepreneur owns his business through an S-corporation. He is involved in a serious car accident and loses a multi-million dollar lawsuit for the damages caused in the accident. The bulk of his assets are tied up in his business. A court can award his S-corporation shares to the plaintiff as compensation. If that happens, the entrepreneur will completely lose control and ownership of his business, including the business assets. Not a desirable outcome!

Example 2: The same entrepreneur in Example 1 owns his business through an LLC. Now, depending on the state they are in, a court can only award a "charging order" against the LLC. That means the plaintiff can intercept actual distributions of income from the LLC, similar to the way a garnishment works, but the plaintiff cannot take over ownership of the business or access assets directly held by the business. A much better outcome!

Not every state has a charging order statute in effect, but many states do, and they create a very strong barrier around your business assets. This strategy may also be used to effectively protect personal assets.

The Bottom Line

The common thread to all of the above listed types of business entities is that none of them protect your personal assets.

Let's continue our example from above and say our same entrepreneur has a liability personally as well as to the business entity. In the event the plaintiff cannot get to the entrepreneur's business assets because of the charging order protection, the plaintiff could simply move over to the personal assets, including bank accounts, real estate, and even the primary residence, to satisfy the judgment.

This means that not only should you have solid legal entities around your business assets, but it is essential to also protect your personal assets. This is the area of law called "Asset Protection," and it is extremely effective. (You can find out more about protecting your personal assets at the end of this guide.)

In Summary

So how do you determine which business entity is right for you? For your primary **income generating business**, I would use the tax considerations as my primary driver, and the limitation on liability as the secondary.

On the other hand, entities you will be putting your personal assets into, and which generate little or no income, do the reverse. Use the limitation on liability as the primary driver and the tax considerations as secondary.

For your income-generating business, you should consult with your CPA and keep in mind that in addition to the savings on self-employment tax, certain other tax favorable programs are only available for certain types of entities. A few examples include:

- Medical Insurance and Benefits
- Life Insurance Benefits
- IRA, Keogh, and/or ERISA Plans
- Stock Options
- Profit Sharing

These items are not available to all types of business entities. As such, you may or may not need to take advantage of some of the above plans, depending on your level of income. Again, this is a decision that you should make together with your CPA.

Regardless of your ultimate choice, it is always a good idea to make sure your business entity does not hold a lot of cash or valuable assets like real estate. Remember, business entity liability protection in all three entities discussed above is weak. It is best to remove profits and hold them in a far more protective personal asset protection plan than to leave them exposed to your business liabilities.

For your personal assets, I recommend that you consult with an experienced Asset Protection Attorney who can advise you on setting up structures for just that purpose. We have been working exclusively in

this area for over 15 years, helping our clients to create solid barriers between their assets and all potential lawsuits and creditor claims. I would be happy to speak with you about this as well as anything covered in this guide.

The next step is to educate yourself and your family. No matter where you are along your career path, understanding how to protect your current and future assets is the first step on your path to professional and personal peace and a practice without fear. Simply put, knowledge is power.

Steps to Take

I invite you to call us at **(602) 230-2014** and schedule an appointment.

We'll set up a call with you at the time you request, and ask you a series of questions designed to allow us to quickly analyze your assets for strengths, weaknesses, opportunities, and threats.

During the call, we will explain your analysis in clear and concise language. You will be able to ask questions and get answers right then. When your call is completed, you will be able to make an informed choice that is right for you.

Call us at **(602) 230-2014**. Please let our office know you read the Business Entity Guide and would like to set an appointment for an analysis. If you mention this guide, our normal consult fee of \$275 will be waived and there will be no charge for the assessment or the information we provide during your call.

If personal peace and freedom from fear of the *epidemic wave* of lawsuits being filed against healthcare professionals is important to you, I recommend that you contact our office today and schedule an appointment to speak with me.

In Service,

Douglass Lodmell, J.D., LL.M.
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Douglass S. Lodmell, J.D., LL.M. is the Managing Partner of Lodmell & Lodmell, the nation's #1 Asset Protection Law Firm. He has spoken to thousands of doctors and professionals and has worked with hundreds of Dentists to help them protect their assets and structure their business and personal legal strategy. He works with clients nationwide and may be reached at info@lodmell.com or 800-231-7112.