# FORMS OF BUSINESS ORGANIZATION 1

## Learning Objectives

*An understanding of the material in this chapter should enable the student to*

1. Describe the life cycle of a business.
2. Explain how the advisor is a businessperson who shares many common concerns with business owners.
3. Describe 10 different forms of business organization, and identify the distinguishing characteristics of each form.
4. Describe the major advantages and disadvantages of each form of business organization.

This chapter looks at the business owner and the challenges facing the financial advisor who enters the business insurance market. It asks you to view yourself as a business owner and realize you have much in common with the business owners you wish to approach. It looks at the life cycle of a business and discusses 10 forms of business ownership, examining the advantages, disadvantages, and tax implications of each form.

## THE BUSINESS INSURANCE MARKET

There are over 23 million small businesses in the United States, according to the U.S. Census Bureau. That means there are 23 million prospects with business insurance needs. In this book we will examine those needs and discuss how you can successfully help businesses meet them.

The complex business environment is filled with the pressures of running a business, such as product or service considerations, profit margins, government regulations, constant decision-making, worry about the future, changing market conditions, and countless other things. Each type of business also has its own unique challenges. A dry cleaning firm is different from a car dealership; an architecture firm is different from a physician's practice, a manufacturing plant is different from a consulting firm.

This book focuses on what a financial advisor (see Special Notes to Advisors page for an explanation of the terms *financial advisor* and *advisor* as used in this book) needs to know to work with business owners in planning for the continuation of their businesses in the event of the death or disability of an owner or key employee. Working in the business market is not easy. It takes an understanding of accounting principles, tax law, and employment law. It takes an understanding of businesspeople and their psychology: what makes them tick. It also takes time. Developing a business case is not a one-interview process. It takes weeks—sometimes even months or years to bring a case to conclusion. But for those who are successful, it is well worth the effort.

## The Business Life Cycle

In working in the personal market, you learned that there is a life cycle common to most of your clients. It begins when they are young singles and continues through retirement to their long-term care needs. You learned that at each stage in the life cycle, their needs are different. For the young single person, disability insurance is the greatest need. A young couple with children needs life insurance. Empty nesters focus on saving and investing for their retirement.

Like individuals, businesses also experience a life cycle. The over 23 million small businesses in the United States are operating at varying stages of the business life cycle. A newly started business has different needs than a well-established, mature one. Understanding the general business cycle of different businesses can help you understand the insurance needs of a particular business and help you focus your prospecting efforts.

The life cycle of a business has three stages:

1. new or emerging business
2. successfully operating/growing business
3. mature/successful business

### *New or Emerging Business*

A new business operates in a survival mode. It is the culmination of an idea put into action. With the original investment used simply to open the doors, the business is often short of cash. It is fast-paced, with the owner(s) and a few key people often doing everything because the business is understaffed. Its primary focus is to develop customers and meet their needs.

Insurance needs are likely to be a secondary consideration to the other financial demands of the fledgling business. Owners of new businesses are not looking ahead to retirement. They are working hard to make it to the next week. There are, however, some insurance plans they should consider.

For a new business with employees, group insurance plans make sense. They provide a valuable benefit for the employees and for the owners. They also make employment with the business more attractive, enabling it to hire the employees it needs to succeed.

For the individual entrepreneur, personal disability and life insurance coverage can be critical. Often the success of the business depends on the efforts of the owner. If he or she becomes disabled or dies, the business will almost certainly fail. While it may be impossible to insure the success of a new business, personal policies can protect its owner and his or her family.

### *Successfully Operating/Growing Business*

As the business achieves success, its complexion changes. With positive cash flow and established customers, it may hire additional staff, spreading the workload. And as it grows, its insurance needs change.

The group plans initiated in stage one need to be reviewed and improved. Options for employees offered by a cafeteria plan may be appropriate. A qualified retirement plan should be considered as should nonqualified salary continuation and deferred compensation plans.

For the owner(s), increased cash flow and salary may cause personal needs to grow. Personal policies need to be supplemented with additional business life insurance using executive carve-out and executive bonus plans.

The continued success of the business will also become an issue, leading to consideration of a buy-sell agreement and key employee insurance. A business overhead expense policy should be put in place to protect against losses associated with the disability of an owner.

### *Mature/Successful Business*

As the business continues to grow and prosper, its insurance needs also grow. As the owners approach retirement age, their focus changes to securing retirement and stabilizing the business. They must then begin to address the eventual transfer of their business to others.

The business's insurance needs may become more complicated and sophisticated in this stage. Cafeteria and medical expense plans need to be reviewed and should be updated when necessary. Benefit packages must be matched with those offered by competitors. Key employee insurance and deferred compensation plans may also need review and updating. Comprehensive retirement planning is needed for the owner(s) and the key employees who are reaching retirement age. The owner(s) must also address individual estate planning goals.

These are just a few examples of the changing needs in the life cycle of a business. As such, your ongoing advice and service are valuable components of the sales process.

In addition to the life cycle of a business, there may also be an annual business cycle. This is the cycle that controls a business's cash flow and workload. Many businesses are seasonal in nature. Many retail stores depend heavily on the December holiday season for their success. A landscaping business will be extremely busy in the spring and summer and may have relatively little to do in the winter months.

Understanding the annual cycle of a business you are working with is important in your planning. Does an appointment with a retailer a week before Christmas make sense? How about an appointment with an accountant in early April? Do you think you will get their undivided attention to your proposals? Understanding the annual business cycles of different businesses can help you focus your prospecting attention.

## FORMS OF BUSINESS ORGANIZATION

We begin our education of the business market with a review of the different forms a business can take. The form is fundamental to the way the business operates; how it is taxed; what liability its owners have; how expenses, compensation and benefits are treated; and the problems that the business owner may encounter.

Businesses in the United States can be organized in one of three basic legal forms:

- Sole proprietorships
- Partnerships
- Corporations

To complicate matters, there are variations of each of these forms. In addition, a hybrid form known as a limited liability company, with characteristics of both a corporation and a partnership, is now available in all states.

The following list identifies the 10 forms of business found in the United States.

1. Sole proprietorship
2. General partnership
3. Limited partnership
4. Family limited partnership
5. Professional partnership
6. C corporation
7. S corporation
8. Limited liability company
9. Professional corporation
10. Personal service corporation

To a financial advisor working in the business market, understanding the differences between business forms is important but not necessarily easy. The differences are not always apparent to the outside observer. In fact, in deciding how a business will be taxed, the Internal Revenue Service looks at how a business operates instead of what it calls itself, and taxes it accordingly.

There are eight primary factors that define how a business is structured and operates. These factors are:

1. creation—how the business is started
2. management—how it is managed and operates on a daily basis
3. ownership—who owns the business's property and assets
4. profit—how the business's profits and losses are distributed
5. liability—who is accountable for the business's legal responsibilities
6. taxation—how the business is taxed
7. continuity—the length of the business's life
8. termination—how the business can be terminated

Familiarity with each of these areas will help you understand the unique problems facing your business prospects. A working knowledge of the elements of the business will help you understand what the owner(s) has invested, not just in financial terms, but also in time, energy and emotion. You will develop a better understanding of what your clients have at risk, the concerns they have, and the conflicts they face. This working knowledge of the elements of business will also help you focus your clients on the need to plan for the future.

The better you understand the various types of business organizations—their characteristics, advantages, and disadvantages—the better you can identify needs and create solutions. Knowledge breeds confidence, trust, and success.

## Problems of Closely Held Businesses

This book focuses on the closely held business, which is defined as a business not traded on a securities exchange and where ownership is not typically available through shares offered for public sale. The business is controlled by a small group of people who are generally involved in the day-to-day operation of the business and who provide services for the business.

The owners of a closely held business face numerous problems. Some are inherent in the organizational structure of the small business and others exist in enterprises of all sizes. Many problems facing the business owner, such as survival in the marketplace, are obvious. The business owner may not recognize other problems, such as the reduction in business income resulting from the loss of a key employee due to death or disability, until the incident occurs.

Many problems facing the business owner can be avoided, or at least reduced, through proper planning. To plan intelligently to avoid or handle future problems, it is necessary to identify the potential problems and form objectives.

Your role as a financial services professional is to help business owners or professionals recognize these problems and to assist in formulating plans that are appropriate for the special needs of each client. The purpose of this chapter is to discuss typical problems faced by the closely held business owner or professional. Possible solutions to these problems will be discussed in subsequent chapters.

### *Choosing the Form of Business Organization*

Business owners are faced with a number of choices when selecting the form of enterprise. They may elect to operate unincorporated, as a sole proprietorship, a partnership, or a limited-liability company (LLC); or they may incorporate as a regular (C) corporation or as an S corporation. The choice of ownership form is not irrevocable, and owners of existing businesses often decide to change the form as circumstances dictate. For example, the sole proprietor might wonder if the benefits of switching to the corporate form of ownership are worth the costs of incorporation. Or perhaps the owners of an existing closely held corporation are considering what the tax advantages would be if they switched to a subchapter S form of business.

The choice of a form of ownership is a complex decision facing all business owners because it will have a significant impact on the initial start-up cost, the control and flexibility in management, the taxation of the business and individual owners, the ability of the firm to raise capital, and the business risks absorbed by the individual owners.

***Business Owner Objectives.*** Owners often have several objectives when selecting the form of ownership under which the business will operate:

- start-up costs and formalities of operation
- control of the business and management
- flexibility in business operations
- ability of the business to raise funds
- limiting the liability of owners from business operations
- overall tax burden
- business continuity and termination
- compensation and fringe benefits

The priority ranking of these goals will differ from one individual to the next, but the typical business owner or professional shares all to some extent. The following discussion of forms of business organization will examine how each form of business impacts these objectives.

## The Sole Proprietorship

**sole proprietorship**

It is natural to begin with sole proprietorships because they are the simplest and most numerous form of business. There are over 17 million sole proprietorships in this country, representing over 73 percent of all businesses. Thousands of new ones begin each year. More than 90 percent of all sole proprietorships are one-person operations. Most others have a very small number of employees. Less than 8 percent have more than eight employees.

## *Background on Sole Proprietorship*

By definition, a sole proprietorship is an unincorporated business owned by one person. A sole proprietor may run the business directly or may hire others to run it, but ultimately it is the sole proprietor's decisions that determine the firm's destiny. Typically, a sole proprietor performs most of the major functions such as overall manager, sales manager and finance manager. Since the proprietor is the sole owner of the business, there is generally no need for any agreements or formalities.

The proprietorship has its roots in the earliest days of commerce. In primitive economic society, each person depended for survival on his or her own work. This system gave way to the first age of specialization.

In those days, there was no such thing as life insurance and disability income insurance. When the proprietor became disabled or died, the family was suddenly destitute. There were no alternatives, no preplanned solutions.

Today's proprietor lives a much more complex life precisely because specialization has created a highly interdependent business community. Although an electrical contractor may be self-employed, he or she cannot survive without the work of thousands of other people in hundreds of other organizations that produce tools and equipment that are a contractor's stock in trade.

The interdependence of business organizations provides you with the greatest opportunity for endless-chain prospecting among business owners. You can get referrals to a proprietor's suppliers, to the supplier's customers, and to their suppliers, without end. There is a large existing network that can be tapped.

## *Distinguishing Characteristic of Sole Proprietorship*

The majority of sole proprietorships today operate on a relatively small scale, where the capital and credit of one person is adequate. The real distinguishing feature of a sole proprietorship is not size; it is the unlimited and unshared responsibility of the sole owner.

## *Advantages of Sole Proprietorship*

Why choose this form of business rather than another? What are the advantages of sole proprietorships?

- **Simplicity**—Starting a sole proprietorship is relatively simple. This is probably why such a large proportion of all businesses are proprietorships. The only legal formalities are applying for appropriate state or local permits and licenses and filing a special certificate if the sole proprietor intends to operate the business under a name other than his or her own.

  Similarly, no legal action is required to terminate a sole proprietorship. When a sole proprietor wants to quit for whatever reason, he or she simply satisfies any outstanding contracts and financial obligations and takes on no new business.
- **Autonomy**—Autonomy is one of the hallmarks of the sole proprietorship. Far more than any other form of business, the sole proprietorship exemplifies one of the advantages and glittering attractions of going into business alone: freedom of action.

  There is no boss to criticize a sole proprietor's work. There is no partner who must be consulted on decisions and who may begrudge splitting the profits. There is no board of directors to second-guess the decisions of the sole proprietor or enforce a distasteful policy. Neither is there a partnership agreement, a corporate charter from the state, or corporate bylaws to limit the scope of the sole proprietor's powers.

  At will, the owner may expand operations or contract them, move to another location, seize or ignore opportunities, sell or liquidate. In short, the proprietor may do virtually whatever he or she wants.
- **Sole Gain**—Related to this aspect of the proprietorship is the fact that all profits belong to the sole owner. Just as all of the responsibilities of the business fall solely on the owner, so do all the benefits. There are no partners to share the proceeds. There are no stockholders to claim dividends.
- **Single Tax**—The sole proprietor and the sole proprietor's business are taxed as a single unit. The sole proprietor files Form 1040, and along with it Schedule C ("Profit or Loss from Business or Profession"). All profits of the business are personal income to the sole proprietor even any portion not withdrawn. There is no separate federal income tax reporting for the proprietorship. This is known as pass-through taxation.
- **Shelter Income**—Along with other forms of business, the sole proprietor enjoys the tax advantage of reducing taxable income by charging off costs of doing business as "expenses."

Not all "expenses" are actual expenditures. Depreciation expenses are the best example of this advantage. A business may have a profit of $25,000 in terms of actual gain over actual operating costs. On the tax report, however, the owner can deduct depreciation of buildings and equipment.

Depreciation doesn't necessarily mean the equipment or building is wearing out; it just means that the business owner can deduct the cost of the equipment over a prescribed period of time. If depreciation totals $10,000 this year, the proprietor pays income tax on only $15,000 instead of $25,000.

### *Disadvantages of Sole Proprietorship*

Operating as a sole proprietorship has a number of disadvantages. Most of these disadvantages spring from the very feature that makes the sole proprietorship form of business so attractive-the complete identity of the business with its owner.

- **Limited Resources**—One disadvantage is that of limited resources. The capital available to a sole proprietorship is limited by the personal financial resources of the owner and his or her ability to obtain credit and borrow money.

  The sole proprietor has no way to raise funds from outside investors without ceasing to be a sole proprietorship. For this reason, sole proprietorships generally are not practical in large business ventures that demand major capital inputs.

  The sole proprietorship form also is limited in terms of business talent and ability. The success of the business generally is tied to the ingenuity, initiative, resourcefulness, and managerial abilities of the sole owner.

  Even if a sole proprietor is a skilled manager, the business probably will decline any time this person is sick or disabled. In addition, a sole proprietor typically would be reluctant to undertake projects that require a variety of specialized technical skills.
- **Unlimited and Unshared Liability**—Another drawback to the sole proprietorship form of business is that the sole proprietor's financial liability is unlimited and unshared.

  There is no distinction between the sole proprietor's business assets and liabilities and his or her personal assets and liabilities.

In the event of business failure, creditors can come after personal assets and business assets, as they are one and the same.

If the sole proprietor dies or becomes disabled, and if there isn't adequate insurance or other funds to pay off the debts and pay an income to the family, the family can be completely wiped out financially. There is no legal protection against the claims of business creditors.

While the law permits creditors to make claims on all of the sole proprietor's material assets, it protects the owner's family by protecting the owner's life insurance. Both the death benefits and the cash values of the policies are generally untouchable by creditors-with the U.S. Government being the major exception. This could literally be the only asset the proprietor is allowed to keep. This protection against the claims of creditors is strong motivation toward the purchase of life insurance, especially cash value life insurance.

***Business Dies with the Sole Proprietor.*** No disadvantage of a sole proprietorship could be more significant to a financial advisor than the fact that—without planning—the business dies when the sole proprietor dies. This means that the family's source of income is cut off.

The sole proprietor's need here is life insurance to continue the family's income. It doesn't matter whether this is called personal insurance or business insurance; it is life insurance that allows the family to maintain itself and meet its financial obligations.

In general, state laws provide that all of a sole proprietor's business activities cease at the owner's death. Unless the sole proprietor's Last Will and Testament expressly states that the business may be continued, it almost certainly will be terminated at the owner's death.

Even with a will, the business may not survive without planning. All assets pass into the exclusive possession of the personal representative of the deceased's estate to be administered under the supervision of the appropriate courts.

The laws provide further that the personal representative must pay all of the business and personal debts of the proprietor and liquidate any remaining assets. (*Personal representative* is a generic term used instead of *executor, executrix, administrator, or administratrix*.)

Only essential transactions are permitted after the owner's death. If the personal representative continues to run the business and enters into transactions not approved by the courts, the representative is held personally liable for any losses incurred as a result. If the deceased had included a 'hold harmless' clause in the will, the personal representative will not be held liable for losses incurred.

| Whose Price? |
| --- |
| "Business owner, if you were in a position today where you had to sell your business, you would want to do it at your price rather than at the buyer's price. Isn't that so?<br><br>"Chances are you don't want to sell out, but the day might come when your family must sell. When that day comes, they would rather sell at their price. But unless you take action while you're here, they might have no choice but to sell at the buyer's price.<br><br>"Wouldn't it make sense to guarantee your price so this won't happen?" |

Given these facts, the personal representative is not likely to want to continue the business. In the absence of advance planning and legal authorization, it is unlikely that the business will be sold as a going concern (an intact operating business). Lack of planning, therefore, usually means heavy financial losses because assets must generally be sold piecemeal under forced-sale circumstances.

Buyers hold all the advantages in a forced-sale situation. The deceased's personal representative needs cash to settle the estate and therefore must sell the assets.

Life insurance on the sole proprietor will provide the personal representative with cash to settle the estate taxes and other debts. This means that there will now be time to sell the business. The pressure will be off, and the personal representative can get a better price for the business.

As mentioned, the business can be continued if the deceased's will gives such authorization. Without authorization in the owner's will or through a court, the personal representative would be foolish to try to continue the business because it is a no-win situation. That is, the personal representative would be personally responsible for any losses but could not pocket any gains.

Barring authorization through the will, the business legally could be continued only if all of the proprietor's heirs are adults who agree to the continuation, and if there is enough cash to pay administration costs and death taxes. If one or more of the heirs is a minor, continuation of the business would require assent of the trustee/guardian and authorization by the courts.

Even with authorization, the heirs might do a bad job of running the business. For example, considering the heirs' lack of experience, suppliers may not extend credit. Customers may not come back.

Despite this, someone may decide to continue the decedent's business, even without legal authorization. This might be the decedent's personal representative, a family member, an employee, or some combination of interested individuals.

Only rarely, however, does a sole proprietorship continue to operate profitably after losing the experience and expertise of its owner. Even if the heirs have the legal authority to continue the business, they may have little or no practical chance to succeed.

## Partnerships in the U.S.

There are approximately 1,350,000 partnerships currently operating in the United States. The vast majority of all partnerships are commercial partnerships (companies that manufacture or sell products), as contrasted with professional partnerships such as those in law and medicine. Though most of the insurance-related problems are similar, the professional partnership does have a few peculiar problems, which will be discussed later.

### *Background on Partnerships*

When two or more people agree to combine their resources and skills for mutual profit, they have formed a partnership. It is just about as simple as that. The Uniform Partnership Act defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit." The definition given by Chancellor Kent in Corpus Juris says: "A contract of two or more competent persons, to place their money, effects, labor and skill, or some or all of them, in lawful commerce or business, and to divide the profit and bear the loss, in certain proportions."

A partnership, then, is a voluntary association of two or more persons, each contributing money, property, skills, labor, or goodwill as the capital of the new firm. The partners must agree on a division of ownership and profits based on the relative value of each partner's contributions.

### *Types of Partnerships*

There are two basic types of partnerships: general partnerships and limited partnerships.

- **General Partnership**—A general partnership is the usual type where each partner is fully active in the firm with a voice in its management. Each is an agent of the other partner (or partners) with full authority to act for the firm within the scope of its business activities. Each is fully liable for the debts of the business, and each shares in the profits.
- **Limited Partnership**—Every limited partnership has at least one limited partner and one general partner. The limited partner is not legally liable for all the financial obligations of the firm. Instead, this partner's liability is limited to the amount of his or her investment in the venture. A limited partner has no voice in management, no involvement in the day-to-day running of the business. In essence, the limited partner is largely an investor in the firm. A general partner is one who has unlimited liability and is active in managing the partnership.

### *Legal Facts about General Partnerships*

The following are additional facts concerning general partnerships:

- **Oral or Written**—A partnership is created by an oral or written contract between the partners. This agreement indicates the basis on which the partners agree to operate. Although oral contracts may be upheld in court, prudent business practice calls for the agreement to be placed in writing in the form of articles of partnership for the full protection of each partner. Articles of partnership usually include the following items of special interest for our purposes:
    - Names of the partners
    - Name of the partnership
    - Nature of the business to be conducted
    - Capital and property of the firm
    - Capital contribution of each partner
    - Share of each partner in the profits and losses
    - Provisions for settling differences
    - Drawing account arrangements (technically, partners do not receive a salary)

- Duration of the partnership and provisions for dissolution and closure of the firm under circumstances not provided for elsewhere

How can knowledge about such a topic as articles of partnership help you in establishing relationships with partnerships? Here are a few ways:

- **Create Confidence**—One of your hardest but most important jobs in selling insurance and other financial products is helping prospects gain confidence in you. One way to do this is to ask pertinent questions that also exhibit your knowledge. These could be asked in the preapproach, approach or fact-finding.

Here, for example, are a few questions to ask in a partnership situation: *Do you have articles of partnership? Do they define the circumstances where your partnership will be dissolved? Do they speak specifically about what happens at death or disability? What do they say on these points? Did you consult your attorney in drawing up the articles of partnership? Do you have any other written agreements that address these contingencies?*

- **Get Facts**—During the fact-finding process, ask for a copy of the articles of partnership. They can provide helpful facts and insights.

For example, you will probably discover the age of the partnership, the relative "values" of capital contributed to the firm by each partner, and the shares of profit to be taken from the firm. It also lets you know which partner, if any, has more say (or a larger stake) than the others.

- **Changes**—You can get a brief history of the organization and thereby gain a feel for its current status.

For example, are there now more partners than initially? Fewer? Has the nature and scope of the business changed since its inception? How? Perhaps other businesses have spun off from this one? Have former partners started their own business? Who are these businesses? Can you get referrals to them?

- **Confidence Test**—When you ask to see one or more of a prospect's business documents, a positive response is generally a sign of confidence and trust in you.

As co-owners, the partners have equal rights to possession of the partnership assets, but only for partnership purposes. For example, they cannot assign, sell, or transfer their individual shares of this ownership.

Contrast this with a stockowner's ease of selling his or her stock to another person. When a partner dies or withdraws from the firm, this tenancy in partnership ceases to exist, and ownership of the assets of the firm is vested in (belongs to) remaining partners as liquidating trustees who are generally required (in the absence of an agreement to the contrary) to dissolve the business.

The primary exception to the requirement that the partnership be liquidated occurs when the partners have executed a buy-sell agreement. This agreement specifies that the surviving partner(s) must buy the deceased partner's interest from the heirs and that the heirs must sell this interest. Funding the buy-sell agreement with life insurance adds certainty that the surviving partners will be able to fulfill their promises.

Helping partners to assure the survival of their business is one of the important services you can provide your clients. Business continuation options and buy-sell agreements for partnerships are covered in detail later in the course.

When a partner dies, the deceased's partnership interest passes to the decedent's personal representative. But ownership as such does not pass to the personal representative; that is, the personal representative does not become a partner. By the same token, heirs cannot become partners by way of a dead partner's will.

Partnerships are formed only when living people consent to become partners. The personal representative receives from the surviving partner(s) the deceased's share of any profits and surplus remaining after liquidation of the business. The personal representative then distributes these funds to the deceased's heirs. The heirs of the deceased partner are legally entitled to get cash for the decedent's share of the business. If necessary, they can force the issue through court action. Even if the remaining partners want to continue the business, they may have to sell out just to raise cash to pay off the dead partner's heirs. With a little forethought (a written agreement and a source of buy-sell funds), this potentially devastating situation can be readily avoided to everyone's satisfaction.

- **Authority**—Each partner is a principal and has equal authority with the other partner(s), unless the articles of partnership specifically limit such authority. In partnerships of more than two members, the majority usually will rule. Unanimous consent is required for unusual decisions of major or vital importance.

  Each partner becomes an agent of the other associates. Unless specifically restricted in the articles of partnership, each partner may transact business on behalf of the firm and bind the other partners so long as the transaction is within the ordinary scope of the firm's business.

  However, a partner does *not* have authority in the following areas which are of special interest for our purposes: a partner cannot assign or sell partnership property, admit another to the firm without the consent of all associates, or sell his or her interest to another without the consent of the partners.
- **Share**—Partners share in agreed proportions in the net profits and undistributed capital of the firm and in any losses that may be incurred. In the absence of a formal agreement, the partners are assumed to share equally in any profits or losses.
- **Unlimited Personal Liability**—Each general partner is subject to unlimited personal liability for the firm's obligations. As with sole proprietorships, this is a key planning issue. If the firm becomes insolvent for any reason, including death or disability of a general partner, each partner is individually liable for *all* of the firm's debts. Consequently, business debts can eat up not only all of the assets of the firm, but every cent of the personal estates of *all* partners.

  However, partners are entitled to have business assets applied in satisfaction of business debts insofar as such assets are adequate. This, in itself, offers a very good reason for insuring the lives of the owners, with the partnership being the applicant, premium payer, and beneficiary of what is, in essence, key person life insurance. Any indebtedness not covered by business assets will be made up from the personal estates of the partners.

  Likewise, the personal insolvency of any partner can jeopardize the entire partnership business. The personal assets of the insolvent partner must be used first to satisfy his or her personal creditors. But if such assets are inadequate, the personal creditors can force a liquidation of the partnership interest in order to satisfy their claims! It's no wonder the law will not allow anyone to become a member of a partnership except by the mutual consent of all other partners!

| Your Problem |
|---|
| "Business owner, if you had died yesterday, would your family need the money you have invested in this business? Would your partner be able to pay them in cash as soon as your family needs it?" |

Common law holds that lawsuits may not be brought against the partnership, as such, but rather are to be brought against the partners as individuals. However, under the laws of some states a partnership is considered an entity (a separate being) for specified limited purposes and can sue and be sued.

If a partner dies, retires, sells his or her interest, or goes into bankruptcy, the partnership is *dissolved* immediately. The Uniform Partnership Act defines dissolution as "the change in a relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." The partnership is not *terminated* until the surviving partners have folded the business and equitably distributed the net proceeds.

Under arrangements that are explained later in the course, the business may be continued under a new structure. But the old firm has been dissolved, and a new one will have taken its place.

- **Taxation**—A partnership as such is not subject to federal income tax. A partnership is required to file an information return (Form 1065) that reports gross partnership income, business deductions, and net taxable income. However, a partnership is a pass-through entity, not a separate taxable entity, and thus no federal income tax is imposed on the partnership itself.

  As part of its reporting responsibilities, the partnership must provide each partner with a copy of Schedule K of the Form 1065. On an individual income tax return, each partner then must include his or her share of the profits—*whether or not actually distributed during the taxable year.* Partners can also take advantage of partnership losses to offset their other personal income.

### *Advantages and Disadvantages of General Partnerships*

**general partnership**

Following are several advantages and disadvantages of general partnerships. (Limited partnerships have slightly different rules, and will be mentioned shortly.)

***Advantages of General Partnerships.*** First, the partners get all the profits. Unlike corporations, there are no stockholders with whom to share the earnings of the business.

Second, unlike corporations the partnership itself is free from federal income tax. Also, partnerships are not subject to the accumulated earnings tax, as some C corporations are.

Third, any losses or profits of the partnership pass directly to the partners as personal income for federal income tax purposes. This means that any partnership losses can be used by the partners to offset income from other sources, thereby reducing their individual federal income tax bill. This is unlike a corporation, where corporate losses can be used only to offset the past or future profits of the company. This treatment of partnership losses can be particularly important to partners who have significant income from other sources.

Finally, as contrasted with sole proprietorships, partnerships permit a pooling of capital and talent and a sharing of risk. For example, two people may decide to open a wholesale distributorship. They pool their financial resources to lease space and purchase inventory. One partner may have a knack for dealing effectively with people. The other is more detail oriented and excels at the bookkeeping.

***Disadvantages of Partnerships.*** First, the death of a partner may automatically end the partnership—with serious consequences to all concerned. These consequences can be avoided if an *ownership transfer plan* (buy-sell agreement) is implemented and funded.

The second major disadvantage lies in the unlimited personal liability of the partners. Business debts can devour all of the business assets. If the debts cannot be satisfied out of these partnership assets, creditors can attack the personal assets of every partner.

### *Limited Partnerships*

**limited partnership**

The Uniform Limited Partnership Act defines a limited partnership as "a partnership formed by two or more persons having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the [financial] obligations of the partnership beyond the extent of their investment."

To grasp the concept of limited partnership, think of limited partners as investors. This is, in fact, what they are—namely, investment vehicles, as opposed to regular business partnerships. They put their money into the partnership as a financial investment, taking none of the day-to-day responsibilities for managing the business. In addition, their limited liability keeps them from losing more than they invest.

| Your Price |
| --- |
| "Business owner, if your partner had died yesterday, do you think the heirs would sell their interest to you at a price you would consider fair? (Wait for a response.) How would you go about setting a price that both you and the heirs would consider fair?" |

The general partners conduct the day-to-day business for the entire partnership and have *unlimited liability* for the firm's obligations. Most limited partnerships deal in investment ventures such as oil and gas drilling, cattle breeding, and real estate.

***Legal Facts Concerning Limited Partnerships.*** The purpose of the limited partnership is to enable a person who has money to enter into partnership with others, without being exposed to the unlimited liabilities of a general partner. If the business fails, the limited partner can lose no more than the capital invested in the firm.

- The limited partner cannot be active in the management of the firm.
- Usually the limited partner receives a specified share of the profits.
- The partnership interest of a limited partner may be reached (attached) by any of his or her creditors.
- Upon dissolution of the partnership, the limited partner's share has priority over funds due the general partners, but is subordinate to claims of the firm's creditors.
- Upon death, the limited partner's personal representative is entitled to the deceased's portion of assets and deferred profits in order to

settle the estate. Death of the limited partner does not dissolve the partnership. However, the death of a general partner can end the business unless the partnership agreement stipulates otherwise.

If a limited partnership develops too many characteristics of a corporation—even though it calls itself a partnership—it will be taxed as a corporation. Four major corporation characteristics are considered in determining whether or not a limited partnership will be classified by the IRS as a corporation for tax purposes. If the limited partnership has more than two of the following characteristics, it probably will be taxed as a corporation:

- Freely transferable ownership interests
- Continuing of life
- Participation of limited partners in management of the partnership
- Limited liability of the limited partners for debts of the partnership

There are many gray areas concerning what constitutes each of these four characteristics. Thus, the limited partnership agreement must be carefully drawn—and followed—to avoid corporate tax status.

**family limited partnership**

***Family Limited Partnership.*** A version of the limited partnership, the family limited partnership (FLP) is sometimes used in estate planning, especially when there is a family business interest. In a family limited partnership, a property-owning family member transfers property such as real estate and stocks to the partnership, receiving partnership units in exchange. Younger generations receive limited partnership units while the senior, donor member(s) receive general partnership units, maintaining control of the assets. Ultimately, the majority of the ownership interest is transferred to the limited partner, with the general partner retaining only a minimal number of units but retaining, as the general partner, management and responsibility for the assets.

A family limited partnership is a legal agreement that allows business owners and their children to address several business-succession and estate planning needs all at once. It works like this: Mother and father create a limited partnership in which mother and father are the general partners, and their children (and/or grandchildren) are the limited partners.

Mother and father transfer property to this partnership. The property may be stocks, bonds, cash, the family farm or stock in the family C corporation. Mother and father no longer own these assets. In exchange for their contributions of property to the limited partnership, they receive units of ownership in the family limited partnership.

Over time, mother and father will give ownership of most of the partnership to the children, following a "planned gifting" program. But they will not give up control over the partnership until both have died.

Understanding what happens as a result of setting up such a limited family partnership requires an understanding of some tax laws that are beyond the scope of this course. In essence, however, the primary benefit is its ability to reduce the size of mother and father's taxable estate, thereby reducing the amount of federal estate tax at death. This benefit comes as a result of the planned gifting program and is based on tax laws allowing less-than-asset value to be placed on the C-corporation stock of the business held by the children. The reduced value is based the fact that non-marketable stock and minority interest stock are allowed to be discounted for IRS purposes. This discounted price results in lower gift tax at time of giving and lower estate tax at death.

The limited partnership arrangement lets mother and father, as the general partners, control the business despite the fact that they may own less than 1 percent interest in the limited partnership.

There is a lot more to know about family limited partnerships, but this basic information provides enough of a foundation for you to be familiar with the concept and to ask your family-owned C-corporation owners if they have examined the concept with their legal advisers and accountants.

**professional partnership**

***Professional Partnerships.*** Another way of differentiating partnerships is to divide them into commercial (business) partnerships and professional (personal service) partnerships.

Typical professional or personal service partnerships are legal, medical, engineering, architectural, accounting, dental, advertising, consulting firms, realtors, and brokers. Though most of the characteristics of professional partnerships and commercial partnerships are the same, professional partnerships do have a few distinctive characteristics.

Partners often meet the challenge of work a little better and to make more money in a partnership than working alone. For example, a survey by the National Income Division of the Office of Business Economics shows that lawyers operating in partnerships earn more on average than lawyers operating alone. Surveys among other professional groups would undoubtedly indicate the same situation. Because this is true, an obligation is created. The partners owe each other some measure of responsibility for their enhanced positions.

When one of the partners dies, the survivors are keenly aware of this debt. Your opportunity is to help partners realize this obligation before one of them dies, while there is still time to use the best solution.

*The Difference between Partnerships.* How does a professional partnership differ from a commercial partnership? An important difference lies in the character of assets. Most commercial partnerships are capital intensive. That is, a substantial part of the value of the firm is represented by its physical assets such as real estate, machinery, fixtures, equipment, materials, supplies, inventory, and so forth. In short, tangible assets are an essential part of the business. These capital assets constitute a large part of the value of each partner's interest in the business, directly or indirectly. The more capital intensive, the more likely there is debt.

With professional partnerships, the situation is quite different. They are usually not capital intensive. The real value of the typical personal service partnership lies in the training, knowledge, skill, experience, character, and reputation of the individual members of the firm. As a consequence, the firm's income is derived almost entirely from the personal services rendered by the partners.

Capital, in the form of tangible assets, is generally incidental to the operation of most professional partnerships. Little, if any, income results from these physical or tangible assets.

Similarly, commercial partnerships frequently allow a good-sized portion of their profits to remain in the business. Partners in personal service firms are far more likely to withdraw the bulk of the earnings. The result is often minimal working capital within the professional partnership.

*A Key Difference for Professional Partnerships.* There is one additional way in which commercial and professional partnerships differ. Partners must be qualified members of a given profession. A deceased partner's heirs cannot come into the business as partners unless they too are qualified professionals in the same field.

Under the Uniform Partnership Act, professional partnerships face the same threat of liquidation after a partner's death as do commercial partnerships. The need for a solution to the problem is just as urgent and vital with professional partnerships as with commercial partnerships.

## Corporations

A corporation has been defined by Ames and Ames in their authoritative work *Private Corporations* as "a body, created by law, composed of individuals united under a common name, the members of which succeed each other, so that the body continues the same notwithstanding the change of individuals who compose it, and is, for certain purposes, considered as a natural person." From this definition, we may derive the following important facts about the corporate form:

- A corporation is created by law.
- A corporation is invisible and intangible. It cannot be seen, as can the buildings and machinery owned by the corporation.
- A corporation is an intangible artificial being—an entity separate and independent from the owners of its capital stock. As an entity, it is viewed as an artificial person and is subject to many of the privileges and restrictions of a natural person.

Corporations are divided into two classes: (1) those organized and conducted for profit and (2) not-for-profit (nonprofit) organizations, which are generally created for educational, charitable, religious, or public purposes. Nonprofits generally pay no federal income taxes. Corporations organized for profit are the only ones to be considered here. They include all corporations organized for business purposes.

**C corporation**

**closely held corporation**

There are a few kinds of "for profit" corporations. Most corporations are *C corporations,* named after subsection C of the Internal Revenue Code. C corporations not traded on the stock market are referred to as *closely held corporations.* Corporations traded on the stock markets are referred to as publicly held corporations.

**S corporation**

Second are *S corporations,* which resemble partnerships in many ways, including some tax aspects.

**personal service corporation**

**professional corporation**

Third are *personal-service corporations,* which are primarily service oriented as opposed to product oriented. They are taxed somewhat differently than C corporations. One variety of personal service corporation is the *professional corporation,* operating in such services as dentistry, medicine, and accounting.

### *Chief Characteristics of Corporations*

Because a corporation is a separate legal entity, certain characteristics distinguish it from the sole proprietorship and the partnership.

1. **Limited liability of stockholders**

   The corporate form of business enables persons to own part of a business and yet limit their losses (in case of failure) to the amount of their investment in the capital stock. This is true even if the assets of the corporation are not sufficient to pay its own debts. (Sometimes creditors will not extend credit to the corporation; they will insist that stockholders sign *personal notes*. This calls for life insurance to cover the debt, which will be discussed later.)

   The corporation itself is responsible for its own actions and liabilities; creditors have no claim to the personal assets of a stockholder to satisfy claims that are strictly against the corporation.

2. **Continuity of existence**

   Corporations can go on indefinitely. An owner's death, withdrawal, mental incompetence, or bankruptcy does not in itself interrupt the corporation's continued existence. The same is true in the event of a stockholder's retirement or change in the corporation's stockholders, directors, or officers.

3. **Ease of transferability of interest**

   A stockholder is an owner of part of a corporation. Ownership is evidenced by a stock certificate issued by the corporation. Unless restricted by contractual agreement, such a share of stock may be transferred from person to person simply by an endorsement on the certificate by the owner, without necessarily affecting the operations of the corporation. It can also be transferred at death through the stockholder's will.

4. **Capital may be increased**

It is a common occurrence today for corporations to increase their capital stock for expansion purposes. Issuing new shares of stock for this purpose can affect the proportion of ownership among stockholders. This, in turn, can affect who controls the company. As will be discussed later, life insurance can play a key role in providing money to the corporation so that ownership and control need not change at the death of an owner.

### *Advantages of Corporations*

Following are some f the corporate form of doing business. Included are contrasts with proprietorships and partnerships.

- **Tax Status**—The decision to incorporate is often influenced by the fact that owner-employees of C corporations can buy tax-deductible fringe benefits for *themselves.* Except for contributions to their own retirement plans, and their own group health insurance premiums, such deductions are not generally available to sole proprietors, or partners, or to most owners of S corporations.

  For example, if two *partners* buy group life insurance to cover themselves and their three other employees, they can deduct only about three-fifths of the premium for federal income tax purposes. Specifically, sole proprietors, partners and S corporations employees who own more than 2 percent of the outstanding stock or more than 2 percent of the voting power of the corporation can deduct the portion of the group life insurance premium that covers the three other employees, but not the portion that covers them. In general, only the cost of fringe benefits covering employees is income tax deductible by the business.

  If the two partners incorporated the business, they could deduct the entire premium, including the portion that covers their own lives. The law's rationale is that corporate owners who work for their own corporation are generally considered employees of the corporation for federal income tax purposes. Partners in a partnership, sole proprietors and S corporation owners are not considered to be employees.
- **Income Tax Levels**—Many corporations manage to pay little or no income tax. This is possible if times are bad, and expenses exceed income. It is especially likely to happen if there are major items of depreciation, deductible fringe benefits, tax credits, and high salaries.

The corporate alternative minimum tax helps assure that large corporations with real economic income will pay at least a minimum amount of income tax. The alternative minimum tax is discussed at the end of this chapter.

- **Continuity**—With partnerships, even when there is a written agreement to continue, the technical fact of dissolution always occurs when a partner dies. Death of a sole proprietor has a similar result. This is not true of corporations. Legally, even the deaths of all the stockholders at once would cause no dissolution of the corporation.

  Obviously, legal considerations are not the sole considerations. The death of a key executive-and almost certainly the deaths of all the key executives-would shake the business to its foundations.

- **Limited Liability**—Every cent owned by a sole proprietor or partner is subject to the debts of the business. But the owner of a corporation is not liable for any corporate debts (if incurred legitimately).

  If the business folds, the stockholder might lose every cent invested in the business, but no more. The owner's house and all personal property, including shares of stock in other businesses, are safe from the creditors of the failing corporation. This is a key advantage of the corporate form. Only the corporate assets themselves are subject to the claims of creditors.

  As a practical matter, however, the protection of limited liability is lessened in corporations which are relatively new or whose financial situations are somewhat unstable. Lenders often require one or more stockholders in these corporations to sign personal notes for business loans. Such debts become their personal responsibility if the corporation defaults.

  Not all corporate credit is arranged this formally, of course. Customary trade credits, for example, would usually not be a legal responsibility of the owner personally if the corporation defaults.

Whether it is personal or corporate credit, there is often a need for life insurance whenever there is debt. Common reasons for incurring debt are to buy materials for inventory, loans for expansion of the business, and purchase of equipment. Life insurance on the owners or other key people is not only a prudent move; the creditor sometimes requires it.

Since business loans, including normal trade credits, are continuing factors in most businesses, there is almost always a continuous level of substantial debt. This means continuous life insurance to cover the debt, either permanent insurance or renewable term insurance.

### *Ownership Transfer of Partnerships*

No one can legally force an unwanted partner on a partnership. If a partner wants to withdraw from the business, he cannot simply sell his share to someone else without regard to the other partners. They can refuse or accept the offered partner.

Here is a distinct difference for a stockholder. The stockholder has complete freedom legally to transfer shares to *anyone*. The stockholder may give away shares, will them, or sell them at any price—all without legal interference from the other owners of the corporation. They, too, enjoy this same flexibility of ownership. The corporation is blind to the identity of its owners.

### *Disadvantages of Corporations*

Following are some drawbacks of the corporate form of business.

- **Double Taxation on Dividends**—Most publicly held corporations (and some that are closely held) distribute net earnings as dividends to stockholders. Net earnings are profit left after paying corporate taxes. A stockholder receiving such dividends must report them as taxable income on that year's Form 1040. Thus, the earnings are taxed again as personal income to the stockholder. An accompanying illustration demonstrates double taxation.
- **Ease of Transfer**—The ease with which stockholders can transfer shares of stock to others is an advantage. The ease with which a stockholder's associates can transfer his or her shares of stock to others may be a disadvantage to that shareholder.

  Consider a two-person corporation in which one owns 60 percent and the other 40 percent of the shares. The business runs smoothly; the owners like and respect each other. Then the majority owner, for whatever reason, transfers ownership to someone else.

  What happens to the minority stockholder's position then? It certainly won't be the same as before. The minority stockholder might even be voted out of a job. Worse yet, the minority stockholder might have little choice but to remain on the job despite an intolerable new boss. Legally, the minority stockholder is free to sell out, but who would buy into this position that the minority stockholder is trying to escape?

| Double Taxation* Example | | |
|---|---|---|
| Corporate Income Tax | Corporate Earnings | $85,000 |
| | Less Income Taxes Paid by Corporation (34% marginal bracket) | –10,900 |
| | Earnings Available to Stockholders | $74,100 |
| Individual Income Tax | Dividends to Stockholders | $74,100 |
| | Less Personal Taxes Paid by Stockholders (28% marginal bracket) | –20,748 |
| | Net to Stockholders | $53,352 |
| *2010 income tax rates. | | |

- **Regulations**—A price is often paid for any advantage. The owner who incorporates will pay at least the price of increased "red tape" in the form of government reports and regulations.

### Creation of a Corporation

Most states pattern at least part of their incorporation laws after the Model Business Corporation Act. This act is a uniform code that may be adopted with or without modifications-or not at all-by the states.

As a rule, firms seek incorporation in the state in which their principal activities will be conducted. However, companies doing a large interstate business usually incorporate in a state where the laws are most favorable. Some of the considerations governing the choice of the state in which to incorporate are the following:

***Taxes and Corporations.*** States or municipalities generally levy a franchise tax, a real property tax, and a personal property tax. Most states also have a corporate income tax. Some states have more favorable corporate taxes than others and thus have become favorites for those seeking corporate charters.

***Powers Granted to a Corporation.*** The powers granted to a corporation are specified in its charter, which is to a corporation what a constitution is to a state. The application for a charter is called the *articles of incorporation*. The charter is granted when the articles of incorporation (the application) are approved by the proper state official (usually the Secretary of State).

As soon as the charter is granted, the corporation may be authorized to operate its business. The incorporators issue capital stock certificates to the original stockholders and call the first meeting of the stockholders. At this meeting, the stockholders usually elect corporate officers and a board of directors, and adopt bylaws.

### Corporate Management

Some corporations have hundreds or thousands of stockholders. Some have only one or two. In large corporations, the vote of all stockholders on matters of daily routine would be impossible. The exercise of authority is therefore divided among three groups: stockholders, directors, and officers. The stockholders elect the board of directors. The directors formulate company policies and elect the officers. The officers execute the company policies.

In most closely held corporations, the scope is much smaller. The same individuals may hold several positions. For example, closely held corporations typically have a president, a vice president, and a secretary-treasurer. These three officers might also be the directors of the closely held corporation. The same three are probably stockholders as well, quite possibly the only stockholders.

***Stockholders of Corporations.*** The stockholders are the people who own the capital stock of a corporation and therefore own an interest in its assets. Stockholders as such do not necessarily participate actively in the management of the company. They do not have to be employees of the corporation.

A stockholder has certain basic rights in the corporation, including the following:

- sell or transfer shares of stock
- subscribe for additional issues of capital stock if and when issued (*preemptive right*)
- receive dividends, if declared, in proportion to the number of shares of stock owned
- in the event of liquidation, share in the assets in proportion to the number of shares of stock owned

- attend and vote at stockholder’s meetings. Note, however, that not all kinds of stock have voting rights. Usually "common stock" has this right.

***Board of Directors of a Corporation.*** The board of directors is elected by the stockholders and constitutes the managing body of the corporation. The directors can act only as a group. As individuals, they are without power to transact the business of the company.

The board meets at least as often as called for in the bylaws. It selects the administrative officers and thus delegates its management authority to the company officials.

The official decisions of the board are recorded in the minutes of its meetings. These minutes are the corporation accountant’s authority for certain entries pertaining to the corporate capital. Quite often, decisions relating to the purchase of insurance need to be authorized by the directors and officially documented in the minutes of the board of directors meeting.

***Corporation Officers.*** The bylaws of a corporation generally provide that certain officers are to be elected by the corporation. Corporate officers and their functions might typically be as follows:

- The president is usually the chairman of the board of directors and is the chief executive officer. The president generally presides at meetings of the stockholders and directors and makes appointments as needed.
- There may be one or more vice presidents. They are responsible for specified operations, such as engineering, production, or sales.
- The secretary keeps the official records of the corporation, including minutes of meetings.
- The treasurer is the custodian of company funds and supervises their receipt and disbursement.

### Capital Stock

The charter of the corporation gives it the power to issue a specified number of shares of capital stock, which is another way of saying "stock." (The two terms are interchangeable.) The amount of stock originally authorized is determined largely by how much the incorporators want to raise as initial capital.

The corporation does not need to issue the entire number of shares authorized at any one time, or ever. But if it does issue all of this stock and then desires to issue more later, it must first receive approval of the state.

Authorized capital stock may be sold for money, property, or service. When it is sold and certificates issued, the authorized stock is known as *issued capital stock*. Capital stock that is authorized, but not issued, is called *unissued* capital stock.

***Par or No-Par Value Stock in Corporations.*** Each share of capital stock may have a par value or it may be of no-par value, according to specifications in the charter. Par value is simply a nominal figure. It has no necessary relationship to the real value of the stock. It is merely the amount at which it is recorded on the books of the company. For example, many companies set par value at $1.

Originally issued stock may be sold by the company at par or above par value. If state regulations permit, it may even be sold below par. If no-par stock is issued, it is carried on the books at the amounts for which it is sold.

***Classes of Capital Stock.*** The two most usual classes of stock are common and preferred. If a corporation issues only one class of stock, it is called common stock. Practically all common stocks carry the privilege of voting for all stockholders. Since the claims of the common stockholders are subordinate to the claims of other classes of stockholders, relatively greater risk is attached to the ownership of common stock.

However, the power to declare dividends rests with the board of directors, who are elected by the common stockholders. Thus, the greater risk may be rewarded with larger dividends. Most closely held corporations issue only one class of stock.

Preferred stock usually does not carry the right to vote, but it normally enjoys the right to receive dividends before dividends are paid on the common stock. In the event of liquidation of the corporation, the preferred stockholders will receive the return of their investment before the common stockholders receive anything.

## Closely Held C Corporations

This text deals primarily with closely held corporations as contrasted with publicly held corporations. Also known as *closed corporations and close* *corporations*, closely held corporations constitute the vast majority of all corporations. They are seldom owned by more than a handful of people, each of whom is engaged actively in the day-to-day management of the business. The stock is not listed on the stock exchanges and rarely changes hands except at death, retirement, or a major realignment within the firm.

There is a tendency to view corporations as formal business organizations—rigidly structured, managed, and administered. The fact is that many closely held corporations are not this way at all. Some corporations are little more than sole proprietorships with "incorporated" added to the name. Although a sole proprietor might have become president by incorporating, nothing substantial has changed in the day-to-day operation of the business. He or she is the sole stockholder and therefore continues to make all of the decisions just as before.

Other corporations might be partnerships turned corporate. The old partners are now stockholders, but the business goes on much as before despite the fact that one is now president and others are vice presidents. One noticeable difference is that certain major decisions must be recorded and annual meetings of the stockholders must be held. Such annual meetings are also likely to be informal, perhaps taking place at a dinner table over a cup of coffee.

### *Characteristics of Closely Held Corporations*

The general characteristics of a corporation apply to both closely held and publicly traded corporations. However, the personal structure and the methods of operation of the typical closely held corporation bring about some important differences. Understanding these distinguishing characteristics will help you come to know the closely held corporation’s needs for business life insurance.

- **Union of Ownership and Management**—In closely held corporations, each stockholder usually has a threefold role as a director, an officer, and an employee as well. The owners are the managers. Therefore, death of an owner means death of a key employee of the corporation.
- **No Ready Market for the Stock**—A characteristic of a public corporation is that its shares may be bought and sold on the stock exchanges. In closely held corporations, however, a few employees are the major stockholders.

Ordinarily, the only persons interested in buying the shares of a deceased closely held stockholder are the surviving stockholders or possibly a competitor. The stock owned by the deceased stockholder's family generally is worthless to them unless it is sold or unless they own enough of the stock that they can use their influence to hire themselves as paid employees.

In and of itself, stock of a closely held corporation generally provides no income for the family. As will be discussed later, this is a key reason why having a buy-sell agreement is so important for all stockholders of closely held corporations. Here is where your "sale" will be made, and funding the buy-sell is where insurance enters the picture.

- **Limited Liability: Theory Versus Reality**—Many creditors will insist that loan notes be signed not only by the appropriate corporate officer of a closely held corporation, but also by the corporate owners personally. If the corporation cannot repay the loan, the owners are personally responsible to repay it. Thus, the legal limit of a shareholder's liability is meaningless in such cases. Insurance to cover these personal notes is just as important to the stockholder's family as is insurance on a homeowner's life to cover the mortgage.
- **Dividends and Unreasonable Compensation**—In virtually all closely held C corporations, the owners are also salaried employees of the corporation. In theory and in practice, they can set their own salaries at whatever levels they wish. If given free choice, it would be foolish for owners to pay themselves dividends instead of salaries because salaries are tax deductible by the corporation while dividends are not. Closely held corporations generally pay no dividends.

  Were it not for a provision of the law dealing with *reasonableness of compensation*, the owner-employees of a corporation could reduce or even eliminate corporate taxable income simply by paying themselves extremely large (and tax-deductible) salaries. The reasonable compensation provision allows the government, in effect, to force the corporation to treat a portion of the owner's salary as a dividend.

In cases where the IRS audits a corporation's tax returns and is successful in challenging the reasonableness of compensation, it will limit the corporation's tax deduction for that owner's salary to a certain dollar amount. The balance of what had been treated as salary must then be "un-deducted" by the corporation and reported instead as taxable corporate income.

In general, the IRS determines reasonableness of compensation by reviewing the entire compensation package (including fringe benefits) of the owner-employees. The IRS compares this total compensation with that paid in comparable companies.

## S Corporations

Someday you will be talking with a prospective client who will tell you that his or her business organization is an S corporation. This section covers much of what you need to know about this form of business organization—its structure, ownership, tax status, the impact of death, and other insurance-related considerations.

S corporations get their name from that part of the Internal Revenue Code that gave them birth, namely, *Subchapter S of Chapter 1 of the Internal Revenue Code*. Although 1982 legislation officially designated them as "S corporations," you might run into their older names of Subchapter S corporations, Sub S corporations, or simply Sub S. The form used by S corporations for reporting their income is Form 1120S. (C corporations use Form 1120.)

### *Similarity to Partnerships*

Although S corporations have some of the important features of closely held corporations, they are taxed in part like partnerships and in part like corporations. Here's how they resemble a partnership:

- As with partnerships, there is generally no federal income tax levied on S corporations. (Certain levels of capital gain and passive income such as interest are taxable if certain conditions exist.)
- As with partnerships, S corporations are pass-through forms of business. The owners of S corporations are taxed on their proportionate share of the earnings of the corporation.

It does not matter whether the earnings are actually distributed to the owners or remain with the corporation as undistributed earnings. Either way, the owners must report earnings personally. Expenses and losses are passed through directly to the shareholders.

The popularity of S corporations fluctuates with changes in income tax law and the tax status of individuals and their businesses. Corporate tax rates can sometimes exceed individual rates, and individual rates can exceed corporate rates at different income levels. Decisions to incorporate as a C or S corporation will often vary based on the relative income tax brackets of the individual owner(s) and the corporation. At certain income levels, business owners would rather have income taxed to a C corporation, rather than have it passed through to their individual taxes via an S corporation structure.

For example, if there are good business tax deductions, such as in the start-up phase of the business, an S-corporation can be a more favorable organization from a tax standpoint during the early loss years. An "S" election allows corporate losses to be deducted on the returns of individual shareholders. When the business becomes more profitable, the S election may be changed to a C corporation to have profits taxed to the corporation rather than the individual owner(s). Additionally, losses of an S corporation may be used to offset income earned outside the business if this is desirable from an income tax perspective.

- Because all earnings-even undistributed earnings-are reportable by the shareholders, S corporations are not subject to the accumulated earnings tax. (The accumulated earnings tax, covered later in detail, is a tax on certain levels of profit retained by closely held corporations.)
- There is no such thing as unreasonable compensation in S corporations. As you recall, the concept of unreasonable compensation is the way by which the IRS makes sure that tax-deductible salary is not really a disguised dividend. In S corporations (as in partnerships and sole proprietorships), there is no tax on the corporation itself, since it is a pass-through form of business. This allows the stockowner to take out all corporate income without the normal double taxation on C corporate profits.

### *Similarity to Corporations*

S corporations resemble closely held corporations in the following ways:

- Both S corporations and closely held corporations have continuity of life. They can legally continue as going concerns despite death of a shareholder.
- Each shareholder’s liability is limited to the amount of his or her investment. This is true in both closely held corporations and S corporations.
- Legally, shares of ownership are readily transferable. In practice, however, since S corporations cannot have more than 100

shareholders, their shares lack marketability as do those in most other closely held corporations.
- Some states impose corporate taxes on S corporations just as if they were regular corporations.

### *Distinct Characteristics of S Corporations*

S corporations differ from closely held corporations or partnerships in the following ways:

- The legal limit of shareholders in an S corporation is 100. In C corporations the number is unlimited.
- Shareholders of S corporations may be any individuals except nonresident aliens. (This prohibition against nonresident aliens exists because nonresident aliens pay no income tax to the U.S. Government.) In addition to individuals, estates, and certain trusts also are eligible to be shareholders.
- Amounts contributed by the S corporation to qualified retirement plans are generally deductible. This is true regardless of whether or not the employee is a shareholder. Amounts paid by the corporation for other fringe benefits such as group term life insurance or disability income insurance are deductible by the corporation for coverage on all employees except those employees owning more than 2 percent of the corporation. In addition, such over-2-percent-shareholder employees must report these corporate payments as taxable income. This is not the case with C corporations.

Regular corporations are generally referred to as C corporations, taken from the Internal Revenue Code subchapter that establishes them. This terminology is useful, especially to distinguish S corporations from C corporations.

- To become an S corporation, all the shareholders of a corporation must vote in favor of it.
- Revoking the status of an S corporation requires consent of one or more shareholders owning 50 percent or more of the voting stock.
- The corporation must be domestic.
- There can be only a single class of stock.
- Certain events cause the S status of a corporation to be terminated. These disqualifying events include having more than 100 shareholders or having an ineligible shareholder.

### Why Use an S Corporation?

The most important reason why S corporation status is elected is that the owners can take advantage of corporate expenses and losses to reduce and offset their other personal income at tax time each year. In this respect, S corporations are similar to partnerships: business losses and expenses pass through to the owners personally as offsets against current income.

Since it is usually new businesses that anticipate losses, it is therefore new businesses that most frequently elect S status as opposed to regular corporate status. And because such losses are typically "paper losses" brought about primarily by cost recovery (depreciation) of capital assets, it is often new businesses with substantial capital investments that elect S status.

According to the IRS, about 40 percent of all S corporations report net losses. To understand why losses are so important for tax purposes, look at an S shareholder’s ownership as a tax-sheltered investment.

Two characteristics of many tax shelters are that they produce a real dollar income to the investor, while also providing paper losses for federal income tax purposes. For example, an S shareholder might receive, say, $30,000 in distributed earnings while his or her share of depreciation losses might come to $20,000. The result would be taxable income of only $10,000 instead of $30,000.

By way of comparison, losses in a C corporation do not pass through to the stockholders. Even the corporation itself cannot deduct such losses in the current year; it must wait until a year in which it has a taxable gain to offset.

There is one notable limitation relating to the pass through of losses of an S corporation. Each shareholder can deduct losses only to the extent of his or her basis. Basis is the amount invested in the business. The higher the basis, the more a shareholder can deduct.

### Why Not Partnership?

A question to ask at this point is why not just become a partnership? While partners can benefit from a pass-through of losses, partnerships do not have the advantages of continuity of life, limited liability, and ease of ownership transfer that S corporations have.

**Table 1-1 S Corporation Compared with Partnerships**

| | S Corporation | Partnership |
|---|---|---|
| Liability | Shareholders' liability is limited to the amount of investment | Unlimited for general partners; limited for limited partners as long as they retain their status as limited partners |
| Management | Board of Directors with specific authorities | Extent of authority between general and limited partners may be vague |
| Shareholders | Limited to 100 | Unlimited participation |
| Dividends | Typically none are paid | No such thing |
| Unreasonable Compensation | No such thing | No such thing |
| Accumulated Earnings Tax | No such thing | No such thing |
| Federal Income Taxation | All losses and earnings of the S corporation pass through to shareholders. The shareholder is taxed; The corporation is not taxed. | All losses and earnings of the partnership pass through to partners. Partners are taxed as individuals. The partnership is not taxed. |
| Transferability | Stocks transferred by endorsement | May be more complicated, especially with limited partnerships |
| Formation | Specific requirements under federal law | Usually defined under state law. Same as S corporation |
| Taxable Years | December 31 or by approval under federal law | Same as S corporation |
| Deductibility of payments for group insurance and other fringe benefits (other than qualified retirement plans where contributions are deductible even for coverage of owners/partners) | Only deductible for employees holding 2% or less of the company's stock. S corporation's owners can deduct 100% of the cost of fringe benefits on non-shareholder employees, but generally not on themselves. | Can deduct 100% for nonpartner employees. Partners can generally deduct a specified portion of the group health premiums covering themselves. |

Another appealing feature of S corporation status is that it allows the stockholders to vote to go back into a regular corporate form. Usually, the intent is to do this once the major tax losses and high early expenses are used up.

## Limited Liability Companies (LLCs)

**limited liability company**

An important innovation in forms of business organizations is the limited liability company (LLC). All states now allow LLCs, and their numbers are mushrooming nationally into the hundreds of thousands. LLCs are very similar to limited liability partnerships (LLPs are partnerships in which all partners are sheltered from liability for partnership activities).

A limited liability company combines some basic concepts of partnerships, C corporations, and S corporations. Owners of LLCs are called members. In many respects, a limited liability company is like an S corporation, but has some additional advantages, and fewer disadvantages.

Limited liability companies combine the personal liability protection of a corporation with the tax benefits and simplicity of a partnership. In other words, LLCs have the benefit of being taxed only once on their profits, and the owners of the LLC, or "members," are not personally liable for the LLC's debts and liabilities. In addition, LLCs are more flexible and require less ongoing paperwork than an S corporation.

Here are some of the characteristics that make LLCs so popular.

### *Membership in LLCs*

- Unlike S corporations, which have a limit of 100 owners, limited liability companies have no limit on the number of members. Members may be individuals or entities. Generally, start-up costs will exceed those of a simple partnership or corporation due to the more complex nature of the operating agreement.
- Unlike S corporations, which prohibit nonresident aliens as owners, limited liability companies have no restrictions on foreign ownership.
- Unlike S corporations, which allow only one class of ownership, limited liability companies allow different classes of ownership.
- LLCs are attractive to family businesses that want to keep control in the family. How is this accomplished? Generally, ownership interests cannot be transferred without the consent of other members.

### *Limited Liability of LLCs*

Unlike general partners who have unlimited liability for debts of the partnership, the financial liability of LLC members is limited in the same way that shareholders of C and S corporations are limited. That is, a member's financial liability for debts of the business is limited to his or her contribution to the LLC. Unlike limited partners, LLC members can be active in the management of the business.

A limited liability company is valuable for professionals because it protects the assets of each member against the negligence of the other members. There is no shelter from liability for an individual's own actions.

### *LLCs are Taxed as Sole Proprietor, Partnership, or Corporation*

For federal income tax purposes, LLCs may be treated as a sole proprietorship, partnership, or corporation. Tax regulations provide rules to determine how a business entity is classified for tax purposes. If a business has a preponderance of the characteristics of a regular (C) corporation, it will be treated for federal income tax purposes as a corporation.

A business with only one owner can elect to be taxed as a sole proprietorship or as a corporation. Businesses with two or more owners can elect a partnership or corporate tax status. The tax filing status will determine other characteristics, benefits and disadvantages of the business entity as described throughout this chapter. Most of the discussion on LLCs in this section assumes the use of the corporate form of organization.

### *LLCs in General*

LLCs are most useful for new businesses that are just forming, or for partnerships that want to become LLCs. Existing partnerships or S corporations converting to LLC status may do so tax-free. There will be no gain or loss recognized on the transfer of assets and liabilities so long as each partner's or owner's percentage of profits, losses and capital remains the same after the conversion.

If an existing C corporation elects to become an LLC, it will be a taxable event for federal income tax purposes. The corporate shareholders will be responsible for any taxes due on corporate gains, because they will be taxed as though the C corporation assets had been distributed to them.

In most states, dissolution of the LLC is brought about by several events, including death. However, most states allow the remaining members of the LLC to vote to continue the LLC. Depending on the state law and the LLC's operating agreement, this election to continue may require approval of all members, or only a stipulated percentage of them.

## Professional Corporations and Professional Associations

At times, an individual practitioner or a group of practitioners of the same profession decide to incorporate. In most states, C corporations that provide professional services, in areas such as dentistry, accounting, engineering, actuarial science, performing arts, architecture, law, consulting, or medicine, are required to form a *professional corporation*. State laws define what constitutes a professional service, but they typically require a license to operate in that state. They are owned, organized, and operated by licensed practitioners of a common profession as an individual or group corporate practice rather than as a sole proprietorship or partnership.

Some states use the term "association" rather than "corporation." When you see "John Jones, M.D., P.A.," the P.A. stands for Professional Association and has the same meaning as incorporated. "Ltd." (Limited) is sometimes used as well. State laws establish these terms, so there are variations by state.

Some professional corporations are also personal service corporations. The term *personal service corporation* is a federal income tax categorization used by the Internal Revenue Service to describe corporations in which the principal business activity is performing personal services and where those services are performed mostly by owner-employees.

The main difference in these terms, then, is that the term *professional corporations* refers to state regulation and licensing, whereas the term *personal service corporation* refers to the federal income tax treatment of professional corporations.

Of course, not all professionals choose to incorporate. Some find it more advantageous to function as sole practitioners or as partners, while others elect S corporation status.

### Characteristics of a Professional Corporation

Although state laws are not uniform, there are a few basic ways in which virtually all professional corporations differ from other closely held corporations.

***Ownership of Professional Corporations.*** Ownership is limited to licensed practitioners in a given profession. For example, only licensed dentists may be shareholders in a corporation established to practice dentistry. This stipulation applies to initial shareholders and future owners alike.

However, when a shareholder dies, the decedent’s estate can legally be the shareholder for a specified duration, while the estate is being settled. The estate cannot vote or participate in management decisions, however.

When a shareholder of a professional corporation dies, the surviving owners may purchase the deceased's stock within a specified period of time—usually a few months. If they choose not to buy the stock within that time and if no other qualified buyer is found, the corporation itself must acquire it—usually within 6 months. This legal requirement makes it critically important for every professional corporation to have a buy-sell agreement specifying how the price will be determined and how funds will be provided.

***Scope of Operations of a Professional Corporation.*** The practice of a professional corporation is generally limited to one field of endeavor. For example, if several optometrists incorporate, they could not expand into unrelated products or services.

***Limited Liability of Professional Corporations.*** Although no professional is protected against his or her own negligence, a professional corporation can protect a practitioner against liability for the negligence of an associate. Since the primary risk of a practice is malpractice liability, this limitation can be significant.

***Board Membership in Professional Corporations.*** Only practitioners may be officers or board members. They do not have to be shareholders.

***Prospects for Professional Corporations.*** State laws are not uniform as to which professions may incorporate. Some states restrict the eligible professions to as few as four, while other states allow incorporation or association by practitioners of any profession that requires licensing by the state. Among the professionals who may generally incorporate are the following:

- Physicians
- Surgeons
- Attorneys
- Accountants
- Dentists
- Optometrists
- Engineers
- Architects
- Chiropractors
- Osteopaths
- Actuaries
- Psychiatrists
- Podiatrists
- Radiologists
- Pathologists
- Opthamologists
- Pharmacists
- Psychologists
- Social Workers
- Marriage Counselors

- Veterinarians
- Chiropodists

Since there is a wide variance as to who may form a professional corporation or association, check your own state laws to determine your prospects in this area.

### *Insurance Needs of Professional Corporations*

Professional corporations and associations offer about the same advantages as closely held commercial corporations, including tax deductibility of insurance-related fringe benefits for the owner-practitioners.

- The rules for qualified retirement plans for professional corporations are the same as for all other corporations. There are key people to be insured to cover losses that will be incurred as a result of their death or disability.
- Establishing buy-sell agreements is the only sound and prudent way to handle the orderly transfer of ownership at death of a shareholder-practitioner. Life insurance remains the surest, simplest, and most cost-efficient way to fund the agreement.
- Definite plans should be established as to what will be done if an owner becomes disabled for an extended period of time. Funding for these plans should include disability income insurance on the owners' lives.

The personal life and disability income insurance of each owner must be considered.

## Personal Service Corporations

As described above under professional corporations, a personal service corporation's principal business activity is performing personal services. At least 95 percent of the stock must be owned by employees performing the personal services. Corporations in this category are those engaged in accounting, actuarial science, architectural, consulting, engineering, health, law, and performing arts. Many professional corporations are also personal service corporations and are taxed accordingly. IRS takes the position that it is what the company does rather than who the shareholders are or what they call themselves that determines the tax status.

| **Federal Income Tax Rates<br>Personal Service Corporation** | | |
|---|---|---|
| Tax Year 2010<br>Taxable Income | Personal<br>Services<br>Tax Rate | Corporate<br>Tax Rate |
| $0 to $50,000 | 35% | 15% |
| $50,001 to $75,000 | 35% | 25% |
| $75,001 to $100,000 | 35% | 35% |
| $100,001 to $335,000 | 35% | 39% |
| $335,001 to $10,000,000 | 35% | 34% |
| All personal service corporations are taxed at 35 percent on all taxable income, starting with the first dollar. Regular corporation tax rates are graduated, but they are not for personal service corporations. | | |

There are two key points about taxation of personal service corporations. First, there is a flat tax rate paid on profits at the corporate (entity) level. That is, every dollar of income is taxed at the same 35 percent. Second, at most levels of income, they are taxed higher than C corporations, since the benefit of the graduated corporate income tax rates is not available. Because of this, professional corporations are not as popular as they once were. Corporations try to distribute all profits in the form of wages to the employee-shareholders performing the services. This in effect can eliminate the negative results caused by the flat 35 percent tax.

### *Joint Ventures*

A joint venture is a business relationship resembling a partnership. Joint ventures may exist between individuals, corporations, partnerships, or any combination of these. When persons or groups come together in a joint venture they do so for their mutual advantage.

One may bring special skill, knowledge, or judgment; another may contribute property; another may be the source of money. Each person is important. Without this pooling of money, material, and service, the specific project could not be handled adequately.

### *Syndications*

Syndications are much like joint ventures in that they are the joining together of two or more individuals or entities. As a matter of fact, a syndication can be a joint venture. A syndication may also take the form of a general partnership, a limited partnership, a regular corporation, or an S corporation.

| Comparison of Five Types of Business Organizations | | | | | |
|---|---|---|---|---|---|
| **Comparison Item** | **Sole Proprietor** | **Partnership** | **C Corporation** | **S Corporation** | **Limited Liability Company** |
| How Established | No formal document needed. Local business license. | May use either oral or written agreement. Local business license. | Certificate of incorporation must be filed with state. Local business license. | Certificate of incorporation must be filed with state. | Articles of organization filed with state |
| Length of Life | Dies with sole proprietor. Can be sold by beneficiary. | Death of any general partner dissolves partnership. | Perpetual—Not affected by death of a stockholder. | Perpetual—Not affected by death of a stockholder. | Continuity generally disrupted by death, retirement, or resignation. (See applicable state law) |
| How Managed | Entirely by the sole proprietor. | Jointly by the partners, but one partner can obligate the partnership. | By board of directors (elected by shareholders) through officers appointed by the board. | Same as regular corporation. | Jointly by members if so specified by operating agent. |
| Ownership of Business Property | Title held by sole proprietor. | Title held by partnership entity. Not assignable by individual partners. | Title held by corporate entity. | Same as regular corporation. | Title held by LLC entity. |
| Business Liabilities | Sole proprietor fully personally responsible. | Each partner fully liable for all the partnership debts. If partner A can't pay share, partner B must pay all. | Corporation is liable for all debts incurred, and for all employee acts when acting for the corporation. Stockholders are not liable above their investment. | Same as regular corporation. | Limited liability of members. |
| Income Taxation | All income taxable to sole proprietor. | A partnership is not subject to income taxation, but is required to file an informational return. | Corporation pays corporate tax on income over expenses, before paying dividends to stockholders. | Income taxes shareholders-employees similar to partnership. No regular corporate taxes. | Each member pays taxes on share of LLC income designated a noncorporate entity |

| Comparison of Five Types of Business Organizations | | | | | |
|---|---|---|---|---|---|
| How Profit is Distributed | Sole proprietor gets it all. | Partners share in proportion to their partnership interest. | Board of directors determines the amount of dividends to be paid and profit to be retained. | All income is taxed to shareholders. Any amount retained for business purpose is after-tax dollars. | Members share proportion to their interest. |
| Termination of Business | Sole proprietor closes door and settles accounts. | Death of a partner dissolves partnership. If one partner wants out, partnership must be dissolved. | Vote of stockholders, bankruptcy, violation of certificate of incorporation (by court). | Same as regular corporation. | Operating agreement can require a number to obtain interest beyond transferring interest. |

The limited partnership is the most popular form. This is probably because a limited partnership offers the limited partners the advantages of limited financial liability, tax-deductibility of depreciation and other business losses on their individual tax returns, and noninvolvement in the management of the project.

Most syndications are the joining together of a relatively small group of investors for the purchase and development of a large financial undertaking—generally the purchase and development of real estate. They are usually formed by a developer (syndicator) needing investors to put up cash to accomplish the investment objectives.

Additionally, however, there are professional, ongoing syndications—organizations whose only reason for being is to act as syndicators. Their twofold function is to (1) seek out people with large sums of money to invest and (2) seek out investment opportunities that meet the investors' goals for rate of return and level of risk.

## Income Taxation of Businesses

A few summary facts about business taxation follow. They are presented here as a brief overview. The text will also include a discussion of tax information as planning ideas are discussed.

### Taxation of Sole Proprietorships, Partnerships and S Corporations

With sole proprietorships and partnerships, the proprietor or partners are the only taxpaying entities. The business itself pays no income tax. All business income and expenses are passed through to the owner(s) for income tax purposes.

In general, sole proprietors, partners and S corporation owners are taxed directly on the net income of the business. By law, the gains and losses of the business pass through to the owners without the business itself being subject to tax. In computing the net income subject to tax, the owners' salaries are generally not deductible. In general, sole proprietors, partners and S corporation owners may deduct the entire cost of group insurance and other fringe benefits on their employees. Starting in 2003, the premiums for health insurance on the owners and their dependents are fully deductible. Contributions to a qualified retirement plan are fully tax deductible, as long as they are reasonable and meet plan requirements.

It helps to think of partnerships, sole proprietorships, and S corporations as pass-through businesses, because the income from the business passes through to the owners and is taxable to them as individuals. The business itself is not taxed. In contrast, C corporations are taxable entities.

### Taxation of Corporations

With corporations, there are two possible taxpaying entities to pay life insurance premiums. One is the corporation itself. The other is the owner(s) as an individual(s). Having the entity with the lowest taxable income pay nondeductible premiums is the least-expensive option.

By law, C corporations are taxed on the net income of the business; gains and losses are not simply passed through to the shareholders. In computing the net income subject to tax, all salaries and fringe benefit costs are generally deductible by the corporation. This includes salaries and fringe benefits for shareholders who are also employees. What remains after all deductions is the profit of the business, upon which the corporation is taxed.

If a C corporation later distributes these profits to the shareholders, the result will be a dividend. Dividends are taxable as ordinary income to the shareholders and are not deductible by the corporation. For this reason, owner-employees try to avoid or minimize dividend treatment through a number of devices. One way is through deductible items such as salaries and fringe benefits for shareholder-employees.

Through various penalties and restrictions, the IRS tries to force distribution of corporate profits as dividends, because dividends aren't deductible by the C corporation. Among these techniques are disallowing deductions for excessively high salaries and fringe benefits for the shareholder-employees, and imposing penalty taxes on corporations that accumulate too much profit without distributing it.

S corporations are taxed in a manner similar to partnerships. Professional corporations are generally personal service corporations taxed at 35 percent on all taxable income; there are no graduated tax rates.

**Federal Income Tax Rates for C Corporations**

| Taxable Income | Tax Rate |
|---|---|
| $0 to $50,000 | 15% |
| $50,001 to $75,000 | 25% |
| $75,001 to $100,000 | 34% |
| $100,001 to $335,000 | 39% * |
| $335,001 to $10 million | 34% |
| Over $10 million | 35% |

* The 39% rate from $100,001 to $335,000 of income is called a bubble because it is preceded and followed by 34% rates. This seemingly illogical 5% temporary blip has the purpose of recapturing from the corporation the dollar benefit of the 15% and 25% tax rates. That is, a corporation with taxable income of exactly $335,000 will have paid tax of $113,900, which is exactly 34% of $335,000. A second bubble kicks in at 38% from $15 million to $181.3 million. Then the rate returns to 35%.

### *Alternative Minimum Tax (AMT)*

**alternative minimum tax**

The corporate alternative minimum tax (AMT) is an income tax that attempts to make certain C corporations pay a "fair" amount of tax despite deductions, credits, and other tax preference items that reduce their regular income tax to a small amount. Tax preferences are tax items that allow larger than normal deductions, or exemptions for certain types of income, from regular tax rules. A corporate AMT must be paid instead of the corporation's regular tax if the AMT amount is higher. The tax applies only to C corporations, not to S corporations.

Until 1998, C corporations could be subjected to the AMT regardless of size. Beginning in 1998, however, "small" corporations are exempt from the tax. A "small" corporation is a C corporation with no more than $7.5 million in average annual gross receipts for the 3 previous tax years. For corporations in existence less than 3 years, the initial qualification for exemption involves average annual gross receipts of no more than $5 million. Generally, a corporation will be exempt from the AMT in its first years of existence.

Determining the alternative minimum tax is a complex procedure. Alternative minimum taxable income (AMTI) is the corporation's regular taxable income, increased by adjustments for tax preferences. These preferences included certain excess depreciation, tax exempt interest, life insurance cash value increases that exceed annual premiums, and death benefits received in excess of the policyowner's basis. Seven-five percent (75%) of AMTI is subject to a flat 20 percent tax. Since 20 percent of 75 percent is 15 percent, you can think of the tax as 15 percent of AMTI. To the extent that the alternative minimum tax paid exceeds the regular income tax for the year, the corporation may use this excess to offset regular tax liability in future years.

The corporate alternative minimum tax can have an adverse effect on key person life insurance. Urge your corporate clients who may be subject to this tax to increase the amount of life insurance they plan to buy on key employees. If the tax comes into play at the key employee's death, there will be enough after-tax proceeds to meet the firm's needs. For example, if the amount of needed key person life insurance is $1 million, add $150,000 to it for a face amount totaling $1,150,000. Then, following the key person's death, if there is a tax at all, it will be a maximum of 15 percent, and so the net proceeds would be $1 million.

**Project: Feedback**

Are you looking for a way to speed up the process of learning about business and business insurance? If so, try this project.

From businesses you currently do business with, choose three individuals with whom you have a good relationship. Go to those three people and explain that you are interested in business insurance and that you would like to discuss ideas you will be studying.

## KEYS TO SUCCESS

To be successful in the business market, you need to follow a process, understand the prospect, and see yourself as a businessperson.

### Follow a Process

The business owner is a challenging prospect. For many, their businesses not only provide income, but are the consuming passion of their lives. It is not uncommon for the owners of small businesses to invest most of their time, energy and money in the development of the business. Faced with constant challenges in the daily activities of their businesses, it is often difficult to get them to take time to discuss how you can help them. This book will offer many ideas on how you can overcome this problem.

To be successful in this market, you must be able to help the business owner establish realistic financial goals, gather relevant information about the owner's current situation, analyze the situation, devise a plan that bridges the gap between the present reality and desired future, implement the plan, and then monitor it. In some ways, marketing to business owners is very much like marketing in the personal market. After you have identified the prospect, you must

1. establish financial goals
2. gather relevant data
3. analyze the data
4. develop a plan for achieving goals
5. implement the plan
6. monitor the plan

Despite the similarities, there are differences. However, business situations are often more complicated than personal ones, balancing the needs of the owner, the business, and its employees with tax and profit considerations. To be successful, you must not only understand your products and how they can be applied to meet your prospect's needs, but you must also understand the prospect's business and the business environment in which those needs exist.

## Understand the Prospect

To be successful in this market, you must understand what is important to business owners. You need to use all your relationship skills to get the owners to take a realistic look at what they are creating and what will happen to their businesses in the future. As with other prospects, you must learn to listen carefully to what owners are saying to you. You must ask probing questions to determine their goals, not just for themselves, but also for their businesses.

| Exit Strategy |
|---|
| "Business owner, what is your exit strategy from your business? How are you going to get out? Do you have any plans for leaving your business for retirement, or for what may happen if you die or become totally disabled? This is the kind of work I do. Let me help you with this." |

To be successful, you must also be able to speak the language of business owners. You must be knowledgeable enough about the specifics of their businesses to make them feel confident in talking to you. You must also be knowledgeable about business structures and taxation to help them identify problems they might not otherwise notice.

Your understanding of business structures and what will happen in the event of an owner's death, disability, or retirement will allow you to help owners plan for these events. In this regard, the continuity or termination of businesses are of the greatest importance.

As an insurance expert and financial advisor, helping your business prospects plan for the distribution of their business assets can be the most valuable service you provide. For many owners, the business represents not only the way they generate income for themselves and their families, but also their major investment for the future and, often, a way of life.

For business prospects, the issues of life, death, disability, and retirement become even more critical. The element that makes their businesses valuable—their personal involvement-depends on their continued ability to work.

These are only some of the reasons why business owners need the advice of trained financial advisors. Insurance and other financial products can provide the solution to many of the problems created by the death or disability of a business owner. They can also provide at least part of the solution to the transfer of business assets when a business owner decides to retire. Equally important, your role as a financial advisor, working in conjunction with the business owner's other professional advisors, can encourage the owner to address these critical issues before it is too late.

## See Yourself as a Businessperson

Reflect on your experience as a financial advisor. Where have you had your greatest success? If you are like most financial advisors, your greatest success comes from your natural market—people who think like you, act like you, and share common values with you—in other words, people like you. If you want to relate to business owners, you will need to see yourself as a businessperson–an entrepreneur. It is your identity as a businessperson that will help you relate to business owners because you have so much in common with them.

## Strategic Planning

It does not matter what you call yourself because, in the final analysis, you are a businessperson. Do you think of yourself as a businessperson? What is your business? What do you want your business to be? Who are your customers? Who would you like to have as customers? What are your goals for your business? To maximize your successes, you need to answer questions like these.

When you think of successful people, you can almost always identify some common characteristics. Generally, successful people have a clear sense of direction, and they develop and effectively implement their plans. This rarely happens by accident.

In your role as a financial advisor, you ask your prospects to establish financial goals and participate in the fact-finding process. The purpose of fact finding is to determine where your prospects are, so you can analyze their situation and develop a plan that will help them achieve their goals. This may involve recommending products and services to your prospects in order to implement the plan.

Engaging in this process for your business activities is called strategic planning. Strategic planning involves developing a comprehensive plan and strategies for the future of a business. It is establishing long-term direction, setting specific performance objectives and standards, developing strategies and action plans to achieve objectives, executing action plans, and evaluating results.

The process of strategic planning is a fundamental and important aspect of managing a business. The product of the strategic planning process is a detailed plan for business direction and course of action. The advantages of strategic planning are that it

- focuses your thinking
- provides you with a clear sense of direction
- guides you in setting specific, quantifiable goals

- helps you recognize and respond to opportunities and threats that affect your goal achievement
- aids you in coordinating and prioritizing your activities
- helps you establish realistic strategies
- positions you to be proactive rather than reactive

## Your Business Plan

Anyone thinking of starting a business would not attempt it without a sound business plan If one needed to obtain financing, it would be almost unthinkable to approach a bank or potential financial backer without a plan that would lead to success, and subsequently repay the debt. As a businessperson, you should have a working business plan and follow it.

It is important to plan, and most people do plan, at least informally. You may do year-end planning as part of making goals for the New Year. Or you may plan because you want to reach a specific income goal or because the primary company you write for requires you to have a production plan for the coming year. Perhaps you plan because you want to buy a house or a car, fund college educations for your children, or save for retirement.

But have you ever written a plan that spans more than one year-a plan aimed at defining and achieving your long-range goals for the future? Have you taken the time to complete a fact finder on yourself? Do you know where you want to be both personally and professionally in 5 or 10 years? Establishing and achieving your personal and professional goals requires you to decide where you want to be, look at where you are now, and develop a plan that will move you toward your goals.

In its simplest form, a business plan is a written document that lists your business goals and describes how you will achieve them. But it should be much more than that. It should be the end result of strategic planning. It should be a dynamic, flexible document that guides you toward achieving your business goals. It is your blueprint for success.

It is not the intent of this book to review the concept of a business plan. It is simply to make the point that you are a businessperson and have much in common with other business owners that you approach. You need to think of yourself as a business owner and you need to act like one. That means developing and following a business plan, as well as investing a great deal of time, energy, and money into making your business successful, just like your prospects do.