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Section: PRIVATE COMPANIES

That little company you are starting may grow into a big one -- at which point the legal choices you make now will have a powerful and unavoidable impact on your taxes.

S, C OR ME?

TIMOTHY FINLAY studied hotel management at Cornell to good effect: At 34, he runs Scottsdale, Ariz.-based Mischel's, a $6.5 million (revenues) private firm that owns and operates 11 hotels in the Southwest and whose revenues have grown more than tenfold since 1986.

Yet Cornell didn't prepare him for his latest assignment, soon to eat up half his time. Finlay must figure out whether Mischel's should switch from being 11 Subchapter S corporations into being one limited liability company. An S corporation is one that is taxed like a partnership; the LLC is a modern variation on the old S theme, but with many other advantages.

``The Sub S's are getting unwieldy for us, what with 11 separate bank accounts and tax returns, and more in the offing,'' Finlay says. ``Converting to an LLC may make sense if it doesn't cost too much in taxes.''

But it may well cost a bundle in taxes, or at least in legal fees. The question of whether a private business should be a partnership or corporation, and what kind of partnership or corporation it is, is an arcane legal concept that lawyers call ``choice of entity.'' The very phrase puts entrepreneurs to sleep. But if you are planning to start a business or expand one, sit up and take notice. The choices you make can have a big impact on taxes the business and its owners will pay later. Undoing those decisions can be costly or next to impossible.

At least Finlay has a viable choice. Stephen Weiss, who owns CoinPhone Plus, a New Jersey business that operates public pay phones, wishes he did. ``I wanted to get out of Subchapter S status into an LLC, but my accountants told me it would trigger too many taxes.''

Penalties for other kinds of mistakes can be severe, too. Grant Thornton CPA Thomas Ochsenschlager remembers one Subchapter S firm that mistakenly took on a foreign shareholder, something its status prohibited. Getting the mistake forgiven by the Internal Revenue Service cost about $10,000 in letter ruling and other fees. ``There was also lots of lost sleep for the owners,'' he says. ``If the IRS hadn't been forgiving -- and it wouldn't have been if the mistake was there at incorporation -- it would have been a disaster.''

David Marcus, a CPA at New York's Paneth, Haber & Zimmerman, cites a film company that had to pay thousands of dollars in New York City income taxes on work performed in Michigan. Why? Because it was a partnership, and New York taxes partnerships based on where contracts are negotiated, in this case New York. If it had been a corporation, it could have avoided the New York hit because those rules depend on where the work is done.

For publicly traded corporations there is (with some very narrow exceptions) only one choice, a so-called C corporation. The distinguishing feature of C corporations is that profits are taxed twice, once at the corporate level and again when dividends or liquidation payments are distributed to shareholders.

Private firms have far more choices and some tempting ways to avoid that double taxation. But the path is full of booby traps.

Simplest of all is the sole proprietorship, the favored form of about 15 million businesses, most of them small. Starting one is as simple as hanging out a shingle. There are no lawyers to pay and no separate tax returns to file; the owner merely uses Schedule C of his or her personal tax return. Ownership is limited to one person -- or one person and a spouse. The chief disadvantages are two: A proprietorship affords no protection from lawsuits and other liabilities, so you might wind up losing your house; and at 43%*, the current top tax rate for individuals is higher than the top corporate rate of 35%.

[* Almost anyone in the nominal 39.6% bracket also suffers a deduction penalty that raises the effective rate to 40.8%. Sole proprietors and some partners also face a partly deductible 2.9% Medicare tax.]

Next up the chain is the partnership, used by 1.5 million businesses. Partnerships must have two or more partners and are easy to use. They also get to skip a layer of tax, because all income is taxed only once -- on the partner's individual tax return.

On the other hand, protection from liability is hard to get with a partnership; even in a limited partnership, where some partners get protection, there must always be a general partner who is liable.

To further complicate choice, usually a partnership interest is not easily transferable. Partnership law is complex. ``When the IRS shows up, there are very few times it can't find something wrong with a partnership,'' says CPA Douglas Stives of Curchin & Co. in Red Bank, N.J.

Straddling the border between partnership and corporation is the S corporation. Like a corporation, it offers liability protection, and like a partnership, it pays no tax of its own.

But the S corporation has cumbersome restrictions. It cannot have more than 35 shareholders (70 if spouses are included), or any foreign or corporate shareholders, or more than one class of stock.

The Limited Liability Company (LLC), or Limited Liability Partnership (LLP) is relatively new. It has become popular, and for good reason: It is a hybrid that often combines the best features of both a corporation and partnership. Says Sydney, Neb. CPA David Roehr, who used to be a tax partner at Grant Thornton, ``If you lay an LLC next to a partnership or an S corporation, it will win 95% of the time.''

That's because the Internal Revenue Service sees LLCs as partnerships, and imposes only a single tax on them, at the investor's level. The 47 states with LLC laws, however, see them as a special form of corporation and usually give them the same safeguards against lawsuits and other liabilities that corporations have. They also lack many of the restrictions imposed on Sub S corporations.

Disadvantages? The LLC laws vary slightly from state to state, so if there are extensive multistate operations, using LLCs may be a pain. Also, because the entity is so new, the law is still unsettled. ``There's always a risk, however small,'' says Arlington, Va. lawyer Mark Starcher, ``that some judge will get creative.''

Finally there is the regular corporation, known as a C Corporation (after another subchapter in Chapter 1 of the tax code). This venerable form is well established. ``Practically every attorney in the world will tell you that your business should be incorporated,'' says CPA Stives. The advantages are clear: slightly lower tax rates (at least currently), protection from liability, full deduction for medical insurance, choice of any fiscal year and freedom in forming subsidiaries, among other advantages.

But the experts warn to be wary of C corporation status. ``It should be the last thing on your list,'' says Arthur Andersen CPA John Evans. Getting out of corporate form, once you are in it, triggers taxes. Unlike partnerships and LLCs, C corporations are taxed twice, even when the business is sold. Says Evans: ``A small firm doing business as a corporation will sell out to one of our clients, and when the owner hears about the double tax, he is shocked.''

In short, when you start a business there are no easy choices as to choice of format. Tread warily.

ILLUSTRATION

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By Laura Saunders
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NINE QUESTIONS

THINKING of starting a business? Coopers & Lybrand has just published a free 60-page booklet on your choice of legal format. (Write ``Business Entity,'' Coopers & Lybrand, 1800 M St. NW, Washington, D.C. 20036.) Here, according to Coopers CPA Samuel Starr, are key issues:

What's your tax rate? C corporations pay a federal tax of 15% to 35% of profits. Owners pay additional taxes when they receive those profits. Partnerships, Sub Ss and LLCs pay no tax of their own, but owners pay tax on all profits, whether distributed or not, at their individual rates, which range up to 43%.

Could you face a wipeout lawsuit? Usually a partnership offers less protection than a C or S corporation or an LLC.

How will tax items be allocated? Partnerships and LLCs can allocate profits and losses somewhat arbitrarily, while S and C corporations must allocate according to ownership.

Will there be losses? It's easier for a partner or LLC holder than for an S corporation shareholder to claim the loss.

Does the business need a fiscal year different from a calendar year? Most C corporations can have any fiscal year. It's tricky for others to get one.

Who's going to be an owner? Foreigners, corporations and most trusts can't own shares in an S corporation.

How will the business be financed? S corporations can't have more than one class of stock, while LLCs and C corporations can.

Are you going to sell out? If the entity's status must carry over, a C corporation may work best. But if it will be liquidated, other formats are usually the only way to avoid double taxes. Exception: If the owners give their stock to a charity or die owning it.

How will owner-employees be compensated? If they need a lot to live on, better not to have a C corporation, since the IRS could assess a penalty for ``excessive compensation.''