The Accidental Entrepreneur - Part II

The Optimal Corporate Set Up

In April 2016, I wrote Part One of this series. You can read this article on JD Supra. Part One focused on the hobby loss tax rules. Four years later I am writing part two. Did I forget that I had written part one? Perhaps! Nevertheless, the circumstances have not changed at all as we progress through unknown territory, post-pandemic. Millions of Americans find themselves wondering what's next professionally and economically. Is there a new job or profession on the horizon?

I lamented in Part I that both of my parents (of blessed memory) were comfortably retired by my age after a thirty-year career with the federal government. Fortunately, I enjoy my work and will work for as long as I can, otherwise my retirement date would be the earlier of my passing or age 95! The financial calamity created by the convergence of a new Cold War with China, and the economic effect of Covid 19 have left historic levels of American workers unemployed.

In the American workplace, there is a pretty decent chance that if downsizing happens after age 50, you may never get another job in Corporate America of a comparable scale. This dilemma has even carried over to federal, state, and municipal workers who have heretofore enjoyed great employment stability and often richer retirement and employee benefit programs than private industry.

Oddly enough, while Americans sat at home during the pandemic, millions of Americans decided to become day traders chasing the record setting level of market performance. Guess what, you are a new business owner. Congratulations! Many Americans find themselves relying on various "gigs" to keep the ship afloat. IT is the new Normal! Americans whether they like it or not have become the accidental entrepreneur.

My observation is that everyone that works in Corporate American or who is self-employed should live as if they are two weeks away from receiving their Pink Slip. Severance packages are not a constitutional right! As a result, salaried employees will find themselves (whether they like it or not) as accidental entrepreneurs. The time unemployed can seem to be infinite. You can either spend your time looking for a job, or plan for the unemployment contingency by creating your own business while you still have your job.

The bestselling business writer Michael Masterson suggests to his readers that a person should have multiple sources of income. This philosophy should also apply to those that are self-employed. Your primary business today may be great today and obsolete tomorrow.

This article is the second in a series of articles discussing the virtues and financial power of creating your own business as a vehicle for ensuring your current and future financial stability. My thesis is that everyone among the salaried and self-employed will eventually find themselves as “The Accidental Entrepreneur”. This article focuses on the optimal structure for a business owner to own and operate his various business and investment interests.

The Optimal Corporate Set Up

Even though sixty percent of small businesses are structured as S Corporations, I have long thought that this was a planning mistake. Following tax reform, the regular corporation (C Corporation) and its top marginal tax bracket of 21 percent have staged a great comeback. The ideal corporate structure contemplates a combination of various entities. The organizational structure outlined in this article is the optimal way to organize and manage a variety of entrepreneurial and investment interests.

The basic structure is a limited partnership with a corporate general partner. The business owner forms a new limited partnership (LP) and a new C corporation. The business owner owns 100 percent of the shares of the new C corporation. The C corporation serves as the sole general partner own a 1-2 percent interest in the new limited partnership from Day 1. The business owner personally owns initially a 98-99 percent in the new limited partnership. These shares can subsequently be gifted to children or trusts for various family members. The business owner creates a new limited liability (LLC) company for each separate business or real estate activity. Existing LLCs are assigned to the limited partnership.

One of the benefits of the suggested limited partnership format is the opportunity to eliminate the need to contribute to FICA and Medicare due to a special provision in IRC Sec 1402(a) which exempts limited partners from FICA and Medicare taxes. Over the course of a business career, the level of FICA/Medicare savings invested at over twenty-five years at 7 percent amounts to a significant amount approximately $1.4 million over that time.

The asset protection benefits of the structure are also powerful. Each separate business or real estate activity should be owned within separate LLCs. Following the assignment of these LLC interests, these single members LLCs are wholly owned by the limited partnership. Single members LLCs are not required to a separate tax return as a disregarded entity. The only reportable item is the net income or loss. Hence, the business owner’s tax compliance costs are reduced.

The C corporation functions as a management company. One planning measure for consideration is the transfer of the personal vehicle that you own or lease to the corporation. Following the transfer of the vehicle, the vehicle becomes a company owned car making all the vehicle's expenses associated with the vehicle tax deductible.

Another important planning benefit is the possibility of creating staggered year ends for tax purposes. Using our planning structure, the corporate general partner elects a corporate year end that is not a calendar year end (12/31). A staggered year end is created by having the corporate general partner elect a fiscal year end of November 30th.

This tax election provides an opportunity to defer income by having the limited partnership pay income it receives in December to the corporate general partner. This structure will provide the ability to defer the payment of taxes until the tax due date of the corporation which is three months after its year end. A corporation also has a filing extension for an additional six months. The stagger in this scenario increases the filing period until September 15 of the following tax year. This deferral is approximately 19 months.

Good asset protection planning for the business suggests transferring employees from the various businesses into the management company. This planning separates any of the employment related liabilities from the assets of the company. The planning structure also creates the opportunity for income shifting to children or elderly relatives.

Regular (C) corporations provide a more favorable structure for employee benefit purposes. For example, the management company which serves as the general partner of the limited partnership may create a Section 105 provides a tax deductible vehicle for the business owner to pay or reimburse medical expenses for the business owner on a tax deductible basis without incurring tax deductible treatment. I plan to write separately on this topic soon.

Strategy Example Facts

Willy Wonka, age 50, is a human resources consultant for large companies. He sees the writing on the proverbial wall that his corporation may cut the company's middle management workforce over the next several years. Wonka has excellent consulting skills and realizes that many of the small businesses in his community can benefit from the same knowledge. During the Corona Virus pandemic Will started trading stocks after opening an account at Robin Hood. He also owns several rental properties.

Strategy Example

Willy has his attorney create a new corporate structure. He creates Wonka, Inc. to serve as the corporate general partner of a new limited partnership, Wonka Family, LP. Wonka, Inc. is wholly owned by Willy. Wonka Inc. owns a one percent interest in Wonka LP. Willy also owns a 99 percent interest in Wonka LP. Wonka Inc. has a corporate year end of November 30th. Wonka LP has a year end of December 31st. Willy assigns ownership of three separate LLCs owning real estate to the limited partnership. He also creates a separate LLC for his trading activities. He creates a new consulting company in a single member LLC that will also be owned by the limited partnership.

Summary

I have outlined a strategy that has significant planning utility. Every small business owner should reconsider their personal and corporate planning structure. Seriously, reconsider electing out of your existing S corporation election. The proposed structure provides a combination of tax, organizational and asset protection benefits that existing structures don't currently provide. Success does not have to be accidental!