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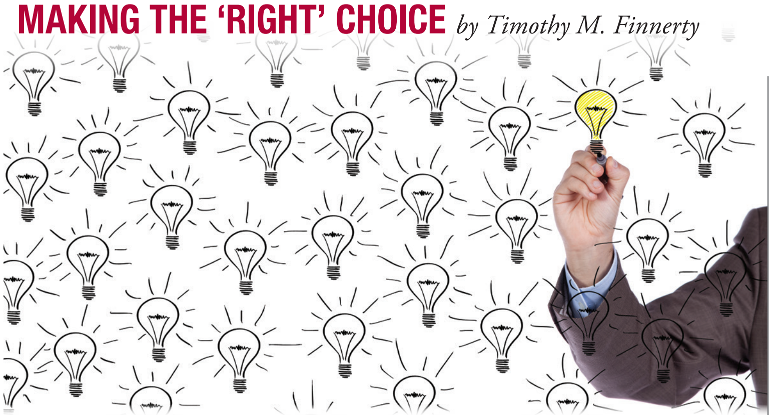
IT'S YOUR BUSINESS

MAKING THE 'RIGHT' CHOICE *by Timothy M. Finnerty*



You have the idea, you have the funds, and you are ready to start your very own business! Now what?!

Whether this is the first and only time you will do this or whether you are an established entrepreneur, one of the first decisions that you must make when starting a new business is the type of entity that you will use to operate the business. With so many different entity types to choose from, it can be quite confusing.

When making this important decision, a key element that you must consider is income taxes. To help with your analysis, you can separate these different entity types into two categories. One category, the "tax-paying" entity type, pays income tax on its taxable income; whereas, the second category type, the "pass-through" entity, pays no income tax itself, but rather passes its income through to its owner(s), and the owner(s) pay tax on that income. The most common tax-paying entity is the C corporation. There are a variety of pass-through entities, but the most common are the limited liability company and the S corporation.

So, which is better? Or, said another way, which entity type will cost you more of your hard-earned cash? Well, the answer to that question depends upon many different variables. For the past ten years or so, most people simply concluded that the pass-through type entity was the better entity choice since there is only one level of tax with the pass-through entity and two layers (corporate and individual tax) with a C corporation that is making distributions. Until December 31, 2012, the highest federal income tax rate for individuals was 35% and the Pennsylvania state income tax rate was 3.07%; whereas for taxpaying entities – like C corporations – the top federal income tax rate was 35% and the Pennsylvania state income tax rate was 9.99%. Some have begun to question whether that conclusion is still the case, however, due to recent tax rate changes. The right answer might require you to review and analyze a number of issues – some of which are discussed below.

Federal and State Income Tax Rates/Owner's Income

In order to determine the amount of tax you will pay with a pass-through entity, for starters, you must know the tax rate or rates for the owner(s) of the new entity, which will depend on the amount of income that will pass through to the individual owners, since federal tax rates are graduated (i.e., they increase as taxable income rises). You also need to know a fair amount about the entity owner's tax situation. All of these variables will be needed to determine how much tax the owners will pay on the income that flows through from the new entity. In addition, you will need to know the state jurisdictions where the owners will be filing income tax returns and the applicable income tax rates in each jurisdiction.

To determine the amount of tax you will pay with a tax-paying entity, you will need to know the applicable federal and state income tax rates for the entity. You will also need to know the amount of income that the entity will earn, since at the federal level, the entity will pay tax at graduated tax rates.

Will the Entity Distribute Earnings?

When calculating the amount of tax burden you will have with a taxpaying entity, you will have to determine whether the entity plans to make distributions of its earnings (often referred to as a dividend) to its owners and the likely amount of those distributions, since those distributions will also be taxed to the owners. You will also need to know the tax rate that the owner will pay upon receipt of a dividend from the entity's earnings, which may necessitate that you understand the owner's tax situation.

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TOP TEN MISTAKES BUSINESSES MAKE REGARDING INSURANCE *by Michael R. Kelley*

10. No Flood Insurance

The standard commercial property policy does not cover flood damage. To be covered for flood damage, a business owner has to purchase a separate flood insurance policy. Flood insurance is not limited to only those businesses located in flood zones. Since flooding can occur when a detention pond overflows, or from run-off on a neighboring property, many business owners suffer flooding following heavy rains even if they are not in a flood zone. If your business is at risk for flood damage, whether it is in a flood zone or not, you should have flood insurance.

9. Buying Only Standard Form Policies

Many insurance policies are sold using a standard form. That means that the standard general liability policy purchased by a small retail business owner is often the same as that purchased by a large manufacturer or a professional business. But, the liabilities faced by such policyholders are often very different. So, even if you start with a standard form policy, make sure that you modify the policy by adding endorsements tailored to your business.

8. Buying Unnecessary Coverages

Most of the commercial liability policies that we review contain coverage for "products completed operations" and many commercial auto policies contain coverage for uninsured and underinsured motorists (UM/UIM). These are both valuable coverages, but only for the right policyholders. If you are a professional business, you are not making any product and therefore liability coverage for making or selling a product is of no value to you. Such coverage may be grouped with other coverage so that there is no additional premium. However, if you are strictly a service industry business and are paying an additional premium for this coverage, you should terminate that coverage immediately and save yourself the additional premiums. UM/UIM coverage is essential for your personal vehicles. However, why should a business pay for insurance coverage that will pay employees additional money if they are injured on the job by an uninsured or underinsured third party in a car accident? In all likelihood, you already pay Workers' Compensation insurance premiums to cover this same risk.

7. Assuming That a Broker Will Make Sure That the Business Is Properly Insured

Except in special circumstances, the law says that it is the business owner's responsibility to make sure the business has the types of coverages that it needs, not the insurance broker. While good brokers will, of course, endeavor to make sure that you are properly covered, it is the business owner's responsibility to educate the broker about the business and to alert the broker to changes that occur from time to time.

6. Underinsuring Commercial Buildings

Many business owners insure commercial buildings for fair market value, not replacement cost value. Especially if your building is older, the cost to replace the building could be several times higher than the fair market value. Most commercial property policies include a co-insurance penalty, which means that the business property owner would be penalized with less coverage in the event of a property loss. In one instance that we handled, the insurance carrier claimed that a $1 million property loss policy would pay less than $400,000 due to the co-insurance penalty. Make sure that your property is insured for replacement cost value, or that you have an agreed-value endorsement on your property policy.

5. Failing to Insist on Using Its Own Counsel

Most standard policies give the insurance company the right to select defense counsel in the event that your business is sued. But, if you want to have greater control over the selection of counsel defending your business, many insurance companies are willing to negotiate an endorsement that

YOU'VE GOT THE JOB, DETAILS WILL FOLLOW - EMPLOYMENT OFFER LETTERS AND NON-COMPETE AGREEM

Most employers understand that, in Pennsylvania, a non-compete agreement (NCA) must be supported by legal "consideration" in order to be enforceable. If a newly hired employee signs an NCA at the time of hire as a condition of employment, the new job is the consideration for the new hire's agreement not to compete in the future. On the other hand, once an employee is already employed, his employer cannot foist an NCA on him and expect it to be enforceable unless new consideration is given (e.g. a special bonus, job protection, promotion, severance benefits, etc.). These basic principles are well established under Pennsylvania law. However, what happens if an employer presents an NCA to a new hire after he accepts a written job offer but before he actually starts work? This scenario was recently addressed by the Supreme Court of Pennsylvania in *Pulse Technologies, Inc. v. Notaro*.

In the *Pulse Technologies* case, the company provided Mr. Notaro with a 2 ½-page offer letter that included a description of the job, salary, benefits, and start date. The letter also stated: "You will also be asked to sign our employment/confidentiality agreement. We will not be able to employ you if you fail to do so." The letter further explained that the employment agreement would contain "definitive terms and conditions" of employment. Mr. Notaro signed and returned his offer letter as instructed. On his first day of employment, he was provided with an "employment/confidentiality agreement" that contained a non-compete provision. Notaro read and signed the agreement without objection, understanding that it contained restrictions on his ability to compete in the future. Significantly, he signed the agreement before he began performing his new job.

Over four years later, Mr. Notaro left Pulse Technologies to take a managerial position with one of the company's competitors. Pulse Technologies successfully enforced its NCA against Notaro in trial court; however, on appeal, the Superior Court of Pennsylvania found the NCA to be gives the business owner the right to select counsel. In most cases, the insurance company selects counsel that it has a relationship with, and has used in many other cases. That counsel may have no familiarity at all with your business. Assuming that they are qualified as litigators in the legal subject being contested, your business may be better served by counsel that is already knowledgeable about your business, and with whom you have an ongoing relationship. Do not just assume that the insurance company controls the selection of counsel. You have a say in which lawyers represent the interests of your business.

4. Overpaying by Having No or Too Small a Deductible

Generally speaking, the higher the deductible or self-insured retention, the lower the overall premiums for an insurance policy. Most businesses can save 10% or more on overall premiums by simply increasing the amount of the deductible or self-insured retention. This means that the business will be on the hook itself for smaller claims and the initial amounts of larger claims (up to the deductible). But, it will still be protected for larger and catastrophic losses. Businesses should use insurance primarily to protect against large and catastrophic losses, not minor claims which the business can readily absorb on its own. At the right deductible amount, your business should save enough on premiums to pay any minor claims that may arise.

3. Failing to Buy Employment Practices Liability Insurance

Employment practices liability insurance (EPLI) protects a business from employment related claims, such as discrimination and wrongful termination, among many others. Employment claims are among the fastest-growing types of lawsuits in the country. Approximately 60% of businesses have EPLI coverage. By comparison, almost all businesses have general commercial liability coverage. If you have employees, you should consider EPLI coverage.

2. Business Income Insurance Is Lacking

In our experience, many businesses either have no business income loss coverage, or an insufficient amount to cover its business. If you suffer a substantial property loss, or even a substantial computer virus, and the business is unable to operate for days, weeks or months at its normal level, you may sustain significant business income losses. There is insurance coverage for such losses, which will pay you for lost business income, as well as the added expense of, for instance, finding another place out of which to run your business. How much business income loss coverage you need depends upon several factors, including the nature of your business, the amount of revenues generated on a daily, weekly, or monthly basis, and the length of time that it would likely take your business to get back up and running after a significant property loss.

1. Failing to Regularly Review Insurance Coverages

For most businesses, insurance premiums represent their third or fourth highest business expense. Most businesses, however, have far greater knowledge about their facilities, inventory, and employees than they do their insurance coverages. A regular review (every one to two years) is essential. Most insurance brokers are happy to perform an insurance review. Our Insurance Recovery practice regularly reviews our clients' insurance policies and provides an independent, unbiased view of the scope, amounts, and adequacy of our clients' insurance coverage. An insurance review is especially valuable for companies that have experienced rapid growth, as their liabilities may be far different now that the company has expanded its operations. ■

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unenforceable. Specifically, the Superior Court found that Pulse Technologies' offer letter did not mention an NCA and the company could not impose one on him after he had started employment.

On appeal to the Supreme Court of Pennsylvania, Pulse Technologies succeeded in having the Superior Court's decision vacated. The Supreme Court disagreed with the lower court's ruling on several counts. First, Mr. Notaro's offer letter explained that he would be required to sign an employment agreement that contained the "definitive terms and conditions" of employment – and nowhere did the letter preclude the possibility of an NCA. Secondly, the offer letter was merely a part of the hiring process and was not itself an employment contract. Third, and most importantly, the Supreme Court found that it was the signing of the employment agreement, and not the offer letter, that signified Mr. Notaro's acceptance of employment. For this reason, Notaro was provided with consideration (i.e., his new job) when he agreed to the NCA provision as necessary for the NCA to be enforceable.

In a nutshell, the *Pulse Technologies* decision means that an NCA signed before an employee begins his job may be enforceable even if it was not mentioned in the employee's written job offer. However, as a matter of best practice, employers should in most cases avoid surprising new hires by presenting them with NCAs on their start date. Notwithstanding the *Pulse Technologies* decision, advance notice to new hires of an NCA requirement is advisable – and the best way to provide this notice is often in an offer letter. ■

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Are the Owners Subject to the Net Investment Income Tax?

Beginning on January 1, 2013, the highest tax rate for individual taxpayers was increased to 39.6%. This increase is only applicable to individual taxpayers with incomes of more than $400,000 or joint returns of more than $450,000. Furthermore, some individual taxpayers are now subject to the additional Medicare tax imposed by the Affordable Care Act. The Affordable Care Act imposes an additional Medicare tax of 0.9% on wages and self-employment income in excess of $250,000 (for joint filers) and $200,000 (for single filers). Also new this year is the 3.8% tax on net investment income (interest, dividends and capital gains) for taxpayers with income in excess of $250,000 (for joint filers) and $200,000 (for single filers). The highest federal and Pennsylvania state corporate rates, however, remain at 35% and 9.99% respectively. As such, where individual owners expect high taxable income, the bottom-line numbers between a tax-paying entity and the pass-through entity may now be much closer than they had been previously. Results may vary by year depending upon whether dividends will be paid in a given year.

Long-Term Implications

Although the tax rates are an important element to the analysis, it is not as easy as simply comparing the individual and corporate tax rates; other long-term tax implications should be considered when making the entity selection choice. For example, one should consider the taxation that will occur upon a sale or other disposition of the business. When a C corporation sells its assets to a buyer, there will typically be a gain that is taxed at the entity level. At the present tax rates, one would expect to pay no more than 35% in federal tax and 9.99% in Pennsylvania state tax from this gain at the corporate level. However, it is likely that the owners of the corporation will want to have the after-tax proceeds distributed to them. As that distribution would also be taxed at the owner level (with an individual owner), that additional tax must also be considered in the equation as well as the long-term implication of one entity form over another.

When business owners crunch the numbers and look at the long-term implications of the ownership and operation of their business, many may still conclude that the pass-through entity type will be cheaper over the long haul. If corporate level taxes are reduced in the future, as has been advocated by some over the past few years, the math may work out differently. However, although taxes are important, it is not the only issue that should be reviewed when making your decision as to which entity you should use to operate your business. There are many other key areas that should be reviewed prior to making your decision. The attorneys at McNees Wallace & Nurick LLC will be happy to consult with you to be sure you select the right entity type for your business. ■

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