thought to what happens to the business when the owner gets married and has a family. Smaller owner-operator businesses are usually structured as sole proprietorships with...

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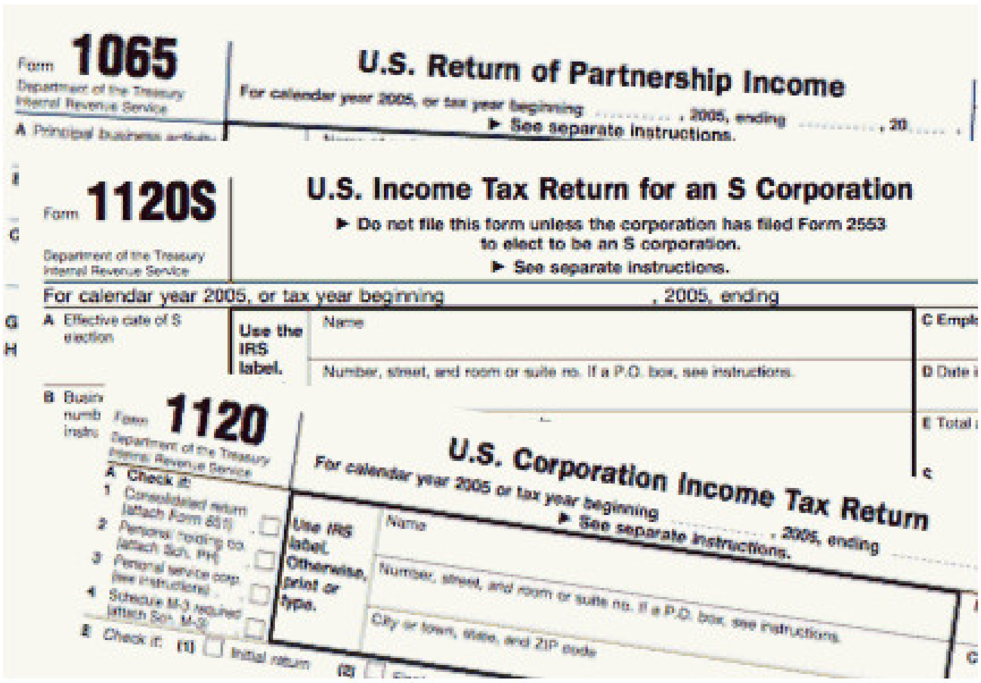

What happens to the family business when your client wants to retire? Or if the cofounders get divorced? Eventually, most family-owned businesses struggle with conflicting business strategies, ownership conditions and combative personalities. As a child raised in a family business, when it came time to create my own businesses, I knew how important it was to carefully plan for all possible risks and to choose the right structure to protect the business and my family. Here are the options your clients have regarding business structure:

Sole Proprietorship

So, what happens when the owner decides to marry and then have children? Of course, it depends on whether or not the couple decides to have the spouse and children become part of the business in some way. Here are a few scenarios for a sole proprietor family business:

1. **The business can stay a sole proprietorship and the spouse and children of the owner can be hired as employees.** As far as taxes go, if one spouse is employed by another, the wages of the spouse are subject to income tax withholding and Social Security and Medicare taxes, but not to the Federal Unemployment Tax Act (FUTA). Wages for children under age 18 are not subject to Social Security and Medicare taxes and not subject to FUTA if the child is under age 21. Wages are subject to income tax withholding, regardless of the child's age.

2. **The business is now run by both spouses, who also share in the profits and losses.** In this scenario, the business is now considered a partnership even if there is no formal partnership agreement. Business income and loss are no longer reported on a Schedule C (From 1040) and the couple are now required to use Form 1065. There is, however, an option for a married couple owning and operating a business together to elect treatment as a "qualified joint venture" instead of a partnership, if they would like to continue to file as sole proprietors for federal tax purposes. In this case, each spouse must file a separate Schedule C to report their share of profits and losses.

Because there is no legal separation between the owner and the business in a sole proprietorship, in the case of the owner's death, the business will terminate, and its assets will become part of the owner's estate. Even if the owner is married (with or without children) the business does not necessarily get passed down to the remaining family members. A sole proprietor must include a provision in his or her will directing the business be sold or appointing a successor or successors.

In the case of divorce between the sole proprietor and the spouse, unless the spouse is

accommodation is made) and each partner is equally taxed.

Equal partnerships can be smooth sailing for a family business as long as there is a partnership agreement in place. Without predetermined resolution methods, any disruption can cause havoc in the family business. For example:

- The company gets an offer for a buy-out and not all partners agree on a course of action.
- One of the partners makes a catastrophic mistake which hurts the business.
- Conflicts erupt about work responsibilities and who works harder than the other
- Disagreements about growing the business.
- Different desires for the children of partners or the choices for the next generation of leaders.

To reiterate, a partnership is like a sole proprietorship and has no legal separation from the owners, which is why it is vital for there to be a legal document such as a buy-sell agreement in place on how to handle plans for the business in the event of a partner's death, retirement, divorce or departure.

C Corporations

C corporations, unlike sole proprietorships and partnerships, are legal entities separate from the owners. Owners (and shareholder), therefore, have a substantial amount of protection of personal liability and those operating the corporation are employees. Family members in the business are also employees and may also be shareholders. The C Corp structure is popular if the business wants to sell stock to raise money for business growth.

As a separate entity from the owner or owners, a corporation files its own tax return (IRS Form 1120). The advantages include being able to claim deductions for business expenses and a flat corporate rate of 21 percent put into effect with the 2017 Tax Cuts and Jobs Act. The disadvantage is the "double taxation" factor where the company is

and whether or not the company must stay in the family or can be sold to an outside party. Because the corporation can potentially sell shares, there must also be rules on what happens to the shares in case of death, divorce, or company buy-out. Some family businesses may decide to have some family members run the business and others serve on the board. If the family corporation goes public, the board of directors governs decision-making. By creating bylaws mandating only family members can be on the board, a family can retain better control. Families can also decide to limit the number of shares going to non-family members.

S Corporation

The S Corp is a special election which allows owners/members to pass business income, losses, deductions, and credits through to their member shareholders for federal tax purposes. Shareholders of S Corps are then required to report the income and losses on their personal tax returns.

Many family-owned businesses choose to elect S Corp status because of the treatment of employment taxes. In both of the businesses my husband and I formed, we chose to file our family business as an S Corp for the tax benefits. Only wages are subject to self-employment taxes and other business profits can be distributed as dividends, which are only subject to income tax, but no payroll taxes are required. To elect S Corp status, the business must file IRS Form 2553 and meet ongoing filing requirements such as:

- Reporting financial activity (Form 1120S, Schedule K-1s for shareholders)
- Withholding federal income tax, Social Security and Medicare taxes from employees' wages
- Filing IRS Form 941 each quarter to report these withholdings.
- Filing a Federal Unemployment Tax Return annually (IRS Form 940)

Missing any deadlines could result in penalty fees and the business could lose its S

rights related to ownership, decision making, transferring of assets and what happens in the case of divorce, death, retirement and more.

Like the corporation, LLC member personal assets are protected if the company gets sued or can't pay its debts. However, unlike the corporation, the LLC is a pass-through entity, and all income flows through to members and is reported on members' personal tax returns. The LLC can choose to be taxed as a C Corp or an S Corp. How the LLC chooses to be taxed also effects how the family members are taxed, so your clients need to be sure they are picking the best method for their circumstances. For example:

- The LLC taxed as a sole proprietorship or partnership will pay payroll taxes on all profits, so paying an immediate family member makes no difference to the owner's taxes. (See special IRS tax accommodations under sole proprietor section)
- The LLC taxed as an S Corp can decide to split up profits as wages and shares so only part of the profits is subject to payroll taxes.
- The LLC taxed as a C Corp with be double-taxed, profits taxed at the corporation level and then wages taxed.

Unfortunately, many family businesses start out too casually when it comes to creating formal operating documents and legal structure and I've seen too many cases where problems could have been avoided with more careful planning. Helping your clients choose the right entities for their family businesses goes a long way to setting them on a straight path to success.

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Nellie Akalp is a passionate entrepreneur, business expert and mother of four. She is the CEO of CorpNet.com, a trusted resource and service provider for business incorporation, LLC filings, and corporate compliance services in all 50 states. Nellie and her team recently *launched a partner program for accountants, lawyers, and business professionals to help*

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