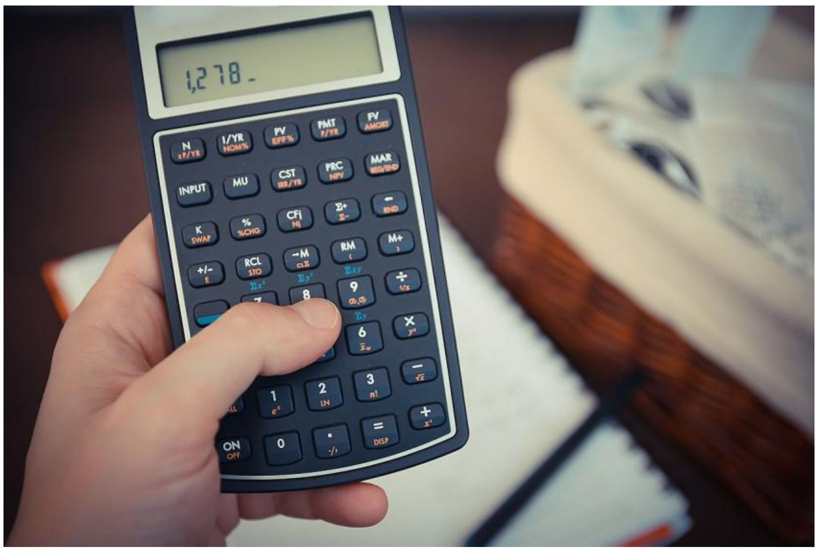
HOME
BUSINESS

Tax Benefits of Operating Through an LLC Instead of a Corporation for Home-Based Businesses



By **Barry Klingman** June 23, 2016

When running a home-based business there are many tax issues to keep in mind, from keeping track of business expenses to calculating the deduction for business use of your home.

One important step is to officially structure your company as an LLC or corporation. Choosing to operate as an LLC instead of a corporation will offer several tax advantages as your business grows (even if it outgrows your house), including:

1) Not getting taxed twice. A limited liability company can sell its assets and operations and liquidate without triggering a double tax – meaning both an entity-level tax and a shareholder-level tax.

Purchasers strongly prefer to purchase assets, rather than equity interests, because an asset sale generally results in a “step-up” in the tax basis of the acquired assets from the seller’s cost (net of depreciation) to the purchaser’s cost. This step-up entitles the purchaser to greater depreciation deductions and/or less gain when the acquired assets ultimately are sold. Purchasers are acutely aware of the tax benefits associated with a basis step-up and typically discount the purchase price significantly where corporate shareholders insist on a stock sale in order to avoid the double tax that would result from an asset sale.

2) An equity compensation program that is treated more favorably than a corporate equity compensation program.

If a limited liability company grants a key employee a “profits interests” (whether restricted or vested), the employee will not recognize income or gain at the time he receives the profits interest (or, if the interest, is restricted, at the time it vests), but only when the company is ultimately is acquired or goes public. On the other hand, regular corporate stock options trigger ordinary income when exercised, qualified corporate stock options trigger alternative minimum tax when exercised and grants of vested corporate stock require the recipient either to pay fair value for the stock or recognize ordinary income on the difference between fair value and purchase price.

3) Losses can generally pass through directly to its owners as current deductions and can offset the income they earn from their “day jobs.” This is especially helpful in the beginning stages of a new company. Of course, this loses significance once the company turns a profit. In a corporation, however, this would fall under operating losses and not offer the same benefit.

4) Distributing some or all of its earnings to its owners without triggering the double tax that is imposed when a profitable corporation distributes earnings to its shareholders as dividends.

5) An easier transition to an IPO or acquisition.

Since an overwhelming majority of start-ups are financed entirely by friends and family or a combination of friends and family and angels and then are acquired or go public without venture capital funding, selecting a business structure for the purpose of attracting venture capital funding is putting the cart before the horse. This is particularly so if a limited liability company reaches a stage in its development where it wishes to attract such funding, it can incorporate at that time without incurring any tax liability.

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