



## Goldstein & Williams PLC

Arts & Entertainment Law, Management, and Immigration

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This is provided for informational purposes only. Please do consult with an attorney familiar with your specific circumstances, challenges, and quirks before drawing any conclusions or doing anything rash!

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### **BASIC BUSINESS STRUCTURES**

1. Certain business structures offer liability protection to their owners, other do not.
2. A sole proprietorship offers no liability protection. If you are doing business as a sole proprietor and a judgment is entered against you in a lawsuit, you will be held personally responsible for the debts of your business. This means that both your personal and business assets could be claimed by a court to satisfy the judgment.
  - a. If you are used a “trade name”, but have never registered as a “corporate” entity, such as a C-Corporation, S-Corporation, or Limited Liability Company, then you are still a sole proprietor.
  - b. Other types of structures that offer no liability protection are partnerships and joint ventures.
3. Types of structures that offer liability protection include the C-Corporation, the S-Corporation, and the Limited Liability Companies (“LLC”). If a judgment is entered against one of these structures, only the assets owned by the structure can be taken by the court. The personal assets of the owner or owners of the structure are protected. The personal assets of an owner are shielded from company liabilities.
4. C-Corps and S-Corps
  - a. A C-Corporation is a business structure that has the familiar “Inc.” after the name of the business.
  - b. C-Corporations are owned by shareholders.
  - c. C-Corps are formed by filing Articles of Incorporation with the state where the corporation will be conducting business.
  - d. C-Corps are the most complex to organize and maintain in that there are number of formalities and restrictions that must be complied with. Among them, the C-Corp must have a board of directors, corporate officers, annual shareholders meetings, and extensive record keeping.
  - e. With a C-Corp, the net business income is subject to corporate income tax, and the monies remaining after the corporate income tax are taxed a second time when they are distributed as dividends to its owners who must then pay personal income tax.
  - f. S-Corps are special sub-set of C-Corps where the shareholders have elected for “pass through” taxation: Instead of double taxation, the income of an S-Corp is passed through to their shareholders and reported on the shareholders’ personal income tax returns (just as if it were a Sole Proprietorship), thereby eliminating the double taxation incurred by owners of a standard corporation, or C-Corp. Like C-Corps, but unlike sole proprietors, the personal assets of the shareholders of an SCorp are protected from liability.
5. Limited Liability Companies
  - a. An LLC is owned by its “members”, not shareholders.
  - b. LLCs are formed by filing Articles of Organization with the state where the LLC will be conducting business.
  - c. Like the S-Corp, the members of an LLC automatically have pass through taxations: the income of an LLC is passed through to their members and reported on the members’ personal income tax returns (just as if it were a Sole Proprietorship), thereby eliminating the double taxation incurred by owners of a standard corporation, or C-Corp.
  - d. LLCs are not required to have a board of directors, officers, or annual meetings. An LLC can be member-managed, meaning that the owners run the company; or it can be managermanaged, with responsibility delegated to managers who may or may not be owners in the LLC.

6. S-Corps v. LLCs

- a. The two most common business structures for the arts are S-Corps and LLCs.
- b. S corps and LLCs are similar in that they are both “pass-through” entities for tax purposes, however, there are a number of key differences.
- c. Business Ownership & Operation
  - a. There are restrictions on who can be shareholders of an S corporation. An S corporation can have no more than 75 shareholders. None of the shareholders can be nonresident aliens and shareholders cannot be other corporations or LLCs. There are no such restrictions on the ownership of an LLC.
  - b. An S-Corp must be operated in the same way as a traditional C-Corp and follow the same formalities and record keeping procedures. The directors or officers of an S-Corp manage the company. LLCs offer greater flexibility in ownership and ease of operation and are simpler to operate because they are not subject to the formalities by which S-Corps must abide.
  - c. An S-Corp has no flexibility in how profits are split up amongst its owners. The profits must be distributed according to the ratio of stock ownership, even if the owners may otherwise feel it is more equitable to distribute the profits differently. The owners of an LLC can distribute profits in the manner they see fit. Let’s say, for example, you and a partner own an LLC. Your partner contributed \$40,000 for capital. You only contributed \$10,000 but you perform 90% of the work. The two of you decide that, in the interest of fairness, you will each share the profits 50/50. As an LLC you could do that; with an S corporation, however, you could only take 20% of the profits while your partner would take the other 80%.
- d. Employment Tax: Savings vs. Paperwork
  - a. A major factor that differentiates an S-Corp from an LLC is the employment tax that is paid on earnings. The owner of an LLC is considered to be self-employed and, as such, must pay a “self-employment tax” which goes toward Social Security and Medicare. The entire net income of the business is subject to this tax at a rate of 15.3%.
  - b. In an S-Corp, only the salary paid to the employee-owner is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules. Therefore, there is the potential to realize substantial employment tax savings.
  - c. For example, John owns a management company. John decides that a reasonable salary for an artist manager \$50,000 and pays himself accordingly. John’s total earnings for the year are \$60,000: \$50,000 paid in salary and the remaining \$10,000 paid as a distribution from the S-Corp. John’s total employment tax would be 15.3% of \$50,000. However, if John were the owner of an LLC, he would have to pay employment tax on the entire \$60,000!
  - d. One might assume that these savings could be further manipulated by reducing the salary to an extremely low amount and attributing the rest of one’s earnings to distributions—but this would be an incorrect assumption. In practice, the IRS is careful to notice whether a salary is reasonable by industry standards. If it determines a salary to be unreasonable, the IRS will not hesitate to reclassify distributions as salary.
  - e. While the potential employment tax savings may make the S-Corp an attractive structure for your business, bear in mind that you would then have to deal with all the paperwork associated with payroll tax. The payroll tax is a pay-as-you-go tax that must be paid to the IRS regularly throughout the year--on time, or you will incur interest and penalties. The paperwork alone can be an overwhelming task for someone who is not familiar with this, and if you expect to incur losses or otherwise experience a cash flow crunch during the year that would hinder you from paying the payroll tax when due, this could present a problem.
  - f. Owners of LLCs pay their self-employment tax once a year on April 15 when income taxes are normally due. Income tax filings are also relatively easy for the owners of an LLC: A single-member LLC files the same 1040 tax return and Schedule C as a sole proprietor (Members in an LLC file the same 1065 and Schedule C as do owners of traditional partnerships.)

e. The comparison chart below sums up the similarities and differences between the two business structures:

	<b>S Corporation</b>	<b>Limited Liability Company</b>
Liability Protection	Yes	Yes
Operational Control	Board of Directors/Officers	May be membermanaged or managermanaged
Federal Income Tax	Pass-through	Pass-through
Flexibility/Ease of Operation	No; subject to some formalities and record keeping rules as traditional C corps	Yes
Ownership Restrictions	Yes	No
Flexibility in Profit-Sharing	No	Yes
Employment Tax	Employment/payroll tax on salary; no employment tax on dividends paid to shareholders	Self-employment tax on total net income

- f. If operational ease and flexibility are important to you, an LLC is a good choice. If you are looking to save on employment tax and your situation warrants it, an S-Corp could work better.

7. Non-Profit Entities

- a. Many performing arts organizations elect to become a non-profit organization. Nonprofits are not taxed on their income. People who donate to a non-profit can deduct the donation from their income tax. (People who donate to a C-Corp, S-Corp, or LLC are called crazy!)
- b. To become a non-profit corporation, you must first form a Non-Stock C-Corp. (Nonprofits do not have the option of becoming S-Corps or LLCs.) A Non-Stock C-Corp means that it has no shareholders. This is because no one actually owns a non-profit. The assets of a non-profit are held “in-trust” for the general public.
- c. Once you have formed the Non-Stock C-Corp, the organization must file and be approved for non-profit status with the IRS. A Non-profit formed for artistic or cultural purposes is given the IRS status of 501(c)(3).
- d. Non-profits must have a board of directors. Do not take this lightly. The board of directors control and manage the non-profit. If not selected properly and carefully managed, nurtured, and contained, non-profit board members can take over an entire organization, burn-out the administrative and artistic staff, and spit you out like a used peach pit!
- e. Contrary to popular belief, non-profits are, in fact, allowed to make a profit, provided the “profits” are all turned over to the company and not “earned” by an employee, officer or director.
- f. An employee of a non-profit is allowed to earn whatever salary the board deems appropriate.