



Which Business Entity is Right for Your Literary Agency?

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WHICH TYPE OF LEGAL ENTITY is best for the business and tax purposes of your literary agency? The answer is not always straightforward. Today, agencies can operate under a variety of different types of entities, each with its own unique tax consequences and business considerations.

There are three basic types of business entities—Sole Proprietorship, Partnership, and Corporation.



Sole Proprietorship

A Sole Proprietorship (SP) exists when one individual owns all of the business assets personally. The advantage of using an SP is the lack of formality and the ease of setting it up, since an SP is not a separate entity for legal purposes. This

also presents a major disadvantage for using an SP, as the owner of an SP is always personally liable without limitation for any debts or claims against the agency.

Tax Considerations: An SP is also not treated as a separate entity from its owners for tax purposes. All income and expenses from the agency are reported on the owner's personal tax return. This has a number of tax advantages. For instance, there is only one layer of tax at the owner's marginal rate. There is no additional tax once money is taken out of the business bank account. If the owner sells the agency, there is only one level of tax on any gain recognized.

On the other hand, there are a number of tax disadvantages. For example, an SP is subject to self-employment tax. An SP cannot fully deduct the cost of fringe benefits paid on his or her own behalf. Additionally, operating as an SP can increase exposure to a possible tax audit.

Partnership

There are various types of Partnerships, each with different characteristics. The various Partnership structures are: General Partnership (GP), Limited Partnership (LP), Limited Liability Company (LLC), and Limited Liability Partnership (LLP).

One common characteristic among these variations is that each type of Partnership is considered

a flow-through entity for tax purposes. This means that all of the income and expense from the Partnership flows through to the partners. Another common characteristic is that distributions generally can be taken out tax-free. Thus, partners will only pay tax on the earnings of the literary agency and will not pay tax when those earnings are distributed.

A type of Partnership currently popular with many literary agencies is an LLC. Partners in an LLC are known as members. Members pay self-employment tax on their share of the net income and have limited liability for the obligations of the agency even if they fully participate in the management of the agency.


LLCs offer flexibility as to different classes of ownership. Members can have multiple classes of ownership including profit interest only and ownership that is not tied to capital.

Corporation

The final choice of entity is a Corporation. Upon formation, it is known as a C Corporation. Although, there are many advantages to C Corporations, they may not apply to most agencies.

Among the greatest disadvantages to using a C Corporation is a double tax. Earnings are subject to a Corporation tax and any distributions of earnings (dividends) are taxable to the shareholders and are not deductible by the Corporation (the recently enacted tax law offers some relief in this matter.)

Corporation Choices: To avoid some of the disadvantages of a C Corporation, yet maintain the corporate structure and its benefits, an election can be made by the shareholders of a Corporation to be treated as a "S Corporation." An S Corporation is taxed like a Partnership in that it generally avoids a double level of tax. Income and losses flow-through to the shareholders. Advantages include limited liability up to shareholder capital contributions, losses are deductible against other income, and distributions of income are tax-free.

It is clear that the "right" business entity is the one that meets the tax and non-tax needs of the agency. A decision about the form of ownership can only be made with careful thought and planning. Thus, your attorney and accountant must work together to balance the legal and tax ramifications with the agency's intentions. 

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