Choosing an Entity for Your Business

Now that you've decided to start a new business or buy an existing one, you need to consider the form of business entity that's right for you. Basically, three separate categories of entities exist: partnerships, corporations, and limited liability companies. Each category has its own advantages, disadvantages, and special rules. It's also possible to operate your business as a sole proprietorship without organizing as a separate business entity.

Sole proprietorship

A sole proprietorship is the most straightforward way to structure your business entity. Sole proprietorships are easy to set up — no separate entity must be formed. A sole proprietor's business is simply an extension of the sole proprietor.

Sole proprietors are liable for all business debts and other obligations the business might incur. This means that your personal assets (e.g., your family's home) can be subject to the claims of your business's creditors.

For federal income tax purposes, all business income, gains, deductions, or losses are reported on Schedule C of your Form 1040. A sole proprietorship is not subject to corporate income tax. However, some expenses that might be deductible by a corporate business may not be deductible by a business structured as a sole proprietorship.

Partnerships

If two or more people are the owners of a business, then a partnership is a viable option to consider. Partnerships are organized in accordance with state statutes. However, certain arrangements, like joint ventures, may be treated as partnerships for federal income tax purposes, even if they do not comply with state law requirements for a partnership.

A partnership may not be the best choice of entity for a business that anticipates an initial public offering (IPO) in the near future. Although there are publicly traded partnerships, most IPO candidates are organized as corporations.

In a partnership, two or more people form a business for mutual profit. In a general partnership, all partners have the capacity to act on behalf of one another in furtherance of business objectives. This also means that each partner is personally liable for any acts of the others, and all partners are personally responsible for the debts and liabilities of the business.

It is not necessary that each partner contribute equally or that all partners share equally. The partnership agreement controls how profits are to be divided. It is not uncommon for one partner to contribute a majority of the capital while another contributes the business acumen or contacts, and the two share the profits equally.

Partnerships are a recognized entity in the sense that the entity can obtain credit, file for bankruptcy, transfer property, and so on. However, the partnership itself is generally not subject to federal income taxes (it does, however, file a federal income tax return). Instead, the income, gains, deductions, and losses of the partnership are generally reported on the partners' individual federal income tax returns. The allocation of these items among the partners is governed by the partnership agreement, subject to certain limitations.

Limited partnerships

A limited partnership differs from a general partnership in that a limited partnership has more than one class of partners. A limited partnership must have at least one general partner (who is usually the managing partner), but it also has one or more limited partner. The limited partner(s) does not participate in the day-to-day running of the business and has no personal liability beyond the amount of his or her agreed cash or other capital investment in the partnership.

Limited liability partnership

Some states have enacted statutes that provide for a limited liability partnership (LLP). An LLP is a general partnership that provides individual partners protection against personal liability for certain partnership obligations. Exactly what is shielded from personal liability depends on state law. Since state laws on LLPs vary, make sure you consult competent legal counsel to understand the ramifications in your jurisdiction.

Corporations

Corporations offer some advantages over sole proprietorships and partnerships, along with several important drawbacks. The two greatest advantages of incorporating are that corporations provide the greatest shield from individual liability and are the easiest type of entity to use to raise capital and to transfer (the majority stockholder can usually sell his or her stock without restrictions).

A corporation can be taxed as either a C corporation or an S corporation. Each has its own advantages and disadvantages.

C corporations

A corporation that has not elected to be treated as an S corporation for federal income tax purposes is typically known as a C corporation. Traditionally, most incorporated businesses have been C corporations. C corporations are not subject to the same qualification rules as S corporations and thus typically offer more flexibility in terms of stock ownership and equity structure. Another advantage that a C corporation has over an S corporation is that a C corporation can fully deduct most reasonable employee benefit costs, while an S corporation may not be able to deduct the full cost of certain benefits provided to 2% shareholders. Virtually all large corporations are C corporations.

However, C corporations are subject to income tax. So, the distributed earnings of your incorporated business may be subject to corporate income tax as well as individual income tax.

S corporations

A corporation must satisfy several requirements to be eligible for treatment as an S corporation for federal income tax purposes.

However, qualification as an S corporation offers a potential tax benefit unavailable to a C corporation. If a qualifying corporation elects to be treated as an S corporation for federal income tax purposes, then the income, gains, deductions, and losses of the corporation are generally passed through to the shareholders. Thus, shareholders report the S corporation's income, gains, deductions, and losses on their individual federal income tax returns, eliminating the potential for double taxation of corporate earnings in most circumstances. However, many employee benefit deductions are not available for benefits provided to 2% shareholders of an S corporation. For example, an S corporation can provide a cafeteria plan to its employees, but the 2% shareholders cannot participate and receive the tax advantages that such a plan provides.

It is important to note that S corporation treatment is not available to all corporations. It is available only to qualifying corporations that file an election with the IRS. Qualifying corporations must satisfy several requirements, including limitations on the number and type of shareholders and on who can own stock in the corporation.

Limited liability company

A limited liability company (LLC) is a type of entity that provides limitation of liability for owners, like a corporation. However, state law generally provides much more flexibility in the structuring and governance of an LLC as opposed to a corporation. In addition, most LLCs are treated as partnerships for federal income tax purposes, thus providing LLC members with pass-through tax treatment. Moreover, LLCs are not subject to the same qualification requirements that apply to S corporations. However, it should be noted that a corporation may be a better choice of entity than an LLC if an IPO is anticipated.

Choosing the best form of ownership

There is no single best form of ownership for a business. That's partly because you can often compensate for the limitations of a particular form of ownership. For instance, a sole proprietor can often buy insurance coverage to reduce liability exposure, rather than form a limited liability entity. Even after you have established your business as a particular entity, you may need to re-evaluate your choice of entity as the business evolves. An experienced attorney and tax advisor can help you decide which form of ownership is best for your business.

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