

# choice of entity?

You've researched for hours, brainstormed for months, bounced ideas off family and friends and ran the numbers. You're excited. You're ready to launch your own business. Now what? Start with your plan, add advice from professionals, and sprinkle in some collaboration with your peers to lay the proper foundation for success your first year and many more to come. We hope that our monthly contributions in these pages will help you navigate your venture through its infancy and position yourself to realize the satisfaction and rewards of business ownership.

One decision you will face as a business owner is selecting the form of legal entity in which to conduct operations. While we'll focus primarily on tax treatment in the discussion below, you'll want input from a variety of perspectives – legal differences, insurance matters, investors and financing, etc. – so, be sure to get your team of advisors together when making this evaluation. Also, while this is an important decision, keep in mind that there is no one perfect entity type; so, if and when conditions change, your entity choice can be amended. Your goal is to make the most appropriate choice based on what you know today and conditions you expect over the next three to five years.

As a business, you have four general categories of entities to choose from: Sole Proprietorship, Corporation, Partnership, and Limited Liability Company. While each type has distinct operating characteristics, two critical areas are usually most important and override the others when making your selection: (a) the degree of liability protection provided to its owners, and (b) the tax treatment of each entity.

In general, Corporations and Limited Liability Companies provide their owners with liability protection while Sole Proprietorships and Partnerships do not. Consideration of state laws and the nature of the business operation, along with legal advice, will be necessary in evaluating this concern. When addressing the tax treatment of each choice, the goal is to select the entity that will deliver the least tax cost under your operating circumstances. Let's take a look at the more significant tax attributes of these entity choices.

**Corporations.** Corporate entities come in two basic flavors – C-corporations and S-corporations – both established similarly under state law, with the difference being their treatment under income tax regulations. C-corporations are taxed on their income at the entity level, and their shareholders are also taxed at the owner level when that income is distributed to them. This double-taxation is often an obstacle to C-corp status being a favored choice. However, there are several other advantages that can make this the best selection.

A corporation that elects to be treated as an S-corporation along with its shareholders, is treated as a pass-through entity for federal income tax, and is generally taxed only once at the shareholder level. In exchange for this pass-through treatment, the corporation must meet a number of limiting criteria in order to be eligible to elect "S" status, which can make the election unavailable.

**Sole Proprietorships.** Since a sole proprietorship is not a separate legal entity, its owner is taxed on the businesses' income and there are no separate tax filings.

**Partnerships.** A partnership's income is taxed only at the partner level, similar to the pass-through treatment afforded to S-corporations.

**Limited Liability Companies.** LLCs are classified under the treatment elected by its managers and can be taxed as a sole proprietorship, treated as a partnership, or even file as a corporation eligible for "C" or "S" status. Some refer to the LLC as the "Swiss Army knife" in the entity choice selection process for its range of features.

In addition to this overview of income tax considerations, other factors such as compensation and benefits, treatment of losses, management structures, and other factors must be addressed. While it may look daunting, this choice can be successfully tackled with the assistance of your advisors, mentors, and maybe even some friendly advice from competitors!



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