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Choice of Business Entities

In order to carry on a trade or business, a type of business entity must be chosen. For all practical purposes, the four major business entities for the current 2000 year are: sole proprietorship, partnership, corporation, and limited liability company. For the purposes of this discourse, all references will be made to the active conduct of a business, rather than passive or limited-activity types.

The most efficient way of selecting a business entity revolves around trying to match the needs (present and future) of the business and its owners in legal, financial, and tax-related areas. In other words, this selection process becomes a form of a needs analysis study. In some cases, it is relatively easy; in fact the choice may be practically automatic. In other cases, it can be quite complex to coordinate the current and future needs of both the business and its owners.

There are a number of variables that should be addressed in this process to help delineate it. Further, the advantages and disadvantages of each type of entity from a legal and tax perspective play important roles in the overall planning process.

Definitions Of The Four Major Types Of Business Entities

A good starting point is to first know what each of the entity choices represents:

SOLE PROPRIETORSHIP: This is a self-employed individual who operates a trade or business where all the tax consequences fall to that proprietor, including all liabilities, debts, profits, and losses.

PARTNERSHIP: An organization or association of two or more participants who carry on a trade or business together, and allocate the ownership and profit/loss aspects according to their contractual terms. This partnership is a separate entity for tax filing purposes, but not tax paying. Rather it is a form of a conduit where income, losses, credits, and certain deductions are passed along to the partners' tax situation instead. There is no liability protection for the general partners.

CORPORATION: A separate, legal entity formed through a state charter using articles of incorporation. It is authorized to perform primarily all the business activities an individual can, including such things as filing and paying taxes, signing contracts, and making loans. It is formed through the issuance of stock or securities. There are two main types: Regular ("C") or Subchapter S ("S").

LIMITED LIABILITY COMPANY(LLC): This is a hybrid, or combination, with some of the features of a partnership and the limited liability aspect of a corporation. To qualify as an LLC, it can't have at least two of the main components of a corporation: continuity, centralized management, transferability of ownership. Thus, the two most significant features of an LLC are that it affords the partners some degree of limited liability protection, yet it still acts as a conduit like a regular partnership. This choice is not available in all states, but the majority allow it.

While the list of determining factors for making the best choice for the type of business entity can be quite long, an overview of the more common ones that tend to affect the vast majority of businesses is in order. In effect, the business owner selects the features or attributes of the entity that best suit the current and future combined needs of business and owner. This is not always easy since many factors are not always so "black and white," but, rather, fall into the "shades of gray" category. Nevertheless, the following represents a list of the more common significant factors to compare the business entity types:

LIABILITY OF OWNERS

Sole Proprietorship:	Unlimited liability for business actions
Partnership:	Unlimited liability for business actions
Corporation:	Possibly limited to assets in corporation
LLC:	Possibly limited to assets in company

TREATMENT OF INCOME/LOSSES

Sole Proprietorship:	Taxable to individual proprietor
Partnership:	Taxable to partners
Corporation:	Taxable to regular "C" corporation; taxable to shareholders for "Sub S" corp on federal(and most states) level
LLC:	Taxable to partners

CONTINUITY OF EXISTENCE OF BUSINESS

Sole Proprietorship:	Ends with death of proprietor
Partnership:	Ends with death, bankruptcy of partner or more than 50% change of ownership
Corporation:	Continues indefinitely
LLC:	May end with death, bankruptcy of partner, or change of ownership

TRANSFERABILITY OF INTEREST

Sole Proprietorship:	Relatively easy transferability
Partnership:	May require partner's approval
Corporation:	Easy unless restricted by agreements
LLC:	May require partner's approval

CHOICE OF TAX YEAR

Sole Proprietorship:	Proprietor's tax year which is usually on a calendar year basis
Partnership:	Usually calendar year unless business purpose is met
Corporation:	Can be calendar or fiscal for most "C" types. Must be calendar for "Sub S" types unless business purpose and special permission is granted
LLC:	Usually calendar unless business purpose is met

EASE OF SETTING UP

Sole Proprietorship:	Very easy, no state charter, or legal agreements usually required, few administrative, filing headaches
Partnership:	Reasonably easy, but agreements are generally recommended, state and federal tax identification numbers needed
Corporation:	More difficult and costly, often requiring state applications, legal paperwork, fees, state and federal tax identification numbers to be filed

LLC:	Somewhat more difficult than a regular partnership to qualify for LLC status; agreements generally recommended, state and federal tax ID numbers required

OWNERSHIP LIMITATIONS

Sole Proprietorship:	Only the individual proprietor can own
Partnership:	No limit
Corporation:	No limit for "C" types; maximum of 75 qualified shareholders for "Sub S" types
LLC:	No limitations

EASE OF SHIFTING OF FUNDS IN AND OUT OF BUSINESS

Sole Proprietorship:	Very easy; draw account is used
Partnership:	Easy; partner's draw or capital account used, but must be tracked
Corporation:	More complicated for deductibility purposes, liability protection, etc.
LLC:	Easy; partner's draw or capital account used, but must be tracked

MINIMUM RECORDKEEPING REQUIREMENTS

Sole Proprietorship:	Easiest of the four entities; no balance sheet requirements, no accounting to other owners, partners
Partnership:	Fairly complicated, especially if partners' capital accounts are tracked
Corporation:	Complicated; balance sheet requirements, minutes of meetings, resolutions, other "arms length" requirements to be met
LLC:	Fairly complicated, more so than regular partnership to keep qualifications as LLC intact

MANAGEMENT TYPE

Sole Proprietorship:	A centralized system with sole owner
Partnership:	Not centralized; partners' agreements usually required
Corporation:	Centralized with appointment by board of directors
LLC:	Not centralized; partners' agreements usually required

AVAILABILITY OF QUALIFIED RETIREMENT PLANS

Sole Proprietorship:	Deductible retirement plan available
Partnership:	Deductible retirement plan available
Corporation:	Deductible retirement plan available
LLC:	Deductible retirement plan available

PASSIVE LOSS DEDUCTIBILITY

Sole Proprietorship:	Can't offset ordinary business income
Partnership:	Can't offset ordinary business income
Corporation:	May be able to offset ordinary income for "C" types; not for "Sub S" types
LLC:	Can't offset ordinary business income

POSSIBLE DOUBLE TAXATION ISSUE

Sole Proprietorship:	No double taxation problems

Partnership:	No double taxation problems
Corporation:	Double taxation possibility for "C" type; no double taxation for "Sub S"
LLC:	No double taxation problems

POSSIBILITY OF TAX-SAVING FAMILY INCOME SPLITTING TECHNIQUES

Sole Proprietorship:	Very possible, if owner is employing offspring, especially those under 18
Partnership:	Definite possibilities to shift income to family members in lower tax brackets
Corporation:	Limited possibilities for "C" type;more possibilities for "Sub S" type
LLC:	Definite possibilities to shift income to family members in lower tax brackets

DEDUCTIBILITY OF VARIOUS FRINGE BENEFITS

Sole Proprietorship:	Limited, especially in health, accident, life insurance, medical reimbursement, death benefits
Partnership:	Limited similar to sole proprietorship
Corporation:	Much more fringe benefit possibilities, especially for "C" types; some restrictions on "Sub S" types
LLC:	Limited similar to partnership or sole proprietorship

ABILITY TO RETAIN EARNINGS TO DEFER INCOME TO OWNERS

Sole Proprietorship:	Cannot retain earnings; taxable to owner in year posted
Partnership:	Cannot retain earnings; taxable to partners in year posted whether or not they are distributed
Corporation:	"C" types can retain earnings up to certain limits; "Sub S" types cannot retain; they are taxable to the shareholders whether distributed or not
LLC:	Cannot retain earnings; taxable to partners in year posted, whether they are distributed or not

LEGALITY ISSUES FROM A STATE PERSPECTIVE

Sole Proprietorship:	Legal form of business in all states
Partnership:	Legal form of business in all states
Corporation:	"C" types recognized in all states; "Sub S" types not recognized for income tax purposes in all states, but recognized as a legal entity in all
LLC:	Not recognized similarly in all states, so formation, filings, and limited liability protection may be questionable especially if operations of business extend to multi-states

TAX RETURNS TO BE FILED

Sole Proprietorship:	Certain business schedules get included on individual 1040 form, but no independent, stand-alone return is filed
Partnership:	Federal Partnership Tax Return, Form 1065 must be filed
Corporation:	Federal Corporation Tax Return, Form 1120 for "C" type; Federal Form 1120S for "Sub S" type
LLC:	File similar to partnerships, Form 1065

General Advantages/Disadvantages Of The Four Entity Types

As can be seen, while the four main entity types have some common denominators, they are mostly intended to fulfill different business and individual needs. There are advantages and disadvantages within each of these entities:

SOLE PROPRIETORSHIP: This is usually the easiest type of entity to set up or terminate. Losses from the business can offset income from other sources. Management is totally centralized since there is only one legal owner. Recordkeeping may be a bit easier. Taking money out of the business is very easy.

However, there are some notable disadvantages, also: There is no way to "retain" earnings like other business forms; the owner has no limited liability protection; continuity and transferability of interest is limited; and certain deductible fringe benefits are not available as with other forms of business.

CORPORATION: Advantages include limited liability protection to owners, easy transferability of ownership, continuity even if original owners no longer exist, easier estate tax planning opportunities, more possible tax-free fringe benefit plans, and more flexible pension plans. In addition, it allows for a number of owners to participate. Obviously there can be numerous advantages.

The disadvantages can be equally as numerous. A corporation is usually more difficult and costly to set up or terminate. Much more planning is required to avoid double taxation issues. Recordkeeping can be quite complicated to preserve the limited liability feature. Taking money out of the corporation can also get tricky. Finally, tax return filings tend to be more involved.

GENERAL PARTNERSHIP: If there is more than one owner, it is the easier of the entity types to set up. Active losses can be used to offset other income for the owners. Some degree of income tax and estate tax planning is possible since ownership percentages can be transferred fairly easily.

The disadvantages are similar in scope to a sole proprietorship: No limited liability protection exists; the partnership usually ends upon the termination of a majority partnership interest, so continuity is limited; earnings cannot be retained, and tax-free fringe benefits are limited.

LIMITED LIABILITY COMPANY: This entity has some of the better aspects of a partnership coupled with that of a corporation. It has limited liability protection, yet allows for the "flow through" of income and losses to the partners so there is less chance for double taxation. Unlike the "Sub S" corporation with its limitations on the number of shareholders, and the type and status of these shareholders, there is much more flexibility here. Income and losses can be allocated more easily as well.

However, the disadvantages center around the fact that these LLC's are still relatively new, and the states have varying rules and regulations concerning their operation, legal status, and degree of limited liability protection available. In addition, like a general partnership, tax-free fringe benefits are restricted. From a qualifying perspective on the federal level, there is always the possibility that the LLC will be challenged on its qualification. This could lead to a disastrous situation where it is re-classified as a corporation, and a double taxation event could occur.

Conclusion

Selecting the best type of business entity is as much an art as a science. This should match the type of business, and the individual needs and wishes of the owners. In addition, it should anticipate the developmental aspects of a changing business so a look into the future is often necessary. To try to make this selection process as efficient and effective as possible, two actions are in order. First, make out your own "wish list" of what you want and need in a business organization. Second, consider getting professional advice from a legal and accounting perspective as early in the selection process as you can. It can be some of the most important advice your business will ever receive.