Business Entity Selection

As an entrepreneur, one of the most important (& often ill-understood) decisions you will make for your business is selecting the "Entity" type.

"Business entity" refers to the legal ownership structure of a given business – some common legal structures include: sole proprietorships, general partnerships, and corporations. While Uncle Sam recognizes these various legal structures, he also imposes very specific (and different) privileges, restrictions and requirements on each. Choosing the ideal ownership structure for your industry, operating model, business, and risk tolerance is a task that many find difficult, if not overwhelming.

However complex the decision may appear on the surface, the entrepreneur is advised to fully understand and consider the fundamental pros and cons inherent in each structure before making any decision. While there are a number of intricacies that could (and have) filled books, this high-level article will focus on two key aspects of this decision - namely legal liability and tax rates.

Legal Liability: To Incorporate or Not to Incorporate…

One of the key considerations in selecting an ownership structure is deciding if you will conduct business as yourself (e.g. Jane Doe Enterprises), as a Corporation (Midwest Cogs, Inc.), or a hybrid Limited Liability Company (Jane's Fine Cogs, LLC).

Corporations and Limited Liability Companies are legal business entities recognized by the government to be separate and independent from the business owner(s). Being recognized as a separate legal entity allows the corporation to conduct business on behalf of the owner(s) - the corporation is allowed to own property, enter into contracts, secure loans, assume liability, pay taxes, sue and be sued. It is precisely this independence which provides one of the major benefits of the corporate entity type – limited liability.

"Limited Liability" means that business owners are generally shielded from unfavorable unlimited legal exposure. Personal assets such as: homes, cars, property, bank accounts and retirement funds cannot typically be used to satisfy the debts and liabilities of the business. This limits the owner's potential for loss to strictly the amount of money invested.

When operating as a standard unincorporated entity (i.e. Sole Proprietor or General Partnership), all business actions are (in the eyes of the law) conducted directly by the owner(s) of the business themselves. Because there is no limited liability for these business structures, owner(s) may be responsible for debt incurred by the business and both the business and personal assets of the owner(s) may be at risk should the business be sued.

Taxes: One of two things certain in life…

A second key consideration in selecting a business structure is the associated tax implications. While all business entities are allowed to deduct legitimate business expenses, thereby reducing taxable income, there are important differences to consider with respect to the effective tax rate imposed on profits of the business.

Sole Proprietor & General Partnership.

For the sake of simplification, these two business structures have been grouped together as they are treated essentially the same for both tax and legal purposes. The key difference lies in the number of owners - whereas a Sole Proprietor has a single owner, a General Partnership has two or more.

For tax purposes, both structures are required to pay self-employment taxes. Any profits or losses of the business are "passed through" to the owner(s) as ordinary income (regardless of distribution), proportionate to their ownership interest in the business. The applicable tax rate will depend on the respective tax bracket of the owner(s).

"C-Corp".

The "C Corporation" (or "C-Corp") is the basic corporate form and is generally most appropriate for companies with more than 100 owners. The defining tax disadvantage of the C-Corp is the issue of "double taxation" – meaning taxes may be paid on the same income twice. Profits are first taxed at the corporate level and then again at the personal level when/if distributed to owners as dividends. It is because of this feature that many small businesses do not opt to incorporate as C-Corps.

"S-Corp".

The "S Corporation" (or "S-Corp") is a specific corporate structure type which affords owners the benefit of limited liability, without the disadvantage of double taxation. This is generally considered to be a good option for many small businesses (<100 owners) that do not require more than one class of stock.

Unlike a C-Corp, S-Corps do not pay corporate income. Instead, as with a Sole Proprietorship or General Partnership, the income of the company is passed through to the shareholder(s), proportionate to their ownership interest in the business. The applicable tax rate(s) will depend on the status and compensation of the owner during the respective tax year.

For owner(s) who both worked and took a reasonable salary during the year, profits are considered to be "ordinary income" and are taxed per the respective owner's tax bracket. For those who worked during the year, but took no reasonable salary, the owner may be liable for self-employment taxes and penalties in addition to ordinary income tax. For those who do not actively work in the company (i.e. Silent Partners or Investors), profits of the company pass through as "passive income" on the shareholder's personal tax return and may be subject to the Net Investment Income Tax.

One potential tax disadvantage of the S-Corp is that owners must pay taxes on all profits of the company, whether distributed or not.

Limited Liability Company.

The "Limited Liability Company" (or "LLC"), often classified as a hybrid ownership structure, is a newer business form that is gaining popularity as an alternative to the S-Corp. The LLC combines the corporate advantage of limited liability, while retaining significant flexibility with regards to tax status. The LLC may elect to be taxed as a C-Corp, S-Corp, or (in the case of a single-member LLC) as a "disregarded entity". The disregarded entity is considered to be a Sole Proprietor for tax purposes.

Nonprofit Corporation.

The "Nonprofit" (sometimes referred to as a Not-for-Profit Corporation) is a special type of incorporated legal entity, typically formed to accomplish some societal good. Nonprofits generally afford the "forming party" all limited liability protections common with other forms of incorporated entities. A defining characteristic of all non-profits is, as the name implies, they are not formed with the goal of generating a profit and hence, do not pay income taxes.

Nonprofits must apply for a special "tax-exempt" status with the federal government and sometimes within the state in which they operate. A key benefit of this tax exemption is that non-profit entities may be exempt from state sales tax when purchasing goods. In order to maintain their tax-exempt status, nonprofits must demonstrate that a substantial portion of their income is spent on services to achieve their corporate goal.

Miscellaneous Considerations.

In addition to certain tax and legal benefits, proponents of incorporating also note that the addition of "Corp.", "Inc." or "LLC" at the end of a business name can give a start-up business some legitimacy – in theory transforming how the business is viewed through the eyes of potential customers, vendors and employees. Corporations may also find it easier to raise capital and transfer ownership of the business, in part or in total. Further, corporations and LLCs generally provide for some added protections of a company trade name within the state where they are registered. Conversely, unincorporated businesses are generally only required to advertise locally before using a "fictitious" or "assumed" trade name.

Opponents of incorporating often point to the added steps and costs of forming and maintaining the organization. While not overly burdensome on either front for most small businesses, it does stand in contrast to that of a sole proprietorship or general partnership, both of which do not require owners to file formation documents or annual reports with the state.

Other considerations may include the complexity of tax filings and requirements for paying "estimated taxes" throughout the year, however these are beyond the scope of this article.

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