Business Entity Selection

When starting a business you must decide what type of business entity you are going to establish. It is important to consider the legal and tax implications for the different types of entities before you make this decision. Listed below are just a few of the most common entities, keep in mind there are several different variations to these basic types of businesses.

1) Sole proprietorship – is the simplest business entity to set-up. There is no formal paperwork to fill out, no separate tax identification number or forms, it is part of the business owner's personal return, and personal and business assets can easily be exchanged. The downside is that there is no real protection against your personal belongings, because everything is considered a business asset. The net profit of the business will be subject to self-employment tax which is 15.3%, as well as income taxes at the owner's federal and state rates. The sole proprietorship is also the business entity audited the most often when compared to other types of formations.

2) Partnership – is considered a flow through entity for tax purposes. Like the sole proprietorship the net profit or loss flows through to the owner's personal return and the owner is subject to the same taxes as the sole proprietorship. There is a separate identification number and annual tax return for partnerships. Personal and business assets are not separate and owners are personally liable for business debts.

3) C Corporation – this entity pays taxes at a corporate tax rate and it depends on the profit and type of company as to what the rate is, but it can be as high as 38%. Payments of profits are considered dividends, and shareholders pay taxes on these dividends. If the officers of the company receive wages they will pay income and social security taxes on these wages. This entity is considered to be subject to double taxation. Income is taxed at the corporate rate and then if any profits are paid out to shareholders, they pay taxes again at their own personal income tax rates. The advantages of this entity is continuous life, clear divisibility of business and personal assets, limited liability for shareholders, able to transfer stock easily, options available for ownership of stock, and ability to deduct more fringe benefits for officers.

4) S Corporation – this entity operates like a C Corporation for liability purposes, but is a flow-through entity for taxes similar to the partnership and sole proprietorship. There are strict rules as to the number of shareholders and type of stocks an S Corporation can have compared to a C Corporation. The S Corporation is a good option for small closely held businesses, and has some significant tax advantages. Profits that flow through to the owner's are not subject to self-employment taxes, but only income taxes. Officer's of the corporation who actively work in the business are required to take out a reasonable salary from the company and pay social security and income taxes on this amount. The advantages of this business entity is the risk of liability is low like a C Corporation, profits flow through to the owners which avoids double taxation, and self-employment taxes are limited to only the amount which is deemed as reasonable wages.

5) Limited Liability Company – offers protection from personal liability against business debts like a corporation, but is a flow through entity for tax purposes. An LLC is considered a disregarded entity to the IRS, meaning there is no separate Limited Liability Company tax return. Instead, if you are a single member LLC, meaning only one owner, it is taxed just like a sole proprietorship. If it is a two or more member LLC, it is taxed like a partnership. The Limited Liability Company can also elect to be taxed as an S or C Corporation by filling out the proper election form. There is a lot of flexibility associated with this business entity type.

When you start a business it is a good idea to sit down with an attorney and an accountant to learn more about all the options and find out what best fits your business needs. It is also very important to learn about your state laws before you choose a business entity because each state has a different set of rules for business entities. You will also need to revisit this decision periodically because as the business changes it might make sense to change your business entity selection. The staff at Kruger & Clary will be happy to go over the business entity selection with you and are available to answer any questions you might have with regards to this information.