Form of Business Organization: Which Should You Choose?

Your choice of the type of business organization to use when starting a business is a major decision. And it's a decision to be revisited periodically as your business develops. While professional advice is critical in making this decision, you should have a general idea of the options available. This Financial Guide provides just such an overview.

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The human mind has devised a wide variety of business entities-that is, of forms of doing business. The mind of the IRS has kept up, devising tax rules for these entities. Often, however, these rules involve taxing the owner of the entity, and not the entity itself.

There are basically two federal tax systems for businesses:

1. *Taxation of both the entity itself (on the income it earns) and the owners (on dividends or other profit participation the owners receive from the business).* This system applies to the business corporation-called the "C corporation" (C-corp) for reasons we'll see shortly-and the system of taxing first the corporation and then its owners is called the "corporate double tax."
2. *"Pass-through" taxation.* The entity (called a "flow-through" entity) is not taxed but its owners are each taxed (more or less) on their proportionate shares of the entity's income. The leading forms of pass through entity (further explained below) are:
   - *Partnerships, of various types.*
   - *"S corporations" (S-corps), as distinguished from C-corps.*
   - *Limited liability companies (LLCs).*

A sole proprietorship-such as John Doe Plumbing or Marcus Welby, M.D.-is also considered a pass through entity even though no "organization" may be involved.

The first major consideration-in this case, a tax consideration-in choosing the form of doing business is whether to choose an entity (such as a C-corp) that has two levels of tax on income or a pass through entity that has only one level (directly on the owners).

Tip: Co-owners and investors in pass through entities may need to have their operating agreements require a certain level of cash distributions in profit years, so they will have funds from which to pay taxes.

Losses are directly deductible by pass through owners while C-corp losses are deducted only against profits (past or future) and don't pass through to owners.

Tip: Business and tax planners therefore typically advise new businesses-those expected to have startup losses-to begin as pass through entities, so the owners can deduct losses currently against their other income, from investments or another business.

The major business consideration (as opposed to tax consideration) in choosing the form of business is limitation of liability, that is, to protect your assets from the claims of business creditors. State law grants limitation of liability to corporations (C and S-corps), LLCs, and partners in certain forms of partnership. Liability for corporations and LLCs is generally limited to your actual or promised investment in the business.

Types of Business Entities

C and S-Corps

The S-Corp (so named from a chapter of the tax code) is a tax device created by federal law in 1958. It is a regular corporation with regular limited liability under state law, whose owners elect pass through status for federal tax purposes. That status requires compliance with a number of often constricting rules but, with some exceptions, complying corporations escape federal corporate tax. As regular business corporations under state law, they may be taxed under state tax law as regular corporations, or in some other way. Corporations whose owners don't choose to make the federal S-corp election-that choose to be taxed as corporations-are called C-corps (after another chapter of the tax code).

Partnerships

Ordinary partnerships, called "general partnerships," do not have limited liability under state law.

Limited partnerships limit liability for some partners but not others. A limited partnership has both general partners (who manage the business) and limited partners (who in essence are passive investors). The liability of limited partners is generally limited to their investments. The liability of general partners is theoretically unlimited, but can be limited in practice where the general partner is an entity, such as a corporation, with limited liability. A limited partner who takes on what state law considers "too much" management participation is treated as a general partner, losing limited liability.

Both general and limited partnerships are treated as pass through entities under federal tax law, but there are some relatively minor differences in tax treatment between general and limited partners.

A still more recent development, not yet adopted everywhere, is the limited liability partnership (discussed below) which was designed for professional practices.

Other partnership forms are the giant "publicly traded partnerships" (treated as C-corps for tax purposes) and limited liability limited partnerships (adopted in only a few states) which limit the liability of general partners (where two or more) as well as of limited partners.

Limited Liability Companies (LLCs)

LLCs have become the most popular business form for new entities, and many existing entities have converted to this form. They exist in some form in every state. They embody limited liability features of corporations and pass through characteristics of partnerships and S-corps, but are more flexible than S-corps.

For business law purposes, LLC members may be either passive investors or active investor-managers. Unlike with limited partnerships, active management won't affect limitation of liability. For federal tax purposes, LLCs are treated as partnerships (unless they elect otherwise).

Note: Since LLC rules vary from state to state, a characteristic, power or rule in the state where an LLC was created may not apply in some other state where it does business.

Note: Some states do, and some states do not, authorize LLCs with only one member.

Tip: Where one becomes the sole surviving LLC member in a state that doesn't allow single member LLCs, consider quickly incorporating (to regain limited liability) and electing S-corp status (to retain pass through treatment).

Choosing the Tax Treatment

Since 1997, the IRS has allowed business owners a previously unheard-of measure of choice as to how the entity will be federally taxed. It allows you to choose between C-corp and pass through treatment (universally called "check-the-box").

A few choices are *not* allowed. If the entity is incorporated, it must be treated as a corporation (which doesn't preclude an S-corp election if otherwise available). *Publicly traded* partnerships and *publicly traded* LLCs must be treated as C-corps.

Note: Special rules apply to foreign entities.

All other forms of partnership may be taxed either as C-corps or as pass through entities (either as partnerships or, if S-corp status is available and elected, as an S-corp.)

An LLC with two or more members may choose to be taxed as a C-corp, a partnership or an S-corp (if elected). An LLC with a single member (where this is allowed) may choose either to be taxed as a C-corp or an S-corp (if elected) or to have the entity disregarded. In this case, if the LLC is owned by an individual, the individual is taxed directly (and can deduct losses) as with a sole proprietorship.

Typically, partnerships and multimember LLCs choose to be taxed as partnerships while single member LLCs choose to have the entity disregarded. With "check-the-box," the IRS will no longer question your right to combine limited liability with pass through treatment or, if you wish, to waive pass through treatment for an entity otherwise entitled to it (with the exceptions noted above).

Any choice has consequences. For example, if you opted last year for corporate treatment and want partnership treatment this year, you'll be treated as liquidating the corporation, and taxed accordingly (discussed below).

Most-but not all-states that impose corporate taxes follow a taxpayer's federal "check-the-box" choice for state tax purposes. This doesn't necessarily mean that the tax treatment will be the same. For example, a state may accept an LLC's election to be taxed as a partnership and still impose an entity level tax on the LLC.

An election to be taxed as a certain type of entity for federal tax purposes does not make it such an entity under state business law.

Choosing the Form

Let us now consider which form will work best for the way you want to run your business, and capitalize on its profits or startup losses. "Compared to what?" will be a major consideration. We'll need to compare the taxable entity (the C-corp) with pass through entities and compare each of the pass-through entity with the others. We'll also look at tax consequences of changing from one entity to another.

A major decision of whether to use a C-corp or some form of pass-through C-corp is sometimes necessary from a business standpoint. For example, if interests in the enterprise are to be publicly traded, only the C-corp is appropriate.

Note: For some activities, states may require the corporate form (banks, for example) and S-corp rules may preclude the S-corp form.

From a tax standpoint, while C corporations present two levels of tax, the first tax (on the corporation) can be at a rate lower than the tax on the owner and the second tax (on the owner) is usually postponed until the owner receives dividends or other assets from the corporation.

Caution: Distribution of appreciated assets to the owner, or sale of such assets and distribution of the proceeds, are taxable both to the corporation and then to owners. They are no longer opportunities, as they once were, to avoid two levels of tax.

The tax on the owner may be at reduced capital gains rates. This is the case for appreciated assets distributed in corporate liquidation and, after 2002 and before 2009, it's also usually the case for dividends distributed by ongoing corporations.

Caution: Funds can build up in the corporation at a relatively low rate until distributed. However, the eventual tax on the owner, plus the corporate tax, may eat up more of the profits than the single (pass through) tax on the owner does.

A C corp can minimize corporate tax by paying out all or almost all of its income to owners in the form of compensation and fringe benefits. Assuming these payments are deductible as business expenses, this approximates pass through treatment, since the corporation isn't taxed on what it receives and then deducts; the owner-recipients alone are taxed on this. This arrangement works best in personal service businesses, where full business expense deduction is more likely to be allowed.

Caution: The IRS and the courts may limit deduction in other settings, finding owner compensation to be "unreasonable" and partly nondeductible where it reflects a distribution of profits from capital or from the efforts of non-owners.

To summarize, some businesses may find C corp status necessary for business purposes. But only comparatively rarely will it be a preferable tax choice for a new business.

Choosing the Pass-through Entity

If you decide on a pass-through entity, which of the several do you choose? Here is a brief discussion of the rules applicable to each.

S Corporation

Limitation of liability gives S-corps the edge-for business reasons-over general partnerships, sole proprietorships, limited partnerships (as to limited partners whose partnership activity might expose them to unlimited liability), and LLCs in states that don't allow single member LLCs.

Caution: Limited liability comes at a cost, however, since states may impose a tax on S-corps not imposed on entities with unlimited liability.

S-corps are subject to a number of significant rules and restrictions:

- All owners must agree to S-corp status. This means that one co-owner can exact a price or impose conditions for his or her agreement.
- An S-corp can have only one class of stock, which means that income, losses and other tax attributes are allotted among stockholders in proportion to stock ownership.
- The number of co-owners is limited (to 100, with qualifications, counting members of the same family as one stockholder).
- There are limitations as to who can be co-owners (for example, a nonresident alien cannot) and as to the kind of business that can qualify for as an S-corp (for example, an insurance company cannot).

Caution: Failure to meet, or ceasing to meet, these requirements means loss of S status and conversion to C-corp status-and C-corp taxes.

These limits and restrictions will be contrasted, below, with the more liberal tax rules for partnerships and LLCs.

Note: S-corps are often preferred because they are simple to operate. However, they are not suitable for many businesses. The much wider range of options for partnerships and LLCs introduces tax planning complexity which may be more than many or most small businesses can effectively use or understand.

LLCs vs. S Corporations

LLCs and S-corps share the same business advantage-limitation of liability. S-corps are a bit better understood by the business community because LLCs are new and vary from state to state.

The *tax* advantages of LLCs, as compared to S-corps, are the tax advantages of *partnerships.* All the points below where LLCs outscore S-corps arise because LLCs can choose *partnership tax status.*

- LLC can to some degree allocate tax attributes, like income or certain kinds of income, depreciation deductions, etc., disproportionately among members to suit their individual tax situations (unlike S-corps limited by the effect of the single-class-of-stock rule).
- S-corp owners can deduct startup or operating losses up to their investment plus any debt that the S-corp owes *them*. LLC members can do the same but can deduct further, up to their share of the debt the LLC owes *others*.
- Adding co-owners after the entity is formed is easier with LLCs. An outsider's transfer of appreciated property for an LLC membership interest is tax-free. A comparable transfer to an S-corp is taxable unless the new co-owner-transferor (or group of transferors) owns more than 80% of the S-corp after the transfer.
- Complex tax adjustments ("basis adjustments") can be made by the LLC when LLC interests change hands or LLC property is distributed. These adjustments, unavailable with S-corps, can have the effect of reducing amounts taxable to certain LLC members.
- Distribution of appreciated LLC property to LLC members is not taxable to the LLC. Comparable S-corp distributions to stockholders **are** taxable to the S-corp.

Tip: Depending on circumstances, S-corp status can be preferable to LLC status when the owners leave the business. The LLC is **not** taxed when appreciated property is distributed to its members, which is a standard form of business liquidation. But the members would be taxed on distributions exceeding the "basis" (broadly, the amount they invested) of their interests. S-corp owners, on the other hand, can arrange a tax-free exit, via a corporate reorganization in which they transfer their S-corp stock for stock in a corporate acquirer. (Later sale of stock in the acquirer would be taxable.)

Depending on state law, S-corps and LLCs may be taxed at the entity level in states where they do business.

LLCs vs. Partnerships

LLCs, with their limited liability for all members, have the edge on general and limited partnerships from a **business** standpoint. While the federal tax treatment of partners and LLC members is basically the same, there are occasional special tax rules for limited partners (especially self-employment tax rules).

Note: It is not clear whether these special tax rules extend to **non**-manager LLC members.

Note: LLCs are more likely than partnerships to be subject to a state tax.

LLCs vs. Proprietorships

LLCs, with their limited liability, are preferable, where available, for sole proprietors from a business standpoint. Where the sole proprietor so elects, the LLC is ignored and the proprietor is taxed directly under federal tax rules as if no separate entity existed.

Note: Some states do-and some do not-ignore the LLC entity for state tax purposes.

Professional Practice Entities

Professional practices (such as doctors and lawyers) have a number of options as to their form of business entity.

Professional Corporations (P.C.s)

These provide limited liability for general business debts but not for the professional's own malpractice and, in some states, no limited liability for malpractice of fellow practitioners in the firm. They may be C-corps or S-corps. Unlike many other C-corps, a P.C. C-corp can use the cash method of accounting.

LLCs

Most states allow professionals to practice in LLCs, either under a general LLC law or a special Professional Limited Liability Company law (PLLC). In either case, liability is not limited for the professional's own malpractice but, depending on the state, may be limited for the malpractice of other firm members and for other firm debts. These LLCs share the comparative advantages (and minor disadvantages) of other LLCs.

Limited Liability Partnerships (LLPs)

LLPs are general partnerships whose general partners have limited liability. They are designed for professional practices. A partner is liable for his or her own malpractice but not for a partner's malpractice or, depending on state law, other acts of partners. Typically they are required by state law to maintain malpractice insurance, and are obliged to pay a per-partner fee to keep their status, but are not subject to entity level tax.

Sole Proprietors and Partners

Many practitioners choose to practice as sole proprietors or partners, rather than in a limited liability entity. They reason that their main exposure to liability is to malpractice claims, and the entity won't protect against claims for their own malpractice (or, in some states, for a partner's malpractice). They therefore choose to rely on malpractice insurance (which practitioners in limited liability entities may have too).

Tip: Sole proprietorships and partnerships are less likely than limited liability entities to be subject to state entity level tax.

Other Pros and Cons of C-Corps

A C-corp can be preferable to pass through entities as to fringe benefits. As employees, owner-employees of a C-corp qualify for certain employee fringe benefits. On the other hand, self-employed persons (partners, LLC members, sole proprietors, and more-than 2% stockholders in S-corps) **don't** qualify.

Example: Health insurance can be wholly tax-free to C-corp owner-employees (through full deduction by the C-corp and full tax exemption for the owner-employee). However, it is only partly tax-free to the self-employed, because of their limited tax deduction for this item.

Another modest *advantage* of the C-corp is that they are less likely to be subject to passive loss deduction limitations. These limit the opportunity to deduct losses from activities the taxpayer doesn't "materially participate" in, against income from investments or other businesses. Typically, limited partners have been the group most subject to passive loss limitations.

Another tax *disadvantage* of C-corp status is its limited ability to report for tax purposes on the cash method of accounting, which generally defers tax as compared to the accrual method.

Further Insights on S-Corps

A qualifying S-corp, generally nontaxable, can be subjected to C-corp taxation on certain items without losing S status for other items. This happens when a C-corp converts to an S-corp and carries over appreciated property later sold at a gain. The S-corp pays a corporate tax on the gain, which is then taxed to stockholders (reduced by the corporate tax). Because S-corps are intended to be operating companies rather than holding companies, this also happens when the S-corp has "excessive" passive investment-type income (interest, dividends, and the like, in excess of 25% of gross receipts). Here the excess is subject to corporate tax and is then taxed to stockholders (minus the corporate tax).

Some see S-corps as a way to reduce employment taxes. For example, one earning $120,000 in a sole proprietorship might convert to an S-corp and take $70,000 in pay and $50,000 in dividends. Income taxes are unchanged by this but, it's reasoned, $50,000 now received as dividends escapes employment tax (the $120,000 of self-employment earnings was subject to both retirement and Medicare tax up to $102,000 for 2008 and $97,500 for 2007 and Medicare tax above that). In abuse situations, such as where little or no wages were paid, IRS has treated the dividends as pay subject to employment taxes on the owner-employees and on the S corp employer. But in cases where substantial wages were paid, along with substantial dividends, IRS has not objected.

Changing To Another Entity

The many advantages of LLCs, for both business and tax reasons, have encouraged many business owners to convert, or consider converting, to the LLC form. But other changes of entity may suit particular situations-for example, general partnership to LLP (for business reasons) or C-corp to S-corp (for tax reasons). For tax purposes, a change of entity via a check-the-box decision is treated for tax purposes as an actual change of the entity (whatever may happen under state business law).

Here, briefly and in broad outline, is what happens for federal tax purposes when entity status is changed (or treated as changed under-check-the-box). How these apply in your own situation must be reviewed in depth with a tax/business advisor.

- C-corp converts to S-corp or vice versa. No tax on the conversion. Pass through treatment applies while it is an S-corp.
- C- corp or S-corp converts to LLC, partnership or sole proprietorship. Generally, a tax on the liquidation of the corporation, with pass through treatment for the new entity (in modified form in the case of a liquidating S-corp).
- Partnership converts to LLC or vice versa; sole proprietorship converts to single member LLC or vice versa. No tax on conversion-pass through treatment continues.
- LLC, partnership or sole proprietorship converts to C or S-corp. Generally, no tax on conversion. Pass through treatment (in modified form) for S-corp income.

Government and Non-Profit Agencies

- The Small Business Association (SBA) has offices located throughout the United States. For the one nearest you, look under "U.S. Government" in your telephone directory or call the SBA Answer Desk at (800) 8-ASK-SBA. To send a fax to the SBA, dial (202) 205-7064. For the hearing impaired, the TDD number is (704) 344-6640.