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Choosing an Entity

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What is an entity?

To start a business, you must first decide what form your business will take--in other words, you must choose an entity. You, the business owner, create the entity. You give the entity its existence and its name. It may live independently of you. It may sue or be sued. It may even be fined if it behaves illegally. Depending upon its type, the entity may be taxed on its income. A business entity is usually, though not always, a group of persons joined together for a particular purpose--an organization. A corporation and a partnership are examples of business entities. Though such entities may have many owners, each is nonetheless considered a single entity, separate from its owners. (A sole proprietorship, however, is considered an extension of the owner.)

What are the primary attributes of the various entities?

In choosing your entity, you must carefully consider the attributes of each type of entity. Which of these attributes you seek for your business will determine the entity you choose. The seven primary attributes are as follows: formalities of existence, limited liability, pass-through tax treatment, centralized management, sharing profits and control, continuity of life, and the free transferability of interests.

Formalities of existence

Some types of entities are simple and inexpensive to form and maintain. To establish a sole proprietorship, for example, all you need to do is start your business. Contrast this to a corporation, which must file documents with the state, adopt rules for self-government, elect corporate managers (the board of directors), and hold shareholder meetings. If you do not wish to spend a lot of money forming or maintaining your business, consider an entity that has few formalities of existence, such as a sole proprietorship, for example.

Limited liability

An entity offers limited liability if an owner can lose nothing more than his or her investment. In other words, the owner's personal assets are insulated and cannot be used to satisfy the entity's liabilities (debts). So, if you do not wish to put all of your personal assets at risk, think about an entity that offers limited liability, such as a corporation, for example.

Pass-through taxation

In a pass-through entity, only the owners are taxed, not the entity. For example, when a partnership (a pass-through entity) earns and/or allocates profits to the partners, the partners are taxed, not the partnership. (Certain publicly traded partnerships are taxed like C corporations rather than as partnerships.) Contrast this to a C corporation, which is a separate taxpaying entity. With a C corporation, the same profits may be taxed twice. The corporation is taxed on its profits when earned. Then the shareholders are taxed when (or if) these profits are distributed to them as dividends. This is known as double taxation, the avoidance of which is usually a primary reason for choosing a pass-through entity. If you plan to have the profits of the business distributed as soon as they are earned, or if you are interested in starting a business that will permit you to deduct business losses from your personal income, you should consider a pass-through entity, such as a partnership or S corporation, for example.

> **Example(s):** As an oversimplified example, assume that shareholder A is in the 35 percent individual tax bracket and is the sole shareholder of XYZ corporation. XYZ is a C corporation in the 34 percent corporate tax bracket. As a C corporation (not a pass-through entity) with $100,000 in profits and assuming no deductions, XYZ's corporate tax would be $34,000 (34 percent of $100,000). The remaining $66,000, if distributed to shareholder A as a dividend, will be taxed again at 15 percent: 0.15 x $66,000 = $9,900 in taxes. When combined, the tax rate for the corporation and the shareholder would equal 43.9 percent for a total of $43,900 in taxes.

> **Example(s):** If instead XYZ were an S corporation (a pass-through entity), only the shareholder would be taxed. Shareholder A would pay $35,000 (35 percent of $100,000) in income tax. Total taxes paid

on the $100,000 would be $8,900 less than it would in the scenario above.

Caution: For tax years beginning prior to January 1, 2003, dividends were taxed as ordinary income. Various pieces of legislation, in an attempt to mitigate some of the burden of double taxation, provide that dividends received by an individual shareholder from domestic corporations and qualified foreign corporations are taxed at the rates that apply to capital gains. Most recently, in general, the American Taxpayer Relief Act of 2012 permanently extended the preferential income tax treatment of qualified dividends and capital gains. Capital gains and qualified dividends are generally taxed at 0% for taxpayers in the 10% and 15% tax brackets, and at 15% for taxpayers in the 25% to 35% tax brackets. However, starting in 2013, dividends and capital gains are generally taxed at 20% for taxpayers in the new 39.6% tax bracket for high-income taxpayers. Also, as a result of the Affordable Care Act of 2010, beginning in 2013, an additional 3.8% Medicare tax applies to some or all of the investment income for married filers whose modified adjusted gross income exceeds $250,000 and single filers whose modified adjusted gross income is above $200,000.

Centralized management

Some entities permit centralized management, others do not. An entity has centralized management if a person or a relatively small group of persons is responsible for management decisions. A corporation has centralized management because the board of directors is responsible for making all management decisions. In most instances, because each partner in a partnership is bound by (responsible for) the decisions of other partners, a partnership typically does not have centralized management. In a limited partnership, general partners are responsible for management decisions. If you only plan to give a few people decision-making power, which usually results in quicker decisions, then you should choose an entity with centralized management.

Flexibility in sharing profits and control

Some entities are more flexible than others in sharing profits and control with their owners. A C corporation can generally sell its stock to any willing buyer (barring shareholder agreements to the contrary). The number of owners is unlimited. A C corporation may issue classes of stock with differing rights regarding the distribution of corporate profits to shareholders (e.g., preferred stock). An S corporation can issue stock with different voting rights, but all stock must have equal rights regarding the distribution of profits. Shareholders of an S corporation must meet eligibility requirements, and the maximum number of shareholders is 100. If you would like to have control over how profits are distributed and who has control over the corporation, you should choose an entity that allows you to do so. A partnership has considerable flexibility to regulate the sharing of profits and control.

Continuity of life

Some entities can "live" forever. This is called continuity of life. An entity does not possess this attribute if the death, bankruptcy, retirement, insanity, or resignation of an owner can cause it to end (dissolve). A sole proprietorship generally ends at the death of the sole proprietor (no continuity of life). A corporation typically has continuity of life because it remains a corporation despite the purchase and sale of shares and the resulting change in shareholders. A partnership, on the other hand, does not technically possess continuity of life because the withdrawal of a partner results in dissolution of the partnership (though not necessarily the business operation). Though the other partners may choose to continue the business, the old partnership no longer exists and a new one is formed. Continuation of the business can be planned for, so this isn't necessarily a real problem, just something you may want to be aware of and consider.

Free transferability of interests

You should consider the ease with which ownership interests may be transferred. Free transferability of interests exists when owners are permitted to sell their ownership interests to others without restriction. For example, if you would like to be able to sell your ownership interest at any time without restriction (barring shareholder agreements to the contrary), you might think about a C corporation, which allows shareholders to buy and sell stock freely to any individual or entity. If this is not important to you, however, you may be content with an S corporation, which has some legal restrictions on the sale of stock that set eligibility criteria and limit the number of shareholders. Some forms of partnership or corporation are restricted by statute to specific professions, which could limit your ability to sell (or buy) an ownership interest without harm to the entity structure and its treatment under the law and the tax code.

What are the primary types of entities from which you can choose?

Your choice of entity is especially important to Uncle Sam when it comes time to pay taxes. Some businesses are taxed as separate entities while others are not. When an entity is taxed separately, it is said to be subject to double taxation. For example, the C corporation is taxed when it earns profits, and then the owner-shareholders are taxed when those profits are distributed to them in the form of a dividend--a double tax.

Some businesses are not taxed as separate entities, however. Instead, these entities pass the profits or losses on to the owners, who report the income on their personal tax returns. From a tax standpoint, entities can be categorized as either double-tax or pass-through (single-tax) entities. Some entity forms are allowed an election to be taxed as one form or another. The C corporation is a double-tax entity. By definition, sole proprietorships (SP), general partnerships, limited partnerships, S corporations, limited liability companies (LLC), and limited liability partnerships (LLP) are pass-through entities, although an LLC can elect to be taxed as a corporation. (Certain publicly traded partnerships are taxed like C corporations rather than as partnerships.) Professional corporations (PC) may be either, depending upon whether an S election is filed.

Double-tax entity

- C corporation --This entity consists of one or more owners. These owners--who purchased stock (a "piece" of the business) from the corporation--are known as shareholders. This type of entity offers limited liability, centralized management, and free transferability of interests. The shareholders are generally protected from the creditors of the C corporation and only risk the loss of their investments (what they paid for their stocks). The management in a C corporation is centralized in the board of directors, though the shareholders indirectly participate in management by electing directors and voting on certain corporate issues. By definition of law, the shareholders may buy and sell their stocks virtually without restriction (free transferability), although contracts among the owners often restrict this ability.

Pass-through entities

- Sole proprietorship (SP) --An SP is a one-owner/one-operator business. The primary advantage of this type of business is its simplicity. Generally, a person need only begin doing business to be considered a sole proprietor. The sole proprietorship is not taxed as a separate entity. Instead, the sole proprietor reports the business's profits and losses on his or her personal tax return. On the other hand, however, the owner is personally liable for all liabilities of the business. If you choose this type of entity, don't forget to buy liability insurance.

- General partnership --A general partnership must consist of at least two owners (partners), although there is no limit to the number of partners in the partnership. Forming a general partnership is generally simple and inexpensive. There may be fewer formalities to follow than with a corporation. There is no entity level taxation on the partnership. Instead the individual partners are taxed on the profits. The general partnership doesn't offer limited liability. Moreover, a general partnership will typically not allow you to freely sell your interest.

- Limited partnership --A limited partnership combines limited liability and centralized management, often associated with a C corporation, with a pass-through taxation feature. This entity consists of two types of partners: general and limited. Only limited partners receive liability protection. If the limited partners participate in management, their liability protection is lost. Only the general partners can manage the partnership. In return for the ability to manage the partnership, general partners remain personally liable. (Certain publicly traded partnerships are taxed like C corporations rather than as partnerships.)

- S corporation --Like a limited partnership, an S corporation combines limited liability with pass-through taxation. Unfortunately, an S corporation is limited to 100 shareholders. Although stock with different voting rights may be issued, different classes such as preferred and common are not allowed. Stock ownership is typically restricted to individuals, estates, and certain trusts. If stock is sold to an ineligible shareholder (such as a partnership), the corporation loses its "S" status and the (tax) benefits that go along with it.

- Limited liability company (LLC) --An LLC with multiple owners can be taxed as either a corporation or a partnership. If taxed as a partnership (the typical choice), an LLC will offer limited liability and pass-through taxation without some of the disadvantages of a limited partnership or an S corporation. For example, owners of an LLC (called members) can contribute to management without compromising their limited liability protection. Unlike an S corporation, an LLC is not restricted regarding the type or number of owners, or the types of stock that can be issued. An LLC with a single owner will be treated like a sole proprietorship for federal income tax purposes if it does not elect to be taxed as a corporation. However, you should be aware that some states do not recognize or permit LLCs with a single owner.

- Limited liability partnership (LLP) --An LLP is an entity form with similarities to both the general partnership and limited liability companies. This form offers more liability protection to the partners than a general partnership, but sometimes less than an LLC. The LLP is designed for those professions that face malpractice suits, and may be adopted in those states, if available, that don't allow certain professionals to form LLCs.

- Professional corporation (PC) --The professional corporation (PC) is a corporation. It is treated as a single entity, it raises its own money by selling stock to shareholders, and it usually handles its profits by either distributing the profits to shareholders or reinvesting the profits in the business. It can assume the basic tax features of either a C corporation or an S corporation. This type of corporation is unique primarily because its shareholders must generally be members of a licensed profession. Each state, by statute, defines the professions that may form a PC.

After you have chosen your entity, be prepared to reassess that choice as your business evolves. Major changes in the work force, sales, profits, or the law may necessitate a change of entity. If, for example, you had chosen an S corporation only to decide years later that you wish to have many more than 100 shareholders, you may have to consider changing your entity to a C corporation.

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