

Choice of Entity

There's a lot to consider in starting your own business: developing a business plan, obtaining sufficient funding, marketing the business and a host of other concerns. Also critical is determining the form of organization that best suits the business because this will impact operating efficiency, the way you report business income, the taxes you pay, and the extent of your personal liability.

To make an informed decision, you must be aware of the income tax law and tax rates, as well as the non-tax issues, such as transferability, control and the potential legal liability.

Every single facet concerning your business is relevant to the Choice of Entity decision. Not all of them are of equal importance, but they all matter to some degree. The initial focus on choosing a business structure should be on:

- the tax and tort liability issues,
- cost of maintenance of the entity,
- protection of intellectual property (very important and often overlooked),
- size and complexity of the entity,
- and regulatory requirements that the local, state or federal government has placed on the proposed business activity.

Provided below is a chart summarizing some of the above considerations based on various entity types.

Selecting the Right Structure for Your Business

	Sole Proprietorship	Partnership	Corporation (“S” and “C”)	Limited Liability Company (LLC)
Management Issues				
FORMATION	As simple as opening a bank account for the business; some states and municipalities may require obtaining a license or permit.	Started with an oral agreement, written is advisable (required in some states) to agree on points such as P/L %; business decisions; add/drop of a partner; and terms of operation. Some partnership allocation structures may subject you and to more IRS scrutiny.	Corporate documents are filed with the state and an annual fee is paid. Separate corporate bank accounts and records are created and assets and money generated by the corporation are owned by the corporation (not the shareholders).	Created through articles of organization and an operating agreement; owners are called members and are not personally liable for the entity's debts and liabilities.

	Sole Proprietorship	Partnership	Corporation (“S” and “C”)	Limited Liability Company (LLC)
Operation and Control	Ultimate control rests with a single owner	Requires at least two partners who own the business and share in the profits and losses. The partnership agreement explains who will control and manage the business. In a general partnership with no agreement, all general partners have equal management rights and control. In a limited partnership, the management and control of the business is handled by the general partners.	Bylaws (operating rules) are created to establish and explain the rules governing the organization. The shareholders have sole authority to approve articles of incorporation, mergers and dissolution of the company, and they elect the directors. Directors are responsible for major decisions, including selection of company officers.	Single-owner LLCs operate like sole proprietorships; multiple-member LLCs operate and are taxed like partnerships, although members may elect to treat and tax an LLC as an S or C corporation if they wish
Investment	Limited to the assets and borrowings of the owner.	Based on the number of partners and the written agreement, which should also explain how a departing partner will be paid for part ownership when he or she leaves, dies or retires.	S Corporations can issue one class of stock to up to 75 shareholders (increased to 100 for years beginning after December 31, 2004). C Corporations can issue different classes of stocks and bonds and can increase borrowing capacity.	Rules are similar to a proprietorship for single-member LLCs and to a partnership for multiple-member LLCs.
Continuity and Transfer	Continues until abandoned or upon death of the owner. Assets and liabilities can be freely transferred by selling all or a portion of the assets.	Continues subject to the partners’ agreement and as long as all general partners remain in the partnership. Partnership dissolves if a GP dies or leaves, unless the agreement provides for continuation of the business by the remaining partners.	Can exist in perpetuity even if one or more owners die. Ownership can be transferred by sale of stock. Continuing S corporation status depends on limiting ownership to 100 shareholders.	For multi-owner LLCs, continuity and transferability are determined by the organizing and operating documents and may affect the LLC’s ability to choose corporate or partnership tax status.

	Sole Proprietorship	Partnership	Corporation (“S” or “C”)	Limited Liability Corporation (LLC)
Legal Liability	Unlimited personal liability. Creditors can make claims against your business and personal assets. Insurance may cover some risk.	General partners are fully liable for all liabilities of the partnership, no matter which general partner incurred them. Limited partners are responsible only to the extent of their investment.	Shareholders are liable only to the extent of their investment in the business.	Liability rules are similar to corporate shareholders; members are not personally liable for the debts and liabilities of the LLC.
Tax Issues				
Taxability of Income	Income or loss reported directly by owner.	Income or loss is passed through to partners using Schedule K-1.	<p>S Corp - Income or loss is passed through to shareholders using Schedule K-1; the amount reported is based on percentage of stock ownership.</p> <p>C Corp - Income is reported and tax paid through the corporate tax return. Shareholders then pay income taxes on dividends distributed by the corporation, with “qualified dividends” subject to lower tax rates.</p>	Single-owner LLCs operate like sole proprietorships; multiple-member LLCs operate and are taxed like partnerships, although members may treat and tax an LLC and an S or C Corporation.
Compensation and Payroll	Must pay self-employment taxes as part of their quarterly estimated tax payments.	General partners are subject to self-employment taxes on their share of self-employment income from the partnership (whether or not distributed); limited partners are not subject to self-employment taxes.	<p>S Corp – Income and Social Security taxes are withheld from wage income paid to shareholder-employees.</p> <p>C Corp – Same as S Corp above.</p>	Treated according to the tax treatment selected. If treated as a partnership, active members must pay quarterly estimated self-employment taxes, but inactive members are not subject to self-employment taxes.

	Sole Proprietorship	Partnership	Corporation (“S” or “C”)	Limited Liability Corporation (LLC)
Tax Years	Must use the proprietor’s tax year, e.g., the calendar year.	If one or more partners using the same tax year own interests in the profits and capital of more than 50 percent, the partnership must use the tax year of those partners. This generally is a calendar year. However, a partnership can (1) establish a business purpose for a different year; (2) make a Section 444 election; or (3) elect to use a 52-53-week tax year referenced to its required tax year or a tax year elected under Section 444.	S Corporations may use the calendar year; a tax year elected under Section 444; or a 52-53-week tax year ending with reference to the calendar year. C Corporations may select any fiscal year unless they are classified as a Personal Service Corporation (PSC); a company with the principal activity of providing services in the fields of health, law, accounting, engineering, architecture, performing arts or consulting.	Treated according to the tax treatment selected

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