Hanis Irvine Prothero, PLLC

CHOOSING THE RIGHT BUSINESS ENTITY

MARCH 2009

There are many different types of business arrangements and entities. When you are starting a new business, it's important to form the right type of business entity to suit your particular circumstances: Different types of business entities include:

- Sole proprietorship
- General partnership
- Limited partnership
- Limited liability company
- C Corporation
- S Corporation

If the potential risk of your business is significant, you should consider operating it as a separate entity, not as a sole proprietorship or general partnership. You may not be personally liable for business debts as a corporate shareholder or LLC member. Creditors may still access the business resources, but not personal assets.

Here are just a few of the tax issues to consider:

Income taxes.
Because the C Corporation is a taxable entity, you are subject to double taxation, first at the corporate level for rates up to 35 percent, and then on the shareholder level, with rates on qualified dividend income currently up to 15 percent. Shareholders of an S corporation and members of an LLC, however, are, in general, not taxable entities. Their owners are subject to only one tax level.

Distributions.
Distributions of appreciated property result in double taxation if from a C corporation or single taxation if from an S corporation. With an LLC, distributions, in general, are not taxable.

Flow through of losses.
Operating losses of an S corporation and an LLC pass through to the shareholders and members, unless subject to certain limitations. The losses from a C corporation are trapped with the entity, and may only offset income when carried back or forward to other tax years.

Basis for deductions.
It is not advised to hold real estate in an S corporation if the property will be leveraged with debt. Corporate liabilities will not increase the shareholders' basis in their stock. The basis of LLC members in their interest would include amounts borrowed by the company.

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Fringe benefits.
Shareholders who are employees of a C corporation are eligible for fringe benefits, which are deductible as business expenses, and are not taxable income for the recipient. Shareholder and member employees who own more than two percent of their entity are not eligible to receive this benefit, and must include medical insurance premiums paid by the entity as income.

Social security and self employment tax.
Distributions in excess of reasonable compensation to an S corporation shareholder are not subject to social security taxes. The IRS requires LLC managers and certain members to be subject to self employment tax on their distributive share of all the company's income.

These are just some of the many tax and financial considerations, and many other variables, that need to be carefully considered when choosing what type of business entity to form. When making these decisions, it would be wise to consult with a business lawyer experienced in these issues.