Your Business Entity Choice: Why It Matters

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From Waldron Rand's January 2012 Newsletter: *Accelerating Business Success*

Whether you've been in business a few years or are just now launching a new organization, determining the type of entity you want your business to operate under is one of the most critical decisions business owners face. There are many factors to consider before you determine if your business should be an LLC, Corporation, Partnership or if you should operate as a Sole Proprietor. When advising clients on entity choice we use the following questions to guide us through the discussion and lead to the answer that will best serve their needs. These questions include, but are obviously not limited to:

- What is the nature of your business?
- What is your liability exposure?
- What state(s) are you doing business in now and in the future?
- What level of legal formality do you desire?
- How do you plan on allocating profit and losses?
- What are the sources of capital for your business, including debt?
- Will capital be repaid? If so, in what order?
- Do you have an exit strategy? If yes, what's your time line?
- Are you considering specific incentives to offer your employees?
- What type of retirement plan do you want to offer, if any?
- Will international expansion be a part of your growth plan?

The answers to these questions will help determine the entity form that is best for your business. Next, we have outlined the types of entities and some of their basic characteristics. If you are struggling with this decision, please contact us so that we can help you make a determination that is right for your organization's future.

SOLE PROPRIETORSHIP

This is by far the simplest of all entity choices. It requires a minimum effort to register. Most states do not impose annual fees nor require separate income tax filings. The primary disadvantage of this type of entity is that it offers no liability shield. Therefore, it is generally most appropriate for small organizations that have very low liability exposure.

CORPORATION

Corporations are separate legal entities organized in accordance with and governed by state law. Unless there are agreements to the contrary or certain acts are committed by the owner(s), shareholders are afforded liability protection. Owners have two choices when incorporating: to be a C corporation or elect to be an S corporation. Both are taxed effectively at a maximum federal tax rate of 35% in 2012, and individual owners of either are generally not subject to self-employment taxes.

For C corporations, profits are first taxed at the corporate level and then the shareholders pay tax at the individual level, if and when they receive dividends or upon liquidation. This is commonly referred to as double taxation. Proper tax planning and the use of wages or other compensation can help minimize the impact of double taxation.

By contrast, S corporations are pass-through entities whereby the company's profits and losses pass through to the shareholders, who report the income or losses on their individual returns. While this can be an excellent choice in many cases, S corporations do have a limit to the type and number of shareholders allowed. Therefore, this may rule them out as an option, depending on your circumstances and make them less attractive to potential investors. In addition, all S corporation shareholders must be treated equally, based on their pro-rata share of ownership, when it comes to profit and loss split, distributions and gain on the sale of the business. Thereby, an S corporation provides less flexibility than some other choices.

PARTNERSHIP

For some businesses with two or more owners, being a partnership may be the better entity choice. Generally there are two types that are prevalent - general and limited.

In a general partnership, as with a sole proprietorship, partners remain personally liable for the business' obligations. In a limited partnership, the partners' personal liability is generally capped at their investment in the partnership. The general partners in a limited partnership typically have authority to make decisions on behalf of the partnership and therefore assume personal liability for the entity's obligations.

The partners of both general and limited partnerships are taxed on their share of the partnership's income or loss, currently also at a maximum 35% tax rate on each partner's personal return. Depending on the type of business, general partners are typically subject to self-employment taxes while limited partners are not. Partnerships are also much more flexible in terms of allocating income and losses than S corporations, have fewer restrictions on partners and are fairly easy to set up.

LIMITED LIABILITY COMPANY

A limited liability company (LLC) elects how it is to be taxed. However, most LLCs with more than one member (owner) typically elect to be treated as a partnership for tax purposes, with the pass-through taxation consistent with the rules for partnerships. Each member of the LLC is taxed on their share of the LLC's income or loss, again at the maximum rate of 35%, on their personal returns. With single member LLCs, the entity's income or loss is reported on the member's tax return. No separate tax return is required.

LLC's are attractive because they provide protection against personal liability for debts and obligations of the business comparable with the protection offered by corporations.

At Waldron Rand, we recognize that these decisions are challenging and can have significant tax consequences. Please feel free to contact me directly at 781.514.1699 or by email at bobg@wrand.com to discuss these challenges in more detail.

About Waldron H. Rand & Company, P.C.

At Waldron Rand, our business, tax and financial experts are more than scorekeepers. We take a holistic approach to working with clients by looking at your business from **your** side of the table. Unlike other accounting firms, our partners work closely with you to implement your strategies, fueling the success of your business.

For more than 100 years, we have been providing partner-level services to help our clients manage challenges and seize business opportunities. For more information or to personally speak with a partner, please call 781.449.5825 or email us at: advice@waldronrand.com.