Entity Choice

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So, you have come up with a great entrepreneurial product or service, discussed the idea with your network of confidants and now have developed a business strategy and plan? All that's left to do is to meet with accounting, tax and or legal advisors to discuss your proposed business. You have been told that you must decide on an entity to house your business. What you have initially been told or have read about has just about convinced you to scrap your plans and go back to work for your current employer……Sound familiar? Let's simplify the subject and hopefully make it less complicated. An entity is a legal and tax term used to describe the operating structure of one's business. The common practice is to separate one's business operations, including assets owned from one's personal affairs and assets. Making an entity choice can be a daunting task. Common entity types include, Sole Proprietorship, Partnership, Corporate and Limited Liability entities. With so many choices out there, how do you know which one is right for you? This question is typically both legal and financial in nature. There can be many things to think about. Here are some, with the pros and cons of these choices.

A **sole proprietorship** is the simplest way of conducting your business, one owner opening a business bank account and starting operations. The entity does not have to apply for an Employer Identification Number or EIN, unless it has employees, because the business can be maintained by using the owner's social security number. For tax filings, the operations of the business are reported on the owner's individual tax return using a Schedule C. While this entity is very easy to start, maintain and operate, it is important to understand that, generally, there is no separate legal existence apart from the owner. In other words, there is no legal separation between the sole proprietor and the owner's personal assets. This concept may vary from state to state. In the event of the death of the owner, the entity ceases to exist. A sole proprietorship business may be transferred by gift or sale.

Next up is a **partnership**. A partnership is an entity that has more than one owner. The owners can be individuals, other partnerships, corporations or trusts. The partnership is formed by creating a legal agreement between all partners and, in some instances, requires a state registration. This agreement will outline the dos and don'ts of the partnership, the partner's responsibilities and how profits are to be split. Because this is a separate entity, distinct from the owners, the entity will need to apply for an EIN from the Federal and State authorities in order to identify itself as such. This entity does not pay taxes at the partnership level, but all net profits are flowed through and taxed at the owners' individual level, as governed by the partnership agreement. Even though a partnership is a separate entity from its owners, the entity generally does not protect its owners from liability. This legal aspect is similar to a sole proprietorship. A partnership business is perpetual as long as there is more than one owner. Partnership interests can be transferred either through gifting or sale.

Third in the entity list are **corporations**. Corporations, in the common law sense, are treated as distinct, separate, legal entities apart from their owners, called shareholders. Corporations are further classified, in tax terms, as C-Corporations and S-Corporations. There are very significant differences between the two; however, C-Corporations are normally maintained for the large businesses and are used in intricate planning instances. We will, based upon this discussion, deal with S-Corporations. This is generally the choice of small business owners if a corporate ownership entity selection is made.

An **S-corporation** is also a "flow through" entity. This simply means that the income generated by the company is flowed through to the owners' income tax return and taxed at that level. An S-Corporation is a special type of corporation that contains various restrictions on the amount and type of shareholders permitted to use this entity. An S-Corporation existence is started by filing incorporation papers with the State and then making an election, both Federal and State, to be treated as an S-Corporation. Once formed, there are multiple administrative requirements that must be maintained. Stock will be issued to the owners, and a board of directors will be elected. In addition, one of these requirements is to have periodic stockholders and board of directors meetings and the keeping of corporate minutes. These minutes, or written records of the shareholder and board of director meetings, will state all of the important activities and decisions of the company. The taxation of this type of entity is very similar to a partnership, where the owners get taxed on their proportionate ownership of the entity's profits. Because this type of entity is a Corporation, generally there is liability separation between the stockholders and the Corporation. This is the distinct difference from the first two entities described above. S-Corporation life is perpetual and its stock is transferrable, either through gifting or sale.

A **limited liability company**, or LLC (or Limited Liability Partnership, LLP), is somewhat of a hybrid entity, a cross between a corporation and a partnership or sole proprietorship. This type of entity gives the limited liability protection of a corporation, as the name suggests, yet can be treated as a partnership or sole proprietorship for income tax purposes. Therefore, the entity receives all the benefits of an S-Corporation without having to fulfill all of the corporate protocol. An LLC that has one owner will file a Schedule C, the same treatment as a sole proprietorship. Operations of LLC's that contain multiple owners (members) will be reported, for tax purposes, on a partnership return. LLC ownership is perpetual and the interest is transferrable, either through gifting or sale.

While it seems that entity selection is voluminous, a business owner does have a choice which entity can and should be tailored to their needs and planning goals. The above discussion should give you a basic understanding to build upon when meeting with your legal and tax advisor. It is best to discuss all your needs and concerns with a professional that will help guide you through this process.

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