

Choosing the Right Business Entity

Choosing the form of entity under which a business will operate is one of the first, and often the most important, decisions a business owner will make. Although the legal details underlying each entity type are inherently complex, exploring three major variables may help you determine which option is right for you: business control, owner liability, and tax implications.



The major business alternatives today include:

Sole Proprietorship

Partnership

C-Corporation

S-corporation

Limited Liability Company

The following comparison illustrates the most dramatic differences, and similarities, between several entity alternatives.

Sole Proprietorship. As its name implies, a sole proprietorship has a single owner, and is perhaps the most simplistic of all entity types. The main benefits of the sole proprietorship include its ease of implementation and lack of regulatory requirements. In addition, the sole proprietorship allows complete business control to a single business owner (proprietor). Under a sole proprietorship, the business owner is required to file a Schedule C (profit or loss from a business or profession) with their personal income tax filing. The proprietor personally assumes all liability and business risk, which can often be "transferred" through the purchase of liability insurance.

Partnership. The main difference between the sole proprietorship and the partnership is the number of business owners. Although quite easy to establish, it is a good idea to begin a partnership with a formal arrangement known as the partnership agreement. The partnership agreement sets forth the intent of the business owners in the event of a wide variety of business events such as the sale of the entire business, the sale of a single individual's holdings or the disposition of ownership in the event of the death of a partner.

Like the sole proprietorship, the partnership represents a "flow-through entity" where both cash flows and tax liabilities flow through to the business owners. The partnership provides its owners minimal protection from business risk.

C-corporation. Though often costly and time-consuming to establish and maintain, the C-corporation provides the greatest amount of liability and business risk protection to the business owner(s). Strict governmental regulations outline company structure, reporting, and disclosure requirements.

Corporations have unlimited lives with ownership rights passing to designated heirs upon the death of an owner. The corporate entity also has a great deal of income tax flexibility and can offer the broadest array of tax deductible benefits, but may also trigger "double taxation" of some corporate profits as they are taxed at the corporate level as profits and again, potentially, at the individual level as taxable dividends are paid to shareholders.

S-Corporation. The "S Corp" functions as something of a hybrid, assuming many of the best features of several other entity types. The S Corporation is a legal entity that offers owners the benefits of greatly limited liability, while allowing company profits or losses to flow directly through to the business owners for income tax purposes, thus avoiding potential double taxation. The legal requirements and costs associated with starting an S Corporation are modest, as are the regulatory requirements. There are limitations on the number of owners within an S Corporation, and a C Corporation may not be an owner.

Limited Liability Company. Like the S Corporation, the Limited Liability Company (LLC) combines many of the benefits of other entity types. In contrast to the proprietorship and partnership, the LLC provides its owners (or members) with limited liability for the debt and business risk associated with ownership. The LLC also avoids the "double taxation" of the corporation by functioning as a "flow-through entity" for income tax purposes.

Selecting a business entity can be a complex decision with long-term effects on the ownership, owner liability and taxation of a business. Once you have prepared a business plan and evaluated your business ownership goals, consider seeking the advice of trusted financial professionals and advisors in finalizing your final selection of business entity.

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