Choice of entity poses tax, liability issues

Partnership, LLC, or corporation? What you need to know before starting a business

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Tax-Business Formation

For every business, important legal and tax consequences hinge on the "choice of entity" question. You can operate a business through a corporation, partnership, limited liability company (LLC) or a proprietorship. In the last case, there is no legal entity and you simply conduct business by yourself. With a unique mix of tax issues and liability, one size does not fit all.

LIMIT YOUR LIABILITY

Without a legal entity, you are operating as a proprietorship, the oldest form of business. A proprietorship can only have one owner, although husband and wife are considered one for this purpose. To limit your liability, an entity should conduct the business, not you personally. You want the entity's assets at risk, not your house or college fund.

There are circumstances where creditors can pierce the corporate veil, but this usually requires proof the entity is undercapitalized, underinsured, or otherwise not a commercially reasonable separate entity. With or without an entity, consider buying insurance, including general liability, products liability, employee fidelity, workers' compensation, unemployment insurance, etc.

PARTNERSHIP FORMALITIES

A partnership can be formed with a handshake, but write it down, as oral agreements foment disputes. With a general partnership each partner has personal liability.

A limited partnership has one or more general partners, and one or more limited partners. Limited partners might lose their investment, but their other assets are not at risk. You can even get around the general partner's unlimited liability by having a corporation as the general partner.

To get the benefits of limited partnership treatment, you must file a certificate and pay annual fees. Furthermore, if limited partners make day-to-day business decisions, they can wind up with general partner liability. So you may want to consider an LLC.

LLCs ARE MOST FLEXIBLE

By far, the most flexible business entity is an LLC. Adapted from European countries, LLCs exist in every state. Everyone is a "member" (not a partner), and there is almost infinite flexibility. You can have different classes of members, different voting rights, different capital requirements and management roles, and more. LLCs start with a simple fill-in-the-blanks form filed with the secretary of state. They should also have a longer agreement called an "operating agreement." LLCs receive pass-through tax treatment, and investors do not need to worry about acquiring unlimited liability if they are too involved.

BEWARE OF DOUBLE TAX

The most classic business entity is the corporation. Like an LLC or limited partnership, a corporation begins its life with a simple filing with the secretary of state. Its owners are the shareholders, who elect a board of directors, who in turn elect officers. Corporations offer limited liability and an orderly structure that most people understand. Plus, the units of ownership — shares of stock — can (subject to compliance with securities laws) be freely traded.

A corporation is the only alternative for big and public companies. Corporations are separate legal entities and are separately taxed. Plus, if the corporation pays dividends, the shareholders are also taxed. That is a double tax: once to the corporation and once to the shareholders. Suppose a corporation grows for 30 years and is then sold, yielding a whopping capital gain to its retiring owners. There is a double tax there, too. Generally, a corporation is treated as selling its assets, incurring gain (and tax) at the corporate level, as corporations are not entitled to the lower capital gain rate. Any after-tax proceeds are then taxed to the shareholders.

Pass-through entities like partnerships and LLCs are more attractive. Each partner or member receives a Form K-1 reporting their share of the income or loss on their own tax returns. Of course, the amount reported on a Form K-1 by an LLC or partnership may not actually be paid to the member or partner. Most LLCs and partnerships will pay out at least enough cash to enable members/partners to pay their tax, but it is not legally required.

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S CORPORATIONS

You may have heard the term "C corporations" used to distinguish them from S corporations. Under state law, an S corporation is just like any other corporation. But if you file a one page "S election" with the IRS (and California Franchise Tax Board), it is taxed almost like a partnership or LLC. However, an S corporation can face corporate tax if it was previously a C corporation and elected S status within the last 10 years.

An S corporation can have no more than 100 shareholders, only domestic shareholders (U.S. citizens and resident aliens), generally individual shareholders, and a calendar fiscal year. If there are multiple classes of stock, only differences in voting rights are allowed. For most small businesses, these criteria are easy to meet. If the owners are more comfortable with the corporate form than with an LLC, an S corporation can be a good choice.

Unfortunately, the accounting rules for S corporations are complicated, and it is hard for existing C corporations to convert. Many of these rules can be avoided if you start out with an S corporation. To do this, file your S election within 75 days of forming your corporation.

WEIGHING ADVANTAGES AND DISADVANTAGES

Whatever type of business you start or run, the key is the business itself, not the structure through which it operates. You can probably make any of these choices work, no matter which you select (or which you inherit). Still, you will want something that complements your operation and that is tax efficient.

How do you weigh the pluses and minuses on your facts? Usually, C corporations make no sense for small businesses due to double tax currently or when the business is sold. If you want to "go public," you will have to be a C corporation, but it is easy to later transition from an LLC or S corporation to a C corporation. Besides, if you incur losses, you will want to claim them personally, favoring an S corporation, LLC or partnership.

LLCs have largely replaced limited partnerships as vehicles of choice for passive investments and small business. As between S corporations and LLCs, S corporations have more complicated accounting limitations on the losses a shareholder can claim, and a passive income tax. In contrast, an LLC is a pure pass-through. However, LLCs do not have the many decades of authority and practice experience of corporations, partnerships and even S corporations. Moreover, some sales of interests in an LLC can be taxed less favorably than a disposition of stock in an S corporation; and if 50 percent or more of the total membership interests in an LLC are transferred in any 12-month period, it "terminates" the LLC for tax purposes — a major headache.

Whatever entity you choose, if you sell the business or change it significantly, there may be ways to ameliorate the result. So get expert help when the time comes, and do not feel like whatever entity you choose is engraved in stone.

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