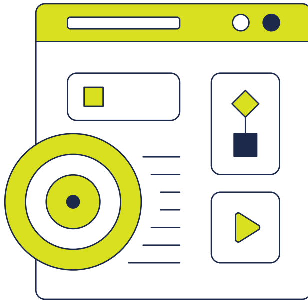

What Entity Should I choose when I start a business?

One of the common questions from new business owners is "Should I form an LLC or corporation?" Although there are legal issues that should be considered, I will address the entity selection from a tax standpoint.

After LLC's became common, the IRS decided to throw in the towel, and told taxpayers forming new entities, "You tell us how you're going to be taxed." They extended that safe harbor to corporations and partnerships. Essentially, when you start a new legal entity to do business, you select how you want to be taxed, and tell the IRS (Form 8832). This election can be done up to three months after the company is active (not filing). So the question is less "Do I want an LLC or corporation" and more "How do I want to be taxed?"

Let's take a look at the three alternatives:

CORPORATION: The corporation (or C Corp) pays its own tax, using a separate set of tax rules and rates. Any distributions to shareholders are considered dividends, and are taxable to the recipient. This causes a "double tax", once when the income is earned, and again when it is taken out of the company. Many small businesses try to avoid this situation, and elect an S-corporation (see below). Since there are restrictions on who qualifies as an S-corporation, larger companies have to be taxed as corporations.

The rates generally are higher, and the brackets are lower (i.e. you pay the higher rates quicker). Additionally, there is no capital gains tax treatment in a corporation. All income is treated as ordinary income, which is a real disadvantage compared to other options. However, the first $50,000 of net income is taxed at 15%, which means new companies showing smaller profits often pay a lower rate than an individual would.

S-CORPORATION: By far the most popular option for small business, the S-corporation does not pay tax separately. Rather, any profit or loss flows through to the individual shareholders. There are limits on who can be shareholders (e.g. U.S. citizens or residents), can only have one class of stock (see partnership below), and fewer than 100 shareholders at one time. Small business owners like S- corporations because they pay themselves a low salary, while taking the remainder of the profits as distributions. This allows them to avoid the self employment tax that is levied against all income of a sole proprietor. Of course the IRS is wise to this idea, and has been targeting S-corporations that they think don't pay their owner/officers enough salary.

PARTNERSHIP: Partnerships are often avoided because of a lack of understanding. Like an S-corporation, the partnership pays no tax, but passes profit/loss to the individual partners. Unlike S-corporations, there are no limits on who can be a partner. Additionally, there are no restrictions on "classes of stock". Although there is no stock in a partnership, partners can set up the rules for profit/loss/capital sharing however they want. For instance, say there is a "money partner" that puts money into the partnership but does not participate in the operations of the business. And let's say she wants her money back from the profits first. So every dollar of profit is distributed to her before any of the other partners receive distributions. With an S-Corporation, this would create a second class of stock (not everyone is treated the same), making the corporation ineligible, and reverting it back to a normal (C) corporation.

One can do the same with profits and losses. One partner can use the losses, so they take 100% of the loss pass through, but only 50% of the profits. Basically, if you can imagine it, you can do it in a partnership. One potential downfall is that the IRS has technically never ruled on weather distributions from an LLC taxed as a partnership are subject to self employment taxes for partners actively involved in the trade or business. Haven't seen them take that position with any of our clients, but you need to be aware it's out there.