Choosing the right business structure.

Of all the decisions to be made when starting a business, one of the most important is the type of legal structure the business owner selects for their company. This decision impacts both the owner and the business in many ways: tax liabilities, the amount of aministrative complexities, the management of debt, and the extent of personal legal liability for the owner.

Choosing the business structure is one of the first steps in starting up a business. The structure that makes the most sense will depend on individual circumstances. Each business structure has advantages and disadvantages that will be integral to the personal and business success of the business owner.

The business structure influences everything from day-to-day operations, to taxes, to the amount of personal assets at risk. The business owner should choose a structure that gives the right balance of legal protection and benefits.

There are five types of business structures: sole proprietorship, partnership, Limited Liability Company (LLC), C corporation and S corporation.

Sole proprietorship

A sole proprietorship is the simplest way to organize a business. It is the least expensive to set up and register and the easiest to manage, due to less onerous government reporting requirements. In this business structure, the business owner has complete control over business decisions and receives all of the profits earned by the business.

In this structure, the business owner is usually considered to be self-employed. Little or no capital is required to set up the business, but raising capital later may be difficult due to the inability to issue shares in exchange for capital.

As a sole owner, the business owner is personally responsible for all debts and obligations related to the business; this is referred to as unlimited liability. This means that the owner's business and personal assets are subject to claims by creditors to satisfy any unpaid debts.

All profits go directly to the business owner, so net business income is taxed as personal income. The business owner must file a personal tax return to report all business income or losses. If the business is performing poorly, business losses can be deducted against other income, such as investment or rental income, generally up to 80% of taxable income with any unused amount carried forward for up to 20 years.

In a sole proprietorship, the owner generally performs all of the functions required to set up and manage the business. It may be difficult to attract other employees, and when the business owner wants to retire it will likely be difficult to ensure the continuity of the business.

Partnership

A partnership is a non-incorporated business established by two or more persons to combine their resources and share in the profits and expenses. This type of business organization is usually easy to set up and manage, but it is highly recommended that a written partnership agreement is drafted at the beginning of the relationship between partners to address operating procedures.

This business structure combines the financial resources and the unique skillsets of the business partners. While this means there are "more hands on deck" to control and manage the business, the division of authority may potentially lead to disagreements or conflict between partners when making important business decisions.

The written partnership agreement is a useful tool for managing the business effectively and minimizing conflict. This legal agreement should clearly define the terms of the business, provide a process for conflict resolution, state how profits or losses will be shared and describe the steps and outcome of the dissolution of the business. It is important to seek the advice of a legal professional when drawing up a partnership agreement to ensure the protection of the individual interests of the partners.

There are two types of partnership: general and limited. The extent of personal liability for each partner is dependent on the type of partnership. In a general partnership, each general partner is jointly and personally liable for all the debts and obligations of the partnership. This is known as unlimited liability. In a limited partnership, a limited partner can contribute to the business without being involved in its day-to-day operations, and so is usually not personally liable for the debts of the business. A limited liability partnership is sometimes used by professionals such as lawyers, accountants and doctors.

The partners of the business will share in all the profits and losses of the business, and these will flow to the individual partners. The individual partners will report their share of the net income or loss on their personal income tax return. A general partner's share of the earnings will be treated as self-employment income and subject to self-employment tax as well as income tax. A limited partner does not pay self-employment tax unless they receive guaranteed payments for services and then only to the extent of those payments.

It can be difficult to raise additional capital for the business from third parties unless a valuation of the partnership can be established and additional partnership units issued. Such capital may need to be sourced from operating profits or the partners' own personal assets.

Compared to a sole proprietorship, business continuity in a partnership is easier as it is less reliant on one individual. Hence, it is important that a partnership agreement is in place to describe how to deal with the exit of one of the partners from the partnership.

If you are considering setting up your business as a partnership or investing in a partnership, you should consult with legal and tax professionals for advice.

The partners of the business will share in all the profits and losses of the business.

Choosing between a pass-through entity (sole proprietorship, partnership, LLC or S corporation) and C corporation structure…

It's often said, "it isn't how much you make, but how much you get to keep…"

Before 2018, avoidance of the double taxation paradigm of a C corporation structure was the knee jerk advice a business owner encountered when querying which structure to use in starting a business. Also, the C corporation tax bracket for business income might have been higher than an individual's tax bracket for the same income if it weren't taxed at the entity level. The Tax Cuts and Jobs Act (TCJA) of 2017 dramatically changed this paradigm, or at least the analysis involved when choosing an entity structure where taxes are a main driver in making a decision. Similarly, many pass-through business owners are reconsidering their original choice of entity.

Since TCJA became effective, the corporate tax rate was lowered to a flat 21% from a bracketed structure where the top rate was 35%. At the same time, the highest individual income tax rate was only lowered from 39.6% to 37% (a business owner of a pass-through entity may also face an additional 3.8% net investment income tax (NIIT)). Because of this disparity in tax law changes, a new pass-through business deduction was created as part of the TCJA. This new deduction is complex. It essentially allows certain pass-through business owners to deduct up to 20% of their share of qualified business income. The complexity comes in the application of the rules surrounding the deduction in that, depending on the nature of the business and income level of the owner there are limitation and exclusions that cause the pass-through business deduction to be less than 20% and in some cases 0%.

Limited Liability Company

LLCs have become popular over the last 20 years. Many real estate ventures use the LLC structure. LLC owners can have limited liability. This means that members are generally not personally liable for the actions of the LLC. The owners are required to follow general business protocols such as record keeping and segregating personal and business assets.

An LLC can have one or more members. If there is only one member, it is referred to as a single member LLC and is taxed like a sole proprietorship unless the owner elects to be taxed as an S or C corporation. If one of these elections is not made, the business income will flow to the owner's personal tax return with no separate income tax filing for the business. Similar to a sole proprietorship, business losses may help offset other personal income. If there is more than one member, unless one of the corporate elections is made, the entity will be taxed similar to a partnership where a separate tax filing is necessary at the entity level with the owners reporting their allocable share of income and losses on their personal tax return.

An LLC can be member managed or manager managed. If it is member managed, the owners share in the day-to-day decision making. If the owners are not experienced in such decision making, a professional manager can be hired. While there is some discord (and the IRS rules are not clear), generally LLC members that are active in the management of the business will likely report self-employment tax on their share of the business income while non-active LLC members may not. Both types of members are subject to self-employment tax on top of income tax on any guaranteed payments for services received.

Start-up costs and fees for establishing an LLC are reasonable; however, in the case of a multi-member LLC, it is highly recommended to have an operating agreement drafted with all appropriate provisions similar to a partnership agreement for the same reasons. There will also be ongoing annual paperwork and administration as an LLC is a state registered entity.

The ability to raise capital by issuing additional member interests (like stock in a corporation) is easily accomplished; however, as most entities using an LLC structure are smaller in size, debt capital is often required to be personally guaranteed. Business continuity can be interrupted by laws in some states depending on member turnover so any operating agreement dealing with succession should account for specific state laws where the business operates.

LLC owners can have limited liability. This means that members are generally not personally liable for the actions of the LLC.

Choosing between a pass-through entity (sole proprietorship, partnership, LLC or S corporation) and C corporation structure... *continued*

Even with the benefit of the pass-through deduction, a pass-through business owner's effective tax rate can be higher than the 21% corporate rate; however, the business owner must now consider the impact of double taxation on a corporation's effective tax rate. If the corporation distributes its income to the owner who pays 23.8% on that distribution 920% qualified dividend rate and 3.8% NIIT). Thus, double taxation can still bring the overall C corporation effective rate above the owner's effective rate.

Yet, savvy C corporation owners know that the effects of double taxation can be avoided, or at least deferred, by paying out the business income in the form of salary or by reinvesting the earnings in the business. The reason the double taxation is actually deferred rather than avoided is found when the business is to be sold. Because most buyers want to avoid contingent liabilities and receive a step up in basis for the corporation's assets, they will require a sale transaction to be structured as an asset sale. In this scenario, the gain on the sale will still be taxed twice: once at the corporate level and again when the proceeds are distributed to the owner.

As you can start to see, which type of entity selected (pass-through or C corporation) can be driven by the short and long term goals of the business itself or it could be affected by the fact the C corporation tax rate change is permanent and the individual tax rate changes are set to sunset in 2026. If your business doesn't intend to distribute earnings and retained earnings won't call for an accumulated earnings, tax or personal holding company tax, or your owners aren't eligible for a sufficient pass-through deduction, or you don't intend to sell the business, or you expect the TCJA to sunset—you might choose C corporation status; otherwise, pass-through entity status may be the way to go.

Determining your business structure must account for tax and nontax considerations. It is also a complex analysis to say the least. Given the recent tax changes, it is especially recommended for business owners to reach out to their tax advisor regarding their choice of entity.

C Corporation

Corporations are complex, with more onerous reporting requirements, and thus tend to be expensive to set up and operate. Depending on where a corporation operates, additional federal and/or state incorporations or registrations may be required, resulting in more legal and accounting fees. Many public companies are structured as C corporations. These corporations are heavily regulated, which leads to a number of reporting and disclosure requirements such as detailed tax filings. This type of business organization is considered to be a legal entity that is separate from its shareholders but controlled by the shareholders and directors of the business. A corporation has the same legal rights as an individual, so it can borrow or lend, incur legal liability and continue operating as a business on its own without relying on any one individual.

A significant advantage for the shareholders of a C corporation is limited liability. The shareholders are generally not personally liable for any of the debts and obligations of the corporation, and their personal assets can be protected from creditors. C corporation shareholders can benefit from reduced tax rates for business income received by the corporation in the form of qualifying dividends or capital gains; however, there is also tax at the entity level – so, there is a double layer of tax on business income when distributed. Unlike a sole proprietorship, LLC or partnership, C corporation losses cannot be used to offset income on a shareholder's personal tax return.

The shares and ownership of a corporation can be easily exchanged with the sale and purchase of corporate shares, and this is advantageous for the business continuity of a company structured as a corporation. This exchange makes it easier to raise capital for the business and also will not impact the continued operation of the corporate business during the exchange. It is advisable to seek professional tax and legal advice before incorporating a business.

S Corporation

An S corporation is somewhat of a hybrid between a C corporation and a partnership. They are limited to 100 owners which may be a drawback for raising significant capital. They can only have one class of stock (as voting shares) which may also hinder capital raising.

On the plus side, the S corporation structure avoids the second layer of tax as business income and losses are passed through to the individual shareholders for reporting on their personal tax returns similar to a partnership. The one significant tax difference between general partners/LLC managing members and S corporation shareholders, is that the distributable income of the S corporation is not self-employment income to the S corporation shareholder.

Owners of S corporations have limited liability. As with other smaller businesses, implementing a shareholder agreement, especially when there is more than one shareholder, is important to document operating, business succession and liquidation procedures.

S corporation owners have all the other administrative obligations (so there are similar costs and fees) like C corporations and it is advisable to consult a professional for tax and legal advice before incorporating as an S corporation.

Changing the business structure

There may be circumstances, personal or business-related, when it may be appropriate to change the business structure of a company. Some conversions may be simple, such as moving from a sole proprietorship to a partnership, but others may be more complex and costly, such as transitioning from a proprietorship or partnership to a corporation. You may consider changing your business structure as your business develops and circumstances change, but you should seek professional legal and tax advice to determine if it is beneficial and how to do it effectively.

It is important to consider your future needs and goals and attempt to build in flexibility to whatever structure you choose in case a change is needed.

Conclusion

Choosing an appropriate business structure that meets your needs is an important decision and will depend on your personal and business situations. Working with experienced advisors, such as a legal professional and a tax accountant, can help you identify and set up the business structure that is most appropriate for you and your business now, and in the future as your business develops.

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