

Business Entity Selection and Taxation

Chapter 16

Federal Tax Classification of Business Entities

- ▶ **Corporations**
 - Formally structured under state or federal law
 - Two types:
 - S-Corporations
 - C-Corporations
- ▶ **Partnerships**
 - Unincorporated business with 2 or more members
 - General Partnerships, Limited Partnerships, LLCs, LLPs
- ▶ **Sole Proprietorships**
 - Unincorporated business with 1 member

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16-2

Selection Criteria

- ▶ Ease and cost of formation
- ▶ Complexity of management and governance
- ▶ Transferability and dissolution
- ▶ Liability protection
- ▶ Reporting requirements and taxation

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Sole Proprietorships

Advantages

- Easy to form
- Simple to operate
- Easy to sell business assets
- Few administrative burdens
- Income passed through to the owner on Schedule C of Form 1040

Disadvantages

- Limited sources of capital
- Unlimited liability
- No guarantee of continuity
- Business income is subject to self-employment income

General Partnerships

Advantages

- More sources of capital than proprietorships
- More management resources available than proprietorships
- Less administrative burdens than corporations
- Income is passed through to the partners

Disadvantages

- Transfer of interests is more difficult than proprietorships
- Unlimited liability
- Partnership tax and basis adjustment rules are complex
- Business net income is subject to self-employment tax
- Partners are entitled to few tax deductible fringe benefits that are generally available to employees

Limited Partnerships

Advantages

- Pass-through partnership tax status
- Flexibility to structure ownership interest
- Limited partners are not personally liable for the debts and obligations of the limited partnership

Disadvantages

- Must file with the state to register
- Limited partners may not engage in management
- Losses for limited partners are passive losses

Limited Liability Partnerships

Advantages

- Pass-through partnership tax status
- Flexibility to structure ownership interest
- Limited partners are not personally liable for the debts and obligations of the limited partnership
- General partners can insulate themselves from the acts of the other partners

Disadvantages

- Must file with the state to register
- Limited partners may not engage in management
- Losses for limited partners are passive losses
- Unlimited liability for own acts of malpractice

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Family Limited Partnerships (FLP)

Advantages

- Control retained by senior family member
- Valuation discounts available
- Annual exclusion gifts may be used to transfer interests
- Some creditor protection
- Restrictions can be placed on transferability of limited partnership interests
- Usually used as part of an estate planning strategy

Disadvantages

- Attorney fees and costs
- Periodic valuation costs
- Operational requirements
- Potential IRS challenges regarding valuation and discounts

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Limited Liability Companies (LLC)

Advantages

- All members have limited liability and can participate in management
- Number of members is unlimited
- Can have multiple classes of ownership
- Single member LLC is a disregarded entity for tax purposes
- Members may be individuals, corporations, trusts, other LLCs, and other entities
- Partnership Taxation applies (unless S or C corporate status is elected)
- Distributions to members do not have to be directly proportional to members' ownership interests

Disadvantages

- May have limited life
- Transfer of interests is difficult and sometimes limited by operational agreement
- Some industries or professions may not be permitted to use LLC status
- Partnership Tax rules apply
- Laws vary from state to state regarding LLCs
- Laws are relatively new; therefore, court precedent cases are limited
- Members not meeting exceptions are subject to self-employment tax on all earned income if partnership is elected

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16-9

Corporations

Advantages

- Relatively easy to:
 - Raise capital
 - Transfer ownership interest
- Shareholders have limited liability
- Unlimited life
- More extensive management resources
- Shareholder employees may receive the full array of employer-provided tax-free fringe benefits

Disadvantages

- Potential for double taxation
- Administrative burdens
- More difficult to form
- Dissolution can cause taxable event.
- Borrowing may be difficult without stockholder personal guarantees
- Requires a registered agent
- Requires a federal tax ID number

S-Corporations

Advantages

- Income passed through to shareholders for income tax purposes
- Shareholders have limited liability
- Distributions from S corporations are exempt from the payroll tax system, if the shareholder / employees are adequately compensated

Disadvantages

- Limited to 100 shareholders
- Only one class of stock is permitted
- Cannot have corporate, partnership, certain trusts, or nonresident alien shareholders
- Shareholder employees owning more than two percent of the company are considered to be self-employed
- Borrowing may be difficult without stockholder personal guarantees

S-Corps v. LLCs

	S Corporation	LLC
Double Taxation	No	No
Pass through tax losses	Yes	Yes
Availability of preferred return for certain investors (1 class of stock in S)	No	Yes
Partnerships, corporations, and trusts can be entity owners	No	Yes
Foreign Investors	No	Yes
Distribute in-kind appreciated assets to owners without gain recognition	No	Yes
Ability to transfer interest to trust for estate planning.	No	Yes
Low filing fees	Yes (Generally)	No
Self employment tax on all income for owner/employees	No	Yes (Generally)
Limited number of owners	Yes (100)	No
Owner's basis for deductibility of losses includes pro rata share of loans to entity by third parties	No	Yes
The law is well settled pertaining to the entity	Yes	No
Filing date with extensions	October 15 th	September 15 th

Entity Comparison Chart

	Proprietorship	General Partnership	Limited Partnership	LLP
Cost to create (money & time)	Low	Medium	Medium-High	High
Personal Liability of investors for enterprise debt	Yes	Yes	No (if limited partner)	Yes
Annual state filing requirement	No	Generally Not	Yes	Yes
Maximum Owners	One	Unlimited	Unlimited	Unlimited
Owners are known as	Owner	Partner	Partner or Limited Partner	Partner or Limited Partner

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16-13

Entity Comparison Chart

	Proprietorship	General Partnership	Limited Partnership	LLP
Tax filing alternatives	Schedule C 1040	Form 1065, K-1 flows to Schedule E of Form 1040	Form 1065, K-1 flows to Schedule E of Form 1040	May file as corporation or partnership
Federal Tax ID required	No	Yes	Yes	Yes
Tax Concept	Individual	Flow Through	Flow Through	Flow Through
Owners income	Self Employment	Self employment but limited partners/ members are not subject to SS tax unless they perform personal services for the entity	Self employment but limited partners/ members are not subject to SS tax unless they perform personal services for the entity	Self employment but limited partners/ members are not subject to SS tax unless they perform personal services for the entity

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16-14

Entity Comparison Chart

	FLP	LLC	S Corp.	C Corp.
Cost to create (money & time)	High	High	High	High
Personal Liability of investors for enterprise debt	Yes	No	No	No
Annual state filing requirement	Yes	Yes	Yes	Yes
Maximum Owners	Unlimited	Unlimited	100	Unlimited
Owners are known as	Partner or Limited Partner	Member	Shareholder	Shareholder

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16-15

Entity Comparison Chart

	FLP	LLC	S Corp.	C Corp.
Tax filing alternatives	Form 1065, K-1 flows to Schedule E of Form 1040	1 member - Schedule C of Form 1040; 2+ members - choose partnership, S corp., or C corp.	Form 1120S, K-1 to shareholders	Form 1120
Federal Tax ID required	Yes	1 member - No 2+ members - Yes	Yes	Yes
Tax Concept	Flow Through	Flow Through	Flow Through	Entity
Owners income	Self employment but limited partners/ members are not subject to SS tax unless they perform personal services for the entity	Depends on filing choice, but limited partners/members are not subject to SS tax unless they perform personal services for the entity.	W-2 and ordinary income. Excess profits distributed are not subject to SS tax.	W-2 and dividend income.
