To 'C' or not to 'C'

How to choose the right corporate entity structure **Interviewed by Troy Sympson**

The most common legal entity structures are sole proprietorships, C corporations, S corporations, partnerships and limited liability entities, such as limited liability companies (LLC) and limited partnerships (LP). Understanding th advantages and disadvantages of each imperative when deciding on the best entity structure for your business.

"Choosing the correct entity is an important decision for every business," says Jason Sanders, CPA, a tax manager with Briggs & Veselka Co.

Smart Business spoke with Sanders about corporate entity structures, the various intricacies of them and how to know which one is right for your business.

Jason Sanders, CPA
Tax Principal
Briggs & Veselka Co.

How do you know what corporate entity structure is right for your business?

Unfortunately, the best choice of entity is not always clear. Many factors must be evaluated before making an ultimate decision. You really need to look long and hard at each option, comparing the major advantages and disadvantages of each. This is not a decision that should be taken lightly.

How do different entities offer different benefits?

A sole proprietorship consists of one individual and is the easiest form of business to organize. There are few legal restrictions associated with the formation and operation of the business.

C corporations offer three distinct advantages. First, they afford business owners limited liability protection. Second, they're advantageous when you're looking to raise outside capital. The flexibility of ownership allows for creativity through the use of different classes of stock with different ownership rights. Finally, owner-employees can take advantage of corporate-provided, tax-free fringe benefits, which are deductible to the corporation for federal income tax purposes but are not taxable to the owner-employees.

S corporations also enjoy limited liability protection but are not faced with the double-taxation dilemma that plagues C corporations. S corporations are often referred to as 'flow-through' entities because the corporate-level profits and losses are passed through to the corporate shareholders. As such, S corporations avoid double taxation as profits are taxed at the shareholder level. Losses are passed through to the owners and are deductible at the shareholder level to the extent of the shareholder's stock and loan basis.

General partnerships also provide freedom from double taxation of earnings. Generally speaking, general partnerships are easier to establish than other forms of entities and offer greater flexibility in ownership and capital structure. Partnerships also allow partner-level basis for partnership debt, the ability to specially allocate tax benefits among partners, and the ability to step up the basis of partnership assets upon the sale or exchange of partnership interest.

LLCs and LPs are often referred to as 'hybrid' entities. These entities are generally structured to ensure limited liability of the owners but also offer greater flexibility and tax benefits. This combination of corporate-like protection and tax benefits has greatly increased the popularity of these types of entities over the last few years.

What problems or issues can arise from the various entities?

najor disadvantage to operating as a sole proprietorship is unlimited liability of the owner. This disadvantage may be alleviated, however, by forming a single-member limited liability company (SMLLC). SMLLCs provide limited liability protection without interrupting the ease of operation of the business.

C corporations are taxed as separate entities from the principal owners, which gives rise to the potential for double taxation of the company's earnings. The earnings are taxed at the corporate level and again upon distribution to the owners. In addition, corporate-level losses are trapped at the corporate level and cannot be deducted by the owners. This is often a problem for start-up entities that experience losses early in the corporations' life span.

S corporations allow for only one class of stock, are limited in the number of owners and types of ownership interests, and do not allow for special allocations of tax benefits. Also, fringe benefits are generally included in income for those who own more than 2 percent.

General partnerships do not offer limited liability protection. All partners are liable for the debts of the partnership and claims based on the actions of all other general partners as well as employees of the partnership. Another disadvantage is that fringe benefits are included in the partner's income as guaranteed payments.

What's involved when a company decides on an entity and begins to implement it?

Every aspect of the business should be carefully considered before a decision is made. Besides the various advantages and disadvantages, factors such as business type, profit and loss expectations, estate planning and ownership transfers should be weighed carefully during the decision-making process. <<

JASON SANDERS, CPA, is a tax principal with Briggs & Veselka Co. Reach him at (713) 667-9147 or jsanders@bvccpa.com.

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