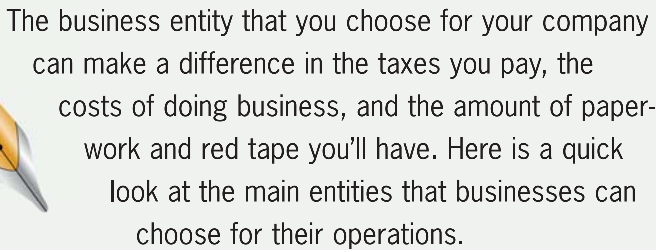
Duncan and Duncan, CPAs, LLC
Certified Public Accountants

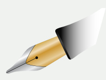
It's your business

Make the right ENTITY choice



The business entity that you choose for your company can make a difference in the taxes you pay, the costs of doing business, and the amount of paperwork and red tape you'll have. Here is a quick look at the main entities that businesses can choose for their operations.

Sole Proprietorship



A sole proprietorship is owned and operated by one individual. It is the least complicated and usually the least expensive way to set up and run a business.

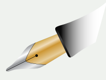
The business income is taxed to the owner on Schedule C of his or her personal tax return. Payroll taxes apply to any employees of the business. The sole proprietor pays self-employment tax rather than social security tax (and gets a tax deduction for 50% of the tax paid).

One of the major disadvantages to a sole proprietorship is unlimited liability, not only for debts of the business, but for lawsuits brought against the business. Liability extends to the proprietor's personal as well as business assets.

The ability to raise capital for the business is limited to the amount the individual can secure personally. Since under-capitalization is a major cause of business failure, this factor can be significant.

The deductibility of fringe benefits is very limited in a sole proprietorship.

Partnership



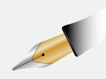
A partnership can have any number of partners. Partners bring to a business more creativity, skills, capital base, and experience than any one person is likely to have.

A partnership files an information tax return (Form 1065), but pays no income tax itself. The income or losses are passed through to the partners who report them on their individual tax returns in shares agreed upon by the partners – not necessarily equally. Partners, like sole proprietors, pay self-employment tax on net income.

The major disadvantage to a partnership is that liability is unlimited. In fact, partners can be held liable for the actions of fellow partners.

Partners have similar options in the area of fringe benefits and retirement plans as those available to sole proprietors.

Regular Corporation



A corporation, the most complex of the business structures, is a distinct legal entity apart from the shareholders who own it. Formed under the requirements of the state in which it will do business, a corporation limits its owners' liability to their investment in the company; personal assets are generally not at risk. The corporate form does not provide complete protection where personal services are involved.

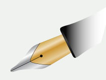
If you set up a corporation and are employed by it, the corporation must withhold and pay payroll taxes on your wages.

A corporation files its own tax return (Form 1120) and pays its own income tax. Therein lies the major drawback to the corporate form: business profits may be taxed twice – once at the corporate level and again at the shareholder level when paid out as dividends or a liquidating distribution.

The corporate form allows for more fringe benefits, deductible by the corporation and tax-free to employees (including shareholder-employees).

Another drawback to the corporate form is the complexity of rules and regulations governing corporate operations (including the tax laws). Personal service corporations (PSCs) have the added drawback of being taxed at a flat rate (the top corporate rate) rather than at the graduated rates available to other corporations.

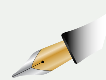
S Corporation



A corporation is allowed to elect S status only if it meets certain qualifications. An S corporation generally does not pay its own income tax. It files Form 1120S and distributes K-1s to shareholders. Shareholders then report their pro rata share of income, losses, and credits on their individual tax returns. The double taxation that regular corporations face is thereby avoided with an S corporation.

The big advantage of S status is that it combines the limited liability of a regular corporation with tax treatment similar to that of a partnership. A disadvantage is that S corporations have some fringe benefit restrictions for owner-employees.

Limited Liability Company



The limited liability company (LLC) combines the general flexibility and income tax treatment of a partnership with the limited liability of a corporation.

COMPARING the major business forms

	Sole Proprietorship	Partnership	Regular Corporation	S Corporation	Limited Liability Company
Liability Exposure	Unlimited	Unlimited for general partners Limited for limited partners	Limited	Limited	Limited
Continuity of Entity	Limited to life of proprietor	Limited unless provided for in partnership agreement	Unlimited	Unlimited	Varies; can affect tax status of the entity
Transfer of Interest	Difficult	Difficult unless provided for in partnership agreement	Readily accomplished through stock transfer	Readily accomplished through stock transfer	Varies; can affect tax status of the entity
Acquisition of Capital	Limited to what proprietor can secure	Easier than sole proprietorship since shared by partners	Acquired by issuing stock or bonds	Acquired by issuing stock	Shared by members
Tax Filing Required	Schedule C with Form 1040	Form 1065; distributes K-1s to partners	Form 1120	Form 1120S; distributes K-1s to shareholders	Depends on classification of LLC
Taxation of Income	Directly to owner	Directly to partners in proportions agreed upon by partners	Taxed once at corporate level, again at shareholder level when distributed (usually as dividends)	Taxed directly to shareholders (no double taxation)	Generally taxed as a partnership (though classification may result in corporate taxation)
Administrative Costs	Lowest	Medium	Highest	Highest	Similar to corporation
Fringe Benefits	Generally not deductible	Generally not deductible for partners	Deductible, but subject to many rules (mainly nondiscrimination)	Generally not deductible for over 2% shareholders	Depends on tax status
Recommended Pension Plans	IRA, Keogh, SEP, SIMPLE	IRA, Keogh, SEP, SIMPLE	Qualified plans	Qualified plans	Depends on tax status
Major Advantage(s)	Independence, flexibility, minimum red tape	Chance of business success enhanced if right combination of partners	Limited liability	Limited liability without double taxation of regular corporation	Limited liability with partnership tax treatment; fewer ownership restrictions than S corporation
Major Drawback(s)	Unlimited liability – a problem if business has financial difficulties	Unlimited liability; frequent changes in partners can be difficult	Greater cost, government regulations, and red tape; double taxation of income	Not every corporation qualifies for S status; more limits on fringe benefits	Inconsistent state tax treatment

There are other factors not mentioned in this quick review that should be considered in choosing your business entity. For more information, contact our office and your attorney.

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