

## Comparing Tax Aspects in Entity Selection

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## Taxation of Entities

- C Corporation
- S Corporation
- Partnership
- Limited Liability Company (LLC)
- Sole Proprietorship

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## Taxation of C Corp

- Income taxed at the corporate level
- Income is usually taxed as a dividend when distributed to shareholders
- Basis is determined by capital contributions
- Third party liabilities do not increase shareholder basis
- Not subject to passive loss rules
- Different classes of stock can be used to facilitate estate and income tax planning

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## Taxation of S Corp

- Avoids Federal Income Tax at the corporate level
- Income is taxed to the shareholder whether or not it is distributed
- Income is taxed based on ownership percentage
- Shareholder basis is determined by capital contributions and shareholder loans to the company
- Third party liabilities do not increase shareholder basis
- If shareholder performs significant services for company and does not receive reasonable compensation, IRS may reallocate a portion of the distribution to the shareholder as compensation
- Not subject to passive loss rules
- Different classes of stock based on voting rights have some use in facilitating estate planning

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## Taxation of Partnership

- Partners report partnership profits and losses on their own tax return
- Partners taxed on their share of partnership profits and losses (distributive share) based on the partnership agreement
- Shareholder basis is determined by capital contributions and all third party liabilities
- Subject to passive loss rules
- Different classes of partnership interests can facilitate estate planning

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## Taxation of LLC

- May elect to be taxed as a corporation, partnership or sole proprietor
- Single member LLCs are always a sole proprietor
- LLCs are usually taxed as a partnership, offering all the advantages of partnership taxation with liability protection

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## Taxation of Sole Proprietorship

- No entity return at all
- Taxed on the individual level only (Form 1040)
  - Schedule C lists receipts and expenses similar to a cash flow statement
- Subject to passive loss rules

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## Advantages/Disadvantages of C Corp

- Advantages
  - Inexpensive to form
  - Liability protection
  - Individuals and entities may own shares
  - Easy to transfer ownership
  - Flexibility with estate and business planning
  - Good for deferred compensation plans
  - Multiple classes of ownership possible facilitating estate planning
- Disadvantages
  - "Double Taxation": Taxed on both the entity level and the individual level
  - Must meet and maintain all corporate formalities
  - Annual documentation requirements

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## Advantages/Disadvantages of S Corp

- Advantages
  - Taxed on the individual level and not at the entity level
  - Liability protection
  - Inexpensive to form
  - Easy to bring in additional capital through new owners
  - Differences in voting rights helps facilitate estate planning
- Disadvantages
  - Only individuals and certain trusts can own S corporation shares
  - Limited number of shareholders
  - Only a single class of ownership (differences in voting rights allowed)
  - Limited (but still significant) flexibility with estate and business planning
  - Must meet and maintain all corporate formalities

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## Advantages/Disadvantages of Partnership

- Advantages
  - Taxed on the individual level and not at the entity level
  - Flexibility in ownership
  - Third party liabilities increases basis in partnership interest
- Disadvantages
  - Higher formation costs
  - No (general partnerships) or less (limited partnerships) liability protection
  - Passive loss rules apply
  - Can exist without proper legal documentation
  - Entity ends on the death of a partner

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## Advantages/Disadvantages of LLC

- Advantages
  - Flexibility in taxation (can select individual, partnership or corporate taxation)
  - Liability protection
  - If taxed as a partnership, third party liabilities increase basis in partnership interests
  - Flexibility in ownership structure facilitates estate planning
  - Allows variance among allocations of profit and loss
  - No formalities like a corporation
- Disadvantages
  - Higher formation costs
  - Passive loss rules apply
  - May be treated differently on the state level

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## Advantages/Disadvantages of Sole Proprietorship

- Advantages
  - Simplest and most inexpensive of all businesses to arrange
  - No formalities in operating the business
  - No extra tax returns
  - Taxed only on the individual level
- Disadvantages
  - No liability protection whatsoever
  - Passive loss rules apply
  - More difficulties in disposing of the business during life or after the death of the owner

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## Additional Issues

- State business registration
- Sales tax
- Trademark and intellectual property
- Contracts
  - Employment agreements
  - Non-compete and confidentiality agreements
  - Privacy policies and agreements
  - Service contracts

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