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WEALTH MANAGEMENT

Choosing the Right Corporate Entity for Your Business

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Selecting the appropriate corporate entity for your business is an essential first step in creating your company. The business structure you choose will determine how your company will pay taxes, what options are available to it for raising capital and whether or not you may be personally liable for your company's debts and liabilities.

There are five common business entity types, each with their own advantages and disadvantages:

- **Sole proprietorship**. Most appropriate for low-risk, one-person businesses or experimenting with a new business idea.
- **Partnership**. Similar to a sole proprietorship, but for multiple owners. Owners can be general partners (more control, greater liability) or limited partners (less control, limited liability).
- **Limited Liability Company (LLC)**. A middle-of-the-road option with favorable tax treatment and increased protection for owners.
- **C corporation**. A more formal structure with greater flexibility for raising capital but requiring greater up-front expenses, more rigorous reporting and additional tax liabilities.
- **S corporation**. Similar in structure to a C corporation, but without the additional tax liability and with more restrictions on raising capital.

TAX TREATMENT

Earnings from sole proprietorships, partnerships, LLCs and S corporations "pass through" directly to the entity's owners and are not taxed at the corporate level (the owners of these entities simply report the earnings on their personal tax return).

In late 2017, Congress passed the Tax Cuts and Jobs Act, which introduced a tax deduction for qualified business income (QBI). This deduction allows taxpayers to deduct up to 20% of their business income from qualifying pass-through corporations through the year 2025, when the provision is set to expire. However, there are some limitations. Those who file as single or head of household and earn more than $207,500 a year, and married taxpayers who file jointly and earn more than $415,000 a year will receive a limited deduction;1 if they receive pass-through income from a specified service business, they may not be able to claim this deduction at all.2

Note that sole proprietors, general partners and members of LLCs are considered by the IRS to be self-employed, and as a result must also pay Medicare and Social Security taxes. In contrast, C corporations are subject to what might be called "double taxation." A C corporation must report its earnings separately and pay taxes on those earnings at the applicable corporate tax rate. Then, when the C corporation's earnings are passed to its shareholders (e.g., in the form of dividends), the earnings are taxed a second time on the shareholders' personal income tax returns.

RAISING CAPITAL

If you think your business may require substantial capital in the future in order to fund its long-term growth, you may want to consider setting up your company as a corporation. Corporations generally make it easier to raise capital and provide investors with more ways to invest in the company, in contrast to partnerships and LLCs.

Corporations issue stock, whereas partnerships and LLCs issue partnership units and membership units, respectively. Stock issuance tends to be comparatively straightforward and thus able to attract greater interest from investors. Issuing partnership or membership units may require navigating the intricacies of the entity's operating agreement and lead to complex tax issues for the investors.

[1] Generally limited to either 50% of W-2 wages or 25% of W-2 wages plus 2.5% of unadjusted basis, whichever is greater.
[2] Anyone with a trade or business that depends on their reputation, e.g., people practicing law, CPAs, actuaries, people involved with the performing arts (actors, singers, etc.), consultants, professional athletes, people in financial services, etc.

C corporations can also issue multiple classes of stock (for example, common stock and preferred stock), which may attract a broader range of potential investors. Although S corporations can only issue one class of stock, they can issue voting and non-voting shares. Keep in mind, however, that S corporations may only have a total of 100 shareholders, which may be problematic for a business owner who may plan on bringing a large number of investors into the company over time.

PERSONAL LIABILITY

Although all business ventures carry some degree of risk, your choice of business entity will determine the extent to which you as the business owner will bear that risk personally.

Sole proprietors and general partners are personally responsible for the liabilities of their businesses, which means that your business's debts are your debts. In the event that your business becomes insolvent or is sued, your personal assets are at risk.

LLC members, limited partners and shareholders of a C corporation or S corporation have limited liability and are not personally responsible for the debts and legal liabilities of the company. Any liabilities are limited to the value of your investment in the business.

CHANGING YOUR BUSINESS STRUCTURE

If your personal and business circumstances change down the road, it is possible to change your company's corporate structure to better suit your new situation. Some entity conversions, such as converting from a sole proprietorship to a partnership, may be relatively simple. Others, such as converting from a corporation into an LLC, could entail additional time, cost and complexity.

Be sure to enlist the help of experienced advisors who can work with you to identify the corporate entity that is most appropriate for your business and can discuss with you the flexibility and alternatives for changing that corporate entity in the future, if appropriate.

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