

**YOUR GUIDE TO:**

# **BUSINESS ENTITY SELECTION**

**Start your  
business off right**

## Start your business off right

Selecting the right business entity is a crucial decision that can impact many elements of your business. This includes taxes, liability and management structure. Because entity selection is one of the first to-dos for a new business owner, it's important to have all the facts before you make a final decision.

This guide is designed to walk you through key business entity structures—complete with an easy-to-digest comparison chart. Of course, it's strongly recommended that you consult with an attorney and/or your trusted advisor before making a final decision. These professionals can guide you through the pros and cons of each entity so you start your entrepreneurial career off with a positive bang.

## Get into the details...

Selecting the right business entity takes research and deep consideration. Leave no stone unturned. The following offers a sound list of elements to consider before moving forward.

**Liability protection:** Different entity structures offer varying degrees of personal liability protection for business owners. Corporations and LLCs generally provide the strongest liability shields, protecting personal assets from business debts and lawsuits. Sole proprietorships and general partnerships offer no separation between personal and business liabilities.

Considering this, be sure to assess the level of risk in your industry or profession and then choose a structure that provides adequate protection.

**Tax implications:** The chosen structure significantly impacts how the business and its owners are taxed. Here's how each entity lays out:

## AT A GLANCE: Tax implications

- **Sole proprietorships, partnerships and S corporations** are known as pass-through entities, where business income is reported on the owners' personal tax returns.
- **C corporations face double taxation**—profits are taxed at the corporate level and again when distributed as dividends.
- **LLCs (limited liability companies)** offer flexibility in taxation, allowing owners to choose how they want to be taxed.

**Management structure:** Different entity types offer varying management requirements. Sole proprietorships offer complete control to the owner, while partnerships require shared decision-making. Corporations have a board of directors, officers and a more formal structure with shareholders. LLCs provide flexibility in management, allowing members to choose between member- or manager-managed structures.

**Flexibility for future growth:** Consider how easily the structure accommodates future expansion, additional owners or changes in business direction. Corporations and LLCs generally offer more flexibility for growth—supporting easier addition of shareholders or members.

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**Sole proprietorships and partnerships may need to convert to a different structure as the business expands.**

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Internal Revenue Service

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1-19-2018 11/18/18

**Tax Withholding and Estimated**

SCHEDULE D  
(Form 1040)

## REAL-WORLD EXAMPLE

Two friends, Sada and Jane, start a mobile app development business as a partnership. The company launches in Jane's garage where the friends develop mobile apps for local businesses. Initially, their partnership structure works well.

- Profits are split 50/50 and the friends make all business decisions together.
- They file the business taxes as a partnership and report their share of the business income on their personal returns.

While this puts their personal assets at risk, the business is small with minimal liabilities.

The business takes off after landing a major contract with a large corporation. The expansion brings some key challenges.

- **Liability concerns:** The high-stakes project increases potential liability. If there are issues with the app, the corporation could sue for significant damages, putting their personal assets at risk.
- **Need for capital:** To fulfill the contract, they need to hire additional developers and invest in better equipment.
- **Attracting talent:** As they grow, they want to offer stock options to attract top developers.
- **Tax implications:** Their increased income pushes them into higher tax brackets.

Given these factors, the friends convert their partnership to an LLC in order to protect their personal assets from business liabilities, allow them to more easily raise capital, provide stock options and take advantage of more favorable tax treatment.

**Costs of formation and maintenance:** Different entity types have varying costs associated with formation and ongoing compliance. Sole proprietorships are the least expensive to form and maintain, while corporations typically have the highest costs due to more complex regulatory requirements. LLCs fall somewhere in between, offering a balance of liability protection and relatively lower maintenance costs.

**Ability to raise capital:** The chosen structure affects the business's ability to attract investors and raise funds. Corporations, particularly C corporations, have the most flexibility in issuing stock and attracting diverse investors. LLCs can also accommodate multiple investors

but may be less attractive to venture capitalists. Sole proprietorships and partnerships generally have more limited options for raising capital.

**Ownership structure:** Consider how ownership will be divided and transferred. Corporations offer the most straightforward method of dividing ownership through stock issuance. LLCs provide flexibility in ownership allocation through membership interests. Partnerships require careful consideration of profit-sharing and decision-making rights.

**Industry norms:** Some industries have typical entity structures that are commonly used due to regulatory requirements or investor preferences. Consult with your trusted advisor to discuss norms in your specific industry or profession to ensure your chosen structure aligns with expectations and best practices.

**State-specific laws and regulations:** Business entity laws and regulations can vary significantly between states. Consider where you plan to operate and research the specific requirements, tax implications and benefits of different entity types in that jurisdiction. Some states may offer more favorable conditions for certain business structures. Of course, this is where a tax and accounting professional can help immensely.



# Chart your course to a successful business launch

Use our simplified at-a-glance chart to help.

## Sole proprietorship

**Description:** A business owned and operated by one individual.

**Liability:** The owner has unlimited personal liability for business debts.

**Taxation:** Income is reported on the owner's personal tax return.

**Management:** Full control by the owner.

**Pros:** Simple to establish; complete control; minimal regulatory requirements.

**Cons:** Unlimited personal liability; difficulty raising capital; business continuity tied to the owner's life.

## General partnership

**Description:** A business owned by two or more individuals.

**Liability:** Partners share unlimited personal liability for business debts.

**Taxation:** Income is passed through to shareholders' personal tax returns, avoiding double taxation.

**Management:** Shared control among partners.

**Pros:** Easy to establish; shared financial commitment; combined skills and resources.

**Cons:** Unlimited personal liability for all partners; potential for conflicts; shared profits.

## Limited partnership (LP)

**Description:** A partnership with at least one general partner and one limited partner.

**Liability:** General partners have unlimited liability; limited partners have liability up to their investment.

**Taxation:** Income is passed through to shareholders' personal tax returns, avoiding double taxation.

**Management:** General partners manage the business; limited partners typically do not participate in management.

**Pros:** Limited liability for limited partners; potential for raising capital.

**Cons:** General partners bear unlimited liability; more complex to establish; potential for conflicts between partners.

## Limited liability partnership (LLP)

**Description:** A partnership where all partners have limited liability.

**Liability:** Partners have limited liability for business debts.

**Taxation:** Income is passed through to shareholders' personal tax returns, avoiding double taxation.

**Management:** Shared control among partners.

**Pros:** Limited liability for all partners; flexibility in management.

**Cons:** More complex to establish than a general partnership; may have restrictions based on the type of business.

## Limited liability company (LLC)

**Description:** A hybrid entity combining elements of partnerships and corporations.

**Liability:** Owners (members) have limited liability.

**Taxation:** Can choose to be taxed as a sole proprietorship, partnership or corporation.

**Management:** Flexible management structure; can be managed by members or managers.

**Pros:** Limited liability; flexible taxation options; fewer formalities than a corporation.

**Cons:** More complex and costly to establish than sole proprietorships or partnerships; potential for self-employment taxes.

## Corporation (C corporation)

**Description:** A separate legal entity owned by shareholders.

**Liability:** Shareholders have limited liability.

**Taxation:** Subject to double taxation (corporate income and shareholder dividends).

**Management:** Managed by a board of directors.

**Pros:** Limited liability; ability to raise capital through stock; perpetual existence.

**Cons:** Double taxation; more regulatory requirements; complex and costly to establish.

## S corporation

**Description:** A special type of corporation with tax advantages.

**Liability:** Shareholders have limited liability.

**Taxation:** Income is passed through to shareholders' personal tax returns, avoiding double taxation.

**Management:** Managed by a board of directors.

**Pros:** Limited liability; avoids double taxation; can attract investors.

**Cons:** Restrictions on the number and type of shareholders; more regulatory requirements; complex to establish.

### IMPORTANT NOTE:

**Remember that you can change your business entity type as your business grows and evolves. However, this process can have legal and tax implications, so always consult with professionals before making such changes.**



## Wrapping it up...

Choosing the right business entity is a critical decision that can significantly impact your success. By carefully considering your business needs, consulting with professionals, and understanding the pros and cons of each entity type, you can make an informed decision that sets your business up for long-term success.

Remember, there's no one-size-fits-all solution. The best choice depends on your specific business circumstances, goals and risk tolerance. Don't hesitate to seek professional advice to ensure you're making the best decision for your unique situation and that you start your business off right.

## Don't be shy! We're here for you.

We're here to help you navigate your financial future. If you have any questions about the information presented in this educational guide, please reach out and a member of our staff can help get you the right answers. Really. We mean it. Don't be shy. Ask away!