

Choice of Entity

Whether you are planning to purchase a business or form a new business, one of the first issues to consider is choosing the right type of entity to most efficiently accomplish your goals. Should you form a partnership? Should it be a general or limited partnership? If a corporation is the right entity for you, should you elect to be a Subchapter S Corporation, or a traditional C Corporation, or would a limited liability company (LLC) be the right choice? Depending on the facts and circumstances of your situation it may be most beneficial to operate as a sole proprietorship. There are many entities to choose from, each with different tax and liability protection advantages and disadvantages.

The first step in determining the choice of entity is understanding your goals and prioritizing them. These goals are a direct representation of your ideas on lifestyle, risk tolerance, gifting and business succession. It is our job as your business and tax advisors to help identify and prioritize these goals in a manner consistent with your thoughts.

There are many issues to consider when assessing your goals. The major issues can be organized into four main categories; capitalization, compensation, distributions, and allocation of profits and losses. Within each category there are advantages and disadvantage of each type of entity. The following represent just a few:

- Capital - C corporations and LLC's offer more flexibility than S corporations when creating a capital structure. S corporations are limited to the number of shareholders, and there are also limitations on who can own an S corporation. For instance, S corporations, with few exceptions, cannot be owned by other corporations, partnerships, certain trusts, or non-resident aliens.
- Compensation - If you are a member of an LLC, or a partner in a partnership, you cannot take a salary in the traditional sense; members/partners will be subject to the full amount of self-employment taxes on any compensation received for services, called guaranteed payments. Shareholders of both C corporations and S corporations can be paid wages; however there are other issues when taking a salary from a C corporation, such as unreasonable compensation. This would depend on the amount of compensation paid to other employees and their level of service provided to the corporation. For an S corporation the opposite could be an issue; if your salary is too low, tax-free distributions could be recharacterized as salary by the IRS.
- Distributions - The tax treatment of cash distributions would depend on the entity. If you were taking distributions from a C corporation, not only are those earnings taxed at the entity level, they would also be taxed at the individual level as a dividend. For an S corporation, partnership, or an LLC there usually is not a tax at the entity level. All items of income and deduction flow through to the owners and are taxed at their level. This results in cash being distributed tax-free as long as the distributions are within the qualifications required by basis regulations.
- Allocation of profits and losses - LLC's provide the best opportunity to allocate profits and losses to various members. S corporations are restricted by statutory regulations and C corporation do not allocate any profits or losses since everything is taxed at the entity level.

As you can see, there are advantages and disadvantages to each type of entity. The above is just a brief and general overview. The tax laws and liability protection rules are very complex and cumbersome. When considering your choices please contact your Tonneson + Co representative, or any member of our

tonneson+co

Certified Public Accountants & Consultants

401 Edgewater Place, Suite 300, Wakefield, MA 01880-6208 t. 781.245.9999 f. 781.245.8731 www.tonneson.com

staff, for an analysis of your goals and a more in-depth look of the various types of entities. We will be happy to discuss your options and help you to choose an entity that will best meet your goals.