StatonWalsh

Financial Clarity Through Transparency

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Basic Types of Business Organizations

	Sole Proprietor	Partnership	C Corporation	S Corporation	Limited Liability Company
Creation	No written document is necessary.	Created by oral or written agreement.	Articles of Incorporation filed with state.	Articles of Incorporation filed with state.	Operating Agreement/Articles of Organization filed with state.
Life span	Expires when owner dies.	Agreement can set time. Otherwise, dissolved at death of any partner.	Continues on after shareholder's death.	Continues on after shareholder's death.	May dissolve on a member's death, retirement, bankruptcy, resignation or expulsion.
Management responsibility	Rests with sole proprietor.	Rests with partners.	Rests with board of directors who are elected by shareholders.	Rests with board of directors who are elected by shareholders.	Rests with managers or members.
Liability	Sole proprietor is personally liable for all debts.	Each partner is personally liable for all business debts or liabilities.	Liability is limited to the assets of the corporation, not shareholder's assets.	Liability is limited to the assets of the corporation, not shareholder's assets.	Liability is limited to the assets of the company, not member's assets.
Income taxes	All income and expenses are reported on tax return of sole proprietor.	Partnership prepares information return, but income is taxable to partners.[1]	Corporation pays tax on net income. Reasonable salaries are deductible to corporation and taxable to employees.	Corporation files information return, but income is taxed to shareholders.[1]	Company files information return, but income is taxed to the owners (members).[1]

[1] State law will vary: some states tax partnership, S corporations and LLC income.

	Sole Proprietor	Partnership	C Corporation	S Corporation	Limited Liability Company
Sale or transfer during lifetime	Sole proprietor may sell or give away any asset.	A transfer will dissolve the partnership, unless remaining partner(s) agree(s) to new partner.	Stock is transferrable. Remaining shareholders may have a first right of refusal prior to a sale to an outsider.	Restricted to 100 shareholders who are resident U.S. citizens, estates and certain types of trusts.	Members may transfer interests without consent unless restricted by the operating agreement.
Sale or transfer at death	Is usually dissolved. Estate may sell or operate it.	Automatically dissolved, unless agreement to the contrary.	Stock can be transferred to heirs. Stock can also be sold or retained, unless a buy-sell agreement exists.	Estate is eligible shareholder only during estate administration. Otherwise, same as above.	Deceased's estate is an eligible shareholder. Otherwise, same as above.

Advantages and Disadvantages of Corporations

A corporation is a separate legal entity organized and operated under state law. Like a legal person, the corporation can enter contracts, own property, and hire employees. A corporation is a separate and distinct taxpayer from its owners, the shareholders.

Advantages of Incorporation

- **Limited liability:** The shareholders are not generally liable for the debts and liabilities of the corporation beyond their contributions to capital. However, lenders will usually require personal guarantees by the shareholders on loans to the corporation.
- **Continuity:** The corporation continues in existence, even if its shareholders die or sell their shares.
- **Ease of transfer:** Shares of stock can be transferred to children or other buyers to raise capital or for estate distribution purposes.
- **Centralized management:** The shareholders elect the Board of Directors, who manage the affairs of the corporation, including the election of officers.
- **Tax and fringe benefits:**
  - Tax-qualified retirement plans.
  - Medical and disability plans.
  - Group life insurance.
  - Split-dollar insurance plans.
  - Salary continuation plans.

Disadvantages of Incorporation

- Cost to establish a corporation.
- Need to observe corporate formalities.
- Double taxation of income if dividends are paid. Possible tax on excess corporate accumulated earnings.

Limited Liability Companies

The Limited Liability Company (LLC) is, for federal income tax purposes, a pass-through entity like a partnership or S corporation, but it includes the limited liability of a corporation.

	Partnership		Corporation		LLC
	General	Limited	C Type	S Type	
Personal liability for business	Yes fully liable	Only limited	Only limited	Only limited	Only limited
Participate in management	Yes	No[1]	Yes	Yes	Yes[2]
Any type or number of shareholders or members	Yes	Yes	Yes	No[3]	Yes
Avoids double taxation	Yes	Yes	No[4]	Yes	Yes

LLCs are created by statute and vary from state-to-state. The operating agreement sets forth the relationship of its members (owners) and governs how the LLC will be operated, allocation of earnings, capital contributions and distributions. The formalities found in the corporate business organization, like directors meetings, written minutes, etc., may not be required.

Federal Income Taxation of LLCs

Federal income tax law[5] provides some flexibility as to how an LLC and its members are taxed:

- **Single member LLC:** An LLC with a single member by default is “Disregarded as an entity separate from its owner…”. For LLCs with a single individual member, this means that income and expenses are generally reported on the individual’s personal return on Schedule C, E, or F. An LLC with a single individual member may elect to report income and expenses as a corporation. For LLCs with a single corporate member, income and expenses are typically reported on the corporation’s return.

[1] Limited partners cannot participate in management.
[2] For a member-managed LLC. In a manager-managed LLC, members do not typically participate in management decisions.
[3] The S corporation is currently limited to 100 shareholders and there can be only one class of stock.
[4] A C corporation’s net income is subject to tax at the federal level at a 21% rate.
[5] See IRC Reg. 301.7701-3.

- **Multiple member LLC:** An LLC with two or more members (individual or corporate) by default reports income and expenses as a partnership. Such an LLC may elect to report income and expenses as a corporation.

State income tax law can vary and does not necessarily follow federal law.

Seek Professional Guidance

When considering an LLC, professional legal and tax guidance is strongly recommended.

S Corporations

Corporations that elect to be taxed as small business corporations under IRC Sec. 1362 are taxed similarly to a partnership. The corporation (as long as it qualifies for S corporation status) generally pays no tax.[1] All profits and losses flow through the corporation to the shareholders and they are taxed on the profits whether or not they are taken out of the corporation.

The S corporation is often used to spread corporate income among shareholders or family members who own the company stock (after employees receive adequate salaries).

Business losses, often incurred in the early years of a business, can be passed through to the shareholders and can be used to offset other ordinary income. Deductible losses are limited to shareholder's basis in stock including loans to the corporation.

Requirements to Elect S Corporation Treatment

- Election must be made not later than two months and 15 days after the first day of a corporation's tax year to be effective for that year.
- The number of shareholders cannot exceed 100, with all members of a family (and their estates) automatically being treated as one shareholder. The members of a family include a common ancestor, lineal descendent of the common ancestor, and the spouses, or former spouses, of such lineal descendents or common ancestor, spanning no more than six generations. See IRC Sec. 1361(c)(1).
- Each shareholder must be an individual, a decedent's estate, a bankrupt's estate or certain trusts specified in IRC Sec. 1361(c)(2), including a qualified subchapter S trust provided for by IRC Sec. 1361(d)(1).[2] Eligible shareholders also include an electing small business trust,[3] charities, and qualified pension, profit sharing and stock bonus plans,[4] and certain IRAs holding bank corporation stock.[5]

[1] Some states impose a tax on income or a minimum tax.

[2] A shareholder's agreement can be used to prevent stockholders from transferring S corporation stock to a nonqualifying trust.

[3] Each beneficiary of the trust is counted in determining whether the shareholder limit has been exceeded. An interest in these trusts must be acquired by gift or bequest (not purchased).

[4] See IRC Secs. 1361(b)(1)(B) and 1361(c)(6).

[5] IRC Sec. 1361(c)(2)(A)(vi).

- There must not be more than one class of stock, although there can be voting and nonvoting shares.
- All stockholders must consent to elect S corporation status.

Termination of the S Election[1]

- S corporation status is automatically terminated if any event occurs that would prohibit the corporation from making the election in the first place. The election terminates as of the date of the disqualifying event.
- The S election can be revoked with the consent of more than 50% of the outstanding stock held by shareholders.
- If a corporation, for three consecutive years, has both accumulated earnings and profits, as well as passive investment income exceeding 25% of its gross receipts, its election will be revoked beginning with the following tax year.

[1] If the election is terminated or revoked, the corporation cannot re-elect S status without IRS consent until the 5th year after the year the termination or revocation is effective.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Disclosure Notice

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