WHAT BUSINESS ENTITY SHOULD A STARTUP CHOOSE?

Gretchen R. Lawrie
California State University Los Angeles

SUMMARY: What business entity the owners of a startup business choose will determine the tax and non-tax consequences for both the owners and the startup. However, by understanding the similarities and differences of business entities, owners can choose the best business structure for their startup business. As an aid in the process of choosing a business entity for a startup, this paper provides an overview of the rules, requirements, advantages, and disadvantages of several business entities.

Introduction

Should a startup business be structured as a sole proprietorship or as a partnership? What are the tax consequences if a startup business is a C corporation instead of an S corporation? Will the startup's owners be personally responsible for the startup's debts, if it is structured as a limited liability company? The choice of a business entity for a startup is an important decision, because which entity is chosen will determine the tax and non-tax consequences for the startup business and its owners. In this paper, the rules, requirements, advantages, and disadvantages of several business entities are discussed and illustrated through examples.

Business Entities

Sole proprietorships

A sole proprietorship is a business organized under state law and is owned by one individual. Because sole proprietors have unlimited personal liability for the proprietorship's debts, obligations, and other liabilities, claims can be filed against both the proprietorship's and the proprietor's personal assets (Treas. Reg. § 301.7701-3(b)(2)(ii)).

A sole proprietorship does not pay tax on its income, rather its income, losses, deductions, and credits pass through to the sole proprietors, who are taxed on the proprietorship's income at their individual tax rates (26 U.S. Code §§ 1(j)(1) and (2)). For federal tax purposes, sole proprietors can deduct from their proprietorship's income an amount equal to the lesser of 20 percent of their taxable income or 20 percent of the sole proprietorship's qualified business income (Q.B.I.), which is income effectively connected with a U.S. trade or business. Therefore, by claiming the 20 percent pass-through deduction, 80 percent, not 100 percent, of a sole proprietorship's Q.B.I. is subject to tax. (26 U.S. Code § 199A).

Sole proprietors can use the proprietorship's losses, deductions, and credits to offset other income reported on their own tax returns, such as offsetting a capital gain realized from selling their own capital asset with a capital loss realized by the sole proprietorship.

Under the Self-Employment Contributions Act, sole proprietors pay self-employment taxes of 15.3 percent on the sole proprietorship's income, which is a combined 12.4 percent tax for Social Security old age, survivors, and disability insurance and a 2.9 percent tax for Medicare hospital insurance. An additional Medicare tax of 0.9 percent may also apply if the sole proprietor's total self-employment income exceeds certain limits. (26 U.S. Code §§ 1401(a) and (b)). Because sole proprietors are not considered employees of a sole proprietorship, they do not pay the 6 percent Federal Unemployment Tax (F.U.T.A.) on their income. (26 U.S. Code § 3301).

C corporations

A corporation (referred to as a C corporation for federal tax purposes) is a business entity organized under state law with its own rights and privileges and is separate and distinct from its owners, the shareholders (26 U.S. Code § 7701(a)(3); Treas. Reg. §§ 301.7701-2(a) and (b)). A corporation is formed by investors, who become shareholders of the corporation, contributing cash, property, and/or services in exchange for stock in the corporation (26 U.S. Code § 351(a)). A corporation can have one shareholder or an unlimited number of shareholders. Shareholders can be U.S. citizens and residents, domestic and foreign corporations, partnerships, and other entities (e.g., California Corp. Code §§ 162 and 200).

A corporation can issue different classes of stock, such as common stock with voting rights and preferred stock with rights to receive dividends from the corporation (e.g., California Corp. Code § 400). A corporation's stock can be privately held or following an initial public offering, traded on a stock exchange, like the New York Stock Exchange.

A corporation's shareholders, board of directors, and officers have limited personal liability, referred to as the corporate veil, for the corporation's debts and liabilities. However, in certain circumstances, such as when a corporation is engaged in fraudulent activities or is a sham corporation, the corporate veil can be lifted and the shareholders, board of directors, and/or officers will be held personally liable for the corporation's debts and obligations. However, the shareholders' personal liability is limited to the amount they invested in the corporation.

A C corporation's income is subject to double taxation because it is taxed at both the corporate(or entity) level and at the shareholder level. A C corporation pays tax on its earnings and profits at the current flat corporate income tax rate of 21 percent (26 U.S. Code §§ 11(a) and (b)). And, if its earnings and profits are distributed to its individual shareholders as a qualified dividend, meaning that the shareholders received the dividend from domestic or certain foreign corporations and held the stock for a certain number of days, the shareholders pay tax on the dividend at the current dividend income tax rates of either 0, 15, or 20 percent (26 U.S. Code §§ 1(h)(11)(B), 61(a)(7), 301(c)(1), and 316(a).A shareholder's distributive share of a corporation's earnings and profits are not subject to employment taxes. However, under the Federal Insurance Contributions Act (F.I.C.A.), both C corporations and their shareholders are required to pay employment taxes of 15.3 percent on distributions to shareholders for providing services to the corporation with the corporation and shareholders each contributing 6.2 percent for Social Security and 1.45 percent for Medicare. (26 U.S. Code §§ 3101 and 3111). Also, C corporations pay the 6 percent F.U.T.A. tax on distributions to shareholders for performing services for the corporation. (26 U.S. Code § 3301).

Because corporations can classify distributions to shareholders as wages or amounts not subject to employment taxes, such as dividends and loans, corporations cannot avoid employment taxes by paying shareholders dividends or other amounts in lieu of reasonable compensation for services performed for the corporation. The I.R.S. may re-classify distributions to a shareholder as wages subject to income and/or employment taxes if in reality the payments were for services the shareholder provided to the corporation. Or, if the shareholder was compensated, the I.R.S. may determine that it was not reasonable. Factors used by the I.R.S. and courts to determine reasonable compensation include: training and experience, duties and responsibilities, time and effort devoted to the corporation, and payments to non-shareholder employees. (*Gale W. Greenlee, Inc. v. United States,* 1985 and I.R.S. Fact Sheet FS-2008-25).

Partnerships, limited liability companies, and S corporations Pass-Through Entities

For federal income tax purposes, there are three types of pass-through business entities: partnerships, limited liability companies (L.L.C.s), and S corporations (26 U.S. Code § 1(h)(10)). Like sole proprietorships, pass-through entities do not pay federal taxes on their income, rather their income, losses, deductions, and credits pass through to their respective owners, the partners, L.L.C. members, and S corporation shareholders, who pay tax on their share of the pass-through entity's income at their own income tax rates (26 U.S. Code §§ 701, 702, 703, and 704). Similarly to sole proprietors, owners of pass-through entities can use their share of the pass-through entity's losses, deductions, and credits to offset other income.

Like sole proprietors, individual owners of domestic pass-through entities can claim a deduction equal to the lesser of 20 percent of the pass-through entity's Q.B.I. and 20 percent of the owner's taxable income, thereby reducing the amount of the entity's Q.B.I. subject to federal tax by 20 percent. However, except for engineers and architects, traditional service providers, such as doctors, attorneys, and accountants, whose business is organized as a pass-through entity, cannot claim the 20 percent pass-through deduction (26 U.S. Code §§ 199A(a), (b), (c), and (d)).

For federal income tax purposes, a pass-through entity can elect, under the "check-the-box regulations" to be taxed like a C corporation, rather than taxed like a pass-through entity. By electing to be taxed as a C corporation, the pass-through entity's income will be taxed at both the entity level and at the owner level, rather than taxed only at the owner level (26 U.S. Code § 7701; Treas. Reg. §§ 301.7701-1 to -3). For example, an L.L.C. with one owner is generally taxed like a sole proprietorship, but under the check-the-box regulations, it can elect to be taxed like a C corporation. Therefore, like a C corporation, the L.L.C.'s income would be taxed at both the L.L.C. level and at the member-owner level when the L.L.C. distributes its income as a dividend to its members (Treas. Reg. §§ 301.7701-1 to -3).

Partnerships

A partnership is an association formed under state law by two or more individuals, corporations, or other entities to carry on a trade or business with each contributing cash and/or property in exchange for an ownership interest in the partnership and a share of the partnership's income and losses based on the percentage of their partnership interest (26 U.S. Code §§ 761(a), (b), and (c); Treas. Reg. §§ 301.7701-2(a) and (c); U.P.A. §§ 201(a) and 202(a)).

There is no limit as to the number of partners in a partnership and partners can be U.S. citizens or residents, foreign individuals, domestic and foreign corporations, other partnerships, L.L.C.s, and other organizations. There are two types of partners, general partners and limited partners. Usually, general partners, not limited partners, participate in managing the partnership.

Because general partners have unlimited personal liability for the partnership's debts, obligations, and other liabilities, claims can be filed against both the partnership's assets and the general partners' own assets. Unlike general partners, limited partners have limited liability protection, but if they are held liable for a partnership's debts and obligations, their liability is limited to the amount they invested in the partnership (Treas. Reg. § 301.7701-3(b)(2)(ii)).

There are also several different types of partnerships. In a general partnership, there are only general partners, who are all jointly and severally liable for the partnership's debts, obligations, and liabilities. In a limited partnership, there is at least one general partner and one limited partner. In a limited liability partnership, the partnership, not the partners, are solely responsible for its debts, obligations, and other liabilities and the partners are liable for their own malpractice, but not for other partners' own malpractice (U.P.A. § 306(a)).

General and limited individual partners pay self-employment, but not F.U.T.A. taxes, on amounts they receive for providing services to a partnership. General partners also pay self-employment taxes on their distributive share of a partnership's income. But, limited partners do not pay self-employment taxes on their distributive share, except to the extent that their share is a guaranteed payment, which is an amount paid to limited partners for providing services to the partnership without regard to their partnership interest. (26 U.S. Code §§ 1401 and 1402(a)(13)).

Limited Liability Companies

A limited liability company is a business entity organized under state law and is formed by investors, who become members of the L.L.C., contributing cash and/or property in exchange for a share in the L.L.C. and the right to a percentage of the L.L.C.'s profits and losses. An L.L.C. can have one member or an unlimited number of members and members can be U.S. citizens, U.S. residents or foreign individuals, domestic and foreign corporations, partnerships, other L.L.C.s, and other entities, except certain banks and insurance companies. (e.g., California L.L.C. Act §§ 17701.02(k), 17701.04, and 17701.05). An L.L.C. can have member classes with different rights, such as one member class having more decision making rights than another member class.

An L.L.C. is a hybrid entity because it has partnership and corporate characteristics. Like a partnership, an L.L.C.'s income, losses, deductions, and credits pass through to its members, who report their share of the L.L.C.'s income and pay any taxes due on the income at their own tax rate. As with corporations, L.L.C. members have limited liability protection, but if they are held liable for an L.L.C.'s debts and obligations, their liability is limited to the amount they invested in the L.L.C.

L.L.C. members pay self-employment, but not F.U.T.A. taxes on both the amounts they receive for providing services to the L.L.C. and on their distributive share of the L.L.C.'s income. (I.R.S. Private Letter Ruling 9432018).

S corporations

An S corporation is a small business entity that is formed as a C corporation under state law, but for federal income tax purposes, elects to be taxed like a partnership. (26 U.S. Code §§ 1361(a) and (b)). An S corporation is a hybrid entity, because like a C corporation, the S corporation's shareholders, board of directors, and officers have limited liability protection and like a partnership, its income is taxed only at the shareholder level. If S corporation shareholders are held responsible for the S corporation's debts and liabilities, their liability is limited to the amount of their investment in the S corporation.

An S corporation cannot issue more than one class of stock, be a foreign corporation, or a subsidiary of a C or S corporation. An S corporation generally can have only 100 shareholders, who must all be U.S. citizens, U.S. residents, or domestic trusts, estates, or tax-exempt organizations. However, the number of shareholders can exceed 100 without jeopardizing the S corporation's tax status, because for federal tax purposes, certain S corporation shareholders, who are related to each other, such as a father and his daughter, are treated as one shareholder.

In certain circumstances, such as an S corporation issuing a second class of stock, an S corporation can involuntarily lose its S corporation tax status, resulting in it being taxed as a C corporation, rather than as a partnership. Except in certain situations, such as the termination of its S corporation status was not within in its control, an S corporation that loses its tax status must wait five years before re-electing to be taxed like a partnership. (26 U.S. Code §§ 1361(a) and (b), 1362(a) and 1363(a) and (b)).

Like C corporation shareholders, S corporation shareholders pay F.I.C.A. and F.U.T.A. taxes on distributions for providing services to the S corporation, but not on their distributive share of the S corporation's earnings profits, whereas general partners pay self-employment taxes on both distributions for providing services to the partnership and their distributive share of the partnership's income. Also, similarly to C corporations, the Internal Revenue Code (I.R.S). could determine that an S shareholder was not reasonably compensated for their services or may classify a shareholder's distribution as wages subject to income and employment taxes. (*Joseph Radtke, S.C. v. United States*, 1990; I.R.S. Rev. Rul. 59-221 and I.R.S. Rev. Rul. 74-44).

Choice of Entity Example

Betty knows that choosing the form of business entity for her startup business, Pelican Publishing (Pelican), is one of her most important business decisions. Because she does not know what would be the best business structure for Pelican, she is seeking advice about choosing a business entity. Betty is concerned about employment taxes and being personally liable for Pelican's debts and would like to have complete control over Pelican's management and avoid double taxation on its income.

If Pelican is a sole proprietorship, Betty would be in control of Pelican and would avoid double taxation, but she would be personally liable for Pelican's debts. For federal income tax purposes, as a sole proprietorship, an amount equal to the lesser of 20 percent of Betty's taxable income or 20 percent of Pelican's Q.B.I. could be deducted from Pelican's taxable income, thus reducing the amount of Pelican's Q.B.I. subject to tax by 20 percent. As a single shareholder C corporation, Betty would be in control of Pelican and not personally liable for Pelican's debts. However, Pelican's income would be taxed twice, first at the entity level, then at the shareholder level when Pelican distributes its income to Betty as a dividend.

Although Betty generally would have limited liability protection, in certain circumstances, such as Pelican is found to be a sham corporation, the corporate veil could be pierced and Betty would become personally liable for Pelican's debts up to the amount of her investment in Pelican.

For Pelican to be a partnership, Betty would have to partner with at least one other individual, corporation, or entity, because a partnership must have at least two partners. As a general partner, Betty could manage Pelican's daily operations, but she would be personally liable for Pelican's debts. As a partnership, Pelican's income would not be taxed twice, but in contrast to a sole proprietorship or a single shareholder C corporation, its income would be divided between Betty and the other partners.

If Pelican is either a single member L.L.C. or a single shareholder S corporation, Betty would be in control of Pelican, would avoid double taxation, and except in certain circumstances, she would not be personally liable for Pelican's debts. Also, as pass-through entities, a 20 percent pass-through entity deduction could be claimed, thus reducing the amount of Pelican's Q.B.I. subject to tax by 20 percent.

However, because of the limits on the number of S corporation shareholders and who can be S corporation shareholders, it could be more difficult for Pelican to grow as an S corporation, than as an L.L.C., and therefore, an L.L.C. may be a better entity choice. For example, if Pelican is an L.L.C., instead of an S corporation, the number of members could exceed 100 and the members could be foreign individuals and both domestic and foreign C corporations, rather than only U.S. citizens and residents, domestic trusts, estates, or tax-exempt organizations.

Although Betty wants to avoid double taxation, with the current 21 percent flat federal corporate income tax rate, for federal tax purposes, a C corporation, rather than a sole proprietorship or a pass-through entity, could be a better entity choice for Pelican. For example, if Pelican is a C corporation with $1,000 of taxable income, it would pay $210 of taxes on the $1,000 ($1,000 X 21% = $210). If Betty's federal dividend tax rate is the lowest current rate of zero percent and she receives a $790 dividend from Pelican ($1,000 taxable income - $210 taxes paid by Pelican = $790 dividend), she would not pay taxes on the dividend.

If instead Pelican is a single member L.L.C. and Betty's federal income tax rate is the current highest rate of 37 percent, Pelican would not pay taxes on its taxable income of $1,000 and Betty would pay $370 of taxes on it ($1,000 X 37% = $370). Therefore, for tax purposes, a C corporation would be a better structure for Pelican, because the total amount of taxes paid on its taxable income would be less than if it was an L.L.C.

However, if Betty's federal income tax rate is lower than her dividend tax rate, a sole proprietorship or a pass-through entity would be a better option for tax purposes, because the total amount of taxes paid on Pelican's taxable income would be less than if Pelican was a C corporation. For example, if Pelican is a single member L.L.C. with taxable income of $1,000 and Betty's individual tax rate is the lowest current rate of 10 percent, Pelican would not pay taxes on the $1,000 and Betty would pay $100 in taxes on it ($1,000 X 10% = $100).

If Pelican instead is a C corporation and distributes a $790 dividend ($1,000 taxable income - $210 taxes paid by Pelican = $790 dividend) to Betty and her dividend tax rate is the highest current rate of 20 percent, Pelican would pay $210 of taxes on its taxable income ($1,000 X 21% = $210) and Betty would pay $158 on her dividend ($790 X 20% = $158). Thus, an L.L.C., rather than a C corporation, would be a better structure for tax purposes, because less taxes would be paid on Pelican's $1,000 of taxable income.

If Pelican is a sole proprietorship, Betty would pay self-employment, but not F.U.T.A. taxes on Pelican's income. If Pelican is a partnership, as a general or limited partner, Betty's compensation for her services to Pelican would be subject to self-employment taxes, but not F.U.T.A. If Betty was a limited, not general partner, her distributive share of Pelican's income would be exempt from self-employment taxes except to the extent her share was a guaranteed payment. As an L.L.C., Betty would pay self-employment, but not F.U.T.A. taxes on her share of Pelican's income and on compensation for her services to Pelican.

If Pelican is a C or S corporation, neither Pelican nor Betty would pay employment taxes on Betty's share of Pelican's earnings and profits, but distributions to Betty for providing services to Pelican would be subject to F.I.C.A and F.U.T.A. Also, the I.R.S. could question whether Betty was reasonably compensated for her services to Pelican or classify distributions to her as wages subject to income and employment taxes.

Conclusion

As discussed and illustrated above, what business entity the owners of a startup business choose will determine the tax and non-tax consequences for both the owners and the startup. However, by understanding the similarities, differences, advantages, and disadvantages of different business entities, owners can choose the best business structure for their startup business.

Gretchen R. Lawrie, Glawrie@calstatela.edu

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