Business Entity Pros and Cons

2016

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PW Tax and Accounting

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Sole Proprietorship	
Pros	• No formal creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • No double taxation of profits.
Cons	• No liability protection. • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners.
Good Fit	• Seasonal or part-time businesses. • Businesses with little liability. • Home-based businesses. • Businesses intended to operate for the owner’s life only.

Single Member LLC	
Pros	• Simple creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • Liability protection for member, except for malpractice. • No double taxation of profits.
Cons	• Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners. • Laws regulating LLCs vary widely among states.
Good Fit	• Businesses with potential liability in operations. • Businesses intended to operate for the owner’s life only.

Multimember LLC	
Pros	• Limited liability for all members, except for malpractice. • Unlimited number of members. • Separate entity from members, allowing for greater flexibility in operations. • Ownership is in the form of membership interest and can be transferred more easily than ownership in a single member LLC. • No double taxation of profits.
Cons	• Requires a separate tax return. • Laws regulating LLCs vary widely among states.
Good Fit	• Businesses requiring equity capital. • Businesses with potential liability in operations. • Businesses intended to exist beyond the lives of the members. • Businesses expecting changes in ownership over time.

General Partnership	
Pros	• Easy to create. • No limit on partner number or type. • Can be used to hold investments in other businesses and consolidate multiple lines of business. • Flexible allocation of profit, loss, and distributions. • Favorable tax treatment when liquidated. • No double taxation of profits.
Cons	• Requires a separate tax return. • Unlimited liability for all partners. • Difficult to dissolve or change ownership without substantial planning. • Requires tracking of basis for partners, both inside and outside the partnership. • Individual partner’s share of income is subject to self-employment taxes.
Good Fit	• Two established businesses who wish to work as one. • Partners wishing to consolidate multiple entities into one entity.

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Limited Liability Partnership	
Pros	• Liability protection for limited partners. • Separate entity from partners. • Ownership can be transferred within the rules of the partnership agreement. • Limited partners' liability is limited to their investment in the business. • Limited partners pay self-employment tax on guaranteed payments only. • No double taxation of profits.
Cons	• Must have one general partner with unlimited liability. • Limited liability status for damages can be lost for a variety of administrative reasons. • Restrictions on partners based on entity type. • Requires a separate tax return. • Requires tracking of basis for partners, both inside and outside the partnership.
Good Fit	• Businesses with partners not actively involved in business. • Businesses with equity capital needs. • Businesses with exposure to liability.

C Corporation	
Pros	• No liability for non-active stockholders. • No restrictions on ownership. • Ownership can be transferred through the sale of stock. • Separate entity from stockholders. • Fringe benefits for owner-officers. • Can have ownership interest in any other business entity. • Perpetual existence. • Raising capital can be achieved by issuing stock.
Cons	• Double taxation of profits. • Complex and expensive to create and maintain. • Require regular board of directors' meetings and minutes. • Requires a separate tax return.
Good Fit	• Businesses with ownership in multiple other entities. • Businesses with significant exposure to liability. • Businesses intended to exist eternally.

S Corporation	
Pros	• Liability protection similar to that of C corporations. • No double taxation of profits. • Ownership is easily transferred through the sale of stock. • Separate entity from stockholders. • Self-employment tax is not assessed on the entire profit of the business. • Losses can offset shareholders' other taxable income.
Cons	• Complex and expensive to create and maintain. • Requires a separate tax return. • Requires regular board of directors' meetings and minutes. • Requires tracking of basis for stockholders. • Ownership is limited to specific types of entities. • Deductibility of fringe benefits for owner-employees is limited.
Good Fit	• Businesses with significant exposure to liability.

Business Formalities

A common problem with a closely-held business is failure to adhere to business formalities. Trouble can occur when business and personal funds are intermingled, the business is not adequately capitalized, or reasonable compensation for services is not paid.

For example, separation of funds can be a key in preserving the liability protection of the "corporate veil." Courts can pierce the corporate veil if they find the corporation is an "alter ego" of the shareholder, which is likely to occur if shareholders pay personal expenses from the corporation checkbook or vice versa.

Transactions such as capital contributions or loans between the business and the owners can also be recharacterized by the IRS, creating unexpected negative tax consequences.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.

Business Financing—Don’t Intermingle Funds

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Business Financing—Don’t Intermingle Funds

Intermingling Funds

A common problem with single-owner and other closely-held corporations is intermingling of funds. This occurs when a corporate shareholder uses his or her personal checking account for corporate deposits or payment of corporate expenses.

Separation of funds can be a key in preserving the liability protection of the corporate veil. Courts can pierce the corporate veil by finding that the corporation is an “alter ego” of the shareholder, essentially stating that the corporation is not separate and distinct from the individual as evidenced by the intermingling of finances.

Also, a shareholder who deposits personal funds or pays personal expenses from the corporate checking account is intermingling funds. For the same reasons as the reverse, courts can cite this as evidence that the corporation is not a separate and distinct entity from the individual.

Tax Problems Caused by Intermingling Funds

Unintended tax consequences can occur when personal and corporate funds are intermingled. When a shareholder provides funds to or on behalf of a corporation, there are several different types of tax treatment that may apply, depending on the circumstances. For example, when a shareholder provides funds to a corporation, it can be classified as one of the following transactions.

- Capital contribution.
- Loan to the corporation.
- Repayment of a loan from the corporation.
- Expense reimbursement.
- Purchase.

When a shareholder purchases an item for the corporation from his or her personal funds, that shareholder is considered to have provided funds, or made a contribution, to the corporation. Classification is determined by how the transaction is structured and the circumstances surrounding the transaction. Providing funds to corporations without careful planning can cause unintended tax consequences.

If an individual takes funds from a corporation checking account, the transaction can be classified as:

- Taxable dividend.
- Nontaxable distribution.
- Nontaxable expense reimbursement.
- Wages.
- Loan to the shareholder.
- Repayment of a loan from the shareholder.

Failure to carefully structure transactions when taking disbursements from a corporation can result in otherwise nontaxable transactions becoming taxable, in addition to opening the corporation up for a court to pierce the corporate veil.

Example: *Lucy owns a home and garden store. She recently incorporated in order to shield herself from liabilities of the business. Lucy meant to open a corporation checking account, but she never got around to it. Since she had been doing business with her suppliers for many years as a sole proprietor, she continued to purchase supplies and inventory on account and pay the invoices from her personal checking account. Unfortunately, Lucy had a particularly bad year, and she was successfully sued for $1 million by a customer injured by a Venus Flytrap purchased at Lucy’s store. She also fell under audit by the IRS.*