Lowndes

Choosing the Right Entity for Your Business

Article
03.29.2022

Amanda Wilson

Related Expertise

Tax

What is the right entity for your new business? The default answer is often considered to be a corporation, as it provides the owner with protection from business debts and has a lower 21 percent federal tax rate. The downside, however, is that profits are subject to a double layer of tax. The corporation pays taxes, plus the owner generally pays tax when profits are distributed out of the corporation.

Today, there is often a better choice. A limited liability company ("LLC") provides the owner with similar liability protection, while also potentially providing a better tax result. An LLC can elect to be taxed as a corporation, or it can be treated as a pass-through entity. If it elects to be a pass-through, it is disregarded for tax purposes if it has one owner or treated as a partnership if it has two or more owners. This means that the income and losses are taxed at the owner level, and profits can generally be distributed out of the LLC tax free. The result is a single layer of tax.

Additionally, if there are capital gains, the character of this income passes through as well, allowing owners that are individuals to take advantage of the preferential capital gains rates (in comparison, a corporation is taxed federally on capital gains at the same rate as ordinary income). Losses also pass through, allowing owners the potential opportunity to use losses from the LLC to offset income from other businesses or activities (in comparison, losses remain trapped in a corporation).

An LLC or corporation can also affirmatively elect to be treated as an S corporation, another type of pass-through entity for tax purposes. An S corporation has significant limitations on the number and types of owners, though, and provides less flexibility than a partnership. An S corporation can only have one class of stock and all distributions to owners must be shared pro rata or the S corporation will lose its pass-through status. In contrast, a partnership has extreme flexibility in how the owners can share profits and distributions. The S corporation used to provide a benefit to owners over partnerships in the self-employment tax area, but recent case law has largely negated this benefit.

In short, pass-through entities provide owners with significant tax benefits as the business is operated, and LLCs that are taxed as partnerships generally provide the most benefits and flexibility. This is true not only during the operation of the business, but also when it is time to exit the business. A partnership can often be liquidated or restructured in a non-taxable manner, including the distribution of appreciated assets out of the partnership. In contrast, distributions or liquidations out of a corporation or S corporation generally result in a taxable transaction, requiring any appreciation in the assets to be recognized for tax purposes. For these reasons, an LLC that elects to be treated as a partnership generally provides business owners with the most flexibility and a more advantageous tax result. This article is informational only. You should consult an attorney before acting or failing to act. The law may change rapidly and no warranty is given. LOWNDES DISCLAIMS ALL IMPLIED WARRANTIES AND WITHOUT LIMITATION, ANY WARRANTY OF FITNESS FOR A PARTICULAR PURPOSE. ALL ARTICLES ARE PROVIDED AS IS AND WITH ALL FAULTS. Consult a Lowndes attorney if you wish to establish an attorney/client relationship.