Business: Forms of Organizations

Will some types of business organization or entity limit my liability to business creditors?

Yes. Limited liability companies (LLCs), limited partnerships, limited liability partnerships (LLPs) and corporations are the most common forms. General partnerships and sole proprietorships don't restrict owners' liability, whereas limited partnerships limit liability of some partners (such as limited partners) and not others (like general partners).

How can I avoid the "corporate double tax," and what exactly is it?

A "corporate double tax" happens when a business corporation (or an entity that is treated as a business corporation for tax purposes) pays a federal tax on its income, and then its owners pay another tax as they collect corporate profits. The "entity level tax" is the tax on the corporation and so an entity taxed in this way is called a "C corporation" or C corp. Here are ways to avoid the double tax:

- Become an S corporation, which doesn't change the nature of the business under state business law but rather eliminates federal tax at the corporate level.
- The second tax, which is on the owners, can be deferred by suspending profit distributions to corporate owners.

For tax purposes, what type of business entity is best?

Each business is different, although to save on overall taxes a "passthrough" entity is generally best, as it eliminates tax at the entity level. Owners of passthrough entities are taxed on the profits of the entity that they own. Owners are able to make tax deductions for startup and operating losses, against the income from other businesses or investments.

What entities are considered to be "passthrough"?

The leading "passthrough" forms are limited partnerships, LLCs, LLPs, S corps, sole proprietorships and general partnerships. You have a lot of power over whether or not your entity is treated as a passthrough for federal tax purposes. If you have a partnership of any type or a limited liability company, it is possible to choose if your business functions as a corporation or partnership for tax purposes. This is called the "check-the-box" system by tax and business advisors. You can qualify to have it treated as a passthrough by choosing S corporation status if your entity is incorporated or if you elect to be treated as a corporation. This decision is binding. This means if you select one entity one year and a different one the next, you will have to pay the taxes as though last year's entity was sold and use those profits towards this year.

To avoid double tax and limit my liability, which entity should I choose?

Assuming you don't select to have them function as corporations, the following types will avoid double tax and limit liability: LLPs, LLCs, and limited partnerships (only for the limited partners). An S Corporation is usually another option. If you are a sole owner, the only option is an S Corp (or in certain states, LLCs).

Why are limited liability companies (LLCs) so great?

Limited liability and passthrough tax treatment are both combined in LLCs. This provides benefits that are unavailable from S Corps. The main benefits are:

- The possibility of greater loss deductions.
- Tax benefits can be disproportionately distributed among owners.
- When a new owner becomes a member of the business, or when allocations are given to owners in business liquidation, taxes are avoided or reduced.

LLCs are sometimes permitted to have a single owner - laws vary by state. If permitted, the owner has the opportunity to elect to be under the check-the-box rules. A good alternative where sole ownership LLCs aren't permitted is an S Corp. This structure will also defer tax, in comparison to LLCs, when a corporate giant is buying out the business.

If my business is a professional practice, what are the special conditions?

A major concern is the limitation of liability, especially malpractice liability. Against the liability of your own malpractice, there is no entity that will protect you. For protection against liability for malpractice of co-owner professionals in the firm and possibly for other debts, Professional Limited Liability Companies (PLLCs), LLCs, and LLPs, when accessible for professional practices, should be used. Depending on the state law, Professionals Corporations (PCs) might not offer protection from liability for a co-owner's malpractice. LLPs, PLLCs, and LLCs all have about the same tax rules that govern them while those for PCs are a little more liberal.

If I change my form of business organization, what are the federal tax consequences?

A change of entity is an event that may need to be carefully planned and implemented to avoid a taxable event. It also may have significant future tax implications. You should consult with a professional before making any changes or decisions to your business organization.

Is it necessary for state business entity rules to follow federal tax rules?

Bear in mind the differences between state tax law and state business law. Whatever tax status you select for your entity beneath the federal check-the-box system, keep in mind that you may be considered a different type of entity for state business law purposes. This means that if you choose corporate tax treatment for a partnership, it will not necessarily bring corporate limited liability. A state normally treats the entity selected under federal check-the-box as the entity acknowledged for state tax purposes, but this is not always the case. The law of a state may agree to passthrough status for an entity like an S Corp or an LLC, but still enforce some sort of tax on the entity.

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