

ENTITY SELECTION FOR THE BUSINESS OWNER

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The “choice of entity” decision is one of the most important decisions facing those who own and operate businesses. There is no single form of entity that is appropriate for every type of business owner or entity. Further, there are several forms to choose from, each of which generates different legal and tax consequences.

Choosing the appropriate form of entity in which to operate a business is a complex decision. It depends upon many factors, including the owner’s needs and desires, and the particular

characteristics and needs of the business in question. Federal and state tax consequences of each type of entity also play an important role. In closely held entities the parties’ combined tax liabilities should be analyzed as part of the decision-making process.

In order to choose the proper entity it is important to understand the characteristics of each type. With that in mind we include here an insert to assist you and your advisors in this important decision-making process. ☒

ENTITY SELECTION SCHEDULE

LIABILITY OF OWNERS	
Entity	Liability of Owners
Partnership	General partnership: Unlimited. Limited partnership: Limited partner limited to the amount of capital contribution. General partner: Unlimited.
Limited Liability Partnership	Generally limited to the assets of the LLP.
Limited Liability Limited Partnership	Generally limited to the assets of the LLLP.
Corporation	Generally limited to assets of the corporation, unless loans or notes are guaranteed by the shareholders.
S Corporation	Generally limited to assets of the corporation, unless loans or notes are guaranteed by the shareholders.
Multi-Member LLC	Generally limited to assets of the LLC, unless loans or notes are guaranteed by the members. Note that single-member LLCs are disregarded as entities for federal tax purposes unless they elect to be taxed as an association. Items of income and loss are recognized directly by the owner.

MANAGEMENT	
Entity	Management
Partnership	General partnership: Not centralized; all general partners usually participate. Limited partnership: Centralized; only general partners may participate—limited partners are prohibited from participating in control.
Limited Liability Partnership	Not centralized; all general partners usually participate.
Limited Liability Limited Partnership	Centralized; only general partners may participate—limited partners are prohibited from participating in control.
Corporation	Centralized. In a large corporation, control is often in the hands of top management. In a closely held corporation, management is often exercised by the owners.
S Corporation	Centralized. In a large corporation, control is often in the hands of top management. In a closely held corporation, management is often exercised by the owners.
Multi-Member LLC	May be managed by members in their membership capacity, by members as managers or by non-managers.

CONTINUITY OF LIFE	
Entity	Continuity of Life
Partnership	Generally for a specific or agreed-upon term. The death, withdrawal, insolvency or legal disability of a general partner may terminate the partnership.
Limited Liability Partnership	Generally for a specific or agreed-upon term. The death, withdrawal, insolvency or legal disability of a general partner may terminate the partnership.
Limited Liability Limited Partnership	
Corporation	Indefinite, unless limited by state law or terms of the charter.
S Corporation	Indefinite, unless limited by state law or terms of the charter.
Multi-Member LLC	Generally, unlimited or perpetual duration unless limited by state law or terms of the operating agreement.

LEGAL STATUS	
Entity	Legal Status
Partnership	Generally recognized as a separate legal entity.
Limited Liability Partnership	Recognized as a separate legal entity.
Limited Liability Limited Partnership	Recognized as a separate legal entity.
Corporation	Recognized as a separate legal entity.
S Corporation	Recognized as a separate legal entity.
Multi-Member LLC	More closely resembles a corporation for purposes of legal status.

DIFFERENT CLASSES OF OWNERSHIP INTEREST	
Entity	Different Classes of Ownership Interest
Corporation	No limitations on classes of voting stock. Also, different classifications of debt are permitted.
S Corporation	Only one class of stock is permitted. Although voting differences are acceptable, outstanding stock must have identical liquidation and dividend rights to all shareholders. Straight debt is not treated as a second class of stock.
Multi-Member LLC	Generally parallels partnership treatment.
Partnership	Different classes of limited partners and general partners can exist.
Limited Liability Partnership	Different classes of general partners can exist.
Limited Liability Limited Partnership	Different classes of limited partners can exist.

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EASE OF FORMATION	
Entity	Ease of Formation
Partnership	Few formal restrictions; small amount of expense. Limited partnership required to file a Certificate of Limited Partnership. Formation of a limited partnership and syndication costs can be expensive.
Limited Liability Partnership	Few formal restrictions; small amount of expense. Filing with state is required.
Limited Liability Limited Partnership	Limited partnership required to file a Certificate of Limited Liability Limited Partnership.
Corporation	State law requirements for incorporation must be satisfied. Expenses higher than for forming a partnership.
S Corporation	Same as corporation. Since these entities are closely held, costs tend to be less than for a corporation.
Multi-Member LLC	The LLC must file articles of organization with the secretary of state in the state of formation. The formation requirements more closely resemble those of corporations.

NUMBER OF SHAREHOLDERS/PARTNERS/OWNERS	
Entity	Number of Shareholders/Partners/Owners
Partnership	Generally, unlimited. However, security laws must be complied with for a large partnership.
Limited Liability Partnership	Generally, unlimited. However, security laws must be complied with for a large partnership.
Limited Liability Limited Partnership	Generally, unlimited. However, security laws must be complied with for a large partnership.
Corporation	Unlimited. Security laws must be complied with.
S Corporation	Limited to 100.
Multi-Member LLC	No maximum. All states allow single-member LLCs.

ELIGIBLE INVESTORS/OWNERS	
Entity	Eligible Investors/Owners
Partnership	No restrictions.
Limited Liability Partnership	No restrictions.
Limited Liability Limited Partnership	No restrictions.
Corporation	No restrictions.
S Corporation	Only certain individuals, estates and trusts are eligible shareholders.
Multi-Member LLC	No restrictions.

ADOPTION OF TAX YEAR	
Entity	Adoption of Tax Year
Partnership	Same as the majority interest partner(s). If this test does not establish a year end, same year end as principal partners (5-percent interest in profits and capital.) If the principal partners have differing year ends, a calendar year end must be adopted. 9/30, 10/31 and 11/30 year ends allowed if partnership pays for deferral privileges.
Limited Liability Partnership	Same as the majority interest partner(s). If this test does not establish a year end, same year end as principal partners (5-percent interest in profits and capital.) If the principal partners have differing year ends, a calendar year end must be adopted. 9/30, 10/31 and 11/30 year ends allowed if partnership pays for deferral privileges.
Limited Liability Limited Partnership	Same as the majority interest partner(s). If this test does not establish a year end, same year end as principal partners (5-percent interest in profits and capital.) If the principal partners have differing year ends, a calendar year end must be adopted. 9/30, 10/31 and 11/30 year ends allowed if partnership pays for deferral privileges.
Corporation	A calendar or fiscal year end may be adopted. No deferral of income since no pass through of income or losses.
S Corporation	Generally, a calendar year must be adopted unless a business purpose can be shown. Like a partnership, a deferral of three months or less is allowed if S corporation pays for deferral privileges.
Multi-Member LLC	Generally parallels partnership treatment (assuming the LLC is classified as a partnership for federal tax purposes).

TAXATION OF INCOME; DEDUCTIBILITY OF LOSSES	
Entity	Taxation of Income; Deductibility of Losses
Partnership	Partners taxed on their share of income, regardless of distributions. Losses may be deducted by partners to the extent of basis.
Limited Liability Partnership	Partners taxed on their share of income, regardless of distributions. Losses may be deducted by partners to the extent of basis.
Limited Liability Limited Partnership	Partners taxed on their share of income, regardless of distributions. Losses may be deducted by partners to the extent of basis.
Corporation	Corporation taxed on its taxable income, regardless of distributions to shareholders.
S Corporation	Shareholders taxed on their share of income, whether or not distributed. Losses may be deducted by shareholders to the extent of adjusted basis in stock.
Multi-Member LLC	Generally parallels partnership treatment (assuming the LLC is classified as a partnership for federal tax purposes).

FRINGE BENEFITS	
Entity	Fringe Benefits
Partnership	Partner required to include value of fringe benefits in gross income.
Limited Liability Partnership	Partner required to include value of fringe benefits in gross income.
Limited Liability Limited Partnership	Partner required to include value of fringe benefits in gross income.
Corporation	Available to all shareholders/employees. Cannot be discriminatory in favor of highly compensated employees or may be taxable to such individuals.
S Corporation	Fringe benefit payments on behalf of shareholders owning 2 percent or less are treated as deductible business expenses. The 2-percent shareholder is treated like a partner of a partnership.
Multi-Member LLC	Parallels partnership treatment (assuming the LLC is classified as a partnership for federal tax purposes).

RETIREMENT PLANS	
Entity	Retirement Plans
Partnership	Partners may participate in self-employed qualified plans. Limitations are generally on a par with corporate plans.
Limited Liability Partnership	Partners may participate in self-employed qualified plans. Limitations are generally on a par with corporate plans.
Limited Liability Limited Partnership	Partners may participate in self-employed qualified plans. Limitations are generally on a par with corporate plans.
Corporation	Shareholders/employees can be included in corporation's regular qualified plan. Top-heavy rules apply.
S Corporation	Same as corporation.
Multi-Member LLC	Parallels partnership treatment (assuming the LLC is classified as a partnership for federal tax purposes).

SALARIES PAID TO OWNERS	
Entity	Salaries Paid to Owners
Partnership	Since partners are not employees, amounts paid are considered a distribution of earnings, unless they qualify as a guaranteed payment. Self-employment tax on general partner's share of business income is imposed.
Limited Liability Partnership	Since partners are not employees, amounts paid are considered a distribution of earnings, unless they qualify as a guaranteed payment. Self-employment tax on general partner's share of business income is imposed.
Limited Liability Limited Partnership	Since partners are not employees, amounts paid are considered a distribution of earnings, unless they qualify as a guaranteed payment. Self-employment tax on general partner's share of business income is imposed.
Corporation	Generally, the same as an S corporation. In addition, salaries must be reasonable if shareholder/employees are to avoid the unreasonable compensation issue (i.e., treat part of compensation as a dividend).
S Corporation	Salaries are taxable to shareholders/employees and deductible by the S corporation. FICA and FUTA taxes are applicable to compensation for services rendered.
Multi-Member LLC	Parallels partnership treatment, for members actively involved in the management of the LLC (assuming the LLC is classified as a partnership for federal tax purposes).