C Corporation, LLC, or Sole Proprietorship?

What Form Is Best for Your Business?

By Gary M. Fleischman, CMA, CPA, and Jeffrey J. Bryant, CPA

Choosing the optimal company structure is a difficult decision and one of the most important a business owner will ever have to make. Type of ownership, capital formation, management, myriad tax considerations—the form chosen to structure the business will affect nearly every aspect of its operations. It is important, therefore, that management accountants be familiar with the pros and cons of the various forms under which an entity might be set up.

Because the choice of business structure will determine many features of its design, no one factor should dominate this decision. While tax consequences should not be considered in isolation, they are nevertheless a major consideration. C corporations traditionally have been viewed as the vehicle that maximizes nontax advantages, for example. Recent legislation, however, has spread many of the C corporation's strengths to other organizational forms. Because nontax benefits are now widely available in other structures, tax variables have become a more complicated and significant factor in choosing a form for a company. Selecting a suitable business form increasingly is becoming a matter of choosing among the most appropriate tax attributes.

Tax and economic environment change requires that business owners not only must choose an optimum structure for their start-up, but they also must continually reassess their original choice. The appropriate choice inevitably will shift as the business evolves. For example, a tax conduit that passes losses directly to owners' tax returns during the initial years of operation is often a good beginning choice. Then, as the business grows and profits increase, a C corporation that facilitates capital formation and shields owners from profit taxes may become a better alternative. The importance of reviewing structure at all stages in an organization's life cannot be overstated. In an intensely competitive world, a wise initial selection and the diligent monitoring of that choice can significantly impact an enterprise's long-term viability.

Let's look at the current status of four business structures: sole proprietorship, partnership and LLCs, S corporations, and C corporations. For the legal background of the limited liability company (LLC) and limited liability partnership (LLP), see sidebar, "The Evolution of LLCs and LLPs."

The Art of Choosing the Best Business Structure

Selecting the most appropriate structure for an organization is more an art than a science. Seldom do all factors point to an ideal form. Advantages and disadvantages often fluctuate as laws change, further complicating the decision. Several recent tax laws and IRS rulings have significantly altered the analysis. The following observations incorporate these developments and provide useful guides for choosing an entity form.

◆ **SOLE PROPRIETORSHIP.** As its name implies, this form is an option only for a business with one owner. For many reasons, the sole proprietorship is often maligned as having no meaningful tax planning opportunities. Recently enacted law is changing this perception.

Nearly every piece of recent major tax legislation has benefited sole proprietorships. Health insurance premiums paid by proprietors and other self-employed persons, for example, are now scheduled to become fully deductible by the year 2004. The political clout from a growing segment of small business lobbyists should continue this trend.

Perhaps one of the most important factors to consider, given the current legislative environment, is flexibility—a strong point in favor of the sole proprietorship. Major tax legislation has become an annual event, and nearly every notable interest group is clamoring for a tax overhaul. An organizational form—particularly for a start-up—that is easy to escape from would make a good initial choice. A proprietorship can be inexpensively switched to a different structure if future tax reform alters your tax advantage. The low cost of changing forms is unique to proprietorships.

Converting an entity's classification is not necessarily economical, even when it can be readily accomplished. Owners of entities eligible for check-the-box regulations can easily change formats at least once after their first election. Reelection is a "conversion event," however, and that may trigger liquidation and other adverse tax consequences. The mere election of S status by a C corporation can impose a heavy double-tax burden on the corporation and its shareholders. An S corporation-level tax is possible due to the built-in gains tax, the LIFO recapture tax, and the excess net passive income tax. A proprietorship, therefore, is probably the least risky business form from which to change. In an era of tax reform, this flexibility is important.

◆ PARTNERSHIPS AND LLCs. General partnerships, LPs, LLPs, and LLCs have many similar tax characteristics, but there are noteworthy differences in tax treatments as well. Although LLCs do not have to be taxed as partnerships under the check-the-box regulations, owners are likely to do so in the vast majority of cases.

Partnerships and LLCs are conduit entities for U.S. tax purposes. Conduit tax treatment implies that income is taxed at only one level: As income is earned, the owners—rather than the entity—are taxed. There is generally no second taxing when income is distributed to the owners. In contrast, C corporation earnings are taxed once at the corporate level and again when distributed to owners as dividends.

Net losses generated at the conduit level are passed on to owners, who may deduct these losses in the current year to offset other taxable income on their personal tax returns. Conversely, initial year losses in a C corporation can only be carried forward by the corporation to offset future corporate income. Losses do not produce an immediate tax benefit and may ultimately be wasted if the corporation never produces sufficient income.

Conduit entity income and losses retain their character when passed through to owners. Therefore, capital gains realized by the entity are characterized as such on the owners' tax returns. For high-income individual taxpayers, the Taxpayer Relief Act of 1997 (TRA 97) lowers the maximum tax rate on net capital gains to 20% when the taxpayer's other income is taxed at a higher rate. To take advantage of this rate differential, individual owners with high marginal rates may find that a partnership or LLC is a good entity choice if the business is expected to generate capital gain income. A corporation's capital gains, on the other hand, are taxed to the corporation at regular corporate rates and taxed again as ordinary income when distributed to individual shareholders.

Most small business owners today realize that at some point they will probably transact business in the international arena. LLCs are especially useful for international businesses. The LLC is relatively new in America, but an equivalent has been widely used in other countries for years. Foreign investors are comfortable with LLCs, which make them popular vehicles for foreign investment in the United States. LLCs also present investors with substantial international tax planning opportunities. Though LLCs have existed on the world stage for a long time, foreign countries do not necessarily tax them in the same manner as in the United States. Typically, LLCs are classified as partnerships for U.S. tax purposes, while foreign countries often consider them taxable entities, much like C corporations. An entity that is treated as a nontaxable partnership by the United States but as a taxpaying organization by a foreign country is called a "hybrid" entity.

Because of this tax dichotomy, businesses sometimes use hybrids as intermediaries to shop for countries with favorable tax treaties and to defeat U.S. income tax. Both Congress and the IRS have recently moved to stop these practices, but LLCs will likely remain a popular choice for international businesses, particularly because S corporations must be domestic, and nonresident aliens cannot own S corporation stock.

Tax implications of an LLC. *Barbara, a U.S. citizen, and Robert, a Canadian resident, organize an LLC in Minnesota. They elect to classify the LLC as a partnership in the United States, while Canada treats this entity as a taxable corporation (a hybrid). The United States will tax Barbara directly on her share of LLC income. Canada, however, considers the LLC a taxpayer and will not tax Robert on its income, even though Canada has no jurisdiction to tax the LLC on U.S. income. Under new law, to prevent Robert from escaping tax altogether, special rules determine withholding tax on certain U.S. source income of the LLC.*

Recent developments in both state and federal

Tax Rates and Legal Liability: A Brief History

◆ Changes in marginal tax rates. The dynamics of analyzing the best form for a business can be illustrated by considering the effects of fluctuating tax rates during the last two decades. For most years prior to 1981, maximum individual marginal tax rates exceeded the maximum rates for C corporations, making C corporations an appealing choice from a tax standpoint. The 1981 Tax Act, however, lowered the maximum individual tax rate from 70% to 50%, while the maximum corporate rate decreased from 48% to 46%. Then, the Tax Reform Act of 1986 (TRA 86) established a maximum rate for individuals that was below the top rate for C corporations. TRA 86 lowered the highest individual rate to 28% and decreased the maximum corporate rate to 34%. This inversion increased the popularity of conduit entities, such as partnerships and S corporations, vis-à-vis C corporations. Today, individual rates once again exceed corporate rates, though not at the pre-1981 magnitude.

◆ A changing legal environment. Over the past two decades exposure to liability has exploded, and limiting this exposure has become a major factor in business planning. National accounting firms organized as general partnerships, for example, were devastated by their legal responsibilities for the savings and loan crisis of the 1980s. Plaintiffs attached the personal assets of partners whether those partners were directly responsible for malfeasance or not. In this environment, the S corporation became popular as owners sought protection behind the corporate veil. Restraints on ownership and capital structure limited the S corporation's usefulness, however. As it became necessary to cap personal assets exposure, demand arose for an entity that could successfully meet two critical needs: more flexibility to maximize individual taxpayer advantages and enhanced liability protection for owners.

tax law have combined to make LLCs particularly useful for single-owner businesses. Originally, many states treated LLCs as partnerships and required at least two members. Now, most states consider single-member LLCs valid, and almost certainly the remaining states will convert as well. Check-the-box regulations also recognize one-member LLCs for federal tax purposes. For U.S. income tax, an electing LLC with one member is [dis]regarded as a separate entity apart from its owner. An individual owner doing business in an LLC thus can achieve income tax treatment identical to a sole proprietorship while establishing a liability shield similar to a corporation.

Individuals are not the only business owners who can profit from limited liability. Corporations also may want to isolate risky ventures behind a liability barrier. Corporate owners customarily have used subsidiary corporations to accomplish this end. The problem with parent and subsidiary C corporations, however, is that achieving single-entity tax treatment requires the affiliated corporations to irrevocably elect the unbearably complex consolidated tax return rules. A single-member LLC may offer a simpler solution. With check-the-box regulations that allow a corporation to disregard its wholly owned LLC as an independent tax entity, an LLC can be treated as a branch or division of its corporate owner for tax purposes. All income and deductions of the LLC are combined with the corporation's other operating results. The disregarded LLC permits a truly single-entity tax result, combined with liability protection from risky ventures, at a fraction of the complexity that comes with filing a consolidated tax return.

◆ S CORPORATIONS. Before the creation of the LLC, S corporations provided the best combination of limited liability and conduit tax status. Numerous ownership and capital structure restrictions, however, undermined their usefulness. Recent tax law modifications have somewhat eased this inflexibility.[1]

The Small Business Job Protection Act of 1996 expanded the number and types of shareholders that can own S corporation stock. Although still not ideal, the new rules improve the S corporation's prospects for raising capital and facilitate its use as a family planning device.

Much like single-member LLCs, a chain of S corporations is a new alternative to the consolidated tax return quagmire. An S corporation now can own 100% of the stock in a qualified subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that elects to be classified as a QSSS but also qualifies as an S corporation. All income and deductions of a QSSS are treated as if incurred by its S corporation parent and are reported on the parent's tax return.[2]

Table 1. LIABILITY OF OWNERS—ENTITY CHOICE

LIABILITY ISSUE	SOLE PROP. (SCH. C)	GENERAL P-SHIP.	LLC (see Note 1)	LLP (see Note 1)	LP (Limited Partner)	C CORP.	S CORP.
Can lose personal investment in the business	Yes	Yes	Yes	Yes	Yes	Yes	Yes
The business entity's assets are exposed to satisfy debts, obligations, and lawsuits	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Owner's personal assets exposed to satisfy professional malpractice of other owners	N/A	Yes	No	No	No	No	No
Owner's personal assets exposed to satisfy general contract liability of entity (debts and obligations)	Yes	Yes	No	Yes	No	No	No
Owner's personal assets exposed to satisfy professional malpractice and other tort claims against that owner	Yes	Yes	Yes	Yes	N/A—Usually just a passive investor	Yes	Yes

Note 1: The LLP is generally a weaker form of an LLC. This generalization, however, is not true in every state because state laws vary.

S Corporation Reporting. *The owners of Blue Company, Inc., an S corporation, form Red Company, Inc., as a QSSS of Blue to pursue a new risky venture. In 1997, Blue Company reports $200,000 net income separately, while Red Company reports a $75,000 operating loss. For 1997, Blue's tax return will show $125,000 ordinary income from business activities, which represents an aggregation of the two corporations' operating results.*

There are also advantages to owning stock in a corporation over other types of ownership interests, discussed below.

◆ C CORPORATIONS. The C corporation may not be as new or as fashionable as other types of entities, but it still provides several unique advantages and opportunities.

C corporations are generally the most effective entities for reinvesting profits in business capital. Because owners do not pay taxes directly on undistributed corporate profits, they do not need additional dividends to cover a tax: More capital can be left in the business. Furthermore, net profits of both C and S corporations are not subject to the self-employment tax, which can be a substantial burden.[3] Proprietors, general partners, LLP partners, and most LLC members must pay this additional tax whether or not earnings are distributed.

At many levels of taxable income, C corporation tax rates are currently lower than those for individuals. For example, the first $50,000 of a C corporation's taxable income is taxed at a 15% rate, while an individual's marginal tax rate at this income level is presently 28%. This leaves a C corporation with more after-tax income to reinvest in business expansion. This comparison is only valid in a static analysis, however. Individual tax rates are indexed for inflation. The top of each range of individual income taxed at every rate increases annually based on changes in the Consumer Price Index. Corporate rates, on the other hand, are not adjusted for inflation. Therefore, particularly at lower income intervals, corporate advantages are diminishing every year.

The alternative minimum tax (AMT) is another

The Evolution of LLCs and LLPs

◆ **Early LLC legislation.** In 1977, Wyoming adopted the limited liability company (LLC) statute—the first such statute in the United States. The LLC potentially combined limited liability protection, similar to that of a corporation, with partnership conduit tax advantages. Although this was an attractive combination, other states did not follow Wyoming's lead. LLCs had little appeal because no one was certain how the IRS would classify them for income tax purposes. It was not until 1982 that Florida became the second state to adopt an LLC statute.

◆ **Revenue Ruling 88-76.** Then, in 1988, the Internal Revenue Service issued Revenue Ruling 88-76. This ruling stated that LLCs organized under Wyoming statutes would be granted partnership tax treatment. According to the IRS, the number of corporate vs. partnership features would determine an LLC's federal tax classification.[1] Though this approach was highly ritualistic, Revenue Ruling 88-76 did provide a road map to guide other states in developing their own LLC law.[2]

◆ **LLC legislation matures.** In the early 1990s, some states enacted "bulletproof" LLC legislation that ensured partnership tax status. Others created more flexible laws that permitted a choice between a partnership or corporation, depending upon how many corporate traits were found in the organization's charter. Today, all 50 states have adopted some form of LLC legislation. In addition, new simplified IRS check-the-box regulations generally permit LLC members simply to elect whether their entity will be taxed as a partnership or as a corporation, regardless of state law. Under current federal law, LLCs with mostly corporate characteristics may still be treated as conduits for federal income tax purposes.

◆ **Evolution of the LLP.** As with S corporations, many states initially restricted the use of LLCs by professionals such as lawyers, physicians, and accountants. To fill this void, Texas enacted the first limited liability partnership (LLP) statute in 1991. This time, other states quickly followed.

Although state laws differ, LLPs generally provide better liability protection than general partnerships but somewhat less protection than LLCs. General partners, like sole proprietors, have no entity liability protection. LLC members have liability protection similar to that of corporation owner-employees: The personal assets of LLC members are protected from general contract and litigation liability as well as from the malfeasance of the other members. Personal assets of LLP partners, on the other hand, generally are not protected from general contract liability, though state laws do vary. LLP partners are sheltered, however, from the professional malfeasance of other partners.

What is the liability? Sally is a partner in an LLP. Roger, an employee, is involved in an auto accident while traveling to the office of a client. Molly, a passenger in the car Roger hit, sustained a severe back injury. Molly sues the LLP and wins. The LLP has insufficient assets to cover the judgment. Sally's personal assets are at risk because the LLP provides no general liability protection for her.

Assume the same situation as in the first illustration, except the entity is an LLC. In this case, Sally's personal assets are protected from Molly's lawsuit, though the LLC's assets can be attached to pay the judgment.[3]

An LLP is also different from a limited partnership (LP) in that all the LLP's owners have some degree of limited liability. An LP, on the other hand, is owned by one or more limited partners and at least one general partner. The mandatory general partner(s) in an LP has unlimited liability for partnership torts and debts, while the limited partner(s) has protection similar to that of a corporation's shareholders. Although limited partners can lose their entire investment, their personal assets are not subject to creditors' claims. In addition, limited partners are not liable for other partners' wrongdoing. Limited partners cannot participate in managing the business, however, and may lose their liability protection if they do.

No owner's liability is limited for his or her own acts of negligence or malfeasance. This caveat includes owner-employees of corporations and LLC members. All owners who actively engage in a business must cover themselves with adequate malpractice insurance. Table 1 summarizes these liabilities.

1 According to the so-called Kintner Regulations, the four distinguishing corporate characteristics are continuity of life, centralization of management, limited owner liability, and free transferability of ownership interests.

2 See, for example, F. McNair and E. Milam, "The Limited Liability Company: An Idea Whose Time Has Come," *Management Accounting*, December 1994, pp. 30-33.

3 The same result occurs if the entity were a C corporation or an S corporation.

Table 2. GENERAL ENTITY CHARACTERISTICS

Entity	Owner Employee Fringe Benefits	Management Rights	S.E. Tax on Earnings	Tax Regime
Proprietorship	No	Yes	Yes	D.E.*
General Partnership	No	Yes	Yes	Elective: 1) Nontaxable conduit through which partners personally report their share of partnership income 2) Association taxed as a C corporation
Limited Partnership				
General Partner	No	Yes	Yes	Same as general partnership
Limited Partner	No	No	No	
Limited Liability Partnership	No	Yes	Yes	Same as general partnership
Limited Liability Company	No	Yes**	Yes**	A) >1 member—Same as general partnership B) 1 member—Elective: 1) D.E.* 2) Association taxed as a C corporation
C Corporation	Yes	Yes	No	Taxable entity under Subchapter C of code.
S Corporation	No, for more than 2% shareholders	Yes	No	With limited exceptions, per Subchapter S of code, a nontaxable conduit through which shareholders personally report their share of corporation income

* Disregarded entity. All entity tax attributes are combined with owner's other tax attributes.

**Management rights are available, but presumably so are nonvoting memberships that may be used to avoid self-employment tax.

set of tax rates even more favorable for C corporations. The AMT is a separate tax system in which alternative minimum taxable income is calculated without the benefit of some regular deductions and exclusions. The AMT is designed to force taxpayers with economic income that exceeds their taxable income to pay more tax. The AMT applies to both individuals and corporations, but new developments have caused some major differences. After a recent increase, the top individual AMT tax rate is now 28%. Meanwhile, the corporate AMT rate is 20%. Further, TRA 97 exempts from AMT those corporations with average annual gross receipts of $7.5 million or less. Consequently, if a small business expects to incur AMT adjustments, such as would occur from extensive depreciation deductions, the corporate form may be the least expensive choice.

AMT liability illustrated. *A business with gross receipts of $1.5 million generates $200,000 of regular taxable income and $150,000 of positive AMT adjustments. As a proprietorship, a single individual owner who uses the standard deduction will incur an additional AMT liability of approximately $34,000 beyond the regular tax due on this income. If the business is incorporated, the incre-*

mental AMT liability on this same income will be zero.

Partners and LLC members may be rewarded if their business generates capital gains, but beneficial capital gain rates decidedly favor ownership interests in small corporations if a disposition of an ownership interest in the business is contemplated. Stock in either a C or S corporation invariably represents a capital asset. However, ordinary income recognition often results when LLC or partnership interests are transferred. To the extent that ordinary income, as opposed to capital gain, would be recognized upon the sale of an LLC's or partnership's underlying assets, gain on the disposition of an ownership interest in the entity is also ordinary. Ordinary income potential exists in cash basis receivables, inventory, and depreciation recapture on operating assets.

In addition, if the transferred corporate stock is qualified small business stock held more than five years, one-half of most gains is excluded from gross income. Qualified small business stock is stock in a C corporation whose gross assets total $50 million or less. Unfortunately, the includable half of the gain does not qualify for the new 20% rate and is therefore taxed at 28%. New law, however, permits stockholders to defer recognition of up to 100% of the gain to the extent disposition proceeds are reinvested in other qualified small business stock. Alternatively, if the stock disposition creates a loss, individuals may annually qualify for up to a $100,000 ordinary deduction on small corporation stock sales under Code Section 1244. No similar advantages are available for gains on LLC and partnership interests, and losses on the disposition of such interests are always capital losses, deductible at a maximum of $3,000 per year.

Qualified small business stock illustrated.
A business owns the following assets:

	FMV	Basis
Cash	$10,000	$10,000
Accounts Receivable	100,000	0
Inventory	76,000	30,000
PPE (with recapture potential)	200,000	170,000

Jane, a half owner, has a basis in her ownership interest equal to $105,000. She sells her interest to Mark for $193,000, causing an $88,000 realized gain. If this is an LLC interest, Jane recognizes $88,000 ordinary income and owes $34,848 in federal tax, assuming her marginal rate is 39.6% (88,000 x .396). If Jane sells shares of qualified small business stock, she will owe $12,320 tax (44,000 x .28). The corporate form saves $22,528 in tax.

Stockholders in a C corporation may be employees of the corporation, which entitles them to several tax-free employee fringe benefits including group term life insurance and health insurance. Partners, LLC members, and S corporation shareholders owning more than 2% of the outstanding shares cannot be employees in the entities they own. Therefore, they cannot receive employee fringe benefits on a fully tax-free basis. (See Table 2.)

Balance in a Changing World

The choice of business structure is an extremely important—and ongoing—decision. The ideal form may change as the business, our economic and tax environments, and the goals of the owners change. Unfortunately, no infallible system exists to guarantee the best choice will be made. There are too many combinations of factors, some concerning tax and some not, that will affect the decision. In light of the facts and owners' objectives, the best choice is one that provides a balance of advantages in a changing environment. ■

Gary M. Fleischman, CMA, CPA, is assistant professor of accounting, University of Tennessee at Chattanooga, Tenn. He can be reached at djflash1@Juno.com.

Jeffrey J. Bryant, CPA, is assistant professor of accounting at Wichita State University, Wichita, Kan. He can be reached at bryant@twsuvm.uc.twsm.edu.

1 Note, however, that the IRS and state agencies have increased their audits of S corporation shareholders that attempt to minimize payroll tax and workers' compensation costs by keeping their salaries low. The resulting larger net profits are then passed through to shareholders free of these taxes. See B. Bernard, "Is the S Corporation Craze Finally Over?" *Taxation for Lawyers*, March/April 1998, p. 274.

2 Based on proposed IRS regulations, it is safest to form a single-member LLC or QSSS and make the appropriate elections before transferring assets and liabilities to the disregarded entity. See Prop. Regs. Sec. 301.7701-3(g).

3 Ordinarily, employees pay one-half (7.65% of taxable wages) of the social security tax, and the employer pays the other half (also 7.65%). The self-employment (SE) tax combines these two halves because the self-employed person is deemed to represent both the employee and employer for a total tax rate of 15.3%. A deduction of one-half the SE tax is permitted for AGI to be consistent with the treatment allowing a deduction for the employer's portion of the tax.