



Business Entity Types

Choose wisely.

Of all the choices you make when starting a business, one of the most important is the type of legal organization you select for your company. As an entrepreneur, be sure to fully consider your options when deciding upon which form of entity to operate under, as your decision will have a significant impact on how income tax rules and regulations affect you and the way you are protected under the law. A brief description of the more common entity types are summarized here.



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Sole Proprietorship

A sole proprietorship is an unincorporated business that is owned by one individual. It is the simplest form of business organization to start and maintain. The business has no existence apart from you, the owner. Its liabilities are your personal liabilities, and you undertake the risks of the business for all assets owned, whether used in the business or personally owned. You include the income and expenses of the business on your own tax return and pay self-employment tax on profit.

Partnership

A partnership is the relationship existing between two or more persons who join to carry on a trade or business – including a spousal team in most circumstances. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business. A partnership is not a taxable entity. Each partner includes his or her share of the partnership's income or loss on his or her tax return. Partners are not employees and should receive a Schedule K-1 for distributions or guaranteed payments from the partnership instead of a Form W-2. Guaranteed payments – and in most cases, shared profits – are subject to self-employment tax.

LLC

The default entity for federal tax treatment of an LLC with two or more members is a partnership. The default entity for federal tax treatment of an LLC with one member is a sole proprietorship. Alternatively, an LLC can elect to be taxed as a C corporation. An entity, such as an LLC, that has filed an election to be taxed as a corporation is eligible for S corporation status. Consequently, the applicable tax forms, estimated tax payment requirements, and related tax publications depend upon whether the LLC operates as a sole proprietorship, corporation, or partnership. State tax treatment may differ from federal.

C Corporation

When forming a corporation, prospective shareholders transfer money, property, or both, in exchange for the corporation's capital stock. A C corporation generally takes the same deductions as a sole proprietorship to compute its taxable income. A C corporation can also take special deductions. The profit of a C corporation is taxed to both the corporation and to the shareholders when the profit is distributed as dividends. However, shareholders cannot deduct any loss of the corporation. The tax treatment of payments to shareholders for services rendered to the corporation is in the form of wages.

S Corporation

An eligible domestic C corporation can avoid double taxation (once to the shareholders and again to the corporation) by electing to be treated as an S corporation. A corporation elects to be treated as an S corporation by filing a special form with the IRS. An S corporation generally is exempt from federal income tax. Its shareholders include on their tax returns their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of nonseparately stated income or loss. The tax treatment of payments to shareholders for services rendered to the corporation is in the form of wages.

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