SECURITY MUTUAL LIFE

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Selecting the Right Entity for Your New Business

So, you have an idea for a new business that you think can make you a lot of money. Now what? One of the most important decisions you'll need to make is what type of business entity you want to create. There are so many choices: sole proprietorship, partnership, C corporation, S corporation or LLC.

Selecting the right format is absolutely critical here. But what type is best for you? Each has its unique advantages and disadvantages. Here are the basic aspects for each type of entity:

Sole Proprietorship

A sole proprietorship is a business in which the owner is normally the only employee. Since it's an extension of you, there's generally no need to register the business with your state, but in certain industries, you may still have to get a business license or permit.[1] One advantage of a sole proprietorship is that it's simple. For one thing, you don't have to file a separate tax return. The income or loss goes onto your own return using Schedule C. But there's one glaring disadvantage: personal liability. In a sole proprietorship, you are personally responsible for any financial losses by the business. This also means that a sole proprietorship provides no protection against lawsuits. Note, however, that it may be possible to use the S corporation or LLC forms of business entities to reduce personal liability, even though there is really only one business owner.

Partnership

As a legal entity, there are generally two types of partnerships: general and limited. A general partnership is essentially the same as a sole proprietorship, except that there are two or more owners. A limited partnership has two different types of owners. A general partner will operate the business and is liable for the acts of the partnership. Limited partners (there are usually more than one) are basically silent partners with no say in day-to-day management. But in exchange, unlike a general partner, limited partners generally don't have any liability for the partnership's debts.

From a taxation standpoint, either type of partnership is considered a "pass through" entity. This means that the partnership's taxable income is passed directly to the owners or investors based on their percentage of ownership, who then report it on their personal tax returns. The partnership itself does not pay income tax.

C Corporation

Many large American companies are C corporations. A C corporation is owned by its shareholders and overseen by a board of directors. One reason C corps are popular for large companies, aside from their limited liability, is it is generally easy to buy and sell shares.[2] The bad news with a C corporation is that there is the potential for what is known as "double taxation." A C corp pays taxes on its net income, with a current maximum federal tax rate of 21 percent.[3] But when it distributes some of that income to shareholders in the form of a dividend, that too can be taxable to the recipient.

S Corporation

Unlike a C corporation, S corporations are not taxed at the corporate level. This makes them a popular option. But there are some restrictions. S corps are limited to a maximum of 100 shareholders. And unlike a C corp, they can issue only one class of stock, and can only be owned by individuals (not an entity) who are US citizens. Although there are some big S corporations, they tend to have less access to capital markets, which often limits how big they can get.

For More Information Contact:

Limited Liability Company (LLC)

An LLC is essentially a hybrid entity that combines the liability protection that you get with either a C or an S corporation with the tax treatment of a partnership. Most LLCs are pass-through tax entities like a partnership or S corporation. But unlike a general partnership, an LLC is designed to limit the liability of the individual owners. Unlike a C corporation, you don't need to have shareholders or a board of directors. An LLC is typically easier to set up than a corporation and generally requires less record keeping.[4] Still, you will need to file articles of organization with the state to establish the LLC, as well as an operating agreement, which explains the roles and duties of members.

Keep in mind that it's sometimes possible to switch from one type of business entity to another. You might start out as a sole proprietorship, but as the business grows, it may make more sense to switch to something more formal. There might be some expenses involved, but the limited liability that you get might make it worthwhile.

As you can tell, there are many legal and tax consequences in determining the right form of structure for your business. Make sure you consult with your tax advisor and legal counsel prior to making a choice.

[1] *Steele, Jason. "Types of Business Entities: Choosing the Right Structure for Your Company." SoFi.com. https://www.sofi.com/learn/content/types-of-business-entities/ (accessed April 22, 2025).*

[2] *CT Corporation Staff. "C corporations advantages & disadvantages." wolterskluwer.com. https://www.wolterskluwer.com/en/expert-insights/c-corporations-advantages-and-disadvantages (accessed April 22, 2025).*

[3] *Tax Policy Center. "Corporate Top Tax Rate and Bracket." taxpolicycenter.org. https://taxpolicycenter.org/statistics/corporate-top-tax-rate-and-bracket (accessed April 22,2025).*

[4] *Fernando, Jason. "What Is an LLC? Limited Liability Company Structure and Benefits Defined." Investopedia.com. https://www.investopedia.com/terms/l/llc.asp (accessed April 22,2025).*

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