Types of Business Organizations: an Overview

Which State or States to Form a Business Entity?

Generally speaking, entrepreneurs incorporate their business in the state where they conduct their business. If you live and work in New Hampshire, for example, you would incorporate your business in New Hampshire. If your business conducts business throughout the United States, you need to incorporate in the state where your headquarters will be. If you have a substantial business presence in another state, you may need to let that state know and file state tax returns or sales tax returns based on your business earnings in that other state. Businesses with substantial nationwide activity sometimes choose to be incorporated in Delaware or Nevada because of the business-friendly laws in those states. Even if you incorporate in Delaware or Nevada, you will still need to register your business in those states where you have an actual business location.

Types of Business Entities for Tax Purposes

While there are a variety of designations at the state level, for **federal tax purposes there are only 6 forms of business organizations** :

- Sole Proprietor (Form 1040 Schedule C or Schedule F),
- C-Corporation (Form 1120),
- S-Corporation (Form 1120S),
- Partnership (Form 1065),
- Trust (Form 1041), and
- Non-profit organization (Form 990)

You may notice that the limited liability company (LLC) is not listed above. That's because an LLC can be treated (for tax purposes) as a sole proprietor, as a partnership, as a C-corporation, or as an S-corporation. The owners of the limited liability company (LLC) can pick which tax treatment will apply. By default, an LLC with just one owner is considered a disregarded entity, with the result that the LLC is treated for tax purposes in the same way that the owner of the LLC is taxed. By default, an LLC with two or more owners is considered a partnership. An LLC can opt out of the default treatment by electing to be treated as a Corporation. After electing to be treated as a corporation, owners of an LLC can further elect to be treated as an S-corporation. (For further details, see Publication 3402, Taxation of Limited Liability Companies.)

Overview of Each Type of Business Organization

Sole proprietors are unincorporated businesses. They are also called independent contractors, consultants, or freelancers. There are no forms you need to fill out to start this type of business. The only thing you need to do is report your business income and expenses on your Form 1040 Schedule C. This is the easiest form of business to set up, and the easiest to dissolve. (An LLC with only a single shareholder, a so-called single-member LLC, is taxed as a sole proprietor on a Schedule C.)

C-Corporations are incorporated businesses. The shareholders of C-corporations have limited liability protection, and corporations have full discretion over the amount of profits they can distribute or retain. Corporations are presumed to be for-profit entities. Corporations must have at least one shareholder.

S-Corporations are a type of corporation. The shareholders of S-corporations have limited liability protection, and the corporation has full discretion over the amount of profits they can distribute or retain. An S-corporation must have at least one shareholder, and cannot have more than 100 shareholders. The net income of the S-corporation is imputed as income to the shareholder, even if the S-corporation decides to retain some or all of the net income.

Partnerships are unincorporated businesses. Like corporations, partnerships are separate entities from the shareholders. Unlike corporations, partnerships must have at lease one General Partner who assumes unlimited liability for the business. Partnerships must have at least two partners. The net income of the partnership is imputed as income to the partners, even if the partnership decides to retain some or all of the net income.

Trusts are usually formed upon the death of an individual and are designed to provide continuity of the investments and business activities of the deceased individual. We will not discuss trusts further.

Nonprofits are corporations formed for a charitable, civic, or artistic purpose. Nonprofits are generally exempt from federal and state taxation on their income, and so they are often called "exempt organizations." Nonprofits reporting their activities, income, and assets to ensure that they are in compliance with federal and state laws governing charities. For additional information on starting, managing, and developing a not-for-profit organization, see the About.com Guide to Nonprofits.

As mentioned above, sole proprietors, S-corporations, and partnerships are taxed at the shareholder level. Corporations, however, are taxed at the corporate level.

Types of Business Organizations: Tax Treatment

Tax Factors to Consider

How the income and expenses of the business will be treated for tax purposes is of the decision factors in deciding an appropriate organizational structure. Consider how profitable your business is or will become, how much of those profits you want distributed to you versus re-investing the profits back into the business, and the relative tax costs of each type of organization.

Each organization have different tax treatment. Let's review each one briefly.

Sole proprietors are taxed on their net income (after subtracting any allowable business expenses from their gross sales income). This net income is subject both the federal income tax and to the self-employment tax (which covers the Social Security and Medicare taxes). Sole proprietors are self-employed. The cost of health insurance is deductible against the federal income tax, but is not deductible against the self-employment tax. Losses in a sole proprietorship offset other income on the owner's personal tax return.

Partners in a partnership are taxed on their net income (gross sales income minus any allowable business expenses). This net income is then divided among the partners and is taxed on each partner's tax return. Partners who perform services through the partnership are self-employed, and just like sole proprietors, have both the federal income tax and the self-employment tax apply to their share of the partnership income. Partners are paid when the partnership distributes net income to the partners, which may differ from the net income imputed as income. Health insurance benefits provided to partners are tax-deductible for the federal income tax, but not for the self-employment tax. Losses from a partnership may offset other income on the owner's personal tax return.

C-corporations are taxed on their net income (that is, gross income minus allowable deductions for various business expenses). C-corporations have their own corporate tax rates (which are structured differently than personal tax rates). Shareholders who perform services through the corporation are employees, and pay federal income tax, Social Security tax, and Medicare tax on their salary. The post-tax net income of the C-corporation can be distributed in the form of dividends, which is taxed to the shareholder. The C-corporation can decide how much to distribute in the form of dividends. Dividends are taxed at a special "qualified dividends" tax rate of 15% or 20%. Dividends from a corporation are thus taxed twice, once at the corporate level and again at the shareholder level. Shareholders receive income from the corporation either in the form of salary or in the form of dividends. Health insurance benefits provided to shareholder-employees in a C-corporation are pre-tax for the federal income tax, Social Security tax, and Medicare tax. Losses offset taxable income of the C-corporation by being carried back or carried forward to other tax years.

S-corporations generally don't pay any corporate tax. Instead, S-corporations divide their net income among their shareholders, and the income is taxed on each shareholder's personal tax return at ordinary tax rates. Shareholders who perform services through the corporation are employees, and pay federal income tax, Social Security tax, and Medicare tax on their salary. The S-corporation can decide how much of the net income is distributed to shareholders, which may differ from the amount of net income imputed as income to the shareholders. Health insurance benefits provided to shareholder-employees in an S-corporation are pre-tax for the federal income tax, Social Security tax, and Medicare tax. Losses from an S-corporation can pass-through to the shareholder and offset the shareholder's other income on their personal tax returns.

As always, if you have any additional questions feel free to contact me at Chilobe@kalambocpa.com