

Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporations, S Corporations, and LLCs

Part I

<u>Attribute</u>	<u>Proprietorship</u>	<u>General, Limited, or LLP Partnerships</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
Life of Entity	Terminated at will or death of proprietor	Terminated at will or death of a major partner or transfer of material ownership	Indefinite	Indefinite	Stated limit
Maximum Number of Owners	One	Unlimited	Unlimited	One hundred	Unlimited
Transferability of Interests	Freely transferable	Typically, subject to partners' approval	Typically, freely transferable; can be restricted through buy-sell agreements	Typically, freely transferable; can be restricted through buy-sell agreements	Same as S corporation

<u>Attribute</u>	<u>Proprietorship</u>	<u>General, Limited, or LLP Partnerships</u>	<u>C Corporation</u>	<u>S Corporation</u>	<u>Limited Liability Company</u>
Liability of Owners	Unlimited	General partners unlimited; limited partners limited to investment in partnership; LLP partners unlimited for own actions, limited to investment for actions of other partners	Generally limited to assets in corporation	Generally limited to assets in corporation	Generally limited to investment in company
Contribution of Property	Nontaxable transaction	Generally, a nontaxable transaction; assumption of liabilities may trigger recognition of gain by partnership	Nontaxable only if transaction meets IRC Section 351 requirements; however, liabilities in excess of asset basis may trigger gain per IRC Section 357	Nontaxable only if transaction meets IRC Section 351 requirements; however, liabilities in excess of asset basis may trigger gain— IRC Section 357	Generally a nontaxable transaction
Taxability of Income	Taxable to proprietor	Taxable to partner; special allocations possible	Taxable at corporate level	Taxable at shareholder level based on shares held; no special allocations	Taxable to member; special allocations possible

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Deductibility of Losses	Deductible by proprietor	Generally, deductible by partner; special allocations possible; partnership liabilities increase loss deduction basis	Deductible by corporation	Generally deductible by shareholder; loss limited to basis in stock and direct loans from shareholders; no special allocations allowed	Generally deductible by member; special allocations possible; company liabilities increase loss deduction basis
Passive Losses	May not offset active or portfolio income	May not offset active or portfolio income at partner level	May offset active but not portfolio income if corporation is closely held; may not offset active or portfolio income of personal service corporation	May not offset active or portfolio income at shareholder level	May not offset active or portfolio income at member level
Required Tax Year	Must use tax year of proprietor	Generally, must use fiscal year of partners or calendar year unless IRC Section 444 election is made	May select any fiscal year if not a personal service corporation	Generally, must use calendar year unless natural business year test is met or IRC Section 444 election is made	Same as S corporation

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Medical Insurance Premium	100 percent of premium cost deductible above-the-line; if a spouse is an employee and a spousal insurance plan is in place, 100 percent of premium cost deductible as a business expense	100 percent of premium cost deductible above-the-line; if a partner's spouse is an employee of the partnership and an insurance plan is in place, 100 percent of the premium cost is deductible	100 percent of premium cost is deductible	100 percent of premium cost deductible above-the-line by more than 2 percent shareholders	Same as partnership
Life Insurance for Employee/Owner	Nondeductible	Nondeductible	Premiums for up to \$50,000 of group term life are deductible and not taxable to employee	Nondeductible	Nondeductible
Distribution to Owner	Nontaxable	Nontaxable to extent of basis in partnership; property nontaxable until sold	Not deductible by corporation; generally, ordinary income to shareholder; appreciated property results in recognition of gain to corporation	Nontaxable to extent of basis in stock and loans to corporation; distribution of appreciated property results in gain recognition to corporation	Nontaxable to extent of basis in membership interest; property nontaxable until sold

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Sale of Interest: Gain	Capital and/or ordinary	Capital and/or ordinary	Capital	Capital	Capital and/or ordinary
Loss	Capital and/or ordinary	Generally, capital	Ordinary to extent of IRC Section 1244 stock; otherwise, capital loss	Ordinary to extent of IRC Section 1244 stock; otherwise, capital loss	Capital and/or ordinary
Liquidating Distribution	Nontaxable	Generally, nontaxable; cash distribution in excess of basis or non-pro rata distribution of IRC Section 751 assets will trigger gain	At corporation level, treated as a sale of property; gain to shareholder if FMV exceeds stock basis	At corporation level, treated as a sale of property; gain passes through and increases shareholder basis; could trigger built-in gains tax	Same as partnership
Social Security (FICA), Self-Employment Tax (SE Tax)	Self-employment tax paid on net earnings	Self-employment tax paid on partnership earnings for general and LLP partners	FICA tax paid on wages paid to employee	FICA taxes paid on wages paid to employee	Self-employment tax paid on member share of earnings

Client Decision-Making Considerations for Choosing an Entity ^{fn *}

Part II

The selection of the proper entity to conduct a business involves both tax and nontax considerations. [Appendix 3, Part I](#) provides a comparison of the attributes of the most common business entities. ^{fn 1} Often there is more than one form of entity that is appropriate for a particular business venture. The purpose of Appendix 3, Part II is to help narrow the choice of entity for the client based on certain key considerations.

1. Simplicity of Tax Filings	Neither a sole proprietorship nor a single-member limited liability company that does not elect to be taxed as a corporation is required to file a separate tax return. Tax returns for S corporations are generally less complex than tax returns for partnerships.
2. Limited Liability	A business owner will almost always seek to limit his or her potential liability for the debts and obligations of the business enterprise. All business entities other than sole proprietorships and general partnerships offer some form of limited liability protection to the business owners. Professionals, such as accountants, doctors, and lawyers, generally cannot limit their liability for their own malpractice regardless of the type of entity used to conduct their business. Given the general availability of single member limited liability companies and limited liability partnerships, it is unlikely that a sole proprietorship or general partnership will be the best choice of entity for a client.
3. Flow-Through of Income and Loss	As a general rule, clients will prefer an entity that is not subject to income tax. The income and loss of an S corporation or partnership (including a limited liability company that does not elect to be taxed as a corporation) generally flows through the entity and is taxed to the owner. Flow through taxation is especially important if the client anticipates that the business will generate losses. If the business intends to reinvest its profits, a C corporation (which pays tax on its profits) may be preferable because corporate tax rates on ordinary income are generally lower than individual tax rates.
4. Taxation at Favorable Capital Gains Rates	C corporations pay a flat rate of tax on their income, including capital gains. In contrast, capital gains realized by an S corporation or partnership (including a multimember limited liability company taxed as a partnership) that flow through to an individual are subject to tax at favorable capital gains rates.

5. Number of Owners	<p><i>One Owner:</i> A single-member limited liability company that does not elect to be taxed as a corporation is generally the ideal business entity for a single owner.</p> <p><i>Multiple Owners:</i> Cannot form a single-member limited liability company.</p> <p><i>More than 100 Owners:</i> Cannot form an S Corporation</p>
6. Type of Owners	<p>The following are prohibited from owning stock of an S Corporation</p> <ul style="list-style-type: none"> • a C corporation (other than certain charitable organizations); • an S corporation (other than an S corporation that owns 100 percent of the stock of the corporation and makes an election to treat the corporation as a qualified sub-chapter S subsidiary); • a partnership; • a limited liability company (other than a single-member limited liability company that does not elect to be taxed as a corporation and is owned by a person that is not prohibited from owning stock of an S corporation); • a trust (other than certain permitted trusts); or • a nonresident alien individual.
7. Subsidiaries	<p>A single-member limited liability company that does not elect to be taxed as a corporation is generally the ideal business entity for an enterprise that will be wholly-owned by another business entity.</p>
8. Need to Issue Preferred Equity Interests	<p>Eliminates S corporations, which are not permitted to have more than one class of stock.</p>
9. Need for Special Allocations of Income or Loss	<p>Must use an entity that is taxed as a partnership (including a multi-member limited liability company that does not elect to be taxed as a corporation).</p>
10. Exit Strategy	<p>Only a corporation (C or S) can participate in a tax-free reorganization under the provisions of Code Section 368. Accordingly, corporate form may be preferable if the client anticipates an exit strategy in which the client would receive stock of the buyer as part of the consideration for the sale of the business. It may be possible, however, to incorporate a partnership or limited liability company prior to a sale transaction in order to take advantage of the reorganization provisions available to corporations.</p>

11. Property Distributions	A corporation (C or S) is generally taxed upon the distribution of appreciated property to its shareholders. Accordingly, a partnership (including a multimember limited liability company that does not elect to be taxed as a corporation), would be preferable if the client anticipates that the business may distribute appreciated assets (e.g., real estate) to its owners.
12. Indebtedness	The owners of a partnership (including a multimember limited liability company that does not elect to be taxed as a corporation) generally receive "outside tax basis" for indebtedness incurred by the partnership. This outside basis may allow partnership losses to flow through to the owners. In contrast, a shareholder of an S corporation only receives outside basis for amounts borrowed by the corporation from such shareholder (i.e., not for third party indebtedness). Accordingly, a partnership would be preferable to an S corporation if the client anticipates that the business will borrow funds from a third-party lender.
13. Cash Method of Accounting	The following are generally not permitted to use the cash method of accounting: <ul style="list-style-type: none"> • C corporations (other than certain service corporations, farming operations, and corporations with average gross receipts of under \$5,000,000). • Partnerships (including a multimember limited liability company that does not elect to be taxed as a corporation) that have a C corporation as a partner.
14. Tax Year	A C corporation (other than a personal service corporation) can elect any fiscal year as its taxable year. Other types of entities generally are restricted to the calendar year or must pay a toll charge to use a fiscal year.
15. Step-Up of Inside Basis	A partnership (including a multimember limited liability company that does not elect to be taxed as a corporation) can elect to step up (or step down) the inside tax basis of its assets in connection with a purchase or inheritance of an interest in the partnership.
16. Capital Gain Exclusion for Qualified Small Business Stock	Only a C corporation can be a "qualified small business."
17. Capital Gain on Sale of Entity	Gain on the sale of stock of a corporation (C or S) is generally treated at favorable capital gains rates if the shareholder owned the stock for more than one year. The sale of an interest in a partnership (including a multimember limited liability company that is taxed as a partnership) may give rise to ordinary income to the extent that the partnership has "hot assets."
18. Self-Employment Tax on Distributions	Distributions to general partners of a partnership, and to managing members of a limited liability company, are subject to self-employment tax.

19. Fringe Benefits	The value of certain employer-provided fringe benefits (including group-term life and health insurance) is excluded from the income of C corporation shareholders. The exclusion is not available to partners or S corporation shareholders who own more than 2 percent of the stock of the corporation (although such persons are entitled to deduct the amount paid for health insurance).
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[fn*](#) This checklist is intended as a sample only. It is included with the understanding that the authors, and editors are not rendering legal or other professional services. It should not be used before the service.

[fn.1](#) There are a number of specialized business entities, such as **real estate investment trusts (REITs)** and **regulated investment companies (RICs)**, that are beyond the scope of this article.