Chapter 1: Entity Selection

A taxpayer launching or acquiring a new business has several forms of business to choose from, including the following.

- Sole proprietorship
- C corporation
- S corporation
- General partnership
- Limited partnership (LP)
- Limited liability company (LLC)

There are other types of entities — such as a limited liability partnership (LLP), limited liability limited partnership (LLLP), and series LLC — that may be available in some states. However, this chapter focuses on the six types of entities listed, comparing and contrasting these entities in the following areas.

- Initial formation
- Taxation of business entities
- Liability protection
- Entity choice and family business considerations
- Other taxation considerations

Please note. Corrections for all of the chapters are available at [www.TaxSchool.illinois.edu](http://www.TaxSchool.illinois.edu). For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.
Although statutory requirements vary between states, the following table represents a simple comparison of typical formation issues for various types of business entities.

<table>
<thead>
<tr>
<th>Entity</th>
<th>State Filing Required</th>
<th>Legal Documents Necessary</th>
<th>Annual Meeting Required</th>
<th>Treatment of Taxable Income</th>
<th>Ease of Formation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sole proprietorship</td>
<td>No</td>
<td>None</td>
<td>No</td>
<td>Entity level</td>
<td>Easy</td>
</tr>
<tr>
<td>C corporation</td>
<td>Yes</td>
<td>Articles, bylaws, share certificates</td>
<td>Yes</td>
<td>Entity level</td>
<td>Complex</td>
</tr>
<tr>
<td>S corporation</td>
<td>Yes</td>
<td>Articles, bylaws, share certificates</td>
<td>Yes</td>
<td>Passthrough</td>
<td>Complex</td>
</tr>
<tr>
<td>General partnership</td>
<td>No</td>
<td>Partnership agreement</td>
<td>No</td>
<td>Passthrough</td>
<td>Easy</td>
</tr>
<tr>
<td>LP</td>
<td>Yes</td>
<td>Partnership agreement</td>
<td>Yes</td>
<td>Passthrough</td>
<td>Complex</td>
</tr>
<tr>
<td>LLC</td>
<td>Yes</td>
<td>Operating agreement</td>
<td>No</td>
<td>By election</td>
<td>Complex</td>
</tr>
</tbody>
</table>

**Note.** When the entity choice requires drafting legal documents (articles of incorporation, partnership agreements), organizational costs increase. The specific laws and requirements of the state in which the taxpayer desires to form an entity must be considered. The preceding table should be regarded as only a general reflection of typical state law.

The easiest type of business entity to establish is the **sole proprietorship**. Paperwork does not generally need to be filed with a state agency, because establishing a sole proprietorship does not serve to create a separate legal entity. However, as with all other types of business entities, it may be necessary to register as an active business, register a business name, obtain any regulatory licenses needed for the business, and meet other state-level legal requirements. These requirements vary between states.

Establishing a **C corporation** always involves completing and filing forms with a state agency to create the corporation, which is a separate legal entity. Typical state statutes outline the rights and obligations of shareholders, officers, and directors. Rigorous recordkeeping and at least an annual shareholders’ meeting (to elect directors for the year) and an annual directors’ meeting (to appoint officers for the year) are also required. Meeting these requirements can impact initial costs at start-up as well as some ongoing annual costs.

Creation of an **S corporation** typically begins by establishing a corporation under state law. The corporation’s tax status is subsequently changed to that of an S corporation by making the appropriate S election. The federal election is made using Form 2553, *Election by a Small Business Corporation*.

**Note.** Most states accept the federal S corporation tax election, but some states also require a separate state-level S corporation tax election or an annual notice to the state taxation authority in order to ensure that the corporation is treated as an S corporation for state tax purposes.
A **general partnership** can be formed by a simple agreement between two or more taxpayers without filing any state forms. However, it is preferable to form a partnership with a partnership agreement that addresses items such as the following.

- Ownership interests of each partner
- Decision-making authority of each partner
- Contribution of money or property by each partner
- Compensation of each partner
- Allocation of profit and loss
- Terms under which a partner must withdraw from the partnership
- Procedures for admission of a new partner

States generally have statutory “default” rules regarding arrangements between partners; such rules prevail unless a partnership agreement specifies other arrangements. Conflicting interests or objectives among the partners — and the fact that some partners may contribute money while others contribute assets or services — frequently make it prudent to ensure that each partner obtains independent legal advice in connection with the drafting of the partnership agreement.

An **LP** usually has more rigorous state filing requirements because it is necessary to establish those who are general partners (who have unlimited personal liability in connection with partnership business) and those who are limited partners (who have limited liability).

An **LLC** typically requires filing state-level forms to indicate aspects of the LLC’s structure, including who will be the LLC’s managers and members.

**Observation.** Filing fees associated with state forms for business organizations generally range from about $45 to over $500, depending on the type of business organization and the state. Accordingly, both the type of business organization and the particular state in which it is established determines some of the initial start-up costs. There may also be annual filing requirements and fees.

**TAXATION OF BUSINESS ENTITIES**

The federal tax treatment of an entity depends on how applicable federal tax regulations categorize that entity for tax purposes. The question of whether a separate entity exists is a matter of federal tax law, but the federal tax regulations refer to state law in their application.

Federal tax regulations that provide basic rules for entity tax classification are summarized as follows.

<table>
<thead>
<tr>
<th>Reference</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treas. Reg. §301.7701-1</td>
<td>Classification of organizations for federal tax purposes</td>
</tr>
<tr>
<td>Treas. Reg. §301.7701-2</td>
<td>Business entities; definitions</td>
</tr>
<tr>
<td>Treas. Reg. §301.7701-3</td>
<td>Classification of certain business entities</td>
</tr>
</tbody>
</table>

---