Pick the business entity that's right for you

There's no "best" entity choice for small businesses. If there were, every business would be a "C" corporation or an "S" corporation or a . . . you get the point.

But there are several common variables that many entrepreneurs give at least some thought to when considering what legal form their business should take.

I'm a big fan of consumers educating themselves, so I recommend learning all you can about these choices. I'm also a fan of knowing when to turn to experts who can help you understand issues you may not have even known existed, so I recommend talking with an attorney and a tax pro for help with specific legal and financial questions that could affect your own venture.

Caveats aside, the following table gives you a thumbnail sketch of some of the characteristics of various business entities — sole proprietorships, general partnerships, S corporations, C corporations and Limited Liability Companies.

Here's hoping this chart helps you choose your entity wisely.

	Sole Proprietor	Partnership	S Corp	C Corp	LLC
Liability protection?	No	No. Not only don't you get liability protection, but all partners are jointly liable for actions of other partners in partnership.	Yes	Yes	Yes
No. of owners allowed	1	At least 2. No top limit.	No more than 75	No more than 75	No maximum. 1-person LLC OK everywhere but Md. and Wash., D.C.
How income is taxed	Owner pays tax on personal returns.	Profits flow through to partners, paid on personal returns.	Profits flow through to partners, paid on personal returns.	Corporation pays a tax on profits; owners pay a tax when cash or property is distributed.	Profits flow through to partners, paid on personal returns.

	Sole Proprietor	Partnership	S Corp	C Corp	LLC
Deduct losses on personal returns?	Yes	Yes	Yes	No	Yes
Avoid payroll paperwork?	Yes	Yes	No	No	Yes
Special allocations of income or expenses among owners?	Not applicable	Yes	No	No	Yes
Is a written agreement advisable when starting?	Not necessary	Yes	Yes	Yes	Yes

Why each business type rocks

Sole proprietor: Easy to set up, easy to run, the easiest for first-time entrepreneurs to understand, and the easiest to get out of.

Partnership: A good way to participate in a venture with other individuals without having to deal with payroll issues; partners can also get "unequal" distributions of income if all parties agree.

S corporation: No Social Security or Medicare taxes on profits or dividends from the corporation to shareholders.

C corporation: 100% deductible health insurance for employees, including shareholders; potentially fully deductible medical reimbursement and fringe benefits plans for all employees, including shareholders; profits of up to $50,000 annually are taxed at 15% if retained in the corporation rather than at your, potentially higher, personal income tax rate.

LLC: Owners get the limited liability features of a corporation combined with the income-splitting flexibility of a partnership; one-person LLCs can report income on a Form Schedule C with personal tax returns.

Why each business type stinks

Sole proprietor: Unlimited personal liability, 15.3% self-employment tax on all earnings up to $94,200.

Partnership: Liability for the financial actions of all your partners; ordinary income from the partnership is subject to self-employment tax; tracking of partners' capital accounts balances can be complicated.

S corporation: Can't fully deduct your own health insurance or benefits plan costs (only those of employees); you also lose most of the benefits of the home office deduction even if that's the only place where you operate your business.

C corporation: If the corporation loses money, you don't get to deduct it on your personal tax returns; if profits that have been already taxed at the corporate level are later distributed to you as dividends, you'll have to again pay tax on that money.

LLC: Owners get stuck with the same self-employment tax treatment as partners and sole proprietors; states may differ in their tax treatment of LLCs; lawyers worry that there is little case law for what happens when an LLC formed in one state gets sued for something that happens in another state.

When it comes to choosing the form of your business, some tax pros feel that C corporations have become "the forgotten entity" among entrepreneurs.

S corporations, with their easy pass-through of losses and dividends, appeal to many people, and limited liability companies (LLCs) are the cool new kid on the block for owners looking for a simple way to reduce legal exposure.

People tend to think of huge businesses like Ford or Boeing or, yes, Microsoft, when they talk about C corporations. But a C corp also can be the right vehicle for small entities.

Deducting benefits costs

"In my honest opinion, too many people do not take the time to consider the potential advantages of a closely held C corporation," says Mark X. Rigotti, a certified public accountant in Taylor, Mich. I think of Mark as "Mr. C Corp" for the passion he brings to this debate.

"The first and most obvious benefit of the C corporation is that the corporation can deduct 100% of the health insurance it pays for its employees, including employees who are shareholders in the corporation. It also can fully deduct the costs of any medical reimbursement plan," Rigotti says. "If you have a small corporation and a lot of medical expenses that aren't covered by insurance, the corporation can establish a plan that results in all of those expenses being deductible."

C corporations also can deduct fringe benefits such as qualified education costs, group term life insurance up to $50,000 per employee, employer-provided vehicles and public transportation passes.

Note: If you have other employees who are not family members, you'll have to be sure to follow the rules that cover employees under a benefits plan.

Better tax treatment

A second potential advantage of C corporations is the tax rate applied to modest profits. The first $50,000 in annual profits is taxed at a rate of 15%. By comparison, anyone with taxable income that high is seeing at least part of it taxed at 28%.

"The owner of the corporation might receive that profit in salary if the total constituted a reasonable salary," Rigotti says. "But if a profit of up to $50,000 is left in the corporation, you get to take advantage of that 15% rate. This is just a deferral strategy, because eventually you have to deal with taking the money out of the corporation if it continues to be profitable. But we like lower current tax rates when possible."

The double-taxation whammy

The "deferral strategy" Rigotti refers to leads to one of the potential negatives of a C corporation.

If the corporation has profits after paying all of its expenses (including your salary), the corporation pays tax on those profits. When the profits are distributed to you as a shareholder, you pay personal income tax on the dividends. This combination of a corporate income tax, followed by a personal income tax, is commonly referred to as double taxation.

I've seen people go nuts — and I mean absolutely government-is-evil bonkers — at the concept of double taxation. But for many small closely held businesses, double taxation may not be that big of an issue.

For openers, many small businesses have little left in the way of earnings after salary and the fringe benefits that I've already outlined are paid out. Little or no earnings mean little or no corporate taxes or double-taxation issue.

Even if there is a dividend, the consequences aren't always financially earth shattering. You'll have to weigh the double-tax issue against many other factors, including the fact that you might be able to delay receiving the dividend and paying the tax on it for several years.

I'll give you a warning here, or rather, a whole bunch of warnings: C corporations can be complicated beasts, as can their tax treatment; owners also have to watch out for pitfalls including (but not limited to) the accumulated earnings tax and the personal holding company tax. If you don't know what these are, then, as they say in the ads, you should consult your tax or financial professional.

Losses get held in a C corp and aren't passed through annually to shareholders, which can make other forms — like S corps — more attractive to people who want to claim losses on their personal returns. In addition, tax rates and considerations change rapidly as C corps get more profitable — the marginal rate escalates to 39% at the $100,000-income level. And the IRS has gone after many C corporation employee-shareholders whom the agency felt were taking unreasonably high compensation to try to avoid taxation at the corporate level.

As Rigotti says, "A C corporation can require close monitoring by your tax pro."