Tax Ready Bookkeeping

Entity Type Selection Guide

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Overview

Choosing the right business entity affects your taxes, liability protection, and operational flexibility. This guide provides a framework for understanding your options. **Always consult with a qualified CPA or attorney before making entity decisions.**

Entity Comparison At-A-Glance

Factor	Sole Prop	LLC	S-Corp	C-Corp
Formation Complexity	None	Low	Medium	High
Liability Protection	No	Yes	Yes	Yes
Self-Employment Tax	Full	Full*	Partial	None**
Pass-Through Income	Yes	Yes	Yes	No
Ownership Flexibility	N/A	High	Limited	High
Annual Filing Requirements	Schedule C	Varies	Form 1120-S	Form 1120
Administrative Burden	Low	Low	Medium	High

*LLC taxed as sole prop or partnership by default **C-Corp income taxed at corporate level; dividends taxed again to shareholders

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Sole Proprietorship

What It Is

The simplest form of business ownership. No separate legal entity–you ARE the business.

Pros

- No formation requirements
- Simplest tax filing (Schedule C)

- Complete control over decisions
- No annual state filings
- Pass-through taxation

Cons

- Unlimited personal liability
- All profit subject to self-employment tax (15.3%)
- Harder to raise capital
- Less credibility with some clients/banks
- Ends with owner's death or incapacity

Best For

- Very small operations
- Low-risk businesses
- Testing a business idea
- Side hustles

QuickBooks Setup

- Single-member, no separate entity
- Schedule C tax mapping
- Track business/personal expenses carefully

Limited Liability Company (LLC)

What It Is

A flexible entity that provides liability protection while allowing pass-through taxation.

Single-Member LLC

- Taxed as sole proprietorship by default
- Schedule C filing
- Liability protection (if properly maintained)
- Can elect S-Corp taxation

Multi-Member LLC

- Taxed as partnership by default
- Form 1065 filing
- K-1s issued to members
- Operating Agreement recommended/required
- Can elect corporate taxation

Pros

- Liability protection

- Tax flexibility
- Operational flexibility
- Fewer formalities than corporation
- Credibility advantages over sole prop

Cons

- Self-employment tax on all profits (by default)
- Annual state fees in most states
- Some states have franchise taxes
- Varying state rules

Best For

- Small to medium businesses wanting liability protection
- Real estate holdings
- Businesses with multiple owners
- Professional service firms

QuickBooks Setup

- Set entity type to LLC
- Tax mapping depends on election (Schedule C, 1065, 1120-S, 1120)
- Track member contributions and distributions

S Corporation

What It Is

A corporation that has elected pass-through tax status with the IRS (Form 2553).

How It Works

- Corporation formed under state law
- Elects S-Corp status with IRS
- Income passes through to shareholders
- Shareholders who work in business must take "reasonable salary"
- Remaining profit distributed as dividends (no SE tax)

Pros

- Self-employment tax savings on dividends
- Liability protection
- Established legal structure
- Credibility with banks/clients
- Single layer of taxation

Cons

- Reasonable compensation requirement
- Payroll complexity
- Ownership restrictions (100 shareholders, one class of stock, US individuals only)
- More administrative requirements
- Annual filing requirements

Self-Employment Tax Savings Example

	LLC (Default)	S-Corp
Net Profit	$150,000	$150,000
Owner Salary	N/A	$80,000
SE Tax Basis	$150,000	$80,000
SE Tax (15.3%)	$22,950	$12,240
Savings	–	**$10,710**

When S-Corp Makes Sense

- Generally when profits exceed $50-70K after reasonable salary
- When payroll complexity is manageable
- When ownership requirements can be met
- When willing to maintain corporate formalities

Best For

- Profitable service businesses
- Consultants and professionals
- Businesses where owner takes significant salary
- Family businesses with simple ownership

QuickBooks Setup

- Set entity type to S-Corporation
- Form 1120-S tax mapping
- Payroll must be set up for owner compensation
- Track shareholder distributions separately

C Corporation

What It Is

A standard corporation taxed at the entity level. Profits taxed when earned; dividends taxed again when distributed to shareholders.

How It Works

- Separate legal entity
- Pays corporate income tax (21% federal)
- Distributions to shareholders taxed as dividends
- Double taxation structure
- Most flexibility in ownership

Pros

- Unlimited growth potential
- Any number/type of shareholders
- Multiple classes of stock allowed
- Retained earnings taxed at corporate rate
- Best for raising outside investment
- Fringe benefits deductible

Cons

- Double taxation
- Highest administrative burden
- Most expensive to maintain
- Complex tax planning required
- Annual meetings and minutes required

When C-Corp Makes Sense

- Planning to seek venture capital
- Significant retained earnings strategy
- Planning eventual IPO
- Need multiple stock classes
- International ownership desired
- Fringe benefit optimization

Best For

- High-growth startups
- Companies seeking investment
- Large enterprises
- Companies retaining significant profits

QuickBooks Setup

- Set entity type to Corporation
- Form 1120 tax mapping
- Track shareholder equity properly
- Retained earnings handled appropriately

Decision Framework

Key Questions

1. How much liability risk does your business have? - Low risk -> Sole Prop may be fine - Any significant risk -> LLC or Corp recommended

2. How much profit do you expect? - Under $50K -> Sole Prop or LLC - $50-150K -> Consider S-Corp election - $150K+ -> S-Corp likely beneficial; consult CPA

3. Will you have investors or partners? - No outside investors -> LLC or S-Corp - Seeking investment -> C-Corp may be required

4. How much administrative work can you handle? - Minimal -> Sole Prop or LLC - Moderate -> S-Corp - Significant -> C-Corp

5. What are your state-specific considerations? - Some states treat LLCs differently - Franchise taxes vary - Annual filing requirements vary

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Common Transitions

Sole Prop -> LLC

- File Articles of Organization with state
- Get new EIN (optional for SMLLC, required for multi-member)
- Update bank accounts
- Update contracts and agreements

LLC -> S-Corp Election

- File Form 2553 within 75 days of tax year start (or within 2 months + 15 days of LLC formation)
- Set up payroll for owner compensation
- Begin paying reasonable salary
- Track distributions vs. salary

S-Corp -> C-Corp

- Usually happens when seeking investment
- Revocation of S-Corp election filed with IRS
- Tax implications require planning
- Usually done with CPA/attorney guidance

QuickBooks Entity Settings

Location

Settings > Account and Settings > Advanced > Company type

What Each Setting Affects

- Tax form mapping
- Chart of Accounts defaults
- Reports available
- Payroll integration

Important Notes

- Change entity type settings carefully–affects many areas
- May need to remap tax lines after change
- Consult with CPA before changing mid-year

Red Flags: When to Seek Professional Help

- ☐ You're making more than $50K profit and haven't evaluated S-Corp
- ☐ You have partners but no operating agreement
- ☐ You're mixing personal and business finances
- ☐ You haven't filed required state annual reports
- ☐ You're taking "distributions" without payroll in an S-Corp
- ☐ You have investors and are still a sole prop
- ☐ Your business has significant liability exposure with no entity protection

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Next Steps

1. **Assess Current Situation**
   - What entity are you currently?
   - What was your net profit last year?
   - What's your risk profile?
2. **Identify Potential Changes**
   - Based on this guide, what might make sense?
   - What questions do you have?
3. **Consult Professionals**
   - CPA for tax implications
   - Attorney for liability and structure
   - Make informed decision with expert guidance

Disclaimer: This guide is for educational purposes only and does not constitute legal or tax advice. Entity selection has significant legal and tax implications. Always consult qualified professionals for your specific situation.

For more resources: projectbits.com/taxready/ch1

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