

What Kind of Legal Entity Should I Choose For My New Business? Why This is Really Two Questions.

One of the most basic questions new business owners have long asked their professional advisors is “as what kind of legal entity should I operate?”

This has never been an easy question. In addition to the fact that there are a number of possible choices for type of legal entity (such as sole proprietorship, partnership, LLC, S corporation and C corporation), there are also various different legal, administrative and tax advantages and disadvantages among the choices. Whatever choice is made, we are always giving up some advantages that a different choice would have given us.

As of several years ago, the IRS made a change to their rules that has a significant and positive impact on our entity selection decision making process. Specifically, it is now possible to create a legal entity of one type, but to elect to be treated as a different type of entity for tax purposes.

Why would we do this? Clearly, if we thought that one type of entity was the first choice based on legal considerations, but a different entity was best from a tax perspective, we now get the best of both worlds. We choose both.

So, the entity choice question is really two questions:

What kind of entity should I choose to get the best possible legal answers?

What kind of entity should I choose to get the best possible tax answers?

The two questions could have the same answer, or two different answers.

If we believe that our ideal situation would, in fact, be to operate as one kind of entity for legal purposes and a different type of entity for tax purposes, we would take the following steps:

First, we would establish our legal entity as the type of entity we would prefer for legal purposes. For example, (and probably the most common situation) if we want to operate as an LLC for legal purposes, we establish our entity as an LLC.

Second, we file IRS Form 8832, Entity Classification Election, to elect which type of entity we choose to be for tax purposes. In our example, where we are legally an LLC, we could choose to be taxed as a corporation. As far as the IRS is concerned, we are then a corporation.

There is one important exception to the above second step. If we want to be an S Corporation, we do NOT file Form 8832. Instead we file Form 2553, Election by a Small Business Corporation. The Form 2553 functions as both our entity election and our S Corporation election.

BrookWeiner LLC
Chicago, IL