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Entity Selection Guide – How to Choose the Right Business Entity for Your New Venture

Expert Guidance from Pavic Consulting – Empowering Entrepreneurs with Smart Decisions

Starting a new business is an exciting journey, but one of the first and most critical decisions you'll make is selecting the right business entity. This choice impacts everything from your personal liability and tax obligations to how you raise capital, manage operations, and plan for growth. In the U.S., the primary entity types include sole proprietorships, partnerships, limited liability companies (LLCs), and corporations, each with unique legal and tax implications. While most are available nationwide, some variations—like benefit corporations or state-specific rules for S corporations—aren't uniform across all states. This article breaks down the pros and cons of each, the complexities of maintenance, and key considerations to weigh before deciding. Remember, this is general guidance; consult a legal or tax professional for advice tailored to your situation.

Sole Proprietorship: The Simplest Start

A sole proprietorship is the default structure for a single-owner business that doesn't register as another entity. It's formed automatically when you start operating, making it ideal for low-risk ventures like freelancing or small side hustles. There is no legal separation between the owner and the business.

Pros:

- **Ease of Setup and Low Cost:** No formal registration required beyond local business licenses; minimal paperwork and fees.
- **Complete Control:** You make all decisions without partners or shareholders.
- **Tax Simplicity:** Income is reported on your personal tax return (Schedule C of Form 1040); no separate business tax filing unless you have employees.

Cons:

- **Unlimited Personal Liability:** Your personal assets (home, savings) are at risk for business debts or lawsuits—no legal separation between you and the business.
- **Limited Funding Options:** Harder to raise capital; can't sell stock, and lenders may view it as riskier.
- **Self-Employment Taxes:** You pay both employer and employee portions of Social Security and Medicare taxes (2025: about 15.3% on net earnings).

Maintenance Complexities: Minimal ongoing requirements—just track income/expenses for taxes and renew any local licenses. However, as business grows, switching to another entity can involve tax implications (recapturing deductions.)

Best scenario where:

- The business has minimal risk and low liability (e.g., freelancer, tutor, home baker).
- The owner is testing a business idea before formalizing.
- There are no outside investors and operations are small-scale.

This structure is available in all states.

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Partnership: Collaborating for Success

Partnerships involve two or more owners and come in forms like general partnerships (GP), limited partnerships (LP), and limited liability partnerships (LLP). GPs are simplest, while LPs have general partners with full liability and limited partners with capped liability. LLPs offer liability protection for all partners, often used by professionals like lawyers.

Pros:

- **Shared Resources and Expertise:** Easier to pool capital, skills, and networks; good for professional services or joint ventures.
- **Pass-Through Taxation:** Profits/losses flow to partners' personal taxes (Form 1065 for the partnership, Schedule K-1 for individuals); avoids corporate double taxation.
- **Flexibility in Management:** Partners can divide responsibilities via agreements.

Cons:

- **Personal Liability Risks:** In GPs and LPs (for general partners), unlimited liability exposes personal assets; LLPs mitigate this but aren't available uniformly. Individual partners can bind the business legally – even without others' knowledge.
- **Potential for Disputes:** Decisions require consensus unless specified in agreements; partner exits can dissolve the entity.
- **Self-Employment Taxes:** General partners pay on their share; limited partners may avoid this but have less control.

Maintenance Complexities: Requires a partnership agreement outlining profit-sharing, roles, and exit strategies to avoid conflicts. File annual information returns (Form 1065); LPs and LLPs need state filings and may involve ongoing fees. In many states, the partnership dissolves if a partner leaves unless agreements specify otherwise.

Best for scenarios where:

- Two or more individuals trust each other deeply and want a simple structure (e.g., family-run business, consulting duo).
- Business is low risk and requires minimal capital.
- Owners want pass-through taxation without forming LLC.

GPs and LPs are available in all states, but LLPs are often restricted to certain professions (e.g., not for all businesses in some states like California, generally limited to licensed profession like law or accounting) and may require specific insurance.

Limited Liability Company (LLC): Balancing Protection and Flexibility

An LLC combines partnership flexibility with corporate liability protection. It can have one or more members and is formed by filing articles of organization with the state.

Pros:

- **Limited Liability:** Personal assets are generally protected from business debts/lawsuits.

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- **Tax Options:** Defaults to pass-through (like sole prop: single member -> schedule C, or partnership: multi-member -> partnership return) but can elect corporate taxation (S-Corp election for potential payroll tax optimization); avoids double taxation in most cases.
- **Operational Flexibility:** Fewer formalities than corporations; flexible management (member-managed or manager-managed), no ownership restrictions (unlike S-Corp), suitable for medium-risk businesses or those with multiple owners.

Cons:

- **Formation and Fees:** Requires state filing (e.g., \$50-\$500) and possible annual reports/fees (varies by state, CA imposed minimum \$800 franchise tax plus potentially gross receipts tax).
- **Self-Employment Taxes:** Members pay on profits unless electing S-Corp status (can take reasonable salary and distributions, which potentially saves on self-employment taxes).
- **Limited Life in Some States:** May dissolve upon a member's death or withdrawal without operating agreements.

Maintenance Complexities: Draft an operating agreement for governance; file annual reports in most states; track member contributions for taxes. If electing S-Corp taxation, meet IRS criteria like U.S. citizen owners, max 100 shareholders and one class of stock.

Best for scenarios where:

- A small or medium-sized business wants liability protection.
- The owners want flexibility in taxation.
- No outside venture capital is expected.
- The business has moderate risk, clients, or contracts that require insurance and liability protection.

LLCs are available in all states, but rules on duration, taxation, and professional restrictions (e.g., for lawyers) vary. Many states require licensed professionals (doctors, lawyers, accountants, engineers) to use a Professional LLC (PLLC), Professional Corporation (PC), or similar. These provide liability protection but often retain personal liability for one's own malpractice.

Corporation: For Growth-Oriented Businesses

Corporations are separate legal entities, taxed separately from its owners, including C corporations (standard), S corporations (tax election to avoid double taxation, can be applied to LLC or corporation that meets criteria), and others like benefit or close corporations.

Pros:

- **Strong Liability Protection:** Shareholders' personal assets are shielded; ideal for high-risk or capital-intensive businesses.
- **Raising Capital:** Can issue stock to investors; attracts funding for expansion or going public.
- **Perpetual Existence:** Continues regardless of owner changes.
- **Qualified Small Business Stock (QSBS) (C-Corps only):** can qualify stock as QSBS under IRC §1202, potentially allowing shareholders to exclude up to \$10M (or 10× basis) of capital gains on sale if held >5 years. Huge incentive for startups expecting VC funding or big exits.

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Cons:

- **Double Taxation (C-Corps):** Profits taxed at corporate level, then dividends taxed personally.
- **High Setup and Compliance Costs:** Requires articles of incorporation, bylaws, board meetings; more expensive to form.
- **Less Flexibility:** Strict governance rules; S-corps limited to 100 shareholders, all U.S. citizens/residents, one class of stock only.
- **Reasonable Salary Requirement for S-Corps:** The IRS strictly requires owner-employees to take a "reasonable" salary (subject to payroll taxes) before distributions. No bright-line rule — based on industry, duties, and comparable pay. Low-balling salary risks reclassification, penalties, and back taxes. Many advisors use 30–60% of net income as a starting benchmark.

Maintenance Complexities: Hold regular board/shareholder meetings; file annual reports and separate tax returns (Form 1120 for C-corps, 1120-S for S-corps). S-corps require IRS election (Form 2553) and may face state taxes on profits above certain thresholds.

Best for scenarios where:

- Business plans to see VC funding or institutional investment.
- Complex stock structures or equity compensation packages are needed.
- Founders plan to scale nationally or internationally.
- S-Corp: LLC owners earning > \$80k net income annually (rule of thumb).

C-corps are available everywhere, but S-corps, while federally recognized, aren't taxed the same in all states (e.g., some like California impose additional taxes). Benefit corporations (for-profit with social missions) aren't available in all states, and close corporations (simplified for small groups) vary by state law.

Special Situations

- **Non-Profit Entities:** if the venture has a charitable, educational, or social mission (and does not intend to distribute profits), a 501(c)(3) or other non-profit corporation may be appropriate. These offer tax-exempt status but require IRS approval and strict operational rules.
- **Series LLCs:** a handful of states (e.g., Delaware, Texas, Illinois, Nevada) allow "series" LLCs, where a single LLC can create multiple "series" with separate assets/liabilities — useful for real estate investors or businesses with distinct product lines. Not recognized in all states, so inter-state risks exist.
- **Benefit Corporations / Public Benefit Corporations:** benefit corporations aren't available in all states. As of 2025, ~40 states + D.C. allow them. They legally require balancing profit with social/environmental impact; useful for mission-driven for-profits seeking B Corp certification.

Key Considerations Before Making a Decision

Before choosing, evaluate:

- **Liability Exposure:** High-risk industries (e.g., construction) need strong protection like LLCs or corporations; low-risk may suffice with sole props.
- **Tax Implications:** Pass-through entities (sole prop, partnership, LLC, S-Corp) avoid double taxation but require self-employment taxes; C-corps suit businesses reinvesting profits.

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- **Costs and Complexity:** Factor in formation fees, ongoing compliance, and professional help (attorneys for agreements, accountants for taxes).
- **Growth Plans:** If seeking investors or planning to go public, corporations are better; for simplicity, start with sole prop or LLC and convert later (though conversions can trigger taxes or require dissolution).
- **Ownership and Control:** Multiple owners? Partnerships or LLCs allow flexibility; corporations formalize shares.
- **State-Specific Rules:** Availability and taxes differ—e.g., LLPs for professionals may not be in all states; check your state's Secretary of State for filings and variations.
- **Future Flexibility:** Changing entities later is possible but may involve costs, tax events, or state approvals.

Important Notes

- **BOI Reporting Requirement (Corporate Transparency Act):** Most new LLCs, corporations, and partnerships formed or registered after Jan 1, 2024 must file a Beneficial Ownership Information (BOI) report with FinCEN within 30 days disclosing owners >25%. Exemptions exist, but non-compliance penalties are steep (up to \$500/day). Note that as of March 26, 2025, BOI reporting for domestic companies has been suspended. Exemptions exist for foreign entities. Review [FinCen website](#) for latest developments.
- **Conversions and Tax Implications:** converting (e.g., sole prop → LLC → Corporation) is common but can trigger taxable events (e.g., asset transfers treated as sales). Statutory conversions or "check-the-box" elections can sometimes minimize this.

Conclusion

In summary, align your choice with your risk tolerance, tax strategy, and long-term vision. Sole proprietorships and partnerships offer simplicity for starters, while LLCs and corporations provide protection for scaling.

Comparison Table

Entity	Liability Protection	Taxation Default	Self-Employment Tax on All Profits?	Best For Raising VC?	Ongoing Formalities
Sole Proprietorship	None	Pass-through (personal)	Yes	No	Minimal
Partnership (GP)	Unlimited	Pass-through	Yes (general partners)	No	Low
LLP/LP	Limited	Pass-through	Varies	No	Medium
LLC	Limited	Pass-through (flexible)	Yes (unless S-election)	Rarely	Low–Medium
S-Corp	Limited	Pass-through	Only on salary	Difficult	High
C-Corp	Limited	Corporate + dividends	No (on dividends)	Yes	High

At Pavic Consulting, we help navigate these decisions to keep your business compliant and thriving. Ready to structure your new business for success? [Contact us](#) today for personalized guidance.

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