Selecting the
Right Structure for Your Business

Advice from CPAs

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Structuring for Success

There's a lot to consider in starting your own business: developing a business plan, obtaining sufficient funding, marketing the business and a host of other concerns. Also critical is determining the form of organization that best suits the business because this will impact operating efficiency, the way you report business income, the taxes you pay, and the extent of your personal liability. There are four types to choose from:

- ***Sole Proprietorship***
- ***Partnership*** — General and Limited
- ***Corporation*** — S Corporation and C Corporation
- ***Limited Liability Company***

To make an informed decision, you must be aware of the income tax law and tax rates, as well as the non-tax issues, such as transferability, control and the potential legal liability. These are likely to be complicated issues and misunderstandings can be costly. That's why it's important to do some research and seek out the advice of a Certified Public Accountant (CPA) who can help you understand how different forms of entity impact your organization's bottom line.

Management Issues

Formation

Sole Proprietorship — As simple as opening a bank account under the business name; some states and municipalities may require obtaining license or permit.

Partnership — Started through an oral agreement, though a written agreement is advisable (and is required in some states) to agree on such points as profit/loss percentages; business decisions; addition and withdrawal of a partner; and term of operation. Some partnership allocation structures may subject you and your business to more IRS scrutiny.

Corporation — Corporate documents are filed with the state and an annual fee is paid. Separate corporate bank accounts and records are created and assets and money generated by the corporation are owned by the corporation and not the shareholders.

Limited Liability Company (LLC) — Created through articles of organization and an operating agreement; owners are called members and are not personally liable for the entity's debts and liabilities.

Operation and Control

Sole Proprietorship — Ultimate control rests with a single owner; and can operate under name of owner or another name.

Partnership — Requires at least two partners who own the business and share in the profits and losses. The partnership agreement explains who will control and manage the business of the partnership. With a general partnership where there is no agreement, all general partners have equal control and equal management rights. In a limited partnership, the management and control of the business is handled by the general partner or partners.

Corporation — Bylaws (operating rules) are created to explain shareholder and director meetings and the responsibilities of each officer. The shareholders have sole authority to approve articles of incorporation, mergers and dissolution of the company, and they elect the directors. Directors are responsible for major decisions, including selection of company officers.

LLC — One owner LLCs operate like sole proprietorships; multiple member LLCs operate and are taxed like partnerships, although the members may elect to treat and tax an LLC as an S or C corporation if they wish.

Investment

Sole Proprietorship — Limited to the assets and borrowings of the owner.

Partnership — Based on the number of partners and the written agreement, which should also explain how a departing partner will be paid for part ownership when he or she leaves, dies or retires.

Corporation — S Corporations can issue one class of stock to up to 75 shareholders (increased to 100 for years beginning after December 31, 2004). C Corporations can issue different classes of stocks and bonds and can increase borrowing capacity.

LLC — Rules are similar to a proprietorship for one member LLCs, and to a partnership for multiple member LLCs.

Continuity and Transferability

Sole Proprietorship — Continues until abandoned or upon death of the owner. Assets and liabilities can be freely transferred by selling all or a portion of the assets.

Partnership — Continues subject to the partners' agreement and as long as all of the general partners remain in the partnership. The partnership dissolves if a general partner dies or leaves the partnership, unless agreement provides for continuation of the business by the remaining partners.

Corporation — Can exist in perpetuity even if one or more owners die. Ownership can be transferred by sale of stock. Continuing S corporation status depends on limiting ownership to 100 shareholders.

LLC — For multi-owner LLCs, continuity and transferability are determined by the organizing and operating documents and may affect the LLC's ability to choose corporate or partnership tax status.

Legal Liability

Sole Proprietorship — Unlimited personal liability. Creditors can make claims against your business and personal assets. Insurance may cover some of the risks of running a sole proprietorship.

Partnership — General partners are fully liable for all liabilities of the partnership, no matter which general partner incurred them. Limited partners are responsible for partnership liabilities only to the extent of their partnership investment.

Corporation — Shareholders are liable only to the extent of their investment in the business.

LLC — Liability rules are similar to corporate shareholders; members are not personally liable for the debts and liabilities of the LLC.

Pros & Cons of Each

Sole Proprietorship

Pros
- Inexpensive to start and simple to run
- One level of tax on net income
- No separate tax return

Cons
- Unlimited personal liability
- Ownership limited to one person

Partnership

Pros
- Ownership not limited to one person
- One level of tax on net income
- Income and expenses allocation is unrelated to percentage of ownership

Cons
- Unlimited personal liability
- Each partner legally responsible for the business acts of other partners
- Requires separate tax returns

S Corporation

Pros
- Limited personal liability for shareholders
- One level of tax on net income possible

Cons
- Requires separate tax returns
- Restrictions on adding investors
- Income and expenses must be allocated according to percentage of ownership

C Corporation

Pros
- Limited personal liability for shareholders
- Easy to transfer ownership/add investors
- Perpetual continuity presumed

Cons
- More costly to set up and maintain
- Requires separate tax returns
- Net earnings may be double taxed

LLC

Pros
- Limited personal liability for members
- All members can participate in management
- Income and expenses may be allocated in a manner unrelated to percentage of ownership

Cons
- Not automatically perpetual like S or C corps
- More costly to set up and maintain

Tax Issues

Taxability of Income

Businesses can be taxed at the entity level or are considered as pass-through entities where the income or loss is taxed at the owner level and reported on their individual income tax returns.

Sole Proprietorship — Income or loss reported directly by owner.

Partnership — Income or loss is passed through to partners using Schedule K-1.

S Corporation — Income or loss is passed through to shareholders using Schedule K-1; the amount reported by each is based on their percentage of stock ownership.

C Corporation — Income is reported and tax paid through the corporate tax return. Shareholders then pay income taxes on dividends distributed by the corporation, with "qualified dividends" being subject to lower tax rates.

LLC — Similar to the form chosen.

Compensation and Payroll Taxes

Employees are paid a salary. Federal, state and Social Security taxes are withheld on the salary. The employer pays a matching amount of Social Security taxes for each employee. An individual who is self-employed pays Federal, state and both "halves" of the Social Security taxes — sometimes called the self-employment tax — on net self-employment income.

Sole Proprietorship — Must pay self-employment taxes as part of their quarterly estimated tax payments.

Partnership — General partners are subject to self-employment taxes on their share of self-employment income from the partnership (whether or not distributed); limited partners are not subject to self-employment taxes.

S Corporation — For wage income paid to shareholder-employees, income and Social Security taxes are withheld.

C Corporation — For wage income paid to shareholder-employees, income and Social Security taxes are withheld.

LLC — Treated according to the tax treatment selected. If treated as a partnership, active members must pay quarterly estimated self-employment taxes, but inactive members are not subject to self-employment taxes.

Tax Years

Sole Proprietorship — Must use the proprietor's tax year, i.e., the calendar year.

Partnership — If one or more partners using the same tax year own interests in the profits and capital of more than 50%, the partnership must use the tax year of those partners. This generally is a calendar year. However, a partnership can (1) establish a business purpose for a different year; (2) make a Section 444 election; or (3) elect to use a 52-53 week tax year referenced to its required tax year or a tax year elected under Section 444.

Corporation — S Corporations may use the calendar year; a tax year elected under Section 444; or a 52-53 tax year ending with reference to the calendar year. C Corporations may select any fiscal year unless they are classified as a Personal Service Corporation (PSC): a company whose principal activity is providing services in the fields of health, law, accounting, engineering, architecture, performing arts or consulting.

LLC — Similar to the form chosen.

Which is Right for Your Business?

There is no one right answer. It depends on the type of business as well as other factors such as your tax situation. Consult with a CPA who has a broad business background and the expertise to help you with tax and non-tax matters. It's better to form your business properly at the outset than to try and correct mistakes and problems you may face later on.