The Foundation of Your Business Rests on the Proper Structure
March 2006

"I don't have to be a team player, Crawford. I'm the team owner."

Submitted by Siobhan Kelleher

If you are a small business owner, determining the appropriate corporate structure can be a daunting task. You may want to separate the identity of the business from your personal affairs for tax and legal reasons. This separation can provide a barrier that protects your home and other assets from creditors. In addition, some corporate structures ease ownership transfers to heirs or buyers, allow for the provision of a more flexible pension plan, and facilitate capital-raising for expansion.

The structure that is right for you today may not be right for you a few years from now. In fact, it is common for a business owner to change the structure of the business as it evolves and as issues related to taxes and financing become more complex.

Here we will discuss the general characteristics of five common forms of corporate entities: sole proprietorship, partnership, limited liability company (LLC), S corporation, and corporation. Because legalities and regulations can differ from state to state, this serves as a starting point for education regarding entity structure. Consult with your attorney and your department of state (or county clerk's office) for additional information and local filing requirements.

SOLE PROPRIETORSHIP

A sole proprietorship is an unincorporated business owned by one individual. It is the simplest type of business organization in that the business does not exist apart from the proprietor (owner). (If a husband and a wife jointly own and operate the business, a partnership, as discussed below, exists.) All of a sole proprietor's assets—regardless of whether the assets are used in the business—are subject to claims by business and personal creditors.

Advantages

- Simple to organize and easy to discontinue.
- Minimal legal restrictions.
- The owner has maximum freedom to make decisions.
- The owner receives all profits.

Disadvantages

- Unlimited liability. The individual owner is legally liable for all debts of the business and all acts of the employees.
- The ability to finance the business is limited to what the owner can secure or produce personally. This may limit a business' expansion when new capital is required.

PARTNERSHIP

A partnership is a relationship between two or more persons who join together to operate a trade or a business. Any number of persons may join in a partnership.

Advantages

- Easy to organize and has a definite legal status.
- May have greater financial strength than a sole proprietorship.
- Combines managerial skills and judgments of the partners.
- Each partner has a personal interest in the business.

Disadvantages

- Each of the partners has unlimited liability for the debts of the business and the acts of employees and the other owners.
- Authority for decision-making is divided.

LIMITED LIABILITY COMPANY (LLC)

An LLC is a separate legal entity formed by filing articles of organization with the state secretary's office. LLCs and

similar entities called limited liability partnerships (LLPs) combine certain features of partnerships with the limited liability feature and other features of corporations.

Advantage

- Individual members of the LLC are not personally liable for the LLC's or the LLP's debts or liabilities, except to the extent of their investment and capital commitment in the company.

Disadvantage

- An LLC or LLP is not a federal tax entity and is generally treated as a sole proprietorship or a partnership by the IRS.

S CORPORATION

An S corporation is a small business corporation whose shareholders elect to have corporate income taxed in a manner similar to that of a partnership.

Advantage

- The income, losses, tax credits, and other tax items of the corporation flow through the corporation to the shareholders. Thus, income is only taxed once, at the shareholder level.

Disadvantages

- Most fringe benefits provided by the corporation are taxable as compensation to employee-shareholders who own more than 2 percent of the corporation.
- May only have up to 75 shareholders (100 shareholders for tax years beginning after 2004).

CORPORATION

The law treats a corporation as a legal entity. It has a life separate from its owners and has rights and duties of its own. The owners of a corporation are the stockholders.
Forming a corporation involves a transfer of money, property, or both by the prospective shareholders, in exchange for capital stock in the corporation.

Advantages

- The life of the business is perpetual.
- Stockholders have limited liability.
- Transfer of ownership is easy (sale of stock).
- Management may be more efficient.
- Easier for corporations to raise capital and to expand than it is for other forms of business.
- Adaptable to both small and large businesses.

Disadvantages

- Subject to tax on income at the corporate level. When the income is distributed as dividends, it is taxed again to the shareholder.
- May be more difficult and more expensive to organize than other forms of ownership. It is wise to consult an accountant and an attorney specializing in corporate law.
- Subject to many state and federal controls.
- The corporate charter filed with the secretary of your state restricts the types of business activities the corporation may conduct.

The Bottom Line

In choosing a structure for your business, you should consult with an attorney and a CPA who specialize in business formation. If you choose to forgo the expense of working with these professionals, there are several online services that provide the necessary state and federal forms and filing information for anywhere from $199 to $500. Some services are more complete, obtaining an EIN tax number for your business and handling the filing, while others simply provide the forms. Below are a few options:

- www.form-a-corp.com
- www.bizfilings.com
- www.create-a-corp.com
- www.mycorporation.com

Questions? Comments? Please let us know what you think.
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