

The way to become rich is to put all your eggs in one basket and then watch that basket.

~Andrew Carnegie

# Which Business Structure is Right for You?

By Suzanne Ervine

One of the most important decisions that business owners must make is how to structure and operate their new company.

Ideally, this decision will be fully considered and implemented before the business has begun operating; however, small businesses often decide to change the business structure as the company grows.

The legal documents necessary to create and maintain a company will vary, depending on the particular situation and the type of business to be undertaken.

The most common business structures are:

- Sole Proprietorship
- General Partnership
- Limited Partnership
- Limited Liability Company
- C-Corporation
- S-Corporation

Which entity is best for your business depends on many factors, and the choice made can have a significant impact on both the profitability of the business and the protection afforded to the business owners.

The type of business entity you choose can affect:

- How the business is taxed
- What accounting and legal records must be kept, and how to keep them
- The availability of financing
- The owner's liability for the debts and obligations of the business

As noted above, once chosen, a business structure is not "set in stone," and may change as the business evolves.

Many small businesses begin as a sole proprietorship, until the

business progresses to a point where another form is clearly indicated.

As the business grows and the potential for liability and tax burdens increase, circumstances may dictate a re-examination of the business structure.

However, many small businesses are created as corporations or LLCs from the very beginning, a process that is easily accomplished by filing a document with the Secretary of State, thereby avoiding the tax implications of a conversion from an already existing sole proprietorship.

## Sole Proprietorship

The sole proprietorship is the simplest and least regulated of all business entity structures. For legal and tax purposes, the sole proprietorship's owner *is* the business. The liabilities of the business are personal to the owner and the business ends when the owner dies. On the other hand, all of the profits are also personal to the owner and the sole owner has full control of the business.

## Disadvantages

The primary consideration in choosing this type of business structure is liability. With a sole proprietorship, you have no asset protection. With just one lawsuit against the business, your house, savings and personal assets can be lost. If the demands of the business' creditors exceed those assets which were formally placed in the

### In this article:

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name of the business, the creditors can tap the owner's personal assets. This unlimited liability is a significant drawback to the sole proprietorship.

Depending on the profitability of the business, a sole proprietorship may incur a larger tax liability than other business structures. Profit from a sole proprietorship is reported on Schedule C of the owner's personal income tax return, and is subject to self-employment tax (the "employer's match" of Social Security and Medicare taxes). You are taxed on all profits in the year they are earned, whether or not you actually take money out of the business.

When you reinvest in your sole proprietorship business, you must do so with "after tax" money. Additionally, certain fringe benefit plans are not tax-deductible to the sole proprietor.

Sole proprietorships also face potential difficulty in obtaining business loans. Often in starting a small business, there is insufficient collateral to obtain a loan and the sole owner must use his own personal assets as collateral to obtain the loan. This, of course, puts the owner's personal assets in a direct position of risk should the business fail.

The sole proprietorship suffers from the lack of continuity that is

inherent in the business form. It is difficult to sell a sole proprietorship, since its value is based on the owner and not the business. Upon the owner's death, the assets of the sole proprietorship become part of the estate, and may face estate tax and probate consequences.

### Advantages

The sole proprietorship is the simplest of all business structures. Aside from the maintenance of records for tax purposes, this type of business is not subject to legal requirements for how it must be operated (e.g. annual documentation and filings with the Secretary of State).

## General Partnership

A partnership is a relationship existing between two or more persons who agree to share profits and losses. A partnership is usually based on a partnership agreement of some type. No formal, written document is required in order to create a partnership. If a formal agreement is not signed, the partnership will be subject to the applicable state laws governing partnerships.

### Disadvantages

Like the sole proprietorship, owners of a partnership have no asset protection. Each partner's personal assets are at risk. However, with a partnership, the owners face twice the liability exposure of a sole proprietorship. Any partner may obligate the partnership, and each individual partner is liable for all of the debts

of the partnership, regardless of which partner may have been responsible for their accumulation.

In addition to the risk of personal financial liability, general partners also face potential personal legal liability for the negligence of another partner. Furthermore, each partner may also be liable for the negligence of an employee of the partnership if such negligence takes place during the usual course of business of the partnership.

Continuity is also an issue for the partnership. A partnership terminates when one partner dies, leaves, or goes bankrupt. In addition, it is often very difficult to sell an interest in a partnership. Most sophisticated buyers do not want the risk associated with a general partnership.

Finally, certain benefits of corporate organization are not available to a partnership. Since a partnership cannot obtain financing through public stock offerings, large infusions of capital are more difficult for a partnership to raise than for a corporation. In addition, many of the fringe benefit programs that are available to corporations (such as certain pension and profit-sharing arrangements) are not available to partnerships.

### Advantages

For a business in which two or more people desire to share in the work and in the profits, a partnership is often the structure chosen. It is, potentially, a much simpler form of business organization than the corporate

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form. There are fewer start-up costs and regulation of partnerships is limited.

However, this simplicity can be deceiving. A sole proprietor knows that his or her actions will determine how the business will prosper, and that he or she is,

ultimately, personally responsible for the success or failure of the company.

In a partnership, however, the duties, obligations, and commitments of each partner are often ill-defined. This lack of definition of the status of each

partner can lead to serious difficulties and disagreements. In order to clarify the rights and responsibilities of each partner and to be certain of the tax status of the partnership, it is good business procedure to have a written partnership agreement.

## Limited Partnership

A limited partnership is similar to a general partnership, except that it has two types of partners: general partners and limited partners.

General partners have broad powers to obligate the partnership (as they do with a general partnership).

General partners are also personally liable for the debts and claims against the partnership. If there is more than one general partner, each of them is liable for the acts and omissions of the remaining general partners.

Limited partners are “limited” to their contribution of capital to the business, and may not become actively involved in running the company.

As with a general partnership, limited partnerships are flow-through tax entities.

### Disadvantages

General partners are personally liable for all partnership debts. However, a corporation or an LLC may be formed to serve as the general partner, thereby limiting the limiting the potential for personal liability.

Because limited partners are prohibited from participating in the management activities of the enterprise, the general partners maintain complete control of the partnership’s business affairs. Limited partners have no control of their investment.

### Advantages

Limited partners are not liable for the partnership’s debts beyond the value of their capital contribution into the business. Creditors of a limited partnership can only reach the partnership assets and those of

the general partner (which is further limited by utilizing a corporation or LLC as a general partner).

Creditors of the individual partners can only reach the partner’s ownership interest in the partnership, but not the partnership assets themselves.

With proper estate planning, family assets can be transferred from one generation to the next at discounted rates. By using a family limited partnership, gifting can be accelerated with an IRS-approved discount. If you are considering this option, you should consult with an attorney.

Limited partnerships afford a great deal of flexibility to the partners. A written partnership agreement can be tailored to the business, family and estate planning needs of any situation.

### Further Reading:

*Own Your Own Corporation*, by Garrett Sutton, Esq.

*Tax Savvy for Small Business*, by Frederick W. Daily

Publication 15B, *Employer’s Tax Guide to Fringe Benefits*, Internal Revenue Service

## Limited Liability Company (LLC)

The limited liability company (LLC) is a hybrid type of business structure. A limited liability company consists of one or more owners (called “members”) who actively manage the company’s business affairs.

The contains elements of both a traditional partnership and a corporation, offering the liability protection of a corporation, with the tax structure of a sole proprietorship (if it has only one member), or a partnership (if the LLC has two or more members).

### Disadvantages

One of the most significant drawbacks to the limited liability company is the fact that it is a new type of business entity.

There are not many court decisions defining the various aspects of the LLC, so members must be aware that the courts may interpret some feature in a way that is unfavorable.

In California, a limited liability company is prohibited from rendering “professional services,” which includes any type of services “that may be lawfully rendered only pursuant to a license, certification, or registration.” If your business is required to be licensed, registered or certified, you should check with the appropriate licensing authority to before forming an LLC.

Limited liability companies are, generally, a more complex form of business operation than either the sole proprietorship or the general partnership.

They are subject to more paperwork requirements than a simple partnership but somewhat less than a corporation.

In California, LLCs are subject to filing fees for the initial formation, and annual information statements filed with the Secretary of State.

Although the limited liability company is a pass-through entity for federal tax purposes, LLCs are subject to state taxes which, in California, can be quite steep.

In addition to the annual LLC tax of \$800, the state also assess a fee based on the gross income of the LLC. This fee is not based on the profitability of the company, rather it is based solely on the revenue. Therefore, it is possible to lose money and still owe the fee.

If you are considering this type of business entity, you are strongly urged to speak with a tax professional to determine whether it is the best option for your specific situation.

### Advantages

LLC members will share in the potential profits and in the tax deductions of the limited liability company, but in fewer of the financial risks involved.

Because the IRS treats the limited liability company is a pass-through entity, the profits and losses of the company pass directly to each member and are taxed only at the individual level (which may or may not be an advantage to you, depending on the profitability of

the LLC and your personal income tax bracket).

Members of an LLC are permitted to be flexible in dividing the profits and losses. In a corporation or partnership, profits must be divided according to percentage of ownership.

However, with an LLC, special allocations are permitted, so long as they have a “substantial economic effect” (e.g. they must be based upon legitimate economic circumstances, and may not be used to simply reduce one member’s tax liability).

LLCs offer a relatively flexible management structure. The business may be managed either by members or by managers. Thus, depending on needs or desires, the limited liability company can be a hands-on, owner-managed company or a relatively hands-off operation for its members where hired managers actually operate the company.

LLC members enjoy a limited liability, similar to that of a shareholder in a corporation. In general, your risk is limited to the amount of your investment in the limited liability company.

Since none of the members will have personal liability and may not necessarily be required to personally perform any tasks of management, it is easier to attract investors to the limited liability company form of business than to a general partnership.

## Corporation

Corporations are the most commonly used business entity.

Corporations are, generally, a more complex form of business operation than either a sole proprietorship or partnership, and are subject to more state regulations regarding both their formation and operation.

In California, a corporation is created by filing Articles of Incorporation with the Secretary of State. The Articles of Incorporation serve as a public record of certain formalities of corporate existence.

Adoption of corporate bylaws, or internal rules of operation, is often the first business of the corporation. The bylaws of the corporation outline the actual mechanics of the operation and management of the corporation.

There are two basic types of corporations: C-corporations and S-corporations. These prefixes refer to the particular chapter in the U.S. Tax Code that specifies the tax consequences of either type of corporate organization. There are significant differences in the tax treatment of these two types of corporations, however, they are both generally organized and operated in a similar manner.

In its simplest form, the corporate organizational structure consists of the following levels:

**Shareholders:** who own shares of the business but do not contribute to the direct management of the corporation, other than by electing the directors of the corporation and voting on major corporate issues.

**Directors:** who may be shareholders, but as directors do not own any of the business. They are responsible, jointly as members of the board of directors of the corporation, for making the major business decisions of the corporation, including appointing the officers of the corporation.

**Officers:** who may be shareholders and/or directors, but, as officers, do not own any of the business. Officers (generally the president, vice president, secretary, and treasurer) are responsible for day-to-day operation of the corporate business.

### Disadvantages

Due to the nature of the organizational structure in a corporation, a certain degree of individual control is necessarily lost by incorporation. The officers, as appointees of the board of directors, are answerable to the board of management decisions. The board of directors, on the other hand, is not entirely free from restraint, since it is responsible to the shareholders for the prudent business management of the corporation.

However, in most small, family-owned incorporated businesses, only one or two people may occupy all roles, from shareholder to director to officer to employee. In this type of situation, the shareholder/directors continue to exercise full control over the operation of the business.

The technical formalities of corporation formation and operation must be strictly observed

in order for a business to reap the benefits of corporate existence. For this reason, there is an additional burden of detailed recordkeeping. Corporate decisions must be reflected in the corporate records. Corporate meetings, both at the shareholder and director levels, must be formally documented.

### Advantages

One of the most important advantages to the corporate form of business structure is that it limits the liability of the founders and investors in the corporation. Liability for corporate debts is generally limited, to the amount of money each owner has contributed to the corporation.

Certain requirements must be met, however, to assure that the limitation on liability remains in effect. Courts may be able to *pierce the corporate veil*, that is, hold shareholders personally liable, for the following reasons:

- **Failure to observe corporate formalities.** The corporation must hold the required shareholders' and directors' meetings (or sign consents), keep a corporate minute book, comply with all state filing requirements, etc. Even a corporation with just one shareholder/director must still comply with these formalities. In addition, corporate officers must always sign all documents with the corporate title (e.g. John Doe, President).
- **Commingling of assets.** Shareholders must take care to

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avoid mixing their personal assets with those of the corporation. Corporate assets should not be used to pay personal debts. Corporate and personal funds should be kept in separate accounts. Transfers between the corporation and the shareholder, whether a loan, reimbursement, paycheck, etc., must be appropriate and clearly documented.

- **Inadequate capitalization.** If corporate founders fail to raise or contribute enough operating capital, the courts may require the shareholders to pay the

corporate obligations. If the shareholders do not have sufficient capital to fund the corporation, they should purchase adequate liability insurance.

- **Fraud.** A corporation may not be used to shelter fraud. Even if the fraud is committed in the name of the corporation, the shareholders may be held personally liable.

Depending on your personal situation, there may be significant tax advantages to incorporating. Every corporation should have an experienced accountant or tax attorney on its team, to help

determine whether tax treatment C-Corporation or an S-Corporation provides the most benefit, and to help with tax planning strategies before the close of each fiscal year.

In many cases, it is possible to reduce taxable profit to the point that the corporation pays only the corporate minimum tax. If the corporation stands to show a substantial profit at the end of the year, that tax is paid at the corporate tax rate (often much lower than individual tax rates), and that income can be reinvested in the corporation to further grow the business. Hiring a qualified tax advisor will pay for itself many times over.

## C-Corporation

The difference between a C-Corporation and an S-Corporation is in the way each is taxed. Under the law, a corporation is considered to be an artificial person.

Shareholders who work for the corporation are employees; they are not “self-employed” as far as the tax authorities are concerned.

In theory, before a C-corporation distributes profits to shareholders, it must pay tax on the income, at the corporate rate.

Then, leftover profits are distributed to the shareholders as dividends, which are then treated as investment income and taxed to the shareholder. This is the “double taxation” you may have heard about.

In reality, most (if not all) of a

small C-Corporation’s earnings are paid out to its employees as wages, bonuses, fringe benefits, etc. Often, there is no “income” for the small C-Corporation to owe tax on, unless the shareholders choose to keep taxable earnings in the company to reinvest for future growth.

Should you choose to keep profits in the corporation and pay tax on that income, it will be taxed at the corporate tax rate, which is typically lower than the individual tax rate the shareholders are subject to.

C-Corporations enjoy many tax-related advantages:

- Income splitting is the division of income between the corporation and its shareholders in a way that

lowers overall taxes. By working with an experienced tax advisor, you can determine exactly how much money the corporation should pay you, as an employee, to ensure the lowest tax bill at the end of the year.

- C-Corporations enjoy the greatest variety of tax-favored fringe benefits of any business entity. Fringe benefits may include things like health insurance, retirement accounts, and medical reimbursement plans.
- With a C-Corporation, medical costs, including health insurance premiums, are 100% tax-deductible to the corporation and tax-free to the recipient.

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- C-Corporations can also pay for an employee's education expenses (if they are directly related to the job), and these expenses are also deductible to the company and tax-free to the employee. The company can also contribute – and deduct – up to \$5,250 per year for an employee's non-job-related education expenses.
- A C-corporation can provide tax-free financial and tax planning to help employees, provided this benefit is part of a written employee benefit plan.
- C-Corporations can deduct insurance disability insurance premiums for employees, and can provide employees and/or former employees with \$50,000 in tax-free life insurance. Premiums paid for these policies are tax-deductible to the corporation.
- A shareholder can borrow up to \$10,000 from a C-Corporation, interest-free. Tax-free loans are not available to sole proprietors, partners, LLC members, or S-Corporation shareholders.

## S-Corporation

S-Corporations pass income through to their shareholders, who pay tax on it according to their individual income tax rates. To qualify for S-Corporation status, the corporation must have less than 100 shareholders; all shareholders must be individual U.S. citizens, resident aliens, other S-Corporations, or an electing small business trust; the corporation may have only one class of stock; and all shareholders must consent in writing to the S-Corporation status.

Electing S-Corporation tax treatment eliminates any possibility of the "double taxation" referenced above. S-Corporations pay no federal corporate income tax, but must file annual tax returns. Because losses also flow through, shareholders who are active in the business can take most business operating losses on their individual tax returns.

S-Corporations must still file and pay employment taxes on

employees, as with a C-Corporation.

An S-Corporation may not retain earnings for future growth without the shareholders paying tax on them. The taxable profits of an S-Corporation pass through to the shareholders in the year they are earned.

S-Corporations cannot provide the full range of fringe benefits that a C-Corporation can.



Red Sky Legal was established a top-notch paralegal with a commitment to making the legal system accessible and easy to navigate. Our document preparation and self-help legal services are concentrated primarily in the areas of business entity formation and management, estate planning, probate, trust administration, litigation and construction law.

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Suzanne is an avid writer. She has authored numerous self-help legal publications, and actively publishes several law-related blogs. She is a contributor to *Paralegal Gateway*, and recently co-authored the *LDA Code of Ethics and Professional Responsibility* and the *Clients' Bill of Rights* adopted by the Alliance of Legal Document Assistant Professionals.

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