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Business Structure Basics

Choosing a structure for your business can be a confusing jumble of legalese and acronyms. But with this basic guide, you'll be able to select the structure that will serve your business best at tax time.

By Thomas J. Stemmy

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You, like every new business owner, must have asked yourself at one time or another, "What kind of business entity is best suited for my particular operation?" For most entrepreneurs, the answer lies within two specific questions.

- 1. Legal liability.** How can I get the best protection from general business liabilities that can threaten not only my business assets but my family's assets as well?
- 2. Tax considerations.** How can I get the best tax breaks out of the business entity that I select?

Liability is an argument best left to yourself, your business partners, and your business attorney. It is the second question involving the search for shelter from high taxes that sets the overall theme for *Top Tax Savings Ideas*.



How to Save Taxes with Your Business Entity

New business owners are quick to learn that confiscatory tax laws have a profound influence on the success or failure of all small business operations. As a small business owner, you want to get every break available under the law, and you don't want to see the results of all your hard work get eaten up by the IRS and the tough tax laws. The problem, however, is that those tax laws have become so painfully complex that new business owners automatically assume they could never make the best of their available options without conceding the strategy planning to the tax professionals. Interestingly, the tax professionals themselves are often at odds with each other as to the best tax saving options in this ever-changing environment.

Understand the Differences Between the Entities

Before we discuss the specific tax advantages and disadvantages of the various business entities, it is important that you know some fundamental tax considerations between a:

- Sole proprietorship
- General partnership
- Limited partnership
- Corporation
- Limited liability company

The Sole Proprietorship

The sole proprietorship is thought of as the quickest and easiest way to set up a business operation. There are no blanket

prerequisites, nor are there any specific costs in starting a sole proprietorship. There may be some minor formalities, however, that will need attention depending on your state or your jurisdiction. These formalities, which of course apply to all business entities, mean that you will probably have to:

- Obtain an occupancy permit for your place of business,
- Secure a business license, and
- Apply for a franchise or registration number for your operation. This registration number will be used by the state agency to monitor the collection of sales tax and other regulatory matters.

All of these procedures are simple and can be done without the assistance of an attorney or accountant regardless of the state in which you are doing business. Once you start a sole proprietorship, you are the sole owner. Unless you are in a community property state in which your spouse is vested with a one-half interest, you alone have full control and responsibility for the operation.

The General Partnership

Like the sole proprietorship, starting up the general partnership could be a relatively easy process. No costs or formalities are required. Wise counsel, however, will give you about a dozen reasons why you should have a detailed partnership agreement drafted whenever you put yourself on the line with any other individual. A few items that you would be best advised to spell out in writing are:

- The amount of capital each partner is expected to contribute up front;
- The rights and duties of the partners;
- The method for sharing profits and losses;
- The authorization for cash withdrawals and salaries,
- The methods for resolving disputes or taking in new partners; and
- The method for dissolving the partnership should dissolution become necessary. Remember, this is often the case.

The Limited Partnership

A limited partnership is much like a general partnership except for one important fundamental difference. The limited partner is protected by law because the limited partner's legal liability in the business is generally limited to the amount of his or her investment. It enables this special type of investor to share in the partnership profits without being exposed to its debts in the event the company goes out of business. This protection exists as long as the limited partner does not play an active role in the partnership operation.

Unlike the partnerships described above, the corporation is considered an artificially created legal entity that exists separate and apart from those individuals who created it and carry on its operations. With as little as one incorporator, a corporation can be formed by simply filing an application for a charter with the respective state. By filing this application, the incorporator will put on record facts, such as:

- The purpose of the intended corporation,
- The names and addresses of the incorporators,
- The amount and types of capital stock the corporation will be authorized to issue, and
- The rights and privileges of the holders of each class of stock.

It is true that operating as a corporation has its share of drawbacks in certain situations. For example, as a business owner, you would be responsible for additional record keeping requirements and administrative details. More important, in some cases, operating as a corporation can create an additional tax burden. This is the last thing a business owner needs, especially in the early stages of operation.

Remember, aside from tax reasons, the most common motivation for incurring the cost of setting up a corporation is the recognition that the shareholder is not legally liable for the actions of the corporation. This is because the corporation has its own separate existence wholly apart from those who run it. However, let's examine three other reasons why the corporation proves to be an attractive vehicle for carrying on a business.



- **Unlimited life.** Unlike proprietorships and partnerships, the life of the corporation is not dependent on the life of a particular individual or individuals. It can continue indefinitely until it accomplishes its objective, merges with another business, or goes bankrupt. Unless stated otherwise, it could go on indefinitely.
- **Transferability of shares.** It is always nice to know that the ownership interest you have in a business can be readily sold, transferred, or given away to another family member. The process of divesting yourself of ownership in proprietorships and partnerships can be cumbersome and costly. Property has to be retitled, new deeds drawn, and other administrative steps taken any time the slightest change of ownership occurs. With corporations, all of the individual owners' rights and privileges are represented by the shares of stock they hold. The key to a quick and efficient transfer of ownership of the business is found on the back of each stock certificate, where there is usually a place indicated for the shareholder to endorse and sign over any shares that are to be sold or otherwise disposed of.
- **Ability to raise investment capital.** It is usually much easier to attract new investors into a corporate entity because of limited liability and the easy transferability of shares. Shares of stock can be transferred directly to new investors, or when larger offerings to the public are involved, the services of brokerage firms and stock exchanges are called upon.

There are pros and cons to operating your business as a corporation. One of the biggest tax disadvantages for the ordinary C corporation is the dreaded double taxation. Many business owners opt for electing to operate their corporations under subchapter S of the Internal Code. Also known as an S corporation, this entity allows income to pass through to the individual shareholders.

The Limited Liability Company (LLC): New Kid on the Block

In earlier editions of this Top Tax Savings Ideas, the S corporation had been referred to as the logical choice for those small businesses that need to steer away from the regular corporation and its potential tax pitfalls. Increasingly, however, the LLC has been coming to the forefront as another viable alternative. This is especially the case now that much of the air is clearing within the various state laws and professional organizations that deal with LLCs. In fact, many practitioners argue that the LLC is now the preferred choice in the following situations where:

- Legal liability protection is a primary concern
- A simplified "one time" tax on the owners is preferred to dealing with cumbersome corporate tax liability
- The entity cannot qualify for subchapter S status.

An LLC is a hybrid entity that has the legal protections of a corporation and the ability to be taxed (one time) as a partnership. In many regards, LLCs are treated much like S corporations for tax purposes. However, there are some additional advantages over S corporations, including the following examples:

- The LLC usually offers better leeway for owners who wish to write off business losses in a business that relies on entity-related debt that is incurred
- The LLC allows greater flexibility for the owner to take assets out of the company without incurring unplanned tax liability

Remember to check with your lawyer or accountant about the advantages of the LLC in your particular state. Ask up front what it would cost to form a corporation versus the cost of forming an LLC. You may be surprised to learn that in some states an LLC could be established by filing a simple, one-page document, which lays out the Articles of Organization of your LLC, with the secretary of state.

You can form an LLC for any lawful business as long as the nature of the business is not banking, insurance, and certain professional service operations. By simply filing articles of organization with the respective state agency, an LLC takes on a separate identity. Similar to a corporation, but without the tax problems of the corporation, it will be taxed like a partnership.

Former IRS agent Thomas J. Stemmy, CPA, MMS, is a widely respected tax specialist and consultant. An award-winning writer, he is also the author of How to Slash the Cost, Time and Aggravation of a Tax Audit.