Legal Structures For A Business

Selecting The Best Business Structure

Small businesses should select the best business structure to meet their current needs. Your choice of a business form will affect your exposure to personal liability, how you draw profits and pay taxes, your ability to raise capital, how you run your business, and how difficult it is for business reporting.

Generally, all businesses fall into one of these broad categories: Sole Proprietorship, Partnership, Limited Liability Corporation, or Corporation.

A sole proprietorship is an unincorporated business owned by one individual. A partnership is a legal entity existing between two or more persons who join to carry on a trade or business.

An LLC is a business structure with flow-through tax treatment of a partnership along with the limited liability protection of a corporation. Income and income tax are distributed among the owning members, but members are not personally liable for debts of the business.

A corporation is a distinct legal entity, distinct from the individuals who own it. Corporations offer limited liability protection for share owners, but profits are taxed at the corporation level and as dividends with the share holder. An S-Corporation offers many of the benefits of incorporation without exposing the shareholders to the double taxation a general corporation requires.

No matter which type of business organization you choose to form, make sure you consider all of your options before making a decision. It's a good idea to consult with an attorney, so you can fully understand the benefits and drawbacks to each type of entity.

Here is a brief summary of some of the advantages and disadvantages of the different kinds of business structures. In the past few years, many new business owners are selecting a Limited Liability Corporation (LLC) for a range of reasons. A sole proprietorship is another option used fairly frequently for a small business with a single owner.

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The Sole Proprietorship

A sole proprietorship is an unincorporated business owned by one individual. It is the simplest form of business organization to start and maintain. A sole proprietorship is created by default, if you begin business operations solo, without forming a specific organization, you're a sole proprietor.

The business has no existence apart from you, the owner. Its liabilities are your personal liabilities, and you undertake the risks of the business for all assets owned whether used in the business or personally owned. You are required to include the income and expenses of the business on your personal Federal income tax return.

Advantages of the Sole Proprietor

- **Ease of formation:** There is significantly less formality and fewer legal restrictions associated with establishing a sole proprietorship. It needs little or no governmental approval and is less expensive than a partnership or corporation to create.
- **Simple decision making:** The control and decision making is vested in one owner. There are no co-owners or partners to consult.
- **Flexibility:** Management is able to respond quickly to business needs in the form of day-to-day management decisions.
- **Sole ownership of profits:** The owner does not share profits with anyone.
- **Simple Reporting:** Sole proprietors pay tax on business income on their personal income tax returns; the business does not pay its own taxes.

Disadvantages of the Sole Proprietor:

- **Unlimited liability:** If your business is sued or pursued for unpaid debt, creditors can seize your personal assets as repayment. This liability extends to all the proprietor's assets such as a house and car. Proper insurance coverage can limit business liabilities.
- **Business financing can be difficult:** Capital financing is dependent on the individual's assets and credit. So, there is less capital available than in other types of business organizations. Long-term financing may be relatively difficult to obtain.
- **No long term business life:** The business may have to be terminated upon illness or death of the owner.

The Partnership

A partnership is a legal entity existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business. Each partner includes his or her share of the income or loss on their federal income tax return.

General partners share unlimited personal liability for all entity debts and obligations, and each is usually responsible for the acts of the other. Limited partners usually risk only his or her agreed investment in the business.

Advantages of the Partnership:

- **Ease of formation:** More difficult than a sole proprietorship, but still fairly simple. Needs a written partnership agreement and a certificate for limited partnership.
- **Direct rewards:** A partnership allocates profits and losses among the partners as it sees fit, usually specified in the partnership agreement.
- **Growth and performance facilitated:** More capital funds and a better range of skills than in a sole proprietorship.
- **Flexibility**: Decision making is less flexible than a sole proprietorship.
- **Relatively Simple Reporting**. Partnerships have to file with the IRS showing "flow-through" of income and losses.

Disadvantages of the Partnership:

- **Unlimited liability of general partners:** General partners share unlimited personal liability for all entity debts and obligations. However, limited liability partnerships offer some liability protection. Business liability may also be mitigated by insurance.
- **Unstable business life:** Elimination of any general partner may result in dissolution of the partnership. The business may continue to operate based on creation of a new successor partnership. Partnership insurance should be considered.
- **Large capital financing issues:** Getting capital financing for a partnership is better than sole proprietorships, but it is still difficult to get large capital funding.
- **Firm bound by the acts of all general partners:** This applies to contracts, torts, and legal commitments.
- **Difficulty of disposing of partnership interest:** The buying out of a partner may be difficult unless specifically arranged for in the written partnership agreement.

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Limited Liability Companies (LLCs)

An LLC is a hybrid entity, bringing together some of the best features of partnerships and corporations. An LLC provides the advantageous flow-through tax treatment of a partnership, but it also comes with the limited liability protection of a corporation.

Owners of an LLC are called members. LLCs have fewer options when it comes to raising capital for business operations or finding investors. The Limited Liability Company is a relatively new legal form of business (since 1977), with all 50 states supporting it.

Advantages of a Limited Liability Company:

- **Limited liability**: The member's liability is limited to their investment.
- **No double taxation**: The federal government taxes an LLC the same way as a partnership. The LLC profit is passed through to the individual members, who report it on their personal taxes.
- **Separate legal entity:** An LLC is a separate legal entity, distinct from the individual members who own it.
- **Easy to create:** An LLC is registered with the state government and is typically fairly easy to create.
- **Limited reporting requirements:** State and Federal tax reporting is fairly simple.

Disadvantages of a Limited Liability Company

- **Limited business life:** Like partnerships, LLCs do not have perpetual life. Some state statutes stipulate that the company must dissolve after 30 years.
- **Capital funding Is more difficult:** Securing capital in large amounts may be difficult compared to a corporation.
- **LLC Laws Vary**: While many of the rules and regulations are common across different states, Limited Liability Corporation laws may vary from state to state. If you plan to operate in several states, you must determine how a state will treat an LLC formed in another state.
- **Membership limitations:** Some states do not permit international members.

The Corporation

A corporation is a distinct legal entity, distinct from the individuals who own it. Usually, a corporation is formed by the authority of a state government.

With the C corporation, income may be subject to tax at two levels: first, to the corporation at corporate tax rates and then, again to the shareholders when distributed as dividends. With an S corporation, you can avoid the double taxation issues of a general corporation.

Advantages of a Corporation:

- **Limited Liability:** Stockholder's liability is generally limited to the amount of the stock investment.
- **Easy to sell ownership:** Corporation stock shares are readily transferable.
- **Separate entity:** The Corporation is a separate legal entity and has a separate legal existence. It can take all of the actions an individual can.
- **Stable business existence:** In the case of the illness, death, or other cause for loss of an officer of the corporation, the corporation continues to exist and do business.
- **Large capital funding is easier:** Capital may be acquired through the issuance of various stocks and bonds.

Disadvantages of a Corporation:

- **Corporations are complex:** Forming a corporation is complex and expensive. Reporting requirements are complex.
- **Charter limits activities:** States regulate corporation activities. Some states allow very broad charters while others have more limitations.
- **State, local and federal regulations:** In most states, you need a charter, bylaws, organizational minutes and a stock subscriptions agreement. In many states, you must file a Corporation Annual Report.
- **Double Taxation:** With the C corporation, income may be subject to tax at two levels: first, to the corporation at corporate tax rates and then, again to the shareholders when distributed as dividends. The cost of individual Social Security contributions, unemployment contributions, and workers' compensation will be higher in a corporation.
- **Complex reporting requirements:** State and federal tax reporting is complex. A fairly wide range of other reporting is also required.

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The S-Corporation

S-Corporations also provide personal liability protection against business debts. S-Corporations are similar to general corporations in many respects. There are certain requirements for formation and operation and the corporation is its own legal entity, but income “passes through” the corporation to shareholders, similar to taxation at the Partnership or Sole Proprietorship level.

An S-Corporation offers many of the benefits of incorporation without exposing the shareholders to the double taxation a C-Corporation requires. An S-Corporation has a limit of 100 shareholders

Use An Attorney And Accountant

These materials are not intended to constitute the rendering of legal or tax advice. In view of the important legal, tax and business planning issues involved with respect to the formation and operation of a business organization, the reader of these materials is strongly advised by SCORE to consult with a competent attorney and certified public accountant with respect to obtaining appropriate advice on such matters.