

Choosing a Legal Structure for Your Business

When starting a new business, you will find that there are several decisions you must make early that can affect the long-term operation of the business. One such decision is the choice of a legal structure for your business. Major issues to consider when choosing a legal structure include the business' legal status, owner's liability, taxation method, management style, and method of capitalizing the business. Below is a review of the most common legal structures for business and the advantages and disadvantages of each.

Sole Proprietorship

As the name implies, a sole proprietorship is a form of business structure with only one owner. It is the most common legal structure and the easiest to set up and maintain. Basically, a startup business that does nothing to define its legal structure defaults to a sole proprietorship. This is because it is not necessary to create or file any paperwork to establish this structure. In a sole proprietorship, the owner is representing himself to the public by the business name and there is no legal separation between the owner and the business. The owner is the business and the business is the owner. Income or loss of the business is accounted for on the owner's personal tax return. This is known as "flowthru" taxation because it "flows through" the owner's tax return.

Advantages:

- Simple and inexpensive to establish, profits are taxed only once at the owner's rate, losses are deducted from other personal income.

Disadvantages:

- A sole proprietorship is not a separate legal entity.
- The owner has unlimited liability for business debts and any judgments against the business.
- The owner is considered self-employed and pays self-employment tax through his/her personal income tax return.

General Partnership

A general partnership is similar to a sole proprietorship except that it includes two or more owners. Like a sole proprietorship, it is a legal structure in which the owners are representing themselves as the business. There is no legal separation between the owners and the business. They are one and the same. While there is no paperwork required to establish a partnership, it is strongly recommended that partners prepare a "Partnership Agreement," defining each partner's contributions, the division of profit and labor, authority of each partner, dissolution

agreement, and method of dispute resolution. At the end of the tax year, a partnership files an Informational Income Tax Return form 1065 with the IRS, although taxes are paid through the owners' personal returns, the same as a Sole Proprietorship.

Advantages:

- Relatively easy to establish.
- Startup costs can be shared.
- Profits and losses flow through owners' tax returns.
- Shared responsibility and liability may provide complementary skills, financial cushion.

Disadvantages:

- A partnership is not a separate legal entity.
- Profits must be shared.
- Owners have unlimited liability for business debts and judgments.
- May be difficult to transfer ownership.
- Shared responsibility and liability may result in disagreements.

Corporation or Subchapter S Corporation

A corporation is defined as a body of persons granted a charter legally recognizing them as a separate entity with its own rights, privileges, and liabilities separate from its members. This means that a corporation is a unique legal entity, separate under the law from those who own it, called shareholders. Shareholders elect a Board of Directors to oversee major policies and decisions. A corporation is created by Articles of Incorporation filed with the Secretary of State. A corporation can be sued, taxed, and can enter into legal agreements.

Advantages:

- Ability to raise capital through sale of stock.
- Easy transfer of ownership.
- Shareholders risk only their investment.
- Costs of benefits for employees and officers can be deducted as expenses.
- Can elect Subchapter S status (if qualified) with the IRS, enabling flow through taxation.

Disadvantages:

- Incorporating requires more time and money to startup.
- Rules must be strictly followed to maintain corporate status and legal separation.
- Monitored by federal, state and local agencies, resulting in more paperwork.
- Corporate profits may be taxed twice: at corporate level and as dividends on personal taxes.

Limited Liability Company

A Limited Liability Company (LLC) is a relatively new form of business structure in this country. An LLC is created by Articles of Organization filed with the Secretary of State.

Its purpose is to provide the limited liability of a corporation combined with the tax simplicity and operational flexibility of a partnership. It is more difficult to set up than a partnership but less complex than a corporation. An LLC must not have more than two of the four characteristics that define corporations: limited liability, continuity of life, centralization of management, and free transferability of ownership interests. These characteristics are chosen and established when organization papers are filed.

Advantages:

- Separate legal entity
- Can elect to be taxed as a partnership (flow through taxation)
- Easier to establish and maintain than a corporation.
- Offers more flexibility than a corporation.

Disadvantages:

- Relatively new structure has not been thoroughly tested through the courts.
- More complex startup requirements and costs.
- May dissolve at death of member.