BUSINESSVISER

Business Formation Guide

There are five main types of business formations, and each one has its own advantages and disadvantages. Some are easy and inexpensive to form while others provide you limited liability protection that protects your personal assets from creditor claims and lawsuits stemming from your business operations.

Sole Proprietorship

A sole proprietorship is the simplest and most common structure chosen to start a business. It is an unincorporated business owned and run by one individual with no distinction between the business and the owner. You are entitled to all profits and are responsible for all your business' debts, losses and liabilities.

➢ Forming a Sole Proprietorship

No formal action is required to form a sole proprietorship. If you are the only owner, this status automatically comes from your business activities. In fact, you may already own one without knowing it. If you are a freelance graphic designer, for example, you are a sole proprietor.

But like all businesses, you need to obtain the necessary licenses and permits. Regulations vary by industry, state and locality.

If you choose to operate under a name different than your own, you will most likely have to file a fictitious name (also known as a trade name, or DBA name, short for "doing business as").

➢ Sole Proprietor Taxes

Because you and your business are one and the same, the business itself is not taxed separately – the sole proprietorship income is your income.

➢ Advantages of a Sole Proprietorship

- **Easy and inexpensive to form**: A sole proprietorship is the simplest and least expensive business structure to establish.
- **Complete control**. Because you are the sole owner of the business, you have complete control over all decisions.
- **Simplified tax preparation**. Your business is not taxed separately, so it's easy to fulfill the tax reporting requirements.

➢ Disadvantages of a Sole Proprietorship

- **Unlimited personal liability**. Because there is no legal separation between you and your business, you can be held personally liable for the debts and obligations of the business. This risk extends to any liabilities incurred because of employee actions.

- **Hard to raise money**. Sole proprietors often face challenges when trying to raise money. Because you can't sell stock in the business, investors won't often invest. Banks are also hesitant to lend to a sole proprietorship because of a perceived lack of credibility when it comes to repayment if the business fails.
- **Heavy burden**. You alone are ultimately responsible for the successes and failures of your business.

Limited Liability Company

A limited liability company (LLC) is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.

The "owners" of an LLC are referred to as "members." Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs.

Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are "passed through" the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

- Forming an LLC

While each state has slight variations to forming an LLC, they all adhere to some general principles:

- **Choose a Business Name**. There are 3 rules that your LLC name needs to follow: (1) it must be different from an existing LLC in your state, (2) it must indicate that it's an LLC (such as "LLC" or Limited Company") and (3) it must not include words restricted by your state (such as "bank" and "insurance"). Your business name is automatically registered with your state when you register your business, so you do not have to go through a separate process.

- **File the Articles of Organization**. The "articles of organization" is a simple document that legitimizes your LLC and includes information like your business name, address, and the names of its members. For most states, you file with the Secretary of State. However, other states may require that you file with a different office such as the State Corporation Commission, Department of Commerce and Consumer Affairs, Department of Consumer and Regulatory Affairs, or the Division of Corporations & Commercial Code.

- **Create an Operating Agreement**. Most states do not require operating agreements. However, an operating agreement is highly recommended for multi-member LLCs because it structures your LLC's finances and organization, and provides rules and regulations for smooth operation. The operating agreement usually includes percentage of interests, allocation of profits and losses, member's rights and responsibilities and other provisions.

- **Obtain Licenses and Permits**. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

- **Announce Your Business**. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLC formation. Check with your state's business filing office for requirements in your area.

LLC Tax Obligations

An LLC is not a separate tax entity, so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC's members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do, so check with your state's income tax agency.

Since an LLC is not recognized as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law.

Advantages of an LLC

- **Limited Liability**. Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is like the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability - members are not necessarily shielded from wrongful acts, including those of their employees.
- **Less Recordkeeping**. An LLC's operational ease is one of its greatest advantages. Compared to an S-Corporation, there is less registration paperwork and their start-up costs are lower.
- **Sharing of Profits**. There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Limited Life**. In many states, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. However, you can include provisions in your operating agreement to prolong the life of the LLC if a member decides to leave the business.
- **Self-Employment Taxes**. Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

Partnership

A partnership is a single business where two or more people share ownership.

Each partner contributes to all aspects of the business, including money, property, labor or skill. In return, each partner shares in the profits and losses of the business.

Because partnerships entail more than one person in the decision-making process, it's important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners) and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended and it is considered extremely risky to operate without one.

- Types of Partnerships

There are three general types of partnership arrangements:

- **General Partnerships** assume that profits, liability and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.

- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.

- **Joint Ventures** act as general partnership, but for only a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

- Forming a Partnership

To form a partnership, you must register your business with your state, a process generally done through your Secretary of State's office.

You'll also need to establish your business name. For partnerships, your legal name is the name given in your partnership agreement or the last names of the partners. If you choose to operate under a name different than the officially registered name, you will most likely have to file a fictitious name (also known as a trade name, or DBA name, short for "doing business as").

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

➢ Partnership Taxes

Most businesses will need to register with the IRS, register with state and local revenue agencies, and obtain a tax ID number or permit.

A partnership must file an "annual information return" to report the income, deductions, gains and losses from the business' operations, but the business itself does not pay income tax. Instead, the business "passes through" any profits or losses to its partners. Partners include their respective share of the partnership's income or loss on their personal tax returns.

➢ Advantages of a Partnership

- **Easy and Inexpensive**. Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- **Shared Financial Commitment**. In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This could be beneficial in terms of securing credit, or by simply doubling your seed money.
- **Complementary Skills**. A good partnership should reap the benefits of being able to utilize the strengths, resources and expertise of each partner.
- **Partnership Incentives for Employees**. Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

➢ Disadvantages of a Partnership

- **Joint and Individual Liability**. Like sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- **Disagreements Among Partners**. With multiple partners, there are bound to be disagreements. Partners should consult each other on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits**. Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

Corporation

A corporation (sometimes referred to as a C corporation) is an independent legal entity owned by shareholders. This means that the corporation itself, not the shareholders that own it, is held legally liable for the actions and debts the business incurs.

Corporations are more complex than other business structures because they tend to have costly administrative fees and complex tax and legal requirements. Because of these issues, corporations are generally suggested for established, larger companies with multiple employees.

For businesses in that position, corporations offer the ability to sell ownership shares in the business through stock offerings. “Going public” through an initial public offering (IPO) is a major selling point in attracting investment capital and high quality employees.

- Forming a Corporation

A corporation is formed under the laws of the state in which it is registered. To form a corporation you’ll need to establish your business name and register your legal name with your state government. If you choose to operate under a name different than the officially registered name, you’ll most likely have to file a fictitious name (also known as a trade name, or DBA name, short for "doing business as"). State laws vary, but generally corporations must include a corporate designation (Corporation, Incorporated, Limited) at the end of the business name.

To register your business as a corporation, you need to file certain documents, typically articles of incorporation, with your state’s Secretary of State office. Some states require corporations to establish directors and issue stock certificates to initial shareholders in the registration process. Contact your state business entity registration office to find out about specific filing requirements in the state where you form your business.

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

- Corporation Taxes

Corporations are required to pay federal, state, and in some cases, local taxes. Most businesses must register with the IRS and state and local revenue agencies, and receive a tax ID number or permit.

Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice - first, when the company makes a profit, and again when dividends are paid to shareholders on their personal tax returns.

- Advantages of a Corporation

  - **Limited Liability**. When it comes to taking responsibility for business debts and actions of a corporation, shareholders’ personal assets are protected. Shareholders can generally only be held accountable for their investment in stock of the company.
  - **Ability to Generate Capital**. Corporations have an advantage when it comes to raising capital for their business - the ability to raise funds through the sale of stock.
  - **Corporate Tax Treatment**. Corporations file taxes separately from their owners. Owners of a

corporation only pay taxes on corporate profits paid to them in the form of salaries, bonuses, and dividends, while any additional profits are awarded a corporate tax rate, which is usually lower than a personal income tax rate.

- **Attractive to Potential Employees**. Corporations are generally able to attract and hire high-quality and motivated employees because they offer competitive benefits and the potential for partial ownership through stock options.

➢ Disadvantages of a Corporation

- **Time and Money**. Corporations are costly and time-consuming ventures to start and operate. Incorporating requires start-up, operating and tax costs that most other structures do not require.
- **Double Taxing**. In some cases, corporations are taxed twice - first, when the company makes a profit, and again when dividends are paid to shareholders.
- **Additional Paperwork**. Because corporations are highly regulated by federal, state, and in some cases local agencies, there are increased paperwork and recordkeeping burdens associated with this entity.

S Corporation

An S corporation (also referred to as an S corp) is a special type of corporation created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation.

An S corp is a corporation with the Subchapter S designation from the IRS. What makes the S corp different from a traditional corporation (C corp) is that profits and losses can pass through to your personal tax return. Consequently, the business is not taxed itself. Only the shareholders are taxed. There is an important caveat, however: any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

➢ Forming an S Corporation

To file as an S corporation, you must first file as a corporation. After you are considered a corporation, all shareholders must sign and file Form 2553 to elect your corporation to become an S corporation.

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality.

➢ S Corporation Taxes

All states do not tax S corps equally. Most recognize them similarly to the federal government and tax the shareholders accordingly. However, some states (like Massachusetts) tax S corps on profits above a specified limit. Other states don't recognize the S corp election and treat the business as a C corp with all the tax ramifications. Some states (like New York and New Jersey) tax both the S corp's profits and the shareholder's proportional shares of the profits.

Your corporation must file the Form 2553 to elect "S" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

- Advantages of an S Corporation

  - **Tax Savings**. One of the best features of the S corp is the tax savings for you and your business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S corp shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.
  - **Business Expense Tax Credits**. Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2% or more shares, then benefits like health and life insurance are deemed taxable income.
  - **Independent Life**. An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

- Disadvantages of an S Corporation

  - **Stricter Operational Processes**. As a separate structure, S corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers and records maintenance.
  - **Shareholder Compensation Requirements**. A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations, and may reclassify your distributions as wages. You could pay a higher employment tax because of an audit with these results.