

How do I choose a Business Structure?

The Types and Factors in Selection: First in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

So, you have decided to start your own business. One of the questions you will be asked early in the process is: “What type of business structure will you be?”. Most people will just pick one, or allow someone else to select one. Instead, this month’s article will briefly mention the types of structures and then concentrate on the factors you need to consider in making an informed decision.

There are many types of business structures. The simplest form is the sole proprietorship. Basically an individual needs to only advertise they are in business. The second type is the general partnership. This is the most common type of partnership requested. The third type is the corporation. The most common are the Sub-chapter S and C. There are also professional and specialized corporate structures as well. The last types of structure are the hybrids: limited liability company and limited liability partnership. These are a blend of the partnership and corporation attributes. Future articles will address each type based on the factors discussed in this article.

In choosing which of these business structures is best for your business you need to look at several factors: complexity, liability, number of owners, capital, taxation and survivorship. This is not a comprehensive list. There will be additional personal factors that impact your decision as well, such as business goals, control, skills, cost, and family commitment.

Complexity: Complexity is evaluated from two points of view. First, how complex is the product or service you are providing, and, second, how complex is the business structure you are considering. If you are creating crafts in your basement, you probably do not need to have a complex business structure, such as a limited liability company. A sole proprietorship may be ideal because it is simple to set up and maintain. However, if you want to manufacture airplanes then a more complex structure may be more appropriate.

Liability: Liability is probably the factor most mentioned when discussing business structures. What personal liability do I have for the operation of the business, and how can I minimize it? There are several issues that must be evaluated. First, how much risk is inherent in the product or service I am offering? If I manufacture jewelry the risk of injury from my product is significantly less than if I manufacture chainsaws. Evaluate the product and service by how the consumer uses it and the possibility of injury. Second, do I have people on my business or home premises? People can be customers, employees or salesmen. Having others on your premise creates a greater potential for accidents and injuries. Third, do I have employees? Employees are one of the biggest risk factors for a business. Legally, as the employer you are responsible for the actions of your employees. Now instead of simply having a responsibility for only your actions, you are now equally responsible for the actions of someone else. Your risk level just doubled, tripled.... Finally, can I avoid liability for the debts of the business? Some of the business structures create a “person” with the ability to contract separate from the owner. This means that this new “person” can create obligations that the owner is not legally responsible for personally. Sounds great in theory. Most new businesses will not have this opportunity, because new accounts, loans or contracts

will be signed by the business, but will also require a personal guarantee by the owner. The personal guarantee obligates the owner personally for the business debts.

Of course there are several areas that you cannot avoid personal liability. You are always responsible for your own actions. If you are the one driving the car for work and are involved in an accident, you are responsible. On the other hand, if you are set up as a corporation and it is an employee driving the car, the corporation and the employee are responsible, not you personally. Second, Uncle Sam will hold any responsible individual (usually owners and officers) liable for withholding taxes if they have been withheld from the employees' pay checks and not paid to the IRS. Third, you must continue to maintain the structural integrity of the business structure. For instance, you cannot use the business checking account as a personal account and all required annual reports must be filed.

Number of owners: The next factor in your decision is: how many owners will there be? Certain business structures will allow only 1 person while others require a minimum of 2 people. Plus, some structures are not ideal for a large number of owners.

Capital: Capital is the amount of money needed to start and operate the business. The structure selected will determine your ability to raise capital. Certain structures are limited to what the owners personally have to put into the business.

Taxation: The second most frequently mentioned factor is taxation. How will the profits be taxed or the losses carried? This factor has an impact not only on the business tax return, but on your personal tax return as well. The decision must be made by evaluating the potential growth of the business and the income potential for the family unit over an extended period of time. What may initially appear as a tax advantage the first few years may be a tax nightmare five years later. Also, some structures may experience the potential for double taxation of profits.

Survivorship: The final factor is survivorship. What do I want to happen to the business if something happens to me? Imagine how difficult it would be to manage IBM if every time a shareholder died IBM had to restructure the business. It would be impossible to maintain a successful business. Each business structure handles survivorship differently.

The next few articles in the series will highlight a specific business structure and evaluate the structure based on the factors just discussed. Next month, sole proprietorships.

How do I choose a Business Structure?

The Sole Proprietorship: Second in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

We started this series by briefly describing the types of business structures: sole proprietorship, general partnership, Sub-chapter S and C corporations, limited liability partnership, and limited liability company. We then developed the factors an owner must consider in choosing the structure. To reiterate the factors: complexity, liability, number of owners, capital, taxation and survivorship. Again, this is not a comprehensive list. There will be additional personal factors that impact your decision as well, such as business goals, control, skills, cost, and family commitment. Let's evaluate the sole proprietorship structure based on these specific factors.

Complexity: The sole proprietorship is the least complex and least expensive structure to set up. You can simply hang a sign out that says you are in business. However, once you have chosen your name you may need to register it with the Secretary of State. If the business name is something other than your own name, then you need to file a trade name registration. For example, Linda's Jewelry, does not identify the business as belonging to this particular Linda. The name should be registered. You can obtain the form by going to www.state.nd.us/businessreg/soleprop.htm. The cost of filing is \$25.00 and the registration is good for 5 years. This site also provides information on special licensing requirements, such as contractor's licenses.

Liability: The second factor is liability. Simple, as you are the business, you are personally liable for everything the business does.

Number of owners: Trick question, how many owners can a sole proprietorship have? One...or two? Actually, there can be two owners provided they are legally married and file a joint tax return. Otherwise, only one person can be an owner. If there is more than one person that wants to share in ownership, you need to select a different structure.

Capital: The ability to raise capital is limited in a sole proprietorship. It is limited to your personal net worth and your good name. If you have cash to put in or assets you can use for collateral, like your home, these assets are the extent of your ability to raise capital.

Taxation: The sole proprietorship uses your social security number, as it's federal identification number. So, the sole proprietorship files an annual tax return with your personal tax return. A Schedule C is used to figure the sales, expenses and taxable income. As the owner, you pick up the income on your personal tax return and pay the applicable taxes. You can obtain the Schedule C form at the IRS website, www.irs.gov.

Survivorship: Since you are the business, a sole proprietorship dies upon the death of the owner. The assets of the business can be distributed under the terms of your Will, and the business can continue to operate. However, it now becomes a different sole proprietorship with a different social security number. It legally ceases to exist.

Next article will apply these same factors to the general and limited partnerships.

How do I choose a Business Structure?

General Partnership: Third in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

The series continues with a look at the most common type of partnership, the general partnership. Again, we will review it using the same six factors: complexity, liability, number of owners, capital, taxation and survivorship.

Complexity: General partnerships can be very simple to set up. You need to register the business name if you do not disclose the names of all the partners in the business name. To obtain the registration form from the secretary of state go to their website at: www.state.nd.us/businessreg/genpart.htm. The cost is \$25.00 for a 5-year registration.

General partnerships do not have to be in writing to be a legal partnership. You can have an oral, “handshake deal”. However, ask yourself, what happens to my interest in the business if I die? What if I need to move out of state? What if this doesn’t work out? What if.....? In other words, it is best to evaluate what your, and your partners, goals are before you go into business together. The expectations may not be the same. By putting together a written partnership agreement before entering into the partnership you establish the basis for the relationship while everyone is thinking you are going to make a million dollars in a year and getting along great. About the time the bills come in and there is not enough money to pay them all, or one partner is not doing enough to bring in sales, or....basically, problems start to develop in the relationship, how likely is it that the parties can agree on anything? Decide at the beginning how to resolve some of those issues and put it in a written agreement. This is especially important when you look at the next factor.

Liability: The liability exposure for each partner is the same as a sole proprietorship, unlimited personal liability for everything the business does. This means if your partner purchases 1,000 tennis rackets for the business, and you thought you were in the business of selling pet supplies, you are still 100% personally responsible for payment. You may be able to collect it from your partner based upon your agreement, but don’t count on it. Therefore, it is extremely important that you know your partners very well and can trust them to make good decisions for the business.

Number of owners: A general partnership requires a minimum of two people. You can have any number over two. However, in a general partnership the partners share control of the business. The more partners involved in the business the more difficult the decision making process can become.

Capital: The ability to raise capital is similar to the sole proprietorship. It is limited to each partner’s personal net worth and good name. To raise more money you have to add partners.

Taxation: A general partnership files an informational tax return listing the sales, expenses and taxable income or losses. It then issues a K-1 statement to each of the partners dividing the taxable income or losses between them in proportion to their ownership interest. The partners must include that income or loss on their personal tax return and pay the taxes due or receive the benefit of the losses against personal income. You can obtain the forms at the IRS website at www.irs.gov.

Survivorship: A general partnership “dissolves” on the death of a partner. It does not have to “terminate” or liquidate and start over, but legally it becomes a different general partnership. The deceased partner’s interest may pass to the heirs or to the other partners depending on the agreement.

Finally, there is another type of partner that most people call a “silent partner”. This is a slightly different partnership form. Most of the factors described above remain the same. The main difference is you must have at least one partner that is a general partner and 100% liable for the business operations, and at least one partner that is a limited, or silent partner that has no liability. Of course everyone wants to be the limited partner. However, the catch is the silent part. The limited partner cannot exercise any control over the decisions made in the operation of the business. If the limited partner participates in control, they will also become liable for the business operations.

Next article will evaluate the corporations.

How do I choose a Business Structure?

C Corporations: Fourth in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

The next types of business structures are the corporation. Most people are generally familiar with the corporate structure because of the stock markets. There are many different types of corporations; general business, farming, professional and closely held are the most common. All of these types may be classified as a C corporation or a Sub-chapter S corporation. We will discuss the corporation generally as an entity looking at both of these classifications. First, I'll provide some basic information on corporations.

The corporation is an entity created by state statute. The law provides a specific method for creating a corporate "person". Articles of Incorporation are filed with the Secretary of State. Think of the Articles of Incorporation as the information provided to create a birth certificate: What is its name? Where will it live? What is the purpose of its existence (don't you wish you could have defined that at your birth)? What type of stock do I want to issue? How many shares do I want the ability to issue? The Secretary of State reviews the information to determine if the corporation is unique. If there are no other corporations in the state with the same name and purpose, they will issue a Certificate of Incorporation (birth certificate) and the corporation now exists. For taxation purposes the corporation is a C corporation.

This article will evaluate the C corporation using the same six factors: complexity, liability, number of owners, capital, taxation and survivorship.

Complexity: The corporation is a fairly simple entity to create since it must follow the state statutory requirements. There are annual filing requirements as well. The Secretary of State website has forms for the Articles of Incorporation and annual reports at www.state.nd.us/businessreg/corporation.htm. It is however, very structured in the organization and operation of the business.

Liability: This factor is the primary reason most people consider a corporation. Generally, an owner (shareholder) is only liable for the operation of the corporation to the extent of the equity invested. Of course there are exceptions to the rule. We mentioned some of these in the first article. First, you are always responsible for your own actions. If you are the one driving the car for work and are involved in an accident, you are responsible. On the other hand, if you are set up as a corporation and it is an employee involved in the accident, the corporation and the employee are responsible. You are not personally liable. Second, if you withhold employment taxes from an employee's paycheck and don't send it in to the IRS, the IRS does not like that. They call it stealing. The responsible individuals will be held liable for those taxes. Usually those individuals are the owners and officers. Third, you must continue to maintain the structural integrity of the business structure. For instance, you cannot use the business checking account as a personal account and all required annual reports must be filed. Otherwise it appears as if the corporation is a sham and you are the business. Finally, if you personally guarantee the obligations of the corporation, you are personally responsible for those obligations if the corporation does not pay.

Number of owners (shareholders): The corporation can have one owner or an infinite number based on the shares it has the ability to issue.

Capital: By selling small pieces of ownership you can raise capital. This is what the stock market does. You are raising money by adding owners, but the capital raised is not based on the owner's personal assets, but on the value of the business itself. For instance, if the business has a net worth of \$100,000 and there are 10,000 shares of stock issued and outstanding, then each share of stock is worth \$10.00. So, if you want to raise additional funds, you could sell more shares of stock at \$10.00 per share. Most small businesses raise capital by selling to family and friends. However, if you need to raise a large amount of capital and want to sell to individuals other than family and friends, then you must register the stock under the state and federal securities laws. If your goal is to eventually take the corporation "public", then you should be planning with the assistance of an attorney that works with securities laws.

Taxation: Early in the formation process, the C corporation requests a federal identification number from the IRS, like your social security number. Then, just like you, it files an income tax return and pays its own taxes each year. Go to the IRS website at www.irs.gov for more information on corporate taxation.

Frequently the words "double taxation" is brought up with C corporations. Yes, there can be a double tax on the income of the C corporation if the corporation declares and pays a dividend to the owners. As payment of a dividend is not an allowable expense, the income used to pay the dividend is taxed. When the dividend is paid, the corporation must also issue a 1099-DIV form. The owner must include the dividend as income on their personal tax return. So, the income is taxed again. How do we avoid this double taxation? Don't declare a dividend. Visit with your accountant or attorney and plan other ways for the owners to receive income. One such idea is to personally own the building, vehicle or equipment and rent it to the corporation. You receive the income and have to pay taxes on it, but the money used to pay the rent is deductible as an expense from the corporate income. No double tax. Or, pay higher wages or a bonus to the owner for work performed. The corporation will pay the additional employment taxes, but again, it is a deductible expense for income tax purposes. Do some research with your tax professional as part of your planning process.

Survivorship: Can you imagine what it would be like if every time an owner of IBM stock died the entire business would have to restructure? It would be a logistic nightmare. As the corporation is a separate person with its own identification number, it is set up to continue as an entity no matter who owns the stock. Upon the death of an owner the ownership of the business simply passes according to the owner's wishes.

The next article in the series will evaluate the Sub-chapter S corporation.

How do I choose a Business Structure?

Sub-chapter S Corporations: Fifth in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

We discussed in the last article the C corporation. There is also a Sub-chapter S corporation. The main difference between the Sub-chapter S and the C corporation is how the corporation is taxed. A Sub-chapter S corporation is taxed like a partnership. Remember the C corporation is treated like an sole proprietorship. The Sub-chapter S corporation will file an informational tax return and issue K-1 statements for the profits or losses to the owners in proportion to their ownership interest. The owner will pay the taxes on the income, or use the losses to offset personal income. As we stated earlier, when you received the Certificate of Incorporation the corporation is treated as a C corporation for tax purposes. So, how does the corporation change to a Sub-chapter S corporation?

There is a special filing required by the IRS to make the change. It is form 2553, Election by a Small Business Corporation. You can download this form at the IRS website at www.irs.gov. All owners must sign it agreeing to change the corporate tax structure. There are some timing concerns in changing to a Sub-chapter S corporation. When you first incorporate you have 2½ months from the date of incorporation to make the Sub-chapter S election in order for the election to be applied in the first year. So for example, if you incorporate on February 1, 2003, you must file the election by April 15th for the election to be good for the 2003 tax year. If you file the election after that date the election will not be good until 2004. The decision to make this election takes some planning. As you can imagine the IRS does not let you flip back and forth based on what is beneficial to you. If you decide to terminate the election you cannot change it again for five years. These decisions can have a significant impact on your personal taxes if the corporation starts making large profits. Plus, the tax impact can be different between the owners based on their personal tax issues. You may not be able to get everyone to agree to change the election once it has been made. Therefore, be sure to evaluate the decision based on each owner's personal tax plan and the corporation's financial projections over a minimum of 5 years.

The Sub-chapter S corporation avoids the double taxation issue because all income flows through to the owners for tax purposes. Keep in mind that when we say "income" we are referring to the taxable income on the tax return. We are not referring to cash. Most likely no cash will be distributed to the owner's to pay the taxes on the income.

Complexity: Other than the additional IRS filing, the complexity factor remains the same as the C corporation.

Liability: The liability factor is the same for the C corporation and Sub-chapter S corporation.

Number of owners (shareholders): A Sub-chapter S corporation is limited to seventy-five owners. You can still have only one person.

Capital: The ability to raise capital is only limited by the number of owners allowed, seventy-five.

Taxation: Taxation was discussed in the first section of this article.

Survivorship: Survivorship is no different than the C corporation.

The final article will discuss the hybrid entities: Limited Liability Partnerships and Limited Liability Companies.

How do I choose a Business Structure?

The Hybrids: Sixth in a Series.

By Linda A. Liebert-Hall, ND Small Business Development Center, Fargo Regional Director

The last business structures are the hybrids. These structures blend some of the corporate and partnership attributes. The first is the Limited Liability Partnership.

Limited Liability Partnership (LLP)

Complexity: The limited liability partnership is more complex than the other partnerships. There should be a written partnership agreement, and a registration of the entity is required with the secretary of state. You can obtain the necessary forms on the secretary of state's website at www.state.nd.us/businessreg/limliabpart.htm.

Liability: Unlike the general partners in the other partnerships, partners in a limited liability partnership enjoy limited liability, like an owner in a corporation. The partnership agreement should create a centralized style of management, similar to a corporation, rather than all members sharing control (which is a partnership attribute). Centralized management establishes a managing partner or partners who make the operational decisions. Just like a corporation, the limited liability is not absolute. Refer back to the C corporation article for the circumstances when an owner in a corporation will be held liable. The same circumstances are applicable to the partners in this structure.

Number of owners: This factor is the same as the other partnership forms. There must be at least two owners.

Capital: Capital is generated only from the personal assets and good names of the partners involved.

Taxation: A limited liability partnership can elect to be taxed as a partnership or as a corporation. A limited liability partnership is automatically taxed like a partnership unless it files an Entity Classification Election Form 8832 to elect to be taxed like a corporation. The form can be downloaded from the IRS website at www.irs.gov. The same considerations previously discussed in making the Sub-chapter S election are applicable here as well. Be sure to plan for all partners' personal tax issues and the business tax issues over the long run.

Survivorship: For survivorship, the limited liability partnership is treated like a general partnership. It "dissolves" upon the death of a partner. As we discussed in the general partnership article, it may choose to not formally liquidate the assets and "terminate", but it legally becomes a different partnership.

Limited Liability Company (LLC)

The limited liability company (LLC) is created by choosing no more than 2 of the following corporate attributes: centralized management, continuity of life, free transferability of interests, and, limited liability.

Complexity: The limited liability company is probably the most complex structure to set up, but is also the most flexible. You need to file Articles of Organization with the Secretary of State's office making your selection of corporate attributes. The Articles themselves are usually basic, similar to the articles of incorporation for a corporation. By-laws can be created, but are not required, to establish the operational rules of the business. These are similar to a partnership agreement. You can also obtain information on the required Articles of Organization format from the Secretary of State's website at www.state.nd.us/businessreg/limliabco.htm.

Number of owners (members): There can be as few as one member if desired. If there is only one member, then the LLC is automatically treated as a sole proprietorship for tax purposes. The one member can elect to be taxed as a corporation by filing the IRS Entity Classification Election Form 8832 as mentioned in the limited liability partnership section above. There is no limit on the number of members an LLC can have.

Capital: The ability to raise capital can have an impact on whether the LLC is taxed like a partnership or a corporation. Free transferability of interest is one of the corporate attributes that can be selected. If you structure the LLC so that members may easily transfer their interests in the LLC then you can raise capital by selling small pieces of the business like corporate stock. If you choose to structure it like a partnership, where the ownership is not easily transferable, then the ability to raise capital is limited to the personal assets and good names of the members like a partnership.

Taxation: An LLC can elect to be taxed as a sole proprietorship, partnership or as a corporation. If the LLC has only one member, it is automatically treated, for tax purposes, as a sole proprietorship. If the LLC has more than one member it is automatically treated, for tax purposes, like a partnership. The LLC can elect to be taxed as a corporation by filing an Entity Classification Election Form 8832. The form can be downloaded from the IRS website at www.irs.gov. If the corporate taxation structure has been elected, the LLC can also choose to file a Sub-chapter S election discussed previously in the prior series article. Again, be sure to plan for all partners' personal tax issues and the business tax issues over the long run.

Survivorship: The LLC is assumed to have perpetual life unless stated otherwise in the articles of organization. You may choose a date that the entity will terminate.

This series has identified the factors you need to consider when selecting a business structure and discussed the common business structures based upon those factors. You are now ready to do your own research and create your own business entity.