

## CHOICE OF ENTITY WHEN STARTING A BUSINESS

Of all the choices you make when starting a business, one of the most important is the type of legal structure you select for your company. Not only will this decision have an impact on how much you pay in taxes, it will affect the amount of paperwork your business is required to do, the personal liability you face and your ability to raise money.

### **Sole Proprietorship**

The simplest structure is the sole proprietorship, which usually involves just one individual who owns and operates the enterprise.

**Advantages:** The expenses and your income from the business are included on your personal income tax return, meaning business losses you suffer may offset the income you've earned from other sources.

**Disadvantages:** You're personally responsible for your company's liabilities. Raising money for a sole proprietorship can also be difficult. Banks and other financing sources are often reluctant to make business loans to sole proprietorships.

### **Partnership**

If your business will be owned and operated by several individuals, look at structuring your business as a partnership. Partnerships come in two varieties: general partnerships and limited partnerships. In a general partnership, the partners manage the company and assume responsibility for the partnership's debts and other obligations. A limited partnership has both general and limited partners. The general partners own and operate the business and assume liability for the partnership, while the limited partners serve as investors only; they have no control over the company and aren't subject to the same liabilities as the general partners.

**Advantages:** A partnership doesn't pay taxes on its income but "passes through" any profits or losses to the individual partners. At tax time, each partner files a Schedule K-1 form, which indicates his or her share of partnership income, deductions and tax credits.

**Disadvantages:** Personal liability is a major concern. Like sole proprietors, general partners are personally liable for the partnership's obligations and debts. Each general partner can act on behalf of the partnership, take out loans, and make decisions that will affect and be binding on all the partners (if the partnership agreement permits). Partnerships are also more expensive to establish than sole proprietorships because they require more legal and accounting services.

### **Corporation**

A corporation is an independent legal entity, separate from its owners, and as such, it requires compliance with more regulations and tax requirements.

**Advantages:** A corporation's debt isn't considered that of its owners, so you're not putting your personal assets at risk. A corporation can also retain some of its profits without the owner paying taxes on them. Another plus is the ability of a corporation to raise money. A corporation can sell stock, either common or preferred, to raise funds. Corporations also continue indefinitely, even if one of the shareholders dies, sells their shares or becomes disabled.

**Disadvantages:** There are higher costs involved. Corporations are formed under the laws of each state, each of which has its own set of regulations. You'll probably need the assistance of an attorney and accountant to guide you. And not only are corporations subject to corporate income taxes at both the federal and state levels, any earnings distributed to shareholders in the form of dividends are taxed at individual tax rates on the owners' personal income tax returns.

### **S Corporation**

The S corporation has some appealing tax benefits but still provides business owners with the liability protection of a corporation.

**Advantages:** With an S corporation, income and losses are passed through to shareholders and included on their individual tax returns.

**Disadvantages:** S corporations are subject to many of the same requirements corporations must follow, and that means higher legal and tax service costs. They also must file articles of incorporation, hold directors and shareholders meetings, keep corporate minutes, and allow shareholders to vote on major corporate decisions. The legal and accounting costs of setting up an S corporation are also similar to those for a standard corporation.

### **Limited Liability Company**

Limited liability companies, often referred to as "Lacs," are hybrid entities, bringing together some of the best features of partnerships and corporations. "An LLC is a much better entity for tax purposes than any other entity," says Ralph Anderson, a CPA and small-business tax specialist with accounting firm M.R. Weiser.

**Advantages:** LLCs were created to provide business owners with the liability protection that corporations enjoy without the double taxation. Earnings and losses pass through to the owners and are included on their personal tax returns.

**Disadvantages:** The tax treatment for LLCs varies by state. If you plan to operate in several states, you must determine how a state will treat an LLC formed in another state. If you decide on an LLC structure, be sure to use the services of an experienced accountant who is familiar with the various rules and regulations of LLCs.

*Excerpted from Start Your Own Business: The Only Start-Up Book You'll Ever Need (Entrepreneur Media Inc.).*