What Structure is right for my Business? - Insights into the differences between Sole Proprietorships, Partnerships, Corporations and LLCs

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Executive Summary

By failing to prepare, you are preparing to fail."
― Benjamin Franklin

When you are thinking of forming an entity for a new business there are many factors to take into consideration for its structure. Among the things you have to think about, such as developing a business plan, how you are going to fund your new business, and how to market your business, you have to think about the type of entity to choose. For a new business, obviously ease and cost can be a deciding factor. However, flexibility of the structure can be significantly important for startups which would allow for different needs at different stages of growth.

There are times when it makes sense to change the type of entity an already established business has. For example, you started your doggie biscuit company, Fido Eats, as a sole proprietorship because you wanted to get going as fast as possible with a minimum cost. But now, Fido Eats is booming and you're making money hand over fist. It occurs to you that there may be a smarter way to structure the business so you don't have to pay so much in taxes and, besides, you might want to offer stock to the public in the future. Forming a Corporation sounds like it may be the way to go.

There are four basic types of entities to choose:

- Sole Proprietorship
- Partnership – General and Limited
- Corporation – C Corporation and S Corporation
- Limited Liability Company (LLC)

What's the difference and why is it important?

It is my goal to give you some insight into the differences between the entities, give you some pros and cons of each and ask you some questions to get you thinking about which business structure would work best for you.

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Insights into Business Entities

Sole Proprietorship

A Sole Proprietorship is an unincorporated business in which one person owns all the assets of the business. It is not a legal entity and is not separate from its owner. The business and the owner are one. This is the simplest and most common structure chosen by an individual starting a business.

Getting started is as simple as opening a bank account and obtaining a permit or license depending on the state and the municipality. Here's a Licensing & Permits tool to help you determine what you'll need to run a business.

Partnership

A Partnership is an unincorporated legal entity in which two or more individuals operate and manage a business. There are two types of partnerships; general and limited. In a general partnership, all the individuals agree to share the associated profits and debts proportionately. In a limited partnership, there is at least one general partner who has unlimited personal liability for partnership debts and, the others are limited partners whom are liable only to the extent of their investment in the partnership. The limited partners have to have a 'passive' role in the partnership and not play a role in management or they will lose their 'limited' status.

A Partnership is started through an oral agreement, although a written agreement is advisable to document how the partners will divide the profits, will add and withdraw partners, and spell out the terms of operation. To form a Partnership you must register your business with your state, usually through your Secretary of State's office and obtain the necessary permits and/or licenses.

C Corporation

A Corporation is an independent legal entity in business to make a profit and is separate from its owners. "Incorporate" means "to create a separate body". "C Corporation" is a general corporation which refers to the Chapter C in the IRS code. A Corporation is owned by shareholders and is managed and controlled by a board of directors who elect a president and are responsible for the business decisions of the Corporation.

Corporations are more complex than other business entities because there are more legal requirements. Corporations are formed under the laws of the state in which it is registered and an annual fee is paid. There are a few ‘formalities’ that have to be adhered to, such as; the Articles of Incorporation, which establishes the directors and the amount of shares to be authorized; the by-laws, which establish and control the rules and actions of the directors; plus yearly, the stockholders need to meet to elect the Board of Directors and the Board needs to have an annual meeting in which corporate minutes are kept; and, separate bank accounts and records need to be maintained with the assets owned by the Corporation, not by the shareholders. All this even if there is only one shareholder!

S Corporation

An S Corporation is a form of corporation that meets the IRS requirements to be taxed under the IRS Subchapter S code. This gives a corporation with 100 or less shareholders some tax advantages that will be discussed later. The hallmark of the S Corporation is that it avoids ‘double taxation’.

LLC (Limited Liability Company)

LLCs have become increasingly common, especially with startups. For the most part, LLCs are easier and less expensive to set up than a corporation. An operating agreement outlining the percentage of interests and allocation of profits is a lot less complicated than the costlier corporate formalities mentioned above. A Limited Liability Company (LLC) is a hybrid type of entity, combining the features of a corporation and the tax efficiencies and operational flexibility of a partnership. This type of entity first became available in the United States in 1977 when Wyoming became the first state to enact LLC legislation, but it wasn’t until the 1990s that other states followed suit. The LLC does not have shareholders or issue stock, the owners are referred to as “members” and, depending on the state, the LLC can consist of a single individual, two or more individuals, corporations or other LLCs.

An LLC is created through Articles of Organization that is filed usually with your state’s Secretary of the State or some such office and there is most likely a fee for filing.

PROS and CONS of Each Business Structure

What business structure to choose is not an easy cut-and-dried answer. There are a lot of moving parts. In the following section, we will talk about a few pros & cons of each structure to help you decide which one might be right for you.

Sole Proprietorship

PROS

- Simplicity – this is by far the easiest structure to form. No fancy accounting system is needed; you don't even need a separate bank account. I highly recommend that you DO have a separate bank account, though. It's very difficult to know how well your business is doing if you co-mingle personal and business finances. Having a separate bank account could make or break your business.
- Easy inexpensive setup – there are no filing fees, you simply hang out your 'shingle' and get started.
- No double taxation – here's the thing about 'double taxation'; you will see this term a few times in the next couple of pages. What it means is, you are taxed only once on the net income. A C Corporation is taxed twice on the net income; once at the corporate level and again when the shareholder receives payouts in the form of dividends.
- No separate tax return – the income is reported on the owner's individual tax return. There is no other tax return to file.
- Complete control – the owner has ultimate control; no one else tells him/her what to do.

CONS

- Unlimited personal liability – get a good business liability insurance policy because you will be personally liable. Anyone can make a claim against your business and your personal assets.

Sole Proprietorship

PROS

- Simplicity
- Setup is easy and inexpensive
- No double taxation
- No separate tax return
- Complete control

CONS

- Unlimited personal liability
- Ownership limited to one person
- Subject to self-employment taxes
- Hard to raise money

Sole Proprietorship (continued)

CONS (continued)

- Ownership limited to one person – a sole proprietor must become a "jack of all trades".
- If you want to bring on a partner to broaden the expertise you have to form a Partnership.
- Subject to self-employment taxes – that's the social security tax (FICA) and the Medicare tax (MED), ½ of which is usually withheld from an employee and the other ½ is paid by the employer. When you are considered self-employed you get to pay both 1/2s and it's not deductible from your net income.
- Hard to raise money – if you want to raise capital, a sole proprietorship has a more difficult time than any other type of business structure. Basically, the assets owned by the owner are the Company's primary collateral.

Partnership

PROS

- Easy inexpensive setup – most Partnerships are easy to form, all that is needed is a partnership agreement showing the rights and obligations of the partners.
- Ownership not limited to one person –a partnership involves two or more owners which broadens the experience and divides up the work.
- No double taxation – there's that term again. Partnerships are taxed on the individual partner's tax returns.
- Easier to raise capital – with a partnership, you can bring in as many investors/partners as you want. Also, it's easier to get a loan in a partnership than a proprietorship because there's generally more collateral owned between the partners.

CONS

- Unlimited personal liability – general partners are fully liable for all the liabilities incurred by any of the partners in the partnership. Limited partners are liable only to the extent of their investment.

Partnership

PROS

- Setup is easy and inexpensive
- Ownership not limited to one person
- No double taxation
- Easier to raise capital

CONS

- Unlimited personal liability
- Difficulty finding the right partners
- Each partner legally responsible
- Requires separate tax returns
- Subject to self-employment taxes

Partnership (continued)

CONS (continued)

- Difficulty finding the right partners – fights among Partners over money, power, ego, who's not pulling the weight, etc. break up many a partnership. Choose your partners wisely.
- Requires separate tax returns – a partnership tax return (Form 1065) has to be filed but the income is passed-through to the partners via the Form K-1 from the partnership tax return.
- Subject to self-employment taxes – that's the social security tax (FICA) and the Medicare tax (MED), ½ of which is usually withheld from an employee and the other ½ is paid by the employer. In a partnership you are considered self-employed you get to pay both 1/2s and it's not deductible from your net income.

C Corporation

PROS

- Limited personal liability – shareholders are liable only to the extent of their investment in the business. If the corporation is set up properly and the corporate formalities, mentioned earlier, are followed, then only the corporate assets can be touched.
- Easy to transfer ownership – ownership can be transferred by sale of stock.
- No self-employment tax – because the income is not passed on to the shareholders, the shareholders are not subject to the self-employment tax. However, the shareholders who do work within the company and receive paychecks have to have social security and medicare tax withheld from their gross income but it's 50% less than the self-employment tax.
- Perpetual continuity presumed – a corporation can exist in perpetuity even if one or more owners die.

CONS

- More costly to setup and maintain – forming a corporation involves paying a fee to file with your state. There is usually an annual fee as well.

C Corporations

PROS

- Limited personal liability
- Easy to transfer ownership
- No self-employment tax
- Perpetual continuity presumed

CONS

- More costly to setup and maintain
- Requires separate tax return
- Double taxation

C Corporation (continued)

CONS (continued)

- Requires separate tax returns – a corporate tax return (Form 1120) and the state equivalent has to be filed.
- Double taxation – (not again!) Tax you once on the corporate tax return and tax you again if there's any dividends paid out.

S Corporation

PROS

- Limited personal liability – shareholders are liable only to the extent of their investment in the business. If the corporation is set up properly and the corporate formalities, mentioned earlier, are followed, then only the corporate assets can be touched.
- No double taxation – S corporations do not pay taxes. The income is passed to the shareholders through the K-1 of the corporation.
- No self-employment tax – even though the income is passed on to the shareholders, the shareholders are not subject to the self-employment tax. However, the shareholders who do work within the company and receive paychecks have to have social security and medicare tax withheld from their gross income but it's 50% less than the self-employment tax.

CONS

- Requires separate tax returns – a corporate tax return (Form 1120S) and the state equivalent have to be filed. The income passes through to the shareholders through the form K-1 and is included on the shareholders' individual tax returns.
- Restrictions on adding shareholders – you must have less than 100 shareholders and one class of stock. The shareholders can only be individuals, estates, or certain limited trusts, not corporations, partnerships or most types of trusts.

S Corporations

PROS

- Limited personal liability
- No double taxation
- No self-employment tax

CONS

- Requires separate tax returns
- Restrictions on adding investors/shareholders
- Distributions must be allocated according to percentage of ownership

S Corporation (continued)

CONS (continued)

- Distributions must be allocated according to % distribution of ownership – if one shareholder takes a distribution, the other shareholders must take a distribution in proportion also. The IRS does not take kindly to disproportional distributions.

LLC (Limited Liability Company)

PROS

- Limited personal liability – the liability rules are similar to corporations; members are not personally liable for the debts and liabilities of the LLC.
- Easier to maintain – unlike corporations, you don't have to have any formal meetings, or minutes. Nor do you have to issue stock. An LLC has the advantages of a corporation but for a one member LLC it is also like a sole proprietorship.
- No separate tax returns if a one member LLC – meaning that the income is reported on the member's individual tax return.

CONS

- Subject to self-employment taxes – that's the social security tax (FICA) and the Medicare tax (MED), ½ of which is usually withheld from an employee and the other ½ is paid by the employer. When you are considered self-employed you get to pay both 1/2s and it's not deductible from your net income.
- Requires separate tax returns if 2 or more members – depending on the IRS tax status, a partnership (Form 1065) or a corporate (Form 1120 or 1120S) tax return would have to be filed.

LLC

PROS

- Limited personal liability
- Easier to maintain
- No separate tax return if a one member LLC
- Can be treated as a C Corporation or S Corporation

CONS

- Subject to self-employment taxes
- Requires separate tax returns if 2 or more members

Comparison Chart

	Sole Prop	Partnership	C Corporation	S Corporation	LLC
Simplicity and low startup costs	YES	YES	NO	NO	NO
Double taxation	NO	NO	YES	NO	NO
Separate Tax Return	NO	YES	YES	YES	DEPENDS*
Taxability of Income	Reported directly by owner on Schedule C of tax return	Passed to partners using Schedule K-1	Reported and paid through corporate tax return. Shareholders pay income taxes on dividends.	Passed through to shareholders using Schedule K-1.	DEPENDS*
Subject to self-employment tax (FICA/MED)	YES	YES	NO	NO	DEPENDS*

DEPENDS* -

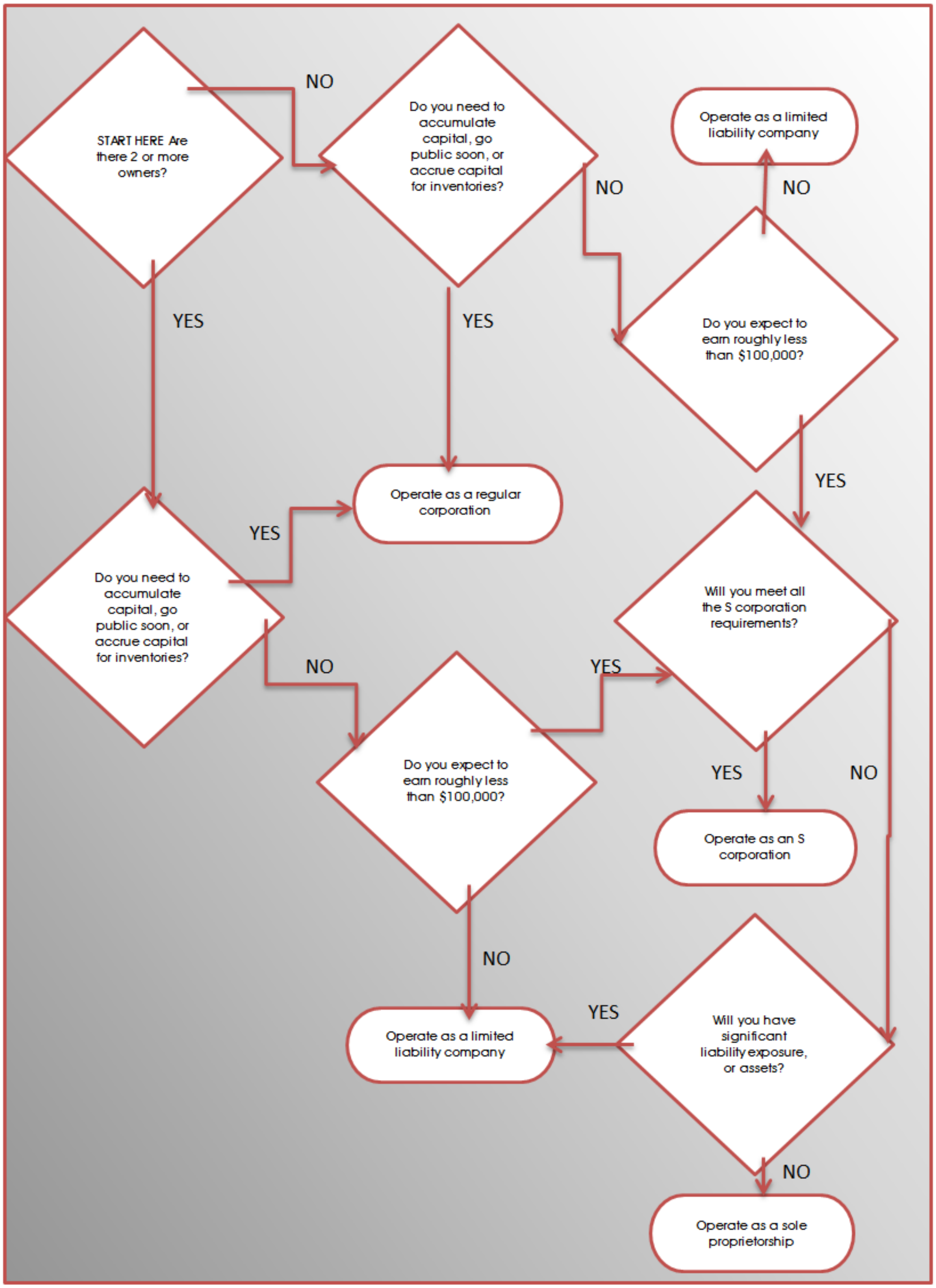
If the **LLC** has only **one member** than no separate tax return is filed, the member reports the income on his individual tax return and the income is subject to self-employment tax (FICA/MED).

If the **LLC** has **two or more members** than a separate tax return (Partnership) has to be filed and the income is passed to the partners using a Schedule K-1 and the income is subject to self-employment tax (FICA/MED).

If the **LLC** has made the special election with the IRS to be considered a **C Corporation** for tax purposes than a separate tax return is filed, the income is reported and paid through the corporate tax return and the income is not subject to self-employment tax (FICA/MED).

If the **LLC** has made the special election with the IRS to be considered an **S Corporation** for tax purposes than a separate tax return is filed, the income is passed through to members using Schedule K-1 and the income is not subject to self-employment tax.

Entity Flowchart



In Conclusion

The business structure you choose will have legal and tax implications. It will affect how much paperwork you need to do, the personal liability you face, and your ability to raise money. It is not a decision to be entered into lightly. In fact, it is very important for business owners to seek the advice from an expert business professional, be they an accountant, attorney, or business coach. These experts can help you weigh the pros and cons of the various business entities so you can make a sound decision.

The purpose of this paper was to give you an overall knowledge of the four types of entities: sole proprietorship, partnership, corporation, and LLC. I hope it got you thinking about what questions you need to answer so that you make an informed decision.

About the Author

Lauren Bakken, CPA is the founder and President of Bakken CPA PC and LegUp Accounting. She is an experienced accounting professional who provides her clients with expertise and insights, addressing their accounting and tax planning needs, while focusing on client education. Bakken CPA stands for small business access to big business accounting. Lauren believes in taking a proactive approach to accounting and tax savings. Lauren has saved her clients hundreds of thousands of dollars through tax planning and representation. She is a member of the AICPA, and the Massachusetts Society of CPAs.

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