

SELECTING A LEGAL STRUCTURE

for your firm

One of the first decisions that you will have to make as a business owner is how the company should be structured. Consult an attorney, an accountant and/or a financial advisor to help you select the form of ownership that is right for you. Take into account the following:

1. The size and nature of your business.
2. The level of control you want.
3. The level of complexity of "structure" with which you are willing to deal.
4. The business's vulnerability to lawsuits.
5. Tax implications of each ownership structure.
6. Expected profit or loss of the business.
7. Whether you need to re-invest earnings into the business.
8. Your need for cash out of the business.

Sole Proprietorships:

Generally small businesses start out as sole proprietorships, firms owned by one person (in some cases a married couple). Typically the sole proprietor is the individual who has day-to-day responsibility for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume sole responsibility for any of its liabilities or debts. In the eyes of the law and the public, you are one in the same with the business.

Advantages of a Sole Proprietorship

- Easiest and least expensive form of ownership to organize.
- Sole proprietors have complete control and decisions as they see fit.
- Sole proprietors receive all income generated by the business to keep or reinvest.
- Profits from the business flow-through directly to the owner's personal tax return.
- The business is easy to dissolve, if desired.

Disadvantages of a Sole Proprietorship

- Sole proprietors have unlimited liability and are legally responsible for all debts against the business. Both their business and personal assets are at risk.
- The proprietor may be at a disadvantage in raising funds and is often limited to using funds from personal savings or consumer loans.

- Sole proprietors may have a hard time attracting high-caliber employees, or those that are motivated by the opportunity to own a part of the business.
- Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income).

Federal Tax Forms for Sole Proprietorship

(only a partial list and some may not apply)

- Form 1040: Individual Income Tax Return.
- Schedule C: Profit or Loss from Business (or Schedule C-EZ).
- Schedule SE: Self-Employment Tax.
- Form 1040-ES: Estimated Tax for Individuals.
- Form 4562: Depreciation and Amortization.
- Form 8829: Expenses for Business Use of your Home.
- Employment Tax Forms.

Partnerships:

In a partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, or what steps will be taken to dissolve the partnership when needed. Yes, it's hard to think about a "break-up" when the business is just getting started, but many partnerships split up at crisis times and unless there is a defined process, there will be even greater problems. They also must decide up front how much time and capital each will contribute, etc.

Advantages of a Partnership

- Partnerships are relatively easy to establish. Be sure to develop a partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits flow directly through to the partners' personal tax returns.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

Disadvantages of a Partnership

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

Types of Partnerships

1. General Partnership

Partners divide responsibility for management and liability, as well as the shares of profit or loss according to their internal agreement. Equal shares are assumed unless there is a written agreement that states differently.

2. Limited Partnership and Partnership with Limited Liability

"Limited" means that most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions, which generally encourages investors for short term projects, or for investing in capital assets. This form of ownership is not often used for operating retail or service businesses. Forming a limited partnership is more complex and formal than that of a general partnership.

3. Joint Venture

Acts like a general partnership, but is clearly for a limited period of time or a single project. If the partners in a joint venture repeat the activity, they will be recognized as an ongoing partnership and will have to file as such, and distribute accumulated partnership assets upon dissolution of the entity.

Federal Tax Forms for Partnerships

(only a partial list and some may not apply)

- Form 1065: Partnership Return of Income.
- Form 1065 K-1: Partners' Share of Income, Credit, Deductions.
- Form 4562: Depreciation.
- Form 1040: Individual Income Tax Return.
- Schedule E: Supplemental Income and Loss.
- Schedule SE: Self-Employment Tax.
- Form 1040-ES: Estimated Tax for Individuals.
- Employment Tax Forms.

"C" Corporations:

A corporation, chartered by the state in which it is headquartered, is considered by law to be a unique entity,

separate and apart from those who own it. A corporation can be taxed; it can be sued; it can enter into contractual agreements. The owners of a corporation are its shareholders. The shareholders elect a board of directors to oversee the major policies and decisions. The corporation has a life of its own and does not dissolve when ownership changes.

Advantages of a Corporation

- Shareholders have limited liability for the corporation's debts or judgments against the corporation.
- Generally, shareholders can only be held accountable for their investment in stock of the company. (Note, however, that officers can be held personally liable for their actions, such as the failure to withhold and pay employment taxes.)
- Corporations can raise additional funds through the sale of stock.
- A corporation may deduct the cost of benefits it provides to officers and employees.
- Can elect "S" corporation status if certain requirements are met. This election enables company to be taxed similar to a partnership.

Disadvantages of a Corporation

- The process of incorporation requires more time and money than other forms of organization.
- Corporations are monitored by federal, state and some local agencies, and as a result may have more paperwork to comply with regulations.
- Incorporating may result in higher overall taxes. Dividends paid to shareholders are not deductible from business income, thus this income can be taxed twice.

Federal Tax Forms for Regular or "C" Corporations

(only a partial list and some may not apply)

- Corporation Income Tax Return (Form 1120 or 1120-A).
- Estimated Tax for Corporation (Form 1120-W).
- Deposit Coupon (Form 8109-B).
- Depreciation (Form 4625).
- Employment Tax Forms.
- Other forms as needed for capital gains, sale of assets, alternative minimum tax, etc.

Subchapter "S" Corporations-(A tax election only).

This election enables the shareholder to treat the earnings and profits as distributions, and pass through directly to their personal tax return. The shareholder, if working for the company, and if there is a profit, must pay themselves wages. The salary must meet standards of "reasonable

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compensation". This can vary by geographical region as well as occupation. The basic rule is to pay yourself what you would have to pay someone to do your job, as long as there is enough profit. If you do not do this, the IRS can reclassify all of the earnings and profit as wages, and you will be liable for all of the payroll taxes on the total amount.

Federal Tax Forms for Subchapter S Corporations

(only a partial list and some may not apply)

- Income Tax Return for S Corporation (Form 1120S).
- Shareholder's Share of Income, Credit, Deductions (1120S K-1).
- Depreciation (Form 4625).
- Employment Tax Forms.
- Individual Income Tax Return (Form 1040).
- Supplemental Income and Loss (Schedule E).
- Self-Employment Tax (Schedule SE).
- Estimated Tax for Individuals (Form 1040-ES).
- Other forms as needed for capital gains, sale of assets, alternative minimum tax and others.

LIMITED LIABILITY COMPANY (LLC)

The LLC is a relatively new type of hybrid business structure that is now permissible in most states. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership.

The owners are members; and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration. LLCs must not have more than two of the four characteristics that define corporations: limited liability to the extent of assets; continuity of life; centralization of management; and free transferability of ownership interests.

Federal Tax Forms for LLC

Taxed as a partnership in most cases; corporation forms must be used if there are more than two of the four corporate characteristics, as described above.

Both North Dakota and Minnesota first recognized the LLC form in 1994. Subsequently, almost all of the 50 states have passed legislation recognizing it; but due to its recent creation, it has limited experience and case law history.

Consult an attorney who is familiar with LLC law when considering formation of this type of organization.