Choosing a Business Structure

Of all the choices you make when starting a business, one of the most important is the type of legal organization you select for your company. This decision can affect how much you pay in taxes, the amount of paperwork your business is required to do, the personal liability you face and your ability to borrow money. Business formation is controlled by the law of the state where your business is organized.

This fact sheet provides a quick look at the differences between the most common forms of business entities.

The most common forms of businesses are:

- Sole Proprietorships
- Partnerships
- Corporations
- Limited Liability Companies (LLC)

While state law controls the formation of your business, federal tax law controls how your business is taxed. Federal tax law recognizes an additional business form, the Subchapter S Corporation.

All businesses must file an annual return. The form you use depends on how your business is organized. Sole proprietorships and corporations file an income tax return. Partnerships and S Corporations file an information return. For an LLC with at least two members, except for some businesses that are automatically classified as a corporation, it can choose to be classified for tax purposes as either a corporation or a partnership. A business with a single member can choose to be classified as either a corporation or disregarded as an entity separate from its owner, that is, a "disregarded entity." As a disregarded entity the LLC will not file a separate return instead all the income or loss is reported by the single member/owner on its annual return.

The answer to the question "What structure makes the most sense?" depends on the individual circumstances of each business owner.

The type of business entity you choose will depend on:

- Liability
- Taxation
- Recordkeeping

Sole Proprietorship

A sole proprietorship is the most common form of business organization. It's easy to form and offers complete control to the owner. It is any unincorporated business owned entirely by one individual. In general, the owner is also personally liable for all financial obligations and debts of the business. (State law may also govern this area depending on the state.)

Sole proprietors can operate any kind of business. It must be a business, not an investment or hobby. It can be full-time or part-time work. This includes operating a:

- Shop or retail trade business
- Large company with employees
- Home based business
- One person consulting firm

Every sole proprietor is required to keep sufficient records to comply with federal tax requirements regarding business records.

Generally, sole proprietors file Schedule C or C-EZ, Profit or Loss from Business, with their Form 1040. Sole proprietor farmers file Schedule F, Profit or Loss from Farming. Your net business income or loss is combined with your other income and deductions and taxed at individual rates on your personal tax return.

Sole proprietors must also pay self-employment tax on the net income reported on Schedule C or Schedule F. You may also be able to deduct one-half of SE tax on your 1040. Use Schedule SE, Self-Employment Tax, to compute this tax.

Sole proprietors do not have taxes withheld from their business income so you will generally need to make quarterly estimated tax payments if you expect to make a profit. These estimated payments include both income tax and self-employment taxes for Social Security and Medicare.

Partnership

A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business.

A partnership does not pay any income tax at the partnership level. Partnerships file Form 1065, U.S. Return of Partnership Income, to report income and expenses. This is an information return. The partnership passes the information to the individual partners on Schedule K-1, Partner's Share of Income, Credits, and Deductions. Partnerships are often referred to as pass-through or flow-through entities for this reason.

Each partner reports his share of the partnership net profit or loss on his personal Form 1040 tax return. Partners must report their share of partnership income even if a distribution is not made.

Partners are not employees of the partnership and so taxes are not withheld from any distributions. Like sole proprietors, partners generally need to make quarterly estimated tax payments if they expect to make a profit.

General partners must pay self-employment tax on their net earnings from self employment assigned to them from the partnership. Net earnings from self- employment include an individual's share, distributed or not, of income or loss from any trade or business carried on by a partnership.

Limited partners are subject to self-employment tax only on guaranteed payments, such as professional fees for services rendered.

Corporation

A corporate structure is more complex than other business structures. It requires complying with more regulations and tax requirements. It may require more tax preparation services than the sole proprietorship or the partnership.

Corporations are formed under the laws of each state and are subject to corporate income tax at the federal and generally at the state level. In addition, any earnings distributed to shareholders in the form of dividends are taxed at individual tax rates on their personal tax returns.

The corporation is an entity that handles the responsibilities of the business. Like a person, the corporation can be taxed and can be held legally liable for its actions. If you organize your business as a corporation, you are generally not personally liable for the debts of the corporation. (Exceptions my exist under state law.)

When you form a corporation, you create a separate tax-paying entity. Unlike sole proprietors and partnerships, income earned by a corporation is taxed at the corporate level using corporate tax rates. Regular corporations are called C corporations because Subchapter C of Chapter 1 of the Internal Revenue Code is where you find general tax rules affecting corporations and their shareholders.

A corporation files Form 1120 or 1120-A, U.S. Corporation Income Tax Return. If a shareholder is an employee, he pays income tax on his wages, and the corporation and the employee each pay one half of the social security and Medicare taxes and the corporation can deduct its half. A corporate shareholder pays only income tax for any dividends received, which may be subject to a dividends-received deduction.

Subchapter S Corporation

The Subchapter S corporation is a variation of the standard corporation. The S corporation allows income or losses to be passed through to individual tax returns, similar to a partnership. The rules for Subchapter S corporations are found in Subchapter S of Chapter 1 of the Internal Revenue Code.

An S corporation has the same corporate structure as a standard corporation. It is a legal entity, chartered under state law, and is separate from its shareholders and officers. There is generally limited liability for corporate shareholders. The difference is that the corporation files an election on Form 2553, Election by a Small Business Corporation, to be treated differently for federal tax purposes.

Generally, an S corporation is exempt from federal income tax other than tax on certain capital gains and passive income. It is treated in the same way as a partnership, in that generally taxes are not paid at the corporate level.

An S corporation files Form 1120S, U.S. Corporation Income Tax Return for an S Corporation. The income flows through to be reported on the shareholders' individual returns. Schedule K-1, Shareholder's Share of Income, Credits and Deductions, is completed with Form 1120S for each shareholder. The Schedule K-1 tells shareholders their allocable share of corporate income and deductions. Shareholders must pay tax on their share of corporate income, regardless of whether it is actually distributed.

Limited Liability Company

A Limited Liability Company (LLC) is a relatively new business structure allowed by state statute.

LLCs are popular because, similar to a corporation, owners generally have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation.

Owners of an LLC are called members. Since most states do not restrict ownership, members may include individuals, corporations, other LLCs and foreign entities. Most states also permit "single member" LLCs, those having only one owner.

A few types of businesses generally cannot be LLCs, such as banks and insurance companies. Check your state's requirements and the federal tax regulations for further information. There are special rules for foreign LLCs.

For additional information on the kinds of tax returns to file, how to handle employment taxes and possible pitfalls, refer to Publication 3402, Tax Issues for Limited Liability Companies.

Which structure best suits your business?

One form is not necessarily better than any other. Each business owner must asses his or her own needs. It may be important to seek advice from business experts and professionals when considering the advantages and disadvantages of a business entity.