How do I determine the best legal structure for my business entity, what are the pro's and con's, tax liability implications, costs both short and long term and how is it accomplished?

Selecting a business structure is one of the most important decisions business owners make. It affects safety of personal assets, taxation and smooth continuation of the business upon ownership change.

Many businesses start out as sole proprietorships or partnerships. Both of these structures provide management flexibility. The primary risk to sole proprietors or partners, however, is personal liability for company debts and judgments. To avoid these risks, businesses may opt to incorporate or form a limited liability company (LLC) to protect their families and financial interests. Here are the five most critical items to consider when selecting or re-selecting your business structure.

- Protection of personal assets-Sole proprietors and partners have unlimited personal liability for business debt or law suits against their company. Creditors can attach homes, cars, savings or other personal assets. Incorporating or forming an LLC separates personal identity from business identity. Corporation shareholders or LLC members have only the money they put into the company to lose.

- Pass-Through Taxation-For sole proprietors and partners, company profits/losses pass directly through to their personal tax returns. For corporations, profits are taxed, then the profits that are distributed to shareholders as dividends are taxed again on the personal level. This "double taxation" can be avoided while still enjoying the benefits of personal asset protection by forming an LLC or by electing an S Corporation. S Corporations and LLCs are taxed just like partnerships.

- Tax Deductible Employee Benefits-Incorporating or forming an LLC usually provides tax-deductible benefits for you and your employees, an advantage that sole proprietors and partners do not enjoy. Even if you are the only shareholder or employee of your business, benefits such as health insurance, life insurance, travel and entertainment expenses may now be deductible. Best of all, corporations and LLCs usually provide an increased tax shelter for qualified pensions or retirement plans (e.g. 401Ks).

- Uninterrupted business-Sole proprietorships and partnerships may automatically end or become legally entangled when one owner dies or retires. Corporations and LLCs are enduring legal business structures. They may continue regardless of individual officers, managers or shareholders. Corporation ownership may be transferred, without substantially disrupting operations, through sale of stock.

- Access to Capital-Sole proprietorships and partnerships may find investors hard to attract because of personal liability. Investors are more likely to purchase shares in a corporation where there is a separation between personal and business assets.

Both S Corporations and LLC's allow owners to avoid "double taxation" and to pay income taxes on a flow-through basis like sole proprietors and partners. However, LLC's are quickly becoming a preferred entity among small business. Here are some key examples of the benefits of an LLC verses an S Corporation:

- An LLC is simpler and faster to form. It may be formed in one step, while an S Corporation election can only be made after a General Corporation is formed first.

- An LLC is not required to hold annual meetings or to keep formal minutes, while an S Corporation is required to do so.

- LLC members can split profits/losses in any way they choose. In an S corporation, shareholders must receive dividends according to the number of shares that they own, regardless of the amount of effort put into the business.

- An LLC can be owned by any combination of individuals or business entities. Only United States citizens and resident aliens may own an S Corporation. Other entities generally may not own an S Corporation.

While many business owners are enjoying the simplicity and flexibility of the LLC, it may not be the best choice in every case:

- Enticing or compensating employees with stock options or stock bonuses requires forming a corporation since LLC's do not issue stock.

- S Corporation shareholders pay Medicare and Social Security tax only on money received as wages or salary, but not on profits received as dividends or that stay within the company. Under certain conditions, LLC members may need to pay Social Security and Medicare taxes on the entire amount of LLC profits. In particular, LLC's that provide professional services such as health, law or engineering should consult a tax advisor on this issue.

While it is possible to go on-line with the Indiana Secretary of State's office, fill out a form and become incorporated and you can subsequently contact the IRS and elect to be an S Corporation, it is usually desirable to work with an attorney to either incorporate or setup and LLC.

The initial costs of incorporation are less than that of an LLC but, over time, the lower costs of quarterly and annual reporting, required for a corporation, will offset the additional up-front costs of the LLC. You should expect to pay a lawyer between $250 and $1000 for a simple incorporation or LLC setup.

Alternatively, you may want to engage the services of a business which specializes in helping others incorporate or form an LLC such as, The Company Corporation, www.incorporate.com, a resource partner with SCORE.

If you are starting a very small business and are strapped for cash, you may want to stick with a sole proprietorship as long as you have liability and worker's compensation insurance.

Sources for this information include Brett Davis and Karen J. Lange both of The Company Corporation in separate writings, "The Importance of Business Structure" and "Choosing Between an S Corporation and a Limited Liability Company". Additional information is available from your SCORE Counselor and www.SCORE.org, search "business structure" or at www.incorporate.com. .