10.0 COMPARISON OF MAJOR BUSINESS STRUCTURES

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10.1 Introduction and Summary

One of the first steps on forming a new business entity is to define its legal structure, which establishes the legal treatment of the entity and the rights of owners or stakeholders in it.

There are four primary concerns that need to be considered in establishing the legal structure of your company: 1) the number and type of owners or stakeholders (also termed principals;) 2) the major risks to which the business is exposed and the financial obligations that could result from these risks; 3) the extent to which the owners must be protected against such obligations and 4) the tax obligations of the entity and the stakeholders.

The following paragraphs consider these points. It is recommended that a final determination be made only after a thorough legal review by an attorney experienced in this area.

10.2 Summary Comparison of Organizational Structure

In making a decision on the best structure, it is necessary to weigh the considerations shown above against the benefits and shortcomings of at least the five possibilities shown in Table 10.1 on the last page. The structures are Sole Proprietorship, Partnership, C Corporation, Subchapter S Corporation or Personal Service Corporation (both representing a particular tax treatment of a C Corp,) and a Limited Liability Company. There are other options too, but they represent variations on the themes described here. Reaching the best decision should include the specific treatment of each structure pursuant to State law and the costs of implementing each. Costs of filing and establishing each legal form can be considerable, and once the form has been established, changing it can be difficult and expensive.

10.3 The Simplest Form, the Sole Proprietorship

Other than obtaining a business license and perhaps registering a fictitious business name, forming a sole proprietorship takes little effort . . . it is by far the easiest form to implement. By its very name it implies its basic limitation; it can have only one owner, although in most states the spouse is considered co-owner. Taxes on profits earned by the sole proprietorship flow directly to the owner and are reported each year on Schedule C of IRS Form 1040.

10.4 Partnerships

Partnerships fall into two categories, general and limited. General partnerships do not offer limited liability for any partner. Limited partnerships have limited liability for the limited partners but not for the general partner (the controlling or operating partner or partners). Lack of limited liability for all partners and owners is a major disadvantage of partnerships, and limited partners have no vote or say in how the business is run.

Here are five key characteristics of partnerships[1]:

1. A partnership is a business owned by two or more people.

2. Each partner can perform all acts that are necessary to operate the business, including hiring employees and spending or borrowing money, subject to established limitations. Each partner is personally liable for all debts incurred by the business. This is one vital reason why your partners must be trustworthy. If a creditor has a claim against your partnership and the partnership assets are insufficient to satisfy that claim, the personal assets of any partner can be taken to pay the business debts.

3. Partners share in profits or losses, in whatever proportion they've agreed on. Partnerships themselves don't pay taxes (although they do file an annual tax form). The partners report their share of (partnership) profits or losses on the appropriate form in their individual tax returns, as part of their regular income.

4. Partnerships begin when two or more people form a business. Although technically a partnership ends if one partner leaves, you can agree at the beginning that the partnership business will continue, to be run by the remaining partners, if there are any. If you want the business to continue if a partner leaves -- and almost all partnerships work this way -- you'll need to work out what will happen to the interest of the departing partner. Who can, or must, buy that interest? How will you determine a fair price for that interest?

5. The owners should have a written and executed partnership agreement specifying each partner’s role, rights, responsibilities and authorities. The purpose of this document is to record all major issues that the partners can anticipate before starting the business relationship, including at least the sharing of the financial obligations and benefits, management of the business, and buy-out provisions in case a partner leaves, dies or otherwise wants to terminate the relationship. This agreement does not have to be filed with any government agency and no official approval is required to start the partnership, but it will serve to eliminate a lot of potential costly and time-consuming disagreements after the business is up and running.

10.5 Incorporating

Incorporating is one of the best ways a business owner has to protect his or her personal assets. Most people choose to incorporate solely for this reason, but there are other advantages as well. For example, the corporate structure allows you to more easily raise money from investors and gives you the choice of offering equity incentives for employees.

[1] **Extracted from www.nolo.com**

Once the decision to incorporate your business has been made, the legal process begins with the preparation of a certificate of incorporation. Only a single legally qualified individual is needed to prepare the certificate. The incorporator does not necessarily have to be a shareholder.

Incorporation documents will require the names and address of incorporators; the corporate name, purpose and corporate life span; location of the registered corporate office in the state; the maximum amount and type of capital stock to be issued at the time of incorporation; a provision for preemptive rights; a provision for regulation of internal affairs of the corporation; names and addresses of corporate directors who will serve until the first shareholders' meeting; and the right to amend or repeal provisions within the certificate of incorporation.

It is a good practice to use a "specific object" clause that spells out the specific purpose for which the corporation is being formed. While most corporations are formed for an indefinite period, it is possible to set up a limited life. Often the reason for creating a corporation is because the life span of the business is considered unlimited.

10.6 Corporate Entities and Taxation

There are several legal forms of incorporation, which vary in the treatment of the rights of shareholders and tax liability. These generally fall within the three Corporate Classifications C, Sub S and PSC (Personal Service Corporation.) There are no C, S and PSC distinctions employed in the legal formation of a business entity; the designations have nothing to do with legal structure provided by the act of incorporation. Instead, these designations simply refer to treatment under federal tax laws. Federal tax law defines the difference in how the three types of corporations are structured, affecting tax and stock/shareholder issues. Otherwise C, PSC and S corporations are identical. *All corporations are automatically a C type under Federal tax law unless a special S election is filed or PSC treatment is selected with the IRS. The tax and stock/shareholder issues are explained below.*

C Corporations - The major advantages of incorporating are limited liability, the efficiency of treating a large number of shareholders, and the ease and legality of buying and selling ownership. Owners of the corporation may receive all legal employee benefits, which are tax deductible to the corporation. The stock of a C corporation can be owned by other business entities as well as by individuals. A serious disadvantage of a C Corp is that all profits are taxed at the corporate level, and dividends or profits distributed to the shareholders are in turn taxable to them, resulting in *double taxation* of profits. Other disadvantages are the required annual reporting to the state, annual formalities such as shareholder and directors' meetings, lack of privacy, franchise taxes at the state level, and potential capital gains tax obligations, discussed below.

PSC Corporations - The letters "PSC" stand for personal service corporations. This type of structure is nearly identical to a C corporation, but with its own special tax rate. It was created for professionals and individuals whose business activity involves the sale of personal services, i.e. those performed in the health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting fields as opposed to the sale of products or other services. One would elect this type of structure with the State, and then select the *Personal Services Corporation* category on the standard IRS form 1120 corporate tax return. The PSC classification is often used by professionals to achieve tax deductible employee benefits for one or more professionals offering personal services.

The applicability and usage of the PSC classification is complicated, and should only be undertaken with the guidance of a professional tax counselor.

Sub S Corporations - With this form, the double taxation problem of the C structure is eliminated, with taxes on profits paid only at the shareholder level. For tax purposes the Sub S is referred to as a "pass-through" entity, meaning that tax liabilities pass to the shareholders. There is a limit to the number of shareholders and they generally must be individuals, i.e. shares cannot be held by other corporations or by partnerships or LLCs. Trusts may hold Sub S shares but only under special provisions. Major advantages are the pass-through tax status, the ease of buying and selling stock, and the limited liability of the members. Sub S corporations can have deductible employee stock ownership plans (ESOPs) and employee pension plans for both owners and non-owner employees. However, many other employee benefits given to the owners of the S corporation are not deductible to the corporation, so they are taxable to the shareholders. Other disadvantages include the required annual reporting to the state and the formalities such as shareholder and directors' meetings, lack of privacy, franchise taxes at the state level and potential capital gains tax problems (discussed below.)

For S Corporation status, your corporation must meet these requirements.

1. All shareholders must be citizens or permanent residents of the United States.
2. The maximum number of shareholders is 35.
3. The S Corporation cannot own foreign corporations.
4. Only one class of stock may be issued.
5. No more than 25% of the gross corporate income may be derived from passive income.
6. State laws vary and can impose additional restrictions on S Corporation Status.

To elect Subchapter S status for your business, you will need to complete Federal Form 2553 and, in some states, file a separate state election form. See additional guidelines at http://www.sba.gov/library/pubs/mp-25.txt and the California State web site, http://www.ss.ca.gov/business/filings.htm.

Limited Liability Companies (LLC) - This entity, which first appeared in Wyoming in 1977, combines the limited liability feature of corporations with most of the characteristics and advantages of partnerships. An LLC can have partnership tax classification when there are at least two members, rendering it a pass-through entity for tax purposes.

It is important to note that the tax treatment of an LLC offers advantages over that of an S corporation, since the LLC can allocate income, deductions and losses to the owners in any proportion. Unlike with the S structure, any person or legal entity can own shares (called units) in an LLC, there can be any number of shareholders (called members), all members can vote (unlike limited partners) and there is limited liability for everyone connected with the LLC (unlike partnerships). LLC's can have deductible employee pension plans for both owners and non-owner employees, although many other owner-employee benefits are not tax deductible to the LLC. LLCs require annual reporting to the state where they are created, but no annual shareholder or directors' meetings are required, and other formalities of corporations have been eliminated. Many states do not charge a franchise tax but they all charge some annual registration fee.

This is an excellent entity choice for a very wide variety of small business situations, and should be given serious consideration.

See also http://www.ftb.ca.gov/forms/misc/3556.html#1 and http://www.irs.gov/businesses/small/article/0,,id=98827,00.html.

10.7 *Which Business Structure Should You Use?*

The above is meant only to provide basic considerations important in making an appropriate decision on forming a legal business structure. Arriving at the best decision should involve the expertise of a tax professional who can best evaluate the specifics of your situation. Recent changes in tax laws will need to be factored in, as well.

Sources: *State of California*
American Business Solutions, Inc.
San Diego Chapter of SCORE
http://taxguide.completetax.com/text/Q10_2023.asp et seq
http://www.nolo.com
http://www.nysscpa.org/cpajournal/old/10428238.htm
http://www.1120accountant.com/personal-service-corporations.htm

See also *Overview of Organizational Structure* on next page.

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Table 10.1 Overview of Organizational Structure

	Sole Proprietorship	**Partnership**	**Regular C Corporation**	**S Corporation**	**Limited Liability Company**
Number of Owners	1	No Limit	No Limit	75	No Limit
Owner Types	Individual	No Limit	No Limit	Individuals and certain trusts; No non-resident aliens	No Limit
Legal Liability of Owners	Unlimited	Unlimited for general partners; Limited for limited partners	Limited	Limited	Limited
Continuity of Entity	Limited to life of proprietor	Limited unless provided for in partnership agreement	Unlimited	Unlimited	Unlimited
Transfer of Interest	Only by Sale of Assets	Difficult unless provided for in partnership agreement	Readily accomplished through stock transfer	Readily accomplished through stock transfer	Readily accomplished through membership transfer
Management	Owner has absolute control	In absence of agreement, all partners have equal voice; limited partners – very limited voice	Shareholders elect directors who set policy; officers manage day to day operations.	Shareholders elect directors who set policy; officers manage day to day operations.	Governed by the operating agreement
Acquisition of Capital	Limited to what proprietor can invest	Limited to what partners can invest.	Acquired by issuing stock or bonds to shareholders	Acquired by issuing stock	Shared by members; acquired by issuing membership interest to members.
Tax Year	Calendar Year	Generally Calendar Year	Any year (Limits on personal service corp.)	Generally Calendar Year	Generally Calendar Year
Tax Filing Required	Schedule C with Form 1040	Form 1065 to IRS; Schedule K-1s to partners	Form 1120	Form 1120S; K-1s to shareholders	Depends on classification of LLC; usually K-1
Taxation of Income	Directly to owner	Directly to partners in proportions agreed upon by partners	Taxed at corporate level and again at shareholder level when distributed (usually as dividends)	Taxed directly to shareholders like partnership (no double taxation)	Generally taxed as a partnership (though classification may result in corporate taxation)
Employee Benefits	Employees' deductible; Proprietor's subject to limits	Employees' deductible; Partners' subject to limits	Deductible but cannot discriminate	Included in shareholders' income when > 2% of shares are held	Employees' deductible; Members' subject to limits
Major Advantage(s)	Independence, flexibility, minimum red tape	Chance of business success enhanced with right combination of partners	Limited liability; potential tax benefits, ease of interest transferability	Limited liability; lower self-employment tax, ease of interest transferability	Limited liability; lower self-employment tax, ease of interest transferability
Major Drawback(s)	Unlimited liability, a problem if business has financial difficulties	Unlimited liability (except for limited partners); frequent changes in partners can be difficult	Greater cost, government regulations and red tape; double taxation of income	Not every corporation qualifies for S status; more limits on fringe benefits, other limitations, see details in §10.3, above.	Inconsistent state tax treatment; subject to CA fee on gross receipts