CHOOSING THE RIGHT BUSINESS STRUCTURE

"One type of business structure is not necessarily better than another, therefore, it is important to evaluate your needs now and into the future, and consider the advantages and disadvantages of each type of structure."

Mother Lode Bookkeeping, Inc.

Choosing the Right Business Structure

When starting a business one of the most important decisions facing you is what type of business structure to choose for your company. The decision can have many implications including how much you pay in taxes, the degree of personal liability you are exposed to, the ability to borrow money and raise capital, and the amount of paperwork required. The formation of your business is controlled by the state in which your business is organized and some business formation laws vary from state to state, so it is important to check with the state your business will be organized under for their specific laws and regulations. Also, the state will tax these structures differently, so make sure you check out the tax laws in the state(s) you plan to operate in.

"The formation of your business is controlled by the state in which your business is organized and some business formation laws vary from state to state, so it is important to check with the state your business will be organized under for their specific laws and regulations."

The most common types of business structures include:

Sole Proprietorships
Partnerships
Corporations
S-Corporations
Limited Liability Companies

Below we will look at each of these structures and discuss some of their advantages and disadvantages. In some cases, depending upon how many "owners" are involved with the business, your choice of structure will be limited. I have also included some information on how the State of California handles each of these structures from a tax perspective.

SOLE PROPRIETORSHIP

Advantages

- Easy and inexpensive to set up and organize
- Profits and losses flow directly to the owner's personal tax return
- Complete control by owner
- Easy to dissolve

Disadvantages

- Owners have unlimited liability
- Personal assets are at risk
- Some employee benefits to the owner are not directly deductable
- May be at a disadvantage raising funds

Sole Proprietorship (One Owner)

This is the most common form of business organization as it is easy to form and offers complete control to the owner; however, a sole proprietorship can only be owned by one owner. As it is an unincorporated business, the owner is personally liable for all debts and obligations of the business. The profits or losses of the business pass through directly to the owner and are combined with their other income and deductions and taxed at the owner's individual tax rate.

The business portion is filed on Form Schedule C (or C-EZ) of the individual's 1040 tax return. Any profits generated by the business are subject to self employment taxes and are filed on Schedule SE of the owner's 1040 return. However, the owner is able to deduct one-half of the self employment taxes.

In a sole proprietorship the owner does not take a wage but takes "draws" as reimbursement, therefore, a sole proprietorship will typically have to make estimated tax payments throughout the year.

California: Generally there is nothing special that needs to be done when filing a return with a sole proprietorship business included. The income or loss generated from the business will be added to the individuals 540 tax return as part of the total income from the federal form 1040.

PARTNERSHIP

Advantages

- Profits and losses flow directly to the partner's personal tax return
- Relatively easy to establish
- With more than one owner funds may be easier to raise
- Business can benefit with partners with complementary skills

Disadvantages

- Partners are individually and jointly liable for their and other partner's actions
- Decisions may need to be shared causing disagreements
- Profits are shared
- Some employee benefits to the partners are not directly deductable
- May have a limited life if a partner withdraws

Partnership (Two or More Owners)

Partnerships are relationships between two or more persons who join together to carry on a business. Each person contributes money, property, labor, or skill with the expectation of sharing in the profits. Like a sole proprietorship the partners are individually and jointly liable for the debts and obligations of the business.

As partnerships are not taxed directly, the partnership files an information return on Form 1065. The profits and losses of the partnership are passed through to each partner in their ownership proportion via the partnership's Schedule K-1 and reported on the individual's 1040 tax return on Schedule E. Their portion of the profits or losses from the business pass through directly to the partner and are combined with their other income and deductions and taxed at the partner's individual tax rate.

Note: Even if there is no distribution to a partner, the partner still must pay income and self employment tax on his portion of the profit generated by the partnership.

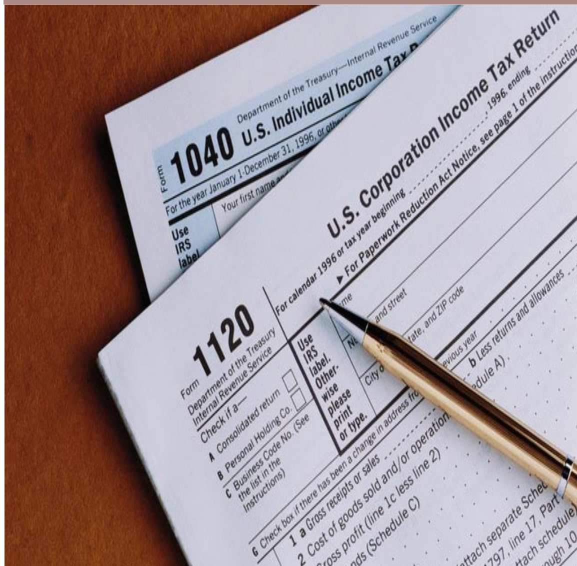
Any profits generated by the business are subject to self employment taxes (excluding non-guaranteed wage to a limited partner) and are filed on Schedule SE of the partner's 1040 return. However, like the sole proprietorship the partner is able to deduct one-half of the self employment taxes.

Partners are not employees and thus do not take a typical wage (although a "guaranteed wage" for a contributing partner can be made to offset that partners contribution to the operation of the partnership) so estimated taxes for the partners may need to be made if they expect a profit.

"Partners are not employees and thus do not take a typical wage (although a "guaranteed wage" for a contributing partner can be made to offset that partners contribution to the operation of the partnership) so estimated taxes for the partners may need to be made if they expect a profit."

There are three types of partnerships that can be formed: General Partnership, Limited Partnership, and Joint Venture. Make sure you check out which type may work best for your situation.

California: California requires that a partnership doing business in California file a form 565 (except LLCs taxed as partnerships file Form 568). There is no state tax on the partnership and the income or loss flows to individual's California Form 540 tax return as part of the total income from the federal form 1040. The CA K-1 will have any adjustments that need to be made to the California return.



CORPORATION

Advantages

- Shareholders have limited liability for the corporation's debt and obligations
- Can raise additional capital through the sale of stock
- Can have multiple classes of stock
- Can deduct the cost of benefits to its officers and employees
- Can have unlimited life
- Can elect S-Corp status if certain requirements are met

Disadvantages

- Incorporation requires more time and money
- May result in higher taxes (double taxation)
- Will have more complex reporting and paperwork requirements.

Corporation (One or More Owners)

A corporation (C Corporation) is formed under the laws of the state in which it is incorporated in and is considered to be a unique entity, separate from those who own it; therefore, its owners (shareholders) typically are not personally liable for the debts and obligations of the corporation. A corporation however, can be sued, taxed, and make contractual agreements. It in effect becomes an entity that handles the responsibilities of the business. Prospective shareholders contribute money and/or property for capital stock in the corporation.

Corporate profits are taxed in the year earned directly at the corporate level using corporate tax rates, and then is taxed to the shareholders when distributed as dividends. This creates a double tax, as the corporation does not get a deduction for the distributed dividends to its shareholders. A corporation files a Form 1120 (or 1120-A) to report it profit or losses.

Corporations have more complex regulations and tax filing requirements than some other business structures. In most states annual minutes are required to be produced as well as additional paperwork filed, thus the maintenance of a corporation is likely to cost more than other types of business structures.

If a shareholder is an employee, the shareholder will pay income tax on his wage and the corporation and employee each pay one half of the Social Security and Medicare taxes. A corporate shareholder only pays for any dividends received.

Because a corporation is taxed on its yearly profits it may have to pay estimated tax payments throughout the year in order to avoid late payment penalties and interest.

California: California has a tax of 8.84% on corporate net profits with a minimum tax of $800. The corporation must file form CA 100.

S CORPORATION

Advantages

- Shareholders have limited liability for the corporation's debt and obligations
- Profits and losses flow directly to the shareholder's personal tax return
- Some profits may be passed through without being subject to self employment taxes
- Can raise additional capital through the sale of stock
- Can have unlimited life

Disadvantages

- Incorporation requires more time and money
- Will have more complex reporting and paperwork requirements
- Must met certain requirements for S Corp status
- Distributions must be made in proportion of ownership
- Some employee benefits to greater than 2% shareholders must be reported as income to the shareholder
- Some benefits plans may not be allowed to greater than 2% shareholders.

S Corporation (One or More Owners)

An S Corporation is a variation of the standard corporation (C Corporation) listed above. It allows the income, losses, and credits of the corporation to be passed directly through to the individual shareholder's tax return, similar to a partnership, thus avoiding the double taxation issue of a regular C Corporation. It has the same structure as a standard corporation, and provides the same liability protection, **but must file the** Form 2553 "**Election by a Small Business Corporation" to be treated differently for federal tax purposes.**

In most cases an S Corporation is exempt from federal income tax, other than tax on certain capital gains and passive income. As an S Corporation generally has no federal tax due it files an Information Return Form 1120S to report its information to the IRS. The income, losses, and credits flow though to the individual shareholders per their percent of ownership via a Form K-1 and are taxed on the individual shareholder's 1040 tax return after being combined with their other income and deductions. Their portion of the S Corporation's income or loss is reported on the individual's Form 1040 Schedule E. **Note:** Even if there is no distribution to a shareholder, the shareholder still must pay income tax on his portion of the income generated by the corporation.

To qualify for S Corporation status the following conditions must be met:

- A domestic corporation
- Shareholders must only be individuals, certain trusts and estates
- Shareholders must **not** be partnerships, corporations, or non-resident aliens
- Have no more than 100 shareholders
- Have one class of stock
- **Not** be an ineligible corporation (i.e. certain financial intuitions, insurance companies, and domestic international sales corporations)

As with a C Corporation, if a shareholder is an employee, the shareholder will pay income tax on his wage and the corporation and employee each pay one half of the Social Security and Medicare taxes. However, because profits passed through to the individual shareholder from an S Corporation are not subject to self employment tax, the shareholder employee must take “reasonable compensation” as wage. If reasonable compensation is not taken the IRS can reclassify all of the earnings and profits as wages and the individual shareholder will be liable for all of the payroll taxes on the total amount. Also, distributions from the S Corporation must be made to the shareholder’s in proportion to their ownership.

California: California has a tax of 1.5% on S corporation net profits with a minimum tax of $800. The corporation must file form CA 100S. The income or loss from the S Corporation flows to individual’s California Form 540 tax return as part of the total income from the federal form 1040. The CA K-1 will have any adjustments that need to be made to the California return

S CORPORATION

Advantages

- Shareholders have limited liability for the corporation’s debt and obligations
- Profits and losses flow directly to the shareholder’s personal tax return
- Some profits may be passed through without being subject to self employment taxes
- Can raise additional capital through the sale of stock
- Can have unlimited life

Disadvantages

- Incorporation requires more time and money
- Will have more complex reporting and paperwork requirements
- Must met certain requirements for S Corp status
- Distributions must be made in proportion of ownership
- Some employee benefits to greater than 2% shareholders must be reported as income to the shareholder
- Some benefits plans may not be allowed to greater than 2% shareholders.

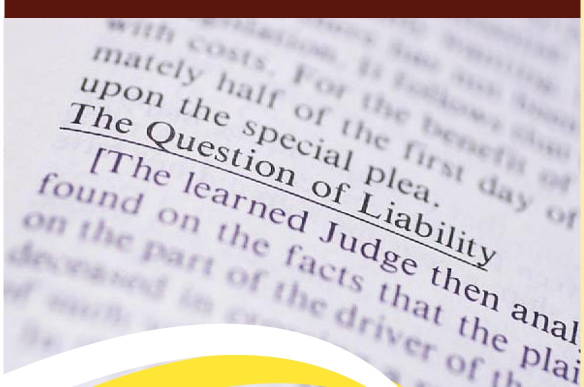
LIMITED LIABILITY COMPANY

Advantages

- Members have limited liability for the corporation's debt and obligations
- Can behave tax wise like any of the business structures based upon available election
- Will have less complex reporting and paperwork requirements than C or S corporations
- Depending upon the tax election, will inherit many of the advantages of that business structure

Disadvantages

- Incorporation requires more time and money
- Depending upon the tax election, will inherit many of the disadvantages of that business structure



Limited Liability Company (One or More Owners)

Limited Liability Companies (LLC) are popular because while they provide the limited personal liability protection of a corporation, they act more like a partnership providing pass-through taxation. They also typically have less reporting requirements than a C or S Corporation thus it's less expensive to administer an LLC than a corporation.

Owners of the LLCs are called Members and since most states do not restrict ownership, members may include individuals, corporations, other LLCs, and foreign entities. There is typically no maximum number of members, and in most states "Single Member" LLCs are permitted.

The federal government does not recognize an LLC as a tax classification; therefore, an LLC must file as a corporation (C or S), partnership, or sole proprietorship. By default, if the LLC has only one Member it will be considered as a "disregarded entity" and must file as a sole proprietorship. If the LLC has two or more members it will be considered by default a partnership and must file a partnership return. To change from the default classification to being taxed as a corporation, Form 8832 "Entity Classification Election" can be timely filed.

Once it is determined how the LLC will be taxed, then the proper rules and procedures should be followed as described for each of the specific types of business structures outlined above.

California: For LLCs taxed as partnerships or sole proprietorships they must file Form 568. The California LLC is taxed not upon its net profits but upon its gross sales based upon a tiered tax structure, with the minimum tax being $800. In California, if you are a high income, low margin results company, than a LLC may prove a disadvantage due to a high tax rate for a low (or no) profit. Also in California, professional service companies (i.e. companies where a license is required to do business) may not be allowed to form an LLC.

BOOKKEEPING
PAYROLL
TAX PREPARATION
BUSINESS SERVICES

Mother Lode Bookkeeping was established in 1978 in Encinitas California with the goal to provide cost effective, professional, and highly personalized service to individuals and business in San Diego's North County. Over those years Mother Lode Bookkeeping has helped thousands of clients achieve their goals by providing cost effective services in a personal, professional, and friendly manner.

simplifying your life

MOTHER LODE BOOKKEEPING, INC.

207 West D Street
Encinitas, CA 92024

760.436.9044 ph
760.942.2137 fax

www.mlbinc.com.