

FINDING THE RIGHT LEGAL FORM FOR YOUR BUSINESS

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Comparison of the Major Business Forms

	Limited Liability Company	Partnership	Regular Corporation	S Corporation	Sole Proprietorship
Legal Liability of Owners	Limited to invested capital	Unlimited for general partners Limited for limited partners	Limited to invested capital	Limited to invested capital	Unlimited to proprietor
Continuity of Entity	Varies: can affect tax status of the entity	Limited unless provided for in partnership	Unlimited	Unlimited	Limited to life of proprietor
Transfer of Interest	Varies: can affect tax status of the entity	Difficult: can have tax affect and required approval	Readily accomplished through stock transfer	Readily accomplished through stock transfer	Requires asset sale
Acquisition of Capital	Shared by members	Easier than sole proprietorship since shared by partners	Acquired by issuing stock or bonds	Acquired by issuing stock	Limited to what proprietor can secure
Tax Filing Required	Depends on classification of LLC	Form 1065; distributes K-1s to partners	Form 1120	Form 1120S; distributes K-1 s to shareholders	Schedule C with Form 1040
Taxation of Income	Generally taxed as a partnership (though classification may result in corporate taxation)	Directly to partners in proportions agreed upon by partners	Taxed once at corporate level <u>again</u> at shareholder level when distributed	Taxed directly to shareholders (no double taxation)	Directly to owner as income and subject to self employment tax
Administrative and Legal Costs	Similar to corporation	Medium	Highest	Highest	Lowest
Fringe Benefits	Depends on tax status	Generally not deductible for partners	Deductible subject to nondiscrimination rules	Generally not deductible for over 2% shareholders	Generally not deductible
Recommended Pension Plans	Depends on tax status	IRA, Keogh, SEP, SIMPLE	Qualified plans, 401K, SIMPLE	Qualified plans, 401K, SIMPLE,	IRA, Keogh, SEP, SIMPLE
Major Advantage(s)	Limited liability with partnership tax treatment; unlimited members; foreign owners permitted	Business entity default when multiple owners operate a business and fail to take other action	Limited liability shareholders only taxed on dividends received	Limited liability without double taxation of regular corporation	Independence, flexibility, minimum red tape
Disadvantages	Inconsistent state tax treatment	Unlimited liability; 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	Unlimited liability—a problem if business has financial difficulties

Your Business Form

If you are starting a new business you must decide which legal structure is best for you and your business. If you are already in business, you should periodically review your business form to see if it is still the best choice.

The form of business entity that you choose can make a difference in the taxes you pay, the costs of doing business, and the amount of paperwork and red tape you'll have. Here is some basic information to help you understand the differences in the various legal entities from which to choose.

Sole Proprietorship

A sole proprietorship is owned and operated by one individual. It is the least complicated and usually the least expensive way to set up and run a business. A sole proprietorship has no legal existence apart from its owner.

The owner controls the business, makes decisions without having to consult co-owners or partners, and is entitled to all of the profits (or losses).

The business income for a sole proprietorship is taxed to the owner via a Schedule C and subject to self-employment tax on Schedule SE both of which are attached to the individual's Form 1040. Income taxes are not withheld on business income, though quarterly estimated taxes may be required.

Payroll taxes apply to any employees of the business. The sole proprietor pays self-employment tax rather than social security tax (and gets a tax deduction of 50% of the tax paid). No social security tax needs to be paid on the owner's children under the age of 18 who work in the business.

A major disadvantage to the sole proprietorship form of operation is unlimited liability, not only for debts of the business but for lawsuits brought against the business as well. Liability extends to the proprietor's personal as well as business assets.

The ability to raise capital for the business is also limited to the amount the individual can secure personally. Since under-capitalization is a major cause of failure this factor can be significant.

Continuity of a sole proprietorship is limited. Since the individual is the business, the business enterprise may be crippled or terminated if the owner becomes ill or dies.

A sole proprietor can establish a retirement plan. Plan options include an IRA, a SEP, a SIMPLE, or a Keogh. Each type of plan has its own restrictions and requirements.

The deductibility of fringe benefits is very limited in a sole proprietorship. In fact, this area comes under close scrutiny by the IRS because of concern that personal expenditures might be deducted as business expenses.

Partnership

A partnership can have any number of partners. Partners bring to a business more creativity, skills, capital base, and experience than any one person is likely have.

Every partnership should have a written agreement (though there is no legal requirement to have one). The agreement should specify how the partnership will operate, how it will be financed, how responsibilities will be divided among the partners, how profits and losses will be shared, and what happens to the partnership if one partner withdraws, becomes disabled, or dies.

A partnership files an information tax return (Form 1065), but pays no income tax itself. The income or losses are passed through to the partners who report them on their individual tax returns in shares agreed upon by the partners – not necessarily equally. Partners, like sole proprietors, pay self-employment tax on net income rather than social security taxes on wages.

A major drawback to a partnership is that liability is unlimited. In fact, partners can be held liable for the actions of fellow partners.

Partners have similar options in the area of fringe benefits and retirement plans as those available to sole proprietors.

Limited Partnership. In a limited partnership, a general partner or partners run the business and are fully liable for partnership obligations. Limited partners do not participate in the business and are generally liable only to the extent of their investment.

Limited Liability Company

A relatively new business entity is the limited liability company (LLC). A properly structured LLC combines the general flexibility and income tax treatment of a partnership with the limited liability of a corporation. Like a corporation liability is limited to invested capital, with the added benefit of allowing foreign managers and or investors as members, while avoiding corporate income taxes.

Regular Corporation

A corporation, the most complex of the business structures, is a distinct legal entity apart from the shareholders who own it. Formed under the requirements of the state in which it will do business, a corporation limits its owners' liability to their investment in the company; personal assets are generally not at risk. However, a corporate form does not provide complete protection where personal services are involved.

Ownership interest in a corporation is easy to transfer via the sale or transfer of stock, and the corporation has relative stability and permanence.

If you set up a corporation and are employed by it, the corporation must withhold and pay payroll taxes on your wages along with those of any employees.

A corporation files its own tax return (Form 1120) and pays its own income tax. In the past corporate tax rates could be as high as 35% depending on income. This all changed with the "2017 Tax Cuts and Jobs Act." Beginning January 1, 2018, the tax rate for corporation's changes to a flat rate of 21% this coupled with the existing lower rates on "qualified dividends" means many businesses should take a new look at regular corporations.

Another benefit is income received by shareholders as dividends is only taxed to the shareholders when received by the shareholders.

S-Corporations A Sub Chapter S Corporation is a regular corporation that has filed an election with the IRS to be treated as a passthrough entity. It files it's tax return on Form 1120S, and shareholders receive a K1 reporting their share of the corporations earnings. It offers both limited liability to shareholders and passthrough of income and is not subject to tax at the corporate level. Except for the tax aspects it is just like a regular corporation.

Personal Services Business is a business that has employee-owners performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

The "2017 Tax Cuts and Jobs Act." (P.L. 115-97) Beginning January 1, 2018, Creates a deduction of as much as 20% of the Qualified Business Income for the owners, shareholders, and partners of qualified passthrough business including; Trusts, Sole Proprietorships, S-Corporations, and Partnerships. The deduction is taken on the personal tax returns of the owners, shareholders, partners and trust beneficiaries, and can effect each differently.

This deduction phases out for Personal Service Businesses owned by married taxpayers with gross income of more than \$315,000 and for all others when gross income exceeds \$157,000.

Warning the rules here are complex so be sure to consult your tax advisor.

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