



Self-Employment Technical Assistance, Resources and Training

Self-Employment Q & A: Selecting a Business Structure

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Selecting a business structure is an important step when starting a small business. The type of structure selected can impact an individual's personal liability, as well as the amount of taxes and when they are paid. Making the wrong decisions can result in personal debt, liability, and loss of public benefits. Therefore, it is important to take the time to learn about each of the pos-

sible business structures in order to select the one that best fits the potential business.

This Q and A provides an overview and is intended as a general introduction only. An individual who is considering business ownership should consult with a Certified Public Accountant (CPA) or a lawyer for more detailed information and advice.



Please describe the types of business structures.



There are basically five types of business structures that an entrepreneur can choose from when starting a business. This includes a sole proprietorship, partnership, C Corporation, S corporation, or limited liability company (LLC). The simplest structure is the sole proprietorship and involves one person who owns and operates the business. The business owner and the business are essentially the same. Business and personal tax returns are filed together.

If the business will be owned and operated by more than one person, then a partnership may be the business structure selected. Partnerships divide profits and losses among the partners based on each individual's percentage of ownership in the business. In a general partnership, the partners manage the company and assume responsibility for the business debts and other obligations. In a limited partnership, some partners are only investors and do not have control over the company.

A standard (or C) corporation is more complex form that is used by most large businesses. It is an independent legal entity that is separate from its owners providing good liability protection. The S corporation may be more appealing to small business owners than a standard corporation.



It combines attractive tax benefits, along with the liability protection of a corporation. Income and losses are passed through to shareholders and included on their individual tax returns. The result is only one level of federal tax to pay. Additionally, the S corporation can have up to 75 shareholders; making it possible to attract more capital.

A Limited Liability Company (LLC, PLLC) is the newest form of business ownership. It is a registered unincorporated entity. It gives the same legal protection as a business but without as much reporting and taxing requirements. An LLC can be set up to function like a sole proprietorship or partnership. There is generally some level of state reporting which varies state by state. While there is some expense in setting up an LLC, the fees are generally less than setting up a corporation or getting a partnership agreement prepared. Each state has certain requirements for setting up and maintaining an LLC.



Who is legally liable for any losses that a business experiences?



Personal liability will vary depending on the type of legal structure selected. Legal liability for a sole proprietorship or a partnership is the same. If the business goes bankrupt, the owners are personally liable. As previously mentioned, there are two types of partnerships, general and limited. In the general partnership, each partner is liable for all business debts. Limited partners are only liable for the amount of their investments. Under a limited liability company, legal protection for the owners is only effective if there is no mixing of personal and corporate money and assets. If there is no mixing of assets, partners are not liable for business debts under the LLC. Finally, a corporation's debts do not belong to the owners. With this liability protection, personal assets are not at risk.



Could an individual with a disability risk losing public benefits such as Supplemental Security Income (SSI) or Medicaid if he or she selected one of these business structures over another?



Currently, the Social Security Administration does not look favorably on an individual with a disability forming a LLC or any type of corporation. An individual with a disability who is receiving SSI and/or Medicaid benefits will lose their eligibility for benefits if they form a LLC, a C corporation, or S Corporation. Individuals who are receiving public benefits must carefully consider their options and consult with a CPA and benefits specialist when selecting a business structure.



What are the basic advantages and disadvantages across the business structures?



The sole proprietorship works well with all public benefits including SSI and Medicaid and allows for maximum control by the owner. The tax aspects are appealing, because the expenses and income for the business are included on a personal income tax return. Profits and losses are recorded on a schedule C. Additionally, business losses may offset the income earned from other sources. A major drawback is the personal legal liability. The sole owner is personally responsible for the company's liabilities. Assets may be at risk and could be taken to satisfy a debt or settle a legal claim. Also, borrowing money may be difficult as some banks may be reluctant to make loans.

One advantage of a partnership is the experience and funds various partners can bring to the business. Another advantage is the partnership works well with all public benefits including SSI and Medicaid. Finally, all income is passed through the partnership to the partners. A disadvantage is that the more people involved, the greater likelihood there is for personality conflicts and disagreements about money or management matters. In addition, as in the sole proprietorship, general

partners are personally liable. This entity is more complex and may take more time and money to start up, as legal counsel may be needed.

The major advantage of a corporation is it is an independent legal entity. As such, the owner that incorporates receives liability protection. Personal assets are not put at risk. Some profits can also be retained, without having to pay tax. The other advantage is the corporation can raise money through the sale of stocks. A major disadvantage is higher costs and loss of Medicaid and/or SSI. Individuals lose their SSI and Medicaid benefits due to excess personal resources from ownership of stock or membership shares.

S corporations have tax benefits and offer liability protection of a corporation. Income and losses are passed through shareholders resulting in one level of federal income tax to pay. S corporations can use simpler accounting method. They can have up to 75 shareholders. S corporations must follow corporate rules and regulations. This means legal and accounting services are likely to be required, which results in higher costs. Owning an S-corporation causes the loss of SSI and/or Medicaid benefits. S corporations can only issue common stock which may obstruct the ability to raise capital.

Limited liability companies offer many advantages such as liability protection, and there is no limit on the number of members of an LLC. The biggest disadvantages are the tax treatment varies from state to state and the loss of SSI and/or Medicaid. This is especially important to consider if the business will be operating in different states, or if the business member or members receive SSI and/or Medicaid.



How is the business income and expenses reported across the legal forms?



In a sole proprietorship, the owner reports all income and expenses on a separate Schedule C attached to his or her personal income tax return. Under the general partnership, all partners report income on separate IRS schedules attached to their individual tax returns. The business does not pay any taxes as it is its own entity. Limited partners report their share of partnership income or loss on their individual returns. Shareholders are responsible for the amount of their investment in corporate stock. Under a LLC partners report income and income tax on their individual tax returns.

Partnership and LLCs reporting as partnerships are reported on a form 1065 with schedule K (partner's interest in income and expense) being sent to each partner. Sub S is reported on a form 1120S with schedule K (shareholder's interest in income and expense) being sent to each owner. It is the schedule K income that is reportable by the individuals. These returns are due by March 15 to allow time for the owners to file individually.



What steps are involved in incorporation?



Incorporation is a process. Entrepreneurs should contact the secretary of state or the state office that is responsible for registering corporations. This is where forms can be obtained as well as specific instructions and fee schedules. Often this information is also offered online. After the materials have been reviewed, the individual must decide if a lawyer will be hired to file for incorporation. Some attorneys specialize in this area and may be listed in the telephone Yellow Pages as Business or Tax Attorneys specializing in small or corporate business. A skilled lawyer can complete the incorporation process with ease. On average, attorney fees cost between 500 to 1000 dollars. An entrepreneur can also complete this process and save the expense of an attorney. There are a number of books and software program available on this topic. However, depending on the entrepreneur's abilities, the process may take longer to complete.

A certificate or articles of incorporation will need to be prepared. Some states have a form to complete. Usually, the form includes the name of the business, its purpose, names and addresses of those incorporating, location of the principle office of the corporation. A set of bylaws will need to be drafted. The bylaws contain important information about how the company will operate. Generally, it describes the responsibilities of owners, partners, shareholders when meetings are held, and other details about running the company. Once completed the articles are filed and reviewed. If accepted, a certificate of incorporation will be forthcoming from the secretary of the state's office.



How long does a business last?



Continuity of a business depends upon the type of legal structure. Under the sole proprietorship, the business will end when the owner withdraws or upon his or her death. A general partnership terminates under the same circumstances unless other provisions have been made. Under a limited partnership, the death of a limited partner does not dissolve a business, but again death or withdrawal of a general partner could lead to ending the business unless other provisions have been made. The general (or C) corporation and S corporation are their own entities. As such, neither is affected by the longevity of owners, partners or shareholders. The laws vary across states on how the continuity of a LLC is affected by the withdrawal or demise of a member.

SUMMARY

The individual with a disability who is starting a business has many decisions to make when selecting a business structure. The information provided in this Q and A is only basic information to illustrate the need for assistance from

a CPA and/or lawyer when making important business decisions. In addition, any individual who is receiving public benefits must consult with a benefits specialist on the impact of business ownership and structure on his or her benefits.

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RESOURCE

- ◆ Business Comparison Chart -- http://www.incorporate.com/business_structure_comparison_chart.html

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