GUIDE TO SELECTING YOUR **SMALL BUSINESS LEGAL STRUCTURE**

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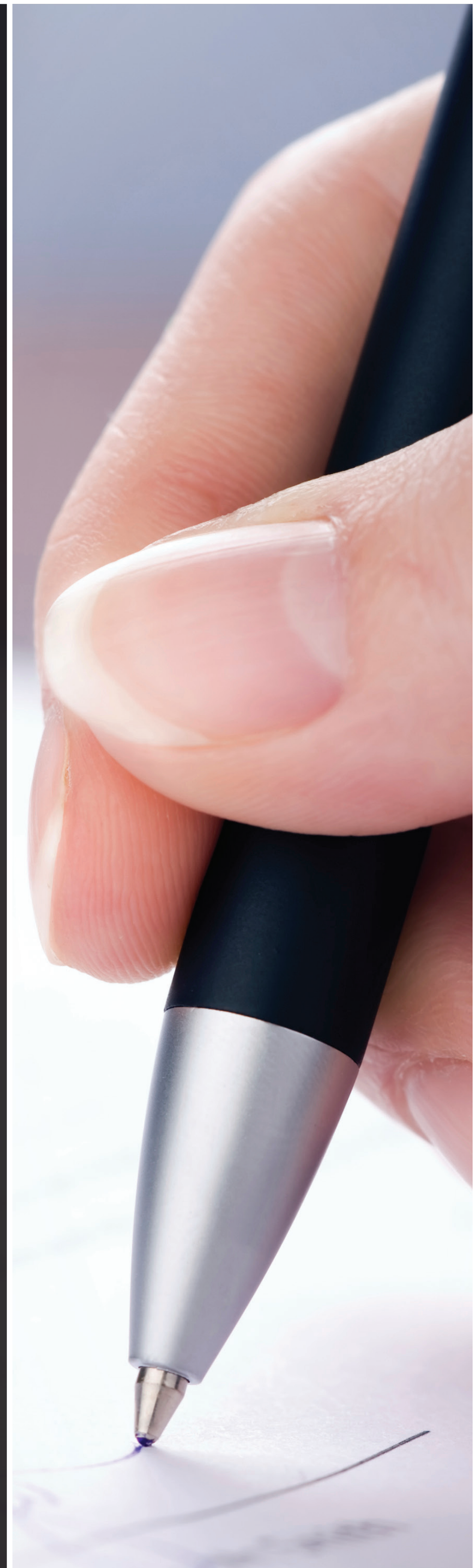

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One important consideration when starting your business is determining the best legal organizational structure. Why? Because it will affect operating efficiency, transferability, control, the way you report income, the taxes you pay and your personal liability.

Four basic structure types are available:
- Sole proprietorship
- Partnership — general and limited
- Corporation — S corporation, C corporation
- Limited liability company (LLC)

The choices can be complicated — and errors can be costly. Business legal structures are regulated by state governments, but your county or municipality also may have license requirements.

What's more, current tax laws make it difficult to change your legal structure after you begin operating. Making the right decision before you open for business is very important.

How do you decide which legal structure is best for you and avoid potential problems? Consult with a certified public accountant (CPA). A CPA can help you make well-informed choices, explain how business structure affects your organization's bottom line and file the necessary paperwork to start your business, if you'd like.

This overview and comparison grid will help you consider the right structure for your new business.

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OVERVIEW

SOLE PROPRIETORSHIP	• The simplest legal structure for any business • The business is not legally separated from you — the owner. (By default, the legal business name is the same as your legal name) • Establishing a business name separate from your own is possible by creating a "doing business as" (DBA) name. Most states require DBAs to be registered with the county clerk or Secretary of State • Owner can take cash withdrawals from the business at will • Owner required to make quarterly estimated tax payments • Establishing a sole proprietorship may be as simple as opening a bank account for the business • Some states and municipalities may require obtaining a license or permit
PARTNERSHIP (GENERAL AND LIMITED)	• Like a sole proprietorship, a general partnership is not a legal entity separate from its owners • The difference between a sole proprietorship and partnership is that a sole proprietorship has only one owner and a partnership has two or more owners • Owners can take withdrawals and, if specified in the partnership, guaranteed payments • Owners pay taxes quarterly • Can be started through an oral agreement, though a written agreement is advisable (and required in some states) • Many states have legal provisions for limited liability partnerships (LLPs) that provide for some limitations on the liability of the owners and on points such as profit/loss percentages; business decisions; addition and withdrawal of a partner and terms of operation • Some partnership allocation structures may subject you and your business to heightened Internal Revenue Service (IRS) scrutiny • To form a partnership, you must register your business with your state, a process generally done through your Secretary of State's office

C CORPORATION	• A separate legal entity from its owners • Corporate documents are filed with the state and an annual fee is paid • Separate corporate bank accounts and records are created, and assets and money generated by the corporation are owned by the corporation • Corporations are required to pay federal, state and, in some cases, local taxes • Most businesses must register with the IRS and state and local revenue agencies. Although any business that has employees will need to get a tax ID number, it is required for a corporation • Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice — first, when the company makes a profit, and again when dividends are paid to shareholders on their personal tax returns • Shareholders who also are employees pay income tax on their wages. The corporation and the employee each pay one half of the Social Security and Medicare taxes, but this usually is a deductible business expense for the corporation • To form a corporation, you must file articles of incorporation with your state, a process generally done through your Secretary of State's office
S CORPORATION	• A corporation with the Subchapter S designation from the IRS • To be considered an S corp, you must first charter a business as a corporation in the state where it is headquartered • An S corp is different from a C corp in that its profits and losses can pass through to the owner's personal tax return. Consequently, the business is not taxed itself. Only the shareholders are taxed. Losses are limited to the shareholder's tax basis • Shareholders can be paid wages, receive distributions of profits or a combination of wages and distributions

LIMITED LIABILITY COMPANY (LLC)	• A hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership • The "owners" are referred to as "members." Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs • Unlike shareholders in a corporation, in most states LLCs are not taxed as a separate business entity. Instead, all profits and losses are "passed through" the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would • To form an LLC, you must file the appropriate documents with your state, a process generally done through your Secretary of State's office

OPERATION AND CONTROL

Although liability and tax implications are important, the legal structure of your business will dictate certain aspects of how you operate in the years to come.

SOLE PROPRIETORSHIP	• Controlled by one person • All liability rests on the owner
PARTNERSHIP — GENERAL	• General partners have equal management rights and control, if not otherwise specified in a partnership agreement • Responsibilities and control can be defined in a written partnership agreement
PARTNERSHIP — LIMITED	• Management and control of the business handled by the general partners • Partners' liabilities limited to their investment
CORPORATION — C AND S	• Bylaws (operating rules) created to establish and explain the rules governing the organization • Shareholders have sole authority to approve articles of incorporation, mergers and dissolution of the company and elect the directors • Directors are responsible for major decisions, including selection of company officers
LIMITED LIABILITY COMPANY (LLC)	• Single-owner LLCs operate like sole proprietorships

INVESTMENT

If you plan to raise capital through equity investments, your legal structure will be especially important for defining the role that investors will have in governance and the distribution of profits.

SOLE PROPRIETORSHIP	• No outside investments permitted
PARTNERSHIP — GENERAL AND LIMITED	• All partners have equal ownership of all business assets and liabilities unless otherwise defined in partnership agreement • Ownership percentages can vary based on the number of partners and the written agreement, which should also explain how a departing partner will be paid for part ownership when he or she leaves, dies or retires
CORPORATION — S	• Can issue one class of stock to up to 100 shareholders
CORPORATION — C	• Can issue different classes of stock and bonds, subject to state and federal securities laws and regulations
LIMITED LIABILITY COMPANY (LLC)	• Rules similar to a proprietorship for single-member LLCs, and to a partnership for multiple-member LLCs

CONTINUITY AND TRANSFERABILITY

Even though you're just starting out, you should begin with the end in mind. What will happen to your business when you retire or die? Each legal structure provides a different answer.

SOLE PROPRIETORSHIP	• Continues until abandoned or upon death of the owner • Assets and liabilities can be freely transferred by selling all or a portion of the assets
PARTNERSHIP — GENERAL AND LIMITED	• Dissolves if a general partner dies or leaves the partnership, unless the agreement provides for continuation of the business by the remaining partners
CORPORATION — C AND S	• Exists in perpetuity even if one or more owners die • Ownership can be transferred by sale of stock
LIMITED LIABILITY COMPANY (LLC)	• For multi-owner LLCs, continuity and transferability are determined by the organizing and operating documents and may affect the LLC's ability to choose corporate or partnership tax status

LEGAL LIABILITY

For many business owners, liability is a serious concern. Although a CPA can provide you with detailed advice on the tax implications of various legal structures and general advice on liability protection, you should direct any specific liability questions to an attorney who specializes in corporate law. Additional liability protection is available to any business structure by purchasing insurance.

SOLE PROPRIETORSHIP	• Unlimited personal liability
PARTNERSHIP — GENERAL AND LIMITED	• General partners are fully liable for all liabilities of the partnership, no matter which general partner incurred them • Limited partners are responsible only to the extent of their investment
CORPORATION — C AND S	• Shareholders are generally liable only to the extent of their investment in the business, but management generally incurs some personal liability
LIMITED LIABILITY COMPANY (LLC)	• Liability rules are similar to corporate shareholders. Members are not personally liable for the debts and liabilities of the LLC

COMPENSATION AND PAYROLL TAXES

Employees are paid a salary, and federal, state, Social Security and Medicare taxes are withheld. The employer matches the Social Security and Medicare taxes withheld for each employee. An individual who is self-employed pays federal, state, Social Security and Medicare taxes on net self-employment income.

SOLE PROPRIETORSHIP	• Must pay self-employment taxes as part of quarterly estimated tax payments
PARTNERSHIP — GENERAL AND LIMITED	• General partners subject to self-employment taxes on their share of self-employment income from the partnership (whether or not distributed) • Limited partners are not subject to self-employment taxes
CORPORATION — C AND S	• Income and Social Security taxes withheld from wage income paid to shareholder employees
LIMITED LIABILITY COMPANY (LLC)	• Treated according to the tax treatment selected • If treated as a partnership, active members pay quarterly estimated self-employment taxes • Inactive members not subject to self-employment taxes

TAX YEARS

Although most businesses operate on a calendar year, in some cases your company may benefit from a fiscal year different from the calendar year. Except for a sole proprietorship, which can only operate on a calendar year, generally other legal structures can elect a different tax year subject to IRS regulations. Because of the tax complexities of operating on a fiscal year, you should only consider this option if you have a sound business purpose for doing so. Your CPA can help you make this determination.

WHICH LEGAL STRUCTURE IS RIGHT FOR YOUR BUSINESS?

There are many factors to consider, from business type to tax implications. The chart on page 11 summarizes the pros and cons of each structure. A CPA has the background and expertise to help you make your decision — and form your business properly from the start.

BUSINESS STRUCTURE PROS AND CONS

STRUCTURE TYPE	PROS	CONS
SOLE PROPRIETORSHIP	• Inexpensive to start and simple to run • One level of tax on net income • No separate tax return	• Unlimited personal liability • Ownership limited to one person
PARTNERSHIP	• Ownership not limited to one person • One level of tax on net income • Income and expenses allocation can be unrelated to percentage of ownership	• Unlimited personal liability • Each partner legally responsible for the business acts of other partners • Requires separate tax returns
S CORPORATION	• Limited personal liability for shareholders • Business net income taxed as personal income of shareholders	• Requires separate tax returns • Restrictions on adding investors • Net income must be allocated according to percentage of ownership
C CORPORATION	• Limited personal liability for shareholders • Easy to transfer ownership/add investors • Perpetual continuity presumed	• Requires separate tax returns • Net income may be double taxed • More costly to set up and maintain
LIMITED LIABILITY COMPANY (LLC)	• Limited personal liability for members • Income and expenses can be allocated in a manner unrelated to percentage of ownership	• Not automatically perpetual like S or C corps • More costly than a sole proprietorship to set up and maintain

OTHER CONSIDERATIONS

Your CPA can help you decide what type of entity and structure is best for your particular situation and type of business. There are situations where forming multiple entities may better accomplish your objectives. For example, a family business may want to separate its land, buildings or other fixed assets from the operating business and lease them back to the operating business to have a different equity ownership by family members who may not be active in the business's day-to-day operations.

You should evaluate the decision to choose an entity in which the tax attributes pass through to the owners in light of the other income or losses that you and other owners have and the extent to which you will have a tax basis in the entity. Other considerations include your objectives for an exit strategy or transitioning the business ownership on to the next generation.

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