The Right Business Structure: Best Fit for Your Business

Description

In order to obtain commercial funding through us, you must have a legal entity to own the subject real estate. This means that you must set-up a corporation, partnership, limited company, or trust to hold the asset. We can assist you with this if necessary.

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Some of the first questions that I pose to anyone who wants to start a new business are “What will be the structure of your company? Will you incorporate, set-up an LLC/LLP, or operate as a partnership or proprietorship?”

The answer to these questions will provide the basis for setting the company’s legal status as an entity. Today, we will review the most common types of business structure, and we will explore the advantages and disadvantages of each.

The most common types of business ownership are Sole Proprietorship (also includes Husband/Wife ownership), Partnership (various forms), and Corporation. LLC and LLP are other options, and include some of the benefits of a Corporation with some of the benefits of non-corporate structures. We will explore each of these in this issue.

Sole Proprietorships and Partnerships

By far, the easiest form of company set-up is the sole proprietorship. All you have to do is decide that you want to go into business, and then go through some basic set-up steps to legitimize it. If this will be a home-based business, you will file a name registration with your county (commonly referred to a DBA or “Doing Business As…”), publish it in a local paper, open a bank account in the business name, secure any licenses required (Home Occupation Permit, Business License, Resale Permit, etc.), and you are good to go!

You will typically file your business income and expenses on IRS Schedule C and attach it to yourForm 1040 at the end of the year. While a sole proprietorship is easy to form, I generally don'trecommend it as a business structure unless the business is never expected to ever grow larger thanbeing home based, and it has minimal to no legal liability exposure.

A partnership follows the same series of events as listed above, with the addition of the need for a partnership agreement. Partnerships can be either General Partnerships or Limited Partnerships.

A General Partnership has one or more General Partners, each of whom assumes full personal legal liability for the partnership. A Limited Partnership has one or more General Partners, along with one or more Limited Partners who may invest money, but who are not allowed to participate in the daily activities of the partnership in any capacity. A Limited Partner's liability for the partnership's actions is limited to the amount of money s/he has invested in the partnership.

Disadvantages

Perhaps the single biggest disadvantage of a Sole Proprietorship or Partnership is the unlimited personal liability that attaches to the owners of either entity. If the business should go bankrupt, whether through mismanagement, a lawsuit, or other business reasons, the owner(s) must take personal responsibility for payment of the business' debts. Often, this causes the owner(s) to file for bankruptcy protection themselves.

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Another issue that can handicap either of these entities is the acquisition of credit. Since the business is not a separate legal entity from the owners, the owners usually wind up using their personal credit capacity to fund the business. This can make deduction calculations difficult, in addition to making credit acquisition difficult for the business.

Taxes

A partnership will file an information report to the IRS every year on Form 1065. This form includes Schedule K, which details how the income and expenses of the partnership are to be allocated amongst the partners. Since a partnership is not a legal entity, it will not pay taxes directly to the IRS, but each member of the partnership will.

Each partner will receive a Schedule K-1 from the business, and will use this form to complete their income tax return. Note that the due date for Form 1065 is one month prior to the due date for the personal income tax returns of the partners. This is to allow the partners time to complete their returns by the standard tax filing day. The information from Schedule K-1 is reported by each partner on Schedule E, which is then attached to their Form 1040 and filed with the IRS.

Corporations and Incorporation

Incorporating can be a simple process, but the decision to set-up a corporation, as well as the continuing administrative requirements to keep a corporation legal, can be daunting. Setting-up the corporation does not take a lot of work, but you must follow some key steps in order to do it properly.

A corporation may be set-up as a C-corp or as an S-corp. S-corps are more common if you have a smaller company and/or a limited number of investors. An S-corp cannot sell shares to the public.

The first decision is to determine which of the fifty United States is most beneficial to the business as a home state. This does not have to be the same state in which the business operates, nor does the business have to have a physical presence in that state, other than a person who will agree to receive any court or legal documents on behalf of the corporation in that state.

This is usually an attorney or accountant, but can be any person of legal age whom you authorize. They must have a physical presence (residence or office) in the state of incorporation, and they must be available to receive personal service of documents on behalf of the corporation.

When filing, you should have Articles of Incorporation and Bylaws to file with the Secretary of State of the state in which you will incorporate. You will also be required (in most states) to name the directors and officers of the corporation. In most states, these can all be the same individual.

Disadvantages

You will be required to keep corporate books and records. These records include Corporate Minutes, key decisions, Stock/Share records, and more. You must also register your corporation in the states in which you will have a physical presence and conduct business. For example, you may decide to register your corporation in Wyoming, Nevada, or Delaware, but actually operate your business in California.

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While your initial registration will be in Wyoming, Nevada, or Delaware, you will also have to be a registered corporation in California. You do not have to register in every state in which you have customers (e.g. mail order), but you must register in any state in which you will have an office. There are exceptions to this, based on your line of business, so check with your attorney or CPA for additional requirements.

A corporation helps you avoid the unlimited liability provisions of proprietorships and partnerships, but you must be careful to run your corporation as a completely separate entity from your person or your household. DO NOT pay any personal bills from the corporation. DO pay yourself a salary from the company, and use this money to pay your personal bills.

If you don’t truly run your corporation as a separate entity, then you run the risk of having your corporate status invalidated in court, and you could find that you are now subject to unlimited personal liability for the actions of the corporation.

Having a corporation also simplifies the process of procuring credit and trade lines in the business name. If done properly, you can avoid having these items appear on your personal credit report, and you can also avoid having to sign personal guarantees for these credit lines.

A corporation will file taxes on Form 1120 (C-Corp) or Form 1120S (S-Corp). A C-Corp may issue dividends, and these dividends will be reported on a Form 1099-DIV issued to each shareholder. An s-corp will issue a Schedule K-1, just like a partnership, and the owners will transfer this information to Schedule E.

Limited Liability Companies (LLC/LLP)

An LLC/LLP works very similar to a corporation, but the recordkeeping requirements are less stringent, as you don't need to keep corporate books and records, but you must still ensure that you are running the business as an independent entity.

An LLC/LLP has a manager and members. The manager is selected as the company's representative and the rest of the owners are the members. An LLC/LLP can also get business credit, just like a corporation, and liability for the actions of the company is limited to the amount invested by the owners. Also, limited liability owners of an LLC/LLP ARE allowed to participate in the daily activities of the business (unlike a Limited Partnership), while maintaining their limited liability status.

An LLC/LLP is appropriate for many small businesses, and I highly recommend this business structure to most of my clients. As the business grows, you may eventually convert to a full corporation, but in most cases an LLC provides liability protection, access to business credit, and simpler administration.

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Tax filing for an LLC is simple. If the LLC has only one owner, the owner can report all LLC income and expense data on a Schedule C, just as if the entity were a sole proprietorship. If structured as an LLP, or if an LLC with partners, then Form 1065 would be filed, and each manager and member would receive a Schedule K-1 and report income and expenses on Schedule E.

Other Options

An LLC has the option to be treated as a corporation, in which case it would file Form 1120 instead. Speak to an Attorney or CPA or both. Prior to setting-up your business, I recommend that you retain counsel and a CPA who will work with you and your business. The attorney can ensure that you are following the proper legal proceedures with respect to your business structure and set-up, as well as the ongoing administration of your status. The CPA will help you set-up your company books and records, and s/he will also be in charge of your annual audit and financial reporting.

Business Credit & Taxes

We have not talked in detail about business credit here, but we will be speaking to these issues in future posts. Your CPA and attorney may play a pivotal role in assisting you with regard to business credit. In any event, you will (or should) find their guidance and counsel of help and comfort while operating your new venture. Your CPA will also help you with tax issues, if necessary.

We will discuss some of the tax issues of each type of business structure in future posts as well. Regardless of whether you set-up your new company as a proprietorship, partnership, corporation, or limited liability entity, you should be sure that you understand the pros and cons of each structure, and decide which provides the best combination of benefits for your type and scale of business.

Working with your financial planner, an attorney, and an accountant will enable you to ensure that you are getting the most from your chosen business structure. As with any of my posts, I urge you to speak to a licensed, qualified attorney or CPA in your area before acting on anything contained herein that speaks to legal or accounting issues, as I am not licensed to work in these areas. Any information contained herein is for informative purposes only, and should be verified prior to being acted upon.

See also:

HOW TO INCORPORATE/FORM LLC

Category

1. Credit
2. Entity Structure
3. Income Tax

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Author
djntwk

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