

Business Structure ABC's and LLC's

If you're a kid who mows lawns in the summer, you've got a legal business structure. The odds are high that it's a sole proprietorship and you didn't think about it, but there it is.

De facto sole proprietorships are probably the majority of our local small businesses. That said, you really ought to think the form of your business through. This is a topic that is admittedly dull, but it's important. There are major differences in your personal liability, in tax treatment, in ongoing costs and in the hassle factor depending on what structure you choose. So, what are some of the considerations that go into this decision?

Let's start with the sole proprietorship. Its beauty is that it's very easy to set up and to run. If you use your own name, there's no need to file a fictitious name statement. You need a business license from your city or county and you're good to go. You don't pay the double taxes of a "C" corporation, where profits are taxed and then dividends to shareholders are taxed again. The downsides include unlimited legal liability, putting your personal property and savings at risk. Sometimes, the tax advantages are with a corporate structure even if there is double taxation. You tend to have more trouble raising capital for a sole proprietorship. And the situations around death of the owner or sale of the business are often more problematic.

Partnerships provide a good way to share work and combine talent and resources. I'll discuss general partnerships here. (Limited partnerships to be complex enough to make my head hurt and definitely beyond what we can cover in this space.) The tax situation can be complicated although double taxation is not a problem. There is again unlimited legal liability in the general partnership. There are not a lot of ongoing processes required such as shareholders meetings. However, here's the biggest issue to me: *treat a partnership as a marriage in which you are 100% certain to want a pre-nuptial agreement.* A clear, solid agreement on how the partnership ends if it needs to is critical going in. My recommendation: get an attorney's help on this.

Both partnerships and sole proprietorships can be excellent business structures over the long haul. One key: make sure your business is well-insured.

For a number of businesses, I like limited liability companies (LLC's). You get protection from unlimited personal liability without the higher hassle factor of being a corporation and without double taxes. There is an initial cost to establish an LLC and the tax treatment of fringe benefits isn't good. In California--and almost nowhere else--a number of licensed occupations such as building contractors and private detectives are not eligible to choose the limited liability company structure. So along with the general research you need to do on business structure, you need to make sure that your specific business is eligible.

The LLC is also a relatively new mechanism. Regulators and legislators are still working some of the bugs out and this has professionals such as many accountants advising people to select a corporate form.

So now we come to corporations. There are two types: the S-Corporation and the C-Corporation. In general, the S-Corp is used for small companies. On the plus side, it provides limited liability. In theory, the corporation exists forever; in practice, that means that issues surrounding sale, death of owners, etc., are less problematic. There are tax benefits for smaller companies, the biggest of which is usually that rather than having double taxation the profit of the S-Corp passes through to the personal taxes of the owners. There are several restrictions that most people in small businesses can live with, including that you have to use the calendar year as your fiscal year, you can only have one class of stock and there can be no more than 35 shareholders. This business structure also has higher reporting requirements. You must have yearly board meetings with minutes, for example.

The C-Corporation is what we think of typically when we speak of a “corporation.” It offers most of the same advantages of the S-Corp, such as limited liability, perpetual existence and ease of transferring ownership. It also has the disadvantages of the S-Corporation with the additional reality of double taxation. This is the form of choice for large, publicly-traded companies. But it has uses for the smaller company and the growing company as well. For many companies, it’s a pretty easy decision when to switch from S-Corp to C-Corp based on accounting for profits and taxes, a strategy to increase the number of shareholders, or other straightforward criteria. It’s also surprisingly easy to make the switch.

You should know that in California there is an \$800 per year minimum tax for a corporation or limited liability company regardless of volume or profitability.

These are some of the issues involved in choosing your business structure. You can research these issues yourself on the web or using one of the excellent guides published by NOLO Press. You can also use a relatively inexpensive filing service if you decide to incorporate. Most people will benefit from the guidance of professionals on these matters, probably involving both a CPA and an attorney. Still, you can think through a lot of the issues for yourself and save some money if you use the time you’re paying a professional efficiently.

If you’d like to learn more about these and other business start up issues, the Small Business Development Center offers a free workshop called “Startup Basics.” You can register for it at our website: www.northcoastsbdc.org.

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