Finding the Right Structure for Your Business

Bill Greener

Making the appropriate choice can help you maximize profits and reduce taxes and legal fees.

Over the past several years, more and more enterprising scientists have applied their knowledge of technology and industry to their own start-up businesses. But what does it take to shape one's vision for an exciting new venture into a sustainable business? You'll need a focused business plan that takes into account technology, management, intellectual property and financing.

Even before that, however, you must figure out which type of business entity will best suit your needs. This is one of the most important decisions you will make when starting a business; it will affect everything from the amount of taxes and paperwork you'll face to your personal liability to the bottom line. This article highlights the characteristics of the major business structures and describes some of the advantages and drawbacks of each one.

Sole proprietorship

A sole proprietorship refers to someone who owns an unincorporated business by himself or herself. The main advantage of a sole proprietorship is its ease of formation. To get started, you need only perform a simple filing, typically with a County Clerk's office. The tax implications and reporting requirements are also straightforward, involving taxation at individual tax rates and standard IRS Schedule C filing. There is no separate entity tax for a sole proprietorship.

As your own boss, you are the sole risk manager and the profit/loss center—for better or for worse.

As your own boss, you are the sole risk manager and the profit/loss center—for better or for worse. Your liability is unlimited with a sole proprietorship, and you may have limited sources of capital and funding. The business terminates upon the death of the proprietor.

General partnership

A general partnership is an association of two or more people who co-own a business for profit. These partnerships are generally easy to form at the state and county levels. Partners agree among themselves how to share profits and losses, which flow through the partnership to each partner's individual tax return via a form K-1. General partnerships are typically not subject to federal or state business entity taxes. The general partners, however, are jointly and severally liable for the obligations of the general partnership entity. The death of a partner terminates the general partnership.

Limited partnership

As the name implies, this arrangement consists of one or more limited partners and at least one general partner. Limited partners cannot be active in the business management; if they are, they risk losing their "limited" status. As such, each limited partner's liability is limited to their respective investment.

There are a number of similarities between a limited partnership and a general partnership, particularly in the areas of taxation and what is referred to as "special allocation of income and loss." Government fees for partnership formation may be higher for a limited partnership than for a general partnership, however. State regulations may require notices about the partnership formation to be published.

C-Corporations

Corporate business entities provide greater segregation between their owners and the entity itself than is provided for in partnership arrangements. A C-Corporation, by example, is your large business "Inc."

With this type of business, taxation issues are comprehensively addressed by the IRS, under subchapter "C" of the Internal Revenue Code. C-Corporations require corporate officers and directors whose identities must periodically be reported to the state. On the plus side, a C-Corporation is taxed for income purposes as a separate corporate entity at both the federal and state levels. In addition, the number and types of shareholders are unrestricted. Shareholders have limited financial liability even if they participate in corporate management; rather, the corporate entity becomes the liable party. In a C-Corporation, the retained corporate earnings can be kept in the business.

On the other hand, C-Corporations are subject to double taxation; that is, corporate income is taxed at the corporate level, while dividends are taxed at the individual (shareholder) level. The formal requirements of a C-Corporation include government formation fees, significant record- and book-keeping, shareholder meetings and corporate elections, the issuance of stock certificates, and the sale of stock for raising capital. Financial losses are only deductible at the corporate level. C-Corporations can continue perpetually, even after the deaths of key stakeholders.

S Corporations

An S-Corporation is a small business entity that makes a valid election with the IRS to be taxed differently than a C-Corporation. S-Corporations generally pay no corporate income taxes on their profits. Instead, shareholders pay income taxes on their proportionate shares of the corporate profits. Thus, an S-Corporation is considered a pass-through entity similar to a partnership, but shareholders enjoy the limited liability of a corporate structure. These are its primary advantages.

S-Corporations generally pay no corporate income taxes on their profits. Instead, shareholders pay income taxes on their proportionate shares of the corporate profits.

However, there are also limitations on S-Corporations. They must be domestic corporations organized under state law, and shareholders are limited in number to fewer than 100 and to certain entities such as individuals, estates and trusts. All individual shareholders must be citizens or residents of the United States. Unlike a C-Corporation, an S-Corporation cannot have retained earnings.

Limited liability company

A limited liability company, or LLC, is formed by filing Articles of Organization with a state's secretary of state. The internal affairs of an LLC are spelled out in an operating agreement. The IRS taxes limited liability companies as if they were partnership entities. There are no restrictions on the number or types of owners or the extent of owner participation in management. An LLC will be dissolved when certain events occur; for example, bankruptcy, the death of a member, or the incapacity or withdrawal of any member unless otherwise voted upon. Annual filing fees are required.

[Bill Greener (wgreener@bsk.com) is a U.S. registered patent attorney who practices in Ithaca, N.Y. and is a partner in the firm of Bond, Schoeneck & King, PLLC.]