CERTIFIED CTC TAX COACH

# Before the "INC" Dries

## Choosing The Right Business Structure

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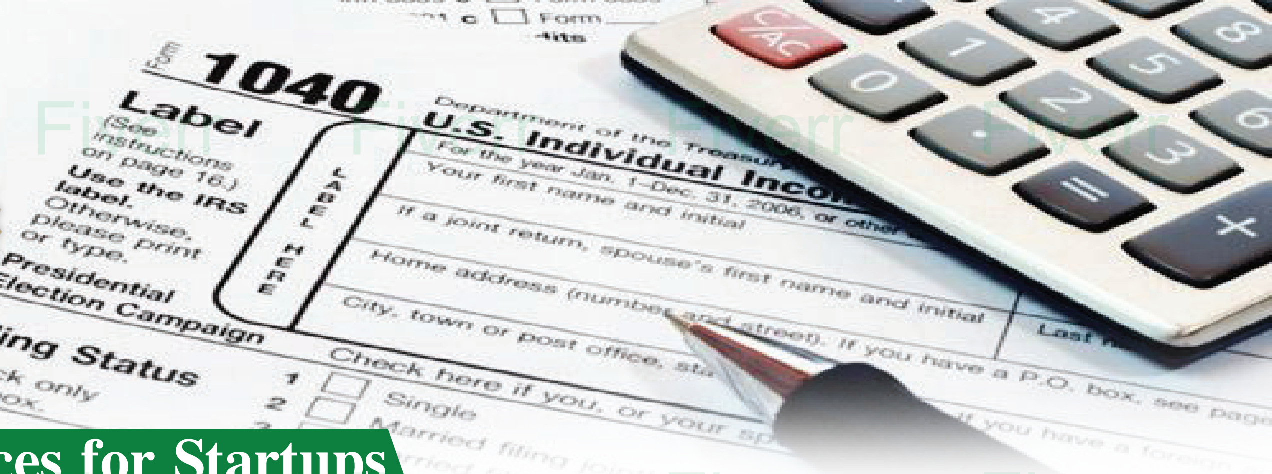



# Tax Choices for Startups

**choosing which entity to operate your business involves two fundamental choices:**

*** Will you remain personally liable for business debts?**

*** How will you and your business pay tax?**

There's no perfect answer, and in many cases you'll want more than one entity. Here is a quick look at the main legal entities that businesses can choose for their operations.

# Sole Proprietorship

This is a business you operate yourself, in your own name or trade name, with no partners or formal entity. It is the least compliated and usually the least expensive way to set up and run a business.

You report income and expenses on your personal tax return and pay income and self employment tax on your profits. Income taxes are not withheld on business income, though quarterly estimated taxes may be required.

A major disadvantage to a sole proprietorship is unlimited liability, not only for debts of the business, but for lawsuits brought against the business. Liability extends to the proprietor's personal as well as business assets.

The deductibility of fringe benefits is very limited in a sole proprietorship. In fact, this area comes under close serutiny by the IRS because of the concern that personal expenditures might be deducted as business expenses.

# Partnerships

Partnerships are an association of two or more partners. They can have any number of partners. Partners bring to a business more creativity, skills, capital base, and experience than any one person is likely to have.

General partners ("GP") run the business and remain liable for partnership debts. Limited partners ("LPs") invest capital, but don't actively manage the business and aren't liable for debts. The partnership files an informational return and passer income and expenses to partners. GP distributions are taxed as ordinary income and subject to self-employment tax; L.P distributions are taxed as passive income.

A major drawback to a partnership is that liability is unlimited. In fact, partners can be held liable for the actions of fellow partners.

Partners have similar options in the area of fringe benefits and retriement plans as those available to sole proprietors.

## C Corporations

"C" corporations pay tax on their income at corporate rates. They can retain after-tax-profits or pay them to shareholders as dividends. Dividends are taxed again as personal income at preferential rates up to 15%. This "double taxation" is more bark than bite if you "zero out" profits by paying them as salary or bonus. This avoids corporate tax as long as your salary is "reasonable compensation" for the services you provide.

If you set up a corporation and are employed by it, the corporation must withhold and pay payroll taxes on your wages.

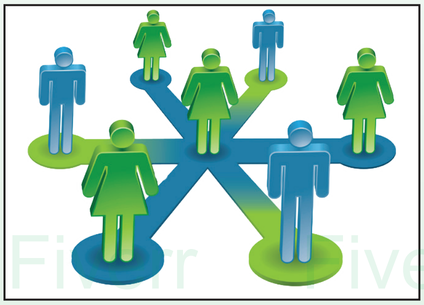
C corporations offer you the widest range of deductible benefits. In fact, many business include C corporations in their entity structure specially to pay benefits.

## S Corporations

"S" corporations are corporations that elect not to pay tax themselves, but to pass income and expenses directly through to shareholders. S corporations can have up to 100 shareholders, all of whom must be individuals (no nonresident aliens), estates, or certain trusts. S corporations can have just one class of shares; however they can own taxable or "qualified subchapter S" subsidiaries.

This big advantage of S status is that it combines the limited liability of a regular corporation with tax treatment similar to that of a partnership. A disadvantage is that S corporations have some fringe benefit restrictions for owner employees.

## Limited Liability Company



Limited liability companies ("LLCs") are associations of one or more members operating the business themselves or through appointed managers. Your liability for business obligations is limited to your investment in the business. LLCs offer the limited liability of a corporation and flexibility to allocate income and losses of a partnership, without the ownership limits of an S corporation or double taxation of a C corporation. This versatility is making the LLC the entity of choice for most new businesses.

Fore more information or assistance in selecting the right legal form for your business or a review to be sure your current business form is still your best choice, contact our office.

| | PROPRIETORSHIP | PARTNERSHIP | C CORPORATION | S CORPORATION | LLC |
|---|---|---|---|---|---|
| **Liability** | Unlimited | Unlimited for general partners Limited for limited partners | Limited | Limited | Limited |
| **Continuity** | Limited to life of proprietor | Limited unless provided for in partnership agreement | Unimited | Unimited | Varies; can affect tax status entity |
| **Interest Transfers** | Difficult | Difficult unless provided for in partnership agreement | Readily by issuing trough stock transfer | Readily by issuing trough stock transfer | Varies; can affect tax status entity |
| **Acquisition of Capital** | Limited to what proprietor can secure | Easier than sole proprietorship | Acquired by issuing stock bonds | Acquired by issuing stock | Shared by members |
| **Compliance** | Schedule C with Form 1040 | Form 1065; distributes K-1's | Form 1120 | Form 1120S; distributes K-1's | Depends on classification of LLC |
| **Taxation of Income** | Directly to owner | Directly to partners in proportions agreed upon by partners | Taxed once at corporate level, again at shareholder level when distributed | Taxed directly to shareholders (no double taxation) | Generally taxed as a partnership |
| **Costs** | Lowest | Medium | Highest | Highest | Similar to corporation |
| **Fringe Benefits** | Generally not deductible | Generally not deductible for partners | Deductible, but subject to many rules (mainly non-discrimination) | Generally not deductible for over 2% shareholders | Depends on tax status |
| **Advantages** | Independence, flexibility, minimum red tape | Chance of business success enhanced if right combination of partners | Limited liability | Limited liability without double taxation of regular corporation | Limited liability with partnership tax treatment; fewer ownership restrictions than S corporation |
| **Disadvantages** | Unlimited liability a problem if business has financial difficulties | Unlimited frequent changes in partners can be difficult | Greatest cost. Government regulations, and red tape; double taxation of income | Not every corporation qualifies for S status; more limits on fringe benefits | Inconsistent state tax treatment |