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Certified Public Accountants

For more information or for assistance in selecting the right legal form for your business, contact our office.

It's Your Business

Finding the Right Legal Form for Your Business

FRIEDMAN, KANNENBERG & COMPANY, P.C.
Certified Public Accountants

91 South Main Street
West Hartford, Connecticut 06107
(860) 521-3790
FAX (860) 561-4339
Web site: www.fkco.com

Your Business Form

If you are starting a new business, you must decide which legal structure is best for you and your business. If you are already in business, you should periodically review your business form to see if it is still the best choice.

The form of business entity that you choose can make a difference in the taxes you pay, the costs of doing business, and the amount of paperwork and red tape you'll have. Here is some basic information to help you understand the differences in the various legal entities from which to choose.

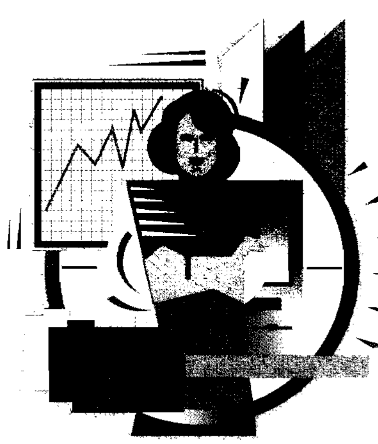
■ Sole Proprietorship

A sole proprietorship is owned and operated by one individual. It is the least complicated and usually the least expensive way to set up and run a business. A sole proprietorship has no legal existence apart from its owner.

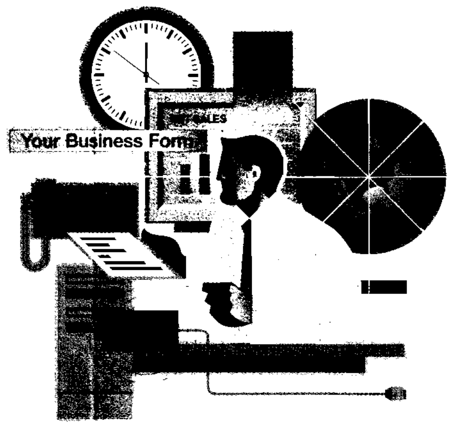
The owner controls the business, makes decisions without having to consult co-owners or partners, and is entitled to all the profits (or losses).

The business income is taxed to the owner via a Schedule C attached to the individual's Form 1040. Income taxes are not withheld on business income, though quarterly estimated taxes may be required.

Payroll taxes apply to any employees of the business. The sole proprietor pays self-employment tax rather than social security tax (and gets a tax deduction for 50% of the tax paid). No social security tax need be paid on the owner's children under the age of 18 who work in the business.



A major disadvantage to the sole proprietorship form of operation 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 ability to raise capital for the business is limited to the amount the individual can secure personally. Since under-capitalization is a major cause of business failure, this factor can be significant.

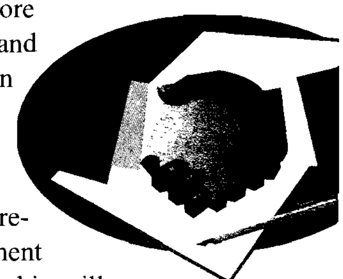
Continuity of a sole proprietorship is limited. Since the individual is the business, the business enterprise may be crippled or terminated if the owner becomes ill or dies.

A sole proprietor can establish a retirement plan. Good options include an IRA, a SEP, a SIMPLE, or a Keogh. Each type of plan has its own restrictions and requirements.

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

■ Partnership

A partnership 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.



Every partnership should have a written agreement (though there is no legal requirement to have one). The agreement should specify how the partnership will operate, how it will be financed, how responsibilities will be divided among the partners, how profits and losses will be shared, and what happens to the partnership if one partner withdraws, becomes disabled, or dies.

A partnership files an information tax return (Form 1065), but pays no income tax itself. The income or losses are passed through to the partners who report them on their individual tax returns in shares agreed upon by the partners – not necessarily equally. Partners, like sole proprietors, pay self-employment tax on net income rather than social security taxes on wages.

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 retirement plans as those available to sole proprietors.

Limited partnership. In a limited partnership, a general partner or partners run the business and are fully liable for partnership obligations. Limited partners do not participate in the business and are generally liable only to the extent of their investment.

■ Limited Liability Company

A relatively new business entity is the limited liability company (LLC). A properly structured LLC combines the general flexibility and income tax treatment of a partnership with the limited liability of a corporation.

■ Regular Corporation

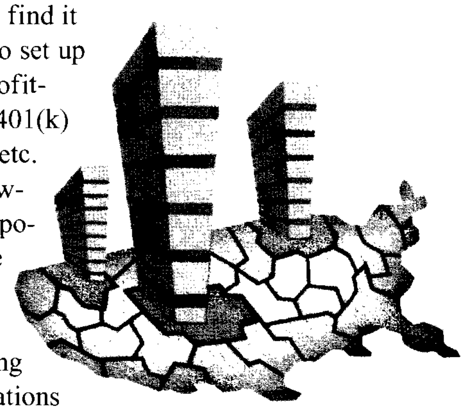
A corporation, the most complex of the business structures, is a distinct legal entity apart from the shareholders who own it. Formed under the requirements of the state in which it will do business, a corporation limits its owners' liability to their investment in the company; personal assets are generally not at risk. The corporate form does not provide complete protection where personal services are involved.

Ownership interest in a corporation is easy to transfer via the sale or transfer of stock, and the corporation has relative stability and permanence.

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

A corporation files its own tax return (Form 1120) and pays its own income tax. Therein lies the major drawback to the corporate form: business profits may be taxed twice – once at the corporate level and again at the shareholder level when paid out as dividends or a liquidating distribution.

The corporate form allows for more fringe benefits, deductible by the corporation and tax-free to employees (including shareholder-employees). Corporations often find it advantageous to set up pension and profit-sharing plans, 401(k) plans, ESOPs, etc.



A major drawback to the corporate form is the complexity of rules and regulations governing corporate operations (including the tax laws).

Personal service corporation. A personal service corporation is a corporation that has employee-owners performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Corporations in this classification have the added drawback of paying tax on corporate income at a flat rate (the top corporate rate) rather than at the graduated rates available to other corporations.

■ S Corporation

The major difference between a regular corporation known as a "C corporation" and an "S corporation" is that the C corporation pays taxes on its income. An S corporation generally does not pay its own income tax. It files Form 1120S and distributes K-1s to shareholders. Shareholders then report their pro rata share of income, losses, and credits on their individual tax returns. The double taxation that regular corporations face is thereby avoided with an S corporation.

A corporation is allowed to elect S status only if it meets certain qualifications.

The 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.

Comparison of the Major Business Forms

	Limited Liability Company	Partnership	Regular Corporation	S Corporation	Sole Proprietorship
Legal Liability	Limited	Unlimited for general partners Limited for limited partners	Limited	Limited	Unlimited
Continuity of Entity	Varies; can affect tax status of the entity	Limited unless provided for in partnership agreement	Unlimited	Unlimited	Limited to life of proprietor
Transfer of Interest	Varies; can affect tax status of the entity	Difficult unless provided for in partnership agreement	Readily accomplished through stock transfer	Readily accomplished through stock transfer	Difficult
Acquisition of Capital	Shared by members	Easier than sole proprietorship since shared by partners	Acquired by issuing stock or bonds	Acquired by issuing stock	Limited to what proprietor can secure
Tax Filing Required	Depends on classification of LLC	Form 1065; distributes K-1s to partners	Form 1120	Form 1120S; distributes K-1s to shareholders	Schedule C with Form 1040
Taxation of Income	Generally taxed as a partnership (though classification may result in corporate taxation)	Directly to partners in proportions agreed upon by partners	Taxed once at corporate level, again at shareholder level when distributed (usually as dividends)	Taxed directly to shareholders (no double taxation)	Directly to owner
Administrative and Legal Costs	Similar to corporation	Medium	Highest	Highest	Lowest
Fringe Benefits	Depends on tax status	Generally not deductible for partners	Deductible, but subject to many rules (mainly nondiscrimination)	Generally not deductible for over 2% shareholders	Generally not deductible
Recommended Pension Plans	Depends on tax status	IRA, Keogh, SEP, SIMPLE	Qualified plans	Qualified plans	IRA, Keogh, SEP, SIMPLE
Major Advantage(s)	Limited liability with partnership tax treatment; fewer ownership restrictions than S corporation	Chance of business success enhanced if right combination of partners	Limited liability	Limited liability without double taxation of regular corporation	Independence, flexibility, minimum red tape
Major Drawback(s)	Inconsistent state tax treatment	Unlimited liability; frequent changes in partners can be difficult	Greater cost, government regulations, and red tape; double taxation of income	Not every corporation qualifies for S status; more limits on fringe benefits	Unlimited liability – a problem if business has financial difficulties