Choosing the Best Ownership Structure for your Business

When you start your own business, you must first decide whether it will be a sole proprietorship, a partnership, a limited liability company (LLC) or a corporation.

Which of these forms is right for your business depends on the type of business you run, how many owners it has, and its financial situation. No one choice suits every business: Business owners have to pick the structure that best meets their needs. This article introduces several of the most important factors to consider, including:

- the potential risks and liabilities of your business

- the formalities and expenses involved in establishing and maintaining the various business structures

- your income tax situation, and

- your investment needs.

Risks and Liabilities

In large part, the best ownership structure for your business depends on the type of services or products it will provide. For example, if your business is small and you will not be engaged in activities which will create liability risks, you may only need to establish a sole proprietorship. On the other hand, if your business will engage in risky activities, such as construction, trading stocks or professional services, you will almost surely want to form a business entity that provides personal liability protection ("limited liability"), which shields your personal assets from any business debts and claims. A corporation or a limited liability company ("LLC") will probably the best choice for you.

Formalities and Expenses

Sole proprietorships and partnerships are easy to set up -- you don't have to file any special forms or pay any fees to start your business. Plus, you don't have to follow any special operating rules.

LLCs and corporations, on the other hand, are almost always more expensive to create and more difficult to maintain. To form an LLC or a corporation, you must file formation documents with the secretary of state and pay a fee, which can be several hundred dollars. In New York, LLCs are also required to publish their formation in two (2) newspapers which can add several more hundreds of dollars in formation expenses. Furthermore, owners of corporations must elect officers (usually, a president, vice president, and secretary) to run the company while LLCs choose managing members to run the company. These limited liability entities must also keep records of important business decisions and follow other formalities.

If you're starting your business on a shoestring, it might make the sense to form the simplest type of business -- a sole proprietorship (for a single owner businesses) or a partnership (for businesses with more than one owner). The limited personal liability provided by an LLC or a corporation may not be worth the additional cost and paperwork required to create and run one. However, the additional cost of forming a limited liability entity, such as an LLC or a corporation is well worth the additional cost and paperwork if you will be engaged in a particularly risky business.

Income Taxes

Owners of sole proprietorships, partnerships, and LLCs all pay taxes on business profits in the same way. These three business types are "pass-through" tax entities, which means that all of the profits and losses pass through the business to the owners, who report their share of the profits (or deduct their share of the losses) on their personal income tax returns. Therefore, sole proprietors, partners, and LLC owners can count on about the same amount of tax complexity, paperwork, and costs.

Owners of these unincorporated businesses must also pay income taxes on *all* net profits of the business, regardless of how much they actually take out of the business each year. Even if all of the profits are kept in the business checking account to meet upcoming business expenses, the owners must report their share of these profits as income on their tax returns.

In contrast, the owners of a corporation do not report their shares of corporate profits on their personal tax returns. The owners pay taxes only on profits they actually receive in the form of salaries, bonuses, and dividends.

The corporation itself pays taxes, at special corporate tax rates, on any profits that are left in the company from year to year (called "retained earnings"). Corporations also have to pay profits on dividends paid out to shareholders, but this rarely affects small corporations, which seldom pay dividends.

This separate level of taxation adds a layer of complexity to filing and paying taxes, but it can be a benefit to some businesses. Owners of a corporation don't have to pay personal income taxes on profits they don't receive. And, because corporations enjoy a lower tax rate than most individuals for the first $50,000 to $75,000 of corporate income, a corporation and its owners may actual have a lower combined tax bill than the owners of an unincorporated business that earns the same amount of profit.

Investment Needs

Unlike other business forms, the corporate structure allows a business to sell ownership shares in the company through its stock offerings. This makes it easier to attract investment capital and to hire and retain key employees by issuing employee stock options.

But for businesses that don't need to issue stock options and will never "go public," forming a corporation probably isn't worth the added expense. If its limited liability that you want, an LLC

provides the same protection as a corporation, but the simplicity and flexibility of LLCs offer a clear advantage over corporations.

Finally, your initial choice of a business structure isn't set in stone. You can start out as sole proprietorship or partnership and later, if your business grows or the risk of personal liability increases, you can convert your business to an LLC or a corporation.

After learning the basics of each business structure and considering the factors discussed above, you may still find that you need help deciding which structure is best for your business. Call the attorneys at the Law Offices of Steven M. Adler, PLLC for your free consultation.