Business Structures

CO.STARTERS

Sole Proprietorship

A sole proprietorship is the simplest legal business form. If your business is a sole proprietorship, **you and your business are one and the same.** You don't have to file separate documents or business tax forms, or really do anything to get started. You report your profits and losses on Schedule C of your personal tax return using your Social Security Number or your business's Employer Identification Number (EIN). Because there is no legal separation between you and your business, you are fully responsible and liable for any debt or legal action against the business. Also, as the name suggests, this structure doesn't work if you have a partner.

LIABILITY:

Your legal responsibility to someone for your actions or failure to act

ADVANTAGES:

- Inexpensive and easy to form
- Retain full control
- Low tax rates and you don't have to file separately

DISADVANTAGES:

- High personal risk
- Difficulties raising money (because you can't have a partner)
- Solely responsible for success or failure
- Pay self-employment tax

Partnerships

In a partnership, **two or more people share ownership of the business.** Each contributes something—money, property, labor or skill—and each shares in the profits and losses of the business. There are three main types of partnerships: (1) general partnerships, (2) limited partnerships, and (3) limited liability partnerships. In a partnership, profits are allocated and taxed on the individual (partner) level.

General Partnership: In a general partnership, **everything is divided equally** unless otherwise stated in a partnership agreement.

ADVANTAGES:

- Inexpensive and easy to form
- Shared financial commitment and the ability to pool resources
- Encourages diverse and complementary skills
- Can offer joining the partnership as an incentive for employees

DISADVANTAGES:

- Shared liability among owners (each partner is personally liable for all partnership actions; personal assets can be used to satisfy partner debts)
- Disagreements can cause trouble among partners
- Shared profits
- Pay self-employment tax

Limited Partnership: A limited partnership is very similar to a general partnership except that, in addition to general partners who have full control over the business, there are also limited partners. **Limited partners are protected from personal risk and usually have little to no management authority.** The primary partner(s) continues to be responsible for all the risk. Limited partners are paid a return on their investments according to whatever percentage is agreed upon in the partnership agreement.

Limited Liability Partnership: In this form of partnership, liability is generally limited to the business assets (items owned). Although it varies by state, **typically the personal assets of the partners cannot be used to satisfy the business's debts and liabilities.** In some states, the limited liability partnership is only available to certain professions such as attorneys, accountants, and doctors. This form of partnership is an attractive entity for certain professionals since it offers limited liability protection, but retains the flexibility and tax benefits of a partnership.

Limited Liability Company (LLC)

The LLC **protects its members (or owners) from personal liability** and limits debts and legal claims to business assets only. Like sole proprietors and partnerships, LLCs are taxed on the individual level, so members report business earnings on personal tax returns. The LLC structure allows for one or more business owners and requires the filing of legal documents with the state. While the LLC typically requires more legal formalities and startup costs than a sole proprietorship or partnership, it offers significant benefits in liability protection.

ADVANTAGES:

- Minimizes liability and risk
- In general, forming involves less paperwork than other forms (save a sole proprietorship)
- Generally more flexible than corporations and can be tailored to the company's specific goals
- Fewer restrictions on sharing profits among members
- Easy to convert to a corporation in the future

DISADVANTAGES:

- Transfer of ownership interest or addition of new owners may be more difficult than in a corporation, depending on the operating agreement
- Pay self-employment tax

Cooperative

Just as the name describes, a cooperative is **a group of people who have decided to cooperate or work together** in order to be more efficient or effective. Cooperatives are owned by and formed for the benefit of their members. Members typically have a common need and agree to a joint strategy for addressing that need. However, members also bear a lot of responsibility for making sure the cooperative works, with each member having an equal vote; if one member shirks his or her duties, all suffer.

ADVANTAGES:

- Fewer taxes
- Government grant opportunities
- Reduce costs by pooling purchasing power (group instead of individual)
- Perpetual existence – doesn't change when members come and go
- Democratic—each member has same vote

DISADVANTAGES:

- Because all members have equal vote, large investors may be dissuaded from investing
- Need to have all members participating fully for business to function properly

Corporations

There are two types of corporations, the C Corporation and the S Corporation.

C Corporation: A corporation is controlled by a board of directors and owned by shareholders. Corporations must hold annual meetings and follow a specific governance structure required by state law. A C Corp's defining characteristic is that it is considered **totally separate from its owners and is taxed as such.** Legally complex, a C Corp is best suited for a large company with many employees.

ADVANTAGES:

- Limited liability—protects owners' personal property
- Ability to raise capital through selling stock
- File taxes separately from owners
- Attractive to potential employees—typically offers competitive salaries and stock options

DISADVANTAGES:

- Complex start up involving time and money
- Double taxation—the corporation pays taxes on business income and the shareholders pay taxes on dividends
- A lot of paperwork

S Corporation: Like the C Corp, the S Corp operates separately from its owners and bears all risk, financial and otherwise. However, the S Corp is different in that **taxes on profits and losses can be passed on to shareholders**, rather than taxing the corporation. Although S Corps have tax benefits, they are also subject to more restrictions.

ADVANTAGES:

- Lower taxes—only wages of a shareholder who is an employee are subject to employment taxes; the remaining income is paid to shareholders as “distributions” and subject to lower taxes
- Business expense tax credits—some expenses incurred by shareholders can be written off as business expenses
- Independent life from its shareholders

DISADVANTAGES:

- More recordkeeping and stricter operational processes (scheduled director and shareholder meetings, etc.)
- Shareholders who perform services must be paid reasonable compensation, subject to employment taxes

Socially-Minded Entities

New entity types have emerged in recent years which combine aspects of a non-profit or socially minded business with aspects of a for-profit business. Two such entities are the **Low Profit Limited Liability Company (L3C)** and the **Benefit Corporation (B Corp)**. These entities are not recognized in all states. **The social mission of the business is integral to the legal structure of both the L3C and B Corp.**

The L3C was designed to allow greater flexibility for companies to raise capital for socially beneficial or charitable purposes by allowing some profit from which to provide a return to investors. However, the IRS has not provided guidance on the tax implications of an L3C and the entity type itself is the subject of much debate. It is recommended that you talk with an attorney before deciding whether this entity is a potential choice for your socially-conscious endeavor.

The B Corp is essentially a corporation formed for a social or environmental purpose. Like the L3C, this entity has not been adopted by most states. If you are interested in the B Corp, seek advice from your attorney.