PLANNING THE LEGAL STRUCTURE OF YOUR BUSINESS

As part of your strategic planning, you should make sure that the form of business under which you currently operate is best meeting your needs. If you need to change the legal structure of your business, it is usually best to do so at the beginning of a new year. In this article, we will review the advantages and disadvantages of the legal structures that you might select for your business.

Sole Proprietorship

A sole proprietorship is a business that one person owns. The fundamental feature of a sole proprietorship is that the law makes no distinction between you as the owner and your business. All the advantages and disadvantages of sole proprietorships flow from this fundamental feature.

Advantages of Sole Proprietorships. Because there is no legal distinction between you and your sole proprietorship, your income from your sole proprietorship is not subject to double tax. You, not your sole proprietorship, personally pay all taxes on income from your business. (Double tax occurs when you pay tax twice on the same amount of income. We will see how this happens in our discussion about corporations, below.) Likewise, if your sole proprietorship operates at a loss, you can deduct the loss from any other source of income you have, including dividends, interest, income you earn if you have another job, and income your spouse earns. Of course, the amount you can deduct cannot exceed the total amount of other income you and your spouse earn.

Disadvantages of Sole Proprietorships. Again, because there is no legal distinction between you and your sole proprietorship, you are personally liable for all debts your business incurs. This means that if your business owes someone money and cannot pay, you are personally liable for the debt, which could be collected from your personal savings, your house, and your car. (Whether this risk is significant depends on what kind of business you conduct.) Another disadvantage concerns health insurance. If you pay for your health insurance from your business, a quirk in the Internal Revenue Code only allows you to deduct 30 percent of the cost (compared with 100 percent for corporations).

Corporations

A corporation can have one or more owners. It is a business that exists only after the owners file a form called Articles of Incorporation with the Secretary of State. If your business is a sole proprietorship or a partnership (discussed below), you can transform your business into a corporation by filing the Articles of Incorporation.

The fundamental nature of a corporation is the opposite of a sole proprietorship. The most important feature of a corporation is that its existence is almost entirely separate and apart from the owners. Most of the advantages and disadvantages flow from this essential feature.

Advantages of Corporations. Because a corporation's existence is separate and apart from the owners, the owners generally are not personally liable for any debts the business incurs. This means that the business may owe money it cannot pay, but the owner usually cannot be held personally liable, and his or her property cannot be tapped into to repay the debt. Also, due to quirk in the Internal Revenue Code, owners can deduct 100 percent of the cost of health insurance paid for by the business. The business can also deduct the cost of a $50,000 life insurance policy for each owner.

Disadvantages of Corporations. Again, because a corporation's existence is separate and apart from the owners, the corporation, not the owners, pays all tax on the business's income. If you are not careful, this can result in paying double tax. Double tax can occur if you pay yourself after a new year (Year 2) from income the corporation earned during the prior year (Year 1). At the close of Year 1, the corporation must pay tax on all its Year 1 income. The payment you take in Year 2 is taxable to you personally, even though the corporation already owes taxes on that income from Year 1. You might avoid paying double tax by making sure that you do not pay yourself in Year 2 from income your corporation earned in Year 1. Do the same for Year 2, and so on.

S Corporations The Internal Revenue Code provides a break for corporations having 35 or fewer owners. Under subchapter S of the Code, the owners personally pay taxes on all the corporation's income in proportion to their ownership interest. For example, if you are the only owner of an S corporation, you would pay taxes on 100 percent of the income. If you own

50 percent of the business, you would pay taxes on 50 percent of the income, and so on.

In order to qualify as an S corporation, a business must first be a corporation; next, you must file the proper form with the Internal Revenue Service. You must file the form within 75 days after your business becomes a corporation or, if your business has been incorporated for more than 75 days, within the first 75 days of your corporation's tax year (which usually starts on January 1.)

Advantages of S Corporations. Because you personally pay all the taxes on the income from your S corporation, you avoid paying double tax. You can also take some of your S corporation earnings as dividends, which will save you some payroll taxes. Moreover, if you have losses, you can deduct them against other income you and your spouse receive. Finally, you avoid personal liability for the corporation's debts to the same extent as a regular corporation.

Disadvantages of S Corporations. Due to another quirk in the Internal Revenue Code, the owners of S corporation are limited to a 30 percent deduction for the cost of health insurance paid for by the business, and the owners cannot take any deduction for life insurance paid for by the business.

General Partnerships A partnership is a business owned by two or more people. The fundamental feature of general partnerships, as with sole proprietorships, is that the law makes no distinction between you, the owner, and your business. All the advantages and disadvantages of partnerships flow from this fundamental feature. Except as noted below, these are the same as sole proprietorships.

Advantages of General Partnerships. The main advantage of partnerships flows entirely from the Internal Revenue Code. The Internal Revenue Code allows partnerships great freedom to allocate income between the partners. For example, as an incentive for investing, partners who invest in the partnership can receive more income than non-investor partners. Also, as a partner, you can deduct losses against other income you and your spouse receive.

Disadvantages of General Partnerships. Because there is no legal distinction between the partners and the business, each partner is personally liable for all debts the business incurs. To avoid personal liability while retaining the freedom to allocate income between the partners, many partners form a partnership called a limited partnership. A limited partnership has two types of partners, one or more general partners and one or more limited partners. Under this form of partnership, only the general partner is liable for the partnership debts. The limited partners can only lose the amount they invest in the business.

Limited Liability Companies A limited liability company is a business owned by two or more persons. A limited liability company exists only after the owners file a form known as Articles of Organization with the Secretary of State.

Limited liability companies combine features of corporations and partnerships. The owners of limited liability companies have the same protection from personal liability for business debts as owners of corporations. Moreover, owners of liability companies will not pay double tax because they personally pay tax on the business's income. Limited liability companies also have the same freedom to allocate income that partnerships enjoy. However, the owners can deduct only 30 percent of the cost of health insurance paid for by the business. Also, unlike S corporation owners, limited liability owners cannot avoid some payroll taxes by taking dividends.

Conclusion Selecting the right form of business might save you a lot of money. And because of income tax complications, the new year is probably the best time to consider making a change.