

# Choosing a Business Structure and Partnership Agreements

Selecting the right legal form is one of the most consequential decisions a small business owner will make. This course walks through the key factors that influence entity selection and then dives into the mechanics of structuring a solid partnership agreement. Ideal for CPAs and tax professionals advising clients at the startup stage, the material helps you ask the right questions and guide clients toward a structure that fits their operational and tax goals.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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## LEARNING ASSIGNMENTS AND OBJECTIVES

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### Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

### Course Objectives

- Recall the characteristics of an accidental partnership.
- Recall the characteristics of various business valuation methods.

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## Chapter 1: WHICH LEGAL FORM IS BEST FOR YOUR BUSINESS?

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### *Chapter Objective*

**After completing this chapter, you should be able to:**

- Recall the characteristics of an accidental partnership.

When you start a business, you must decide on a legal structure for it. This chapter will help you understand the differences between sole proprietorships, partnerships, limited liability companies (LLCs), and corporations, and to pick the one that best fits your business.

Many small businesses start without forming a legal entity (an LLC or a corporation). If such a business has one owner, by default it's a sole proprietorship. If the business has more than one owner, it's a partnership. Sole proprietors and partners are personally liable for the debts of the business, meaning that creditors can reach the personal assets of the owners to satisfy the business's debts. If you're interested in limiting your personal liability, consider operating as a limited liability company (LLC) or corporation. As we discuss below, LLCs can have one owner (a "single-member LLC") or multiple owners (a "multi-member LLC").

In addition to limited liability, you'll want to consider income taxes as you choose your type of business entity. Sole proprietorships, partnerships, LLCs, and S corporations are "pass-through" entities, meaning that profits are not taxed at the business level, but rather pass through to the personal returns of the owners. Profits of a C corporation, on the other hand, are taxed twice—once at the corporate level and again at the individual level when dividends are paid.

Keep in mind that your initial choice of a business form doesn't have to be permanent. You can start out as sole proprietorship or partnership and, later, if your business grows or the risks of personal liability increase, you can convert your business to an LLC or a corporation.

### *Related Topic*

For some small business owners, a less common type of business structure might be **appropriate**. While most small businesses will find at least one good choice among the four basic business formats described above, a handful will have special situations in which a different format is required or at least desirable. For example, a pair of dentists looking to limit their personal liability might need to set up a professional corporation or a professional limited liability company. A group of real estate investors could find that a limited partnership is the best vehicle for them. These and other special types of business organizations, including benefit corporations, are summarized at the end of this chapter.

### *Think About It*

You might need professional advice in choosing the best entity for your business. This chapter gives you a great deal of information to assist you in deciding how to best organize your business. Obviously, however, it's impossible to cover every relevant nuance of tax and business law—especially if your business has several owners with different and complex tax situations. And for businesses owned by several people who have different personal tax situations, sorting out the effects of “pass-through” taxation (where partners and most LLC members are taxed on their personal tax returns for their share of business profits and losses) is no picnic, even for seasoned tax pros.

*The Leading Ways to Organize Your Small Business*

| Type of Entity                   | Main Advantages                                                                                                                                                                                                                                                                                                                  | Main Drawbacks                                                                                                                                            |
|----------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Sole Proprietor</b>           | Simple and inexpensive to create and operate<br><br>Owner reports profit or loss on personal tax return                                                                                                                                                                                                                          | Owner personally liable for business debts                                                                                                                |
| <b>Limited Liability Company</b> | Owners have limited personal liability for business debts<br><br>Pass-through taxation<br><br>Flexibility in allocating profits and losses<br><br>Flexible management structure                                                                                                                                                  | Requires registration and annual maintenance filings with the state<br><br>A member's entire share of LLC profits might be subject to self-employment tax |
| <b>General Partnership</b>       | Requires no state registration<br><br>Owners (partners) report their share of profit or loss on their personal tax returns                                                                                                                                                                                                       | Owners (partners) personally liable for business debts                                                                                                    |
| <b>C Corporation</b>             | Owners have limited personal liability for business debts<br><br>Fringe benefits can be deducted as business expense<br><br>Corporate profit can be split among owners and corporation, resulting in lower overall tax rate<br><br>Preferred by outside investors<br><br>Easier for employee equity plans, such as stock options | More expensive to create than partnership or sole proprietorship<br><br>Paperwork can seem burdensome to some owners<br><br>Separate taxable entity       |

| Type of Entity             | Main Advantages                                                                                                                                                                                                                                                                                                         | Main Drawbacks                                                                                                                                                                                                                    |
|----------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>S Corporation</b>       | <p>Owners have limited personal liability for business debts</p> <p>Owners report their share of corporate profit or loss on their personal tax returns</p> <p>Owners can use corporate loss to offset income from other sources</p> <p>LLCs can elect to be taxed as an S corporation rather than as a partnership</p> | <p>More expensive to create than partnership or sole proprietorship</p> <p>Income must be allocated to owners according to their ownership interests</p> <p>Fringe benefits limited for owners who own more than 2% of shares</p> |
| <b>Limited Partnership</b> | <p>Limited partners have limited personal liability for business debts as long as they don't participate in management</p> <p>General partners can raise cash without involving outside investors in management of business</p>                                                                                         | <p>General partners personally liable for business debts</p> <p>More expensive to create than general partnership</p> <p>Suitable mainly for companies that invest in real estate</p>                                             |

## SOLE PROPRIETORSHIPS

A sole proprietorship is a business with one owner that hasn't been formed as a single-member LLC or a single-shareholder corporation. If you operate as a sole proprietor, you and the business are legally and tax-wise the same. In other words, the business isn't an entity at all, but is simply you doing business. You can continue operating as a sole proprietor as long as you're the only owner of the business.

Establishing a sole proprietorship requires no formalities, such as filing articles of incorporation or organization as you would with a corporation or an LLC.

However, you might need to get a business license to do business under state laws or local ordinances. States differ on the amount of licensing required. In California, for example, almost all businesses need a business license, which is available to anyone for a small fee. In other states, business licenses are the exception rather than the rule. But most states do require a sales tax license or permit for all retail businesses. Dealing with these routine licensing requirements

generally involves little time or expense. However, many specialized businesses—such as an asbestos removal service or a restaurant that serves liquor—require additional licenses, which might be harder to qualify for. (See Chapter 3 of course 82603A for more on this subject.)

In addition, if you're going to conduct your business under a trade name such as Smith Furniture Store rather than John Smith, you'll have to file a fictitious name (better known as a "doing business as" name, or "DBA") certificate at a local or state public office. This is so people who deal with your business will know who the real owner is. (See Chapter 2 of course 82603A for more on business names.)

From an income tax standpoint, the IRS treats a sole proprietorship as a "disregarded entity," and its profits and losses are reported on your own federal tax return (Form 1040, Schedule C).

If you have a business loss, you might be able to use it to offset income that you receive from other sources. (For more tax basics, see Chapter 1 of course 82604A.)

### **Personal Liability**

A potential disadvantage of doing business as a sole proprietor is that you have unlimited personal liability on all business debts and court judgments related to your business.

#### *Example 1*

Liam is the sole proprietor of a small manufacturing business. Believing that his business's prospects look good, he orders \$50,000 worth of supplies and uses them up. Unfortunately, there's a sudden drop in demand for his products, and Liam can't sell the items he's produced. When the company that sold Liam the supplies demands payment, he can't pay the bill.

As sole proprietor, Liam is personally liable for this business obligation. The creditor can sue him and go after not only Liam's business assets, but his personal assets, as well. This can include his house, his car, and his personal bank account.

#### *Example 2*

Sara is the sole proprietor of a flower shop. One day Rex, one of Sara's employees, is delivering flowers using a truck owned by the business. Rex strikes and seriously injures a pedestrian. The injured pedestrian sues Rex, claiming that he drove carelessly and caused the accident. The lawsuit names Sara as a codefendant. After a trial, the jury returns a large verdict against Rex—and Sara as the owner of the business. Sara is personally liable to the injured pedestrian, which means the pedestrian can go after all of Sara's assets, business and personal.

In the example above, Sara could have avoided personal liability by forming a single-member LLC. Alternatively, she could buy liability insurance to cover such a loss.

### **Income Taxes**

If you operate as a sole proprietorship (or a single-member LLC), you won't file a separate tax return for the business. Instead, you report profits and losses from the business on Schedule C of your personal return (Form 1040). Importantly, business profits are taxed to you in the year that the business earns them, whether or not you remove the money from the business. For this reason, pass-through profits are sometimes referred to as "phantom profits"—you're taxed on the profits, but you left the profits in the business. This can cause cash flow issues if your tax liability exceeds your available cash when the tax bill is due. We discuss corporate retained earnings versus pass-through profits later in the section on corporations below.

### **Fringe Benefits**

As a self-employed individual, you can set up retirement plans similar to company plans for employees. For example, a simplified employee pension (SEP) plan or a 401(k) plan allows you to contribute significant amounts of your earnings from self-employment on a tax-deferred basis.

When it comes to medical expenses for you and your family, however, there can be a tax advantage to setting up a corporation or an LLC. As a sole proprietor, you can take a tax deduction for the entire amount of your health insurance premiums, but you can deduct only part of your medical expenses not covered by insurance. Moreover, the personal deduction for uninsured medical expenses is severely limited because you can deduct such expenses only to the extent they exceed 7.5% of your income.

The situation is different if you form a corporation or an LLC and choose to have the corporation or LLC taxed as a separate entity. Your corporation or LLC could hire you as an employee and—if you're the only employee—the business could set up a medical reimbursement plan that pays for your health insurance premiums and 100% of other health costs incurred by you, your spouse, and your dependents. However, if you prefer to be a sole proprietor and you're married, you can reach a similar result by hiring your spouse as an employee. See "Hiring Your Spouse Can Have Tax Benefits," below, for details.