

*When beginning a business, you must decide what form of business entity to establish. Your form of business determines which income tax return forms you have to file. The most common forms of business entities are the sole proprietorship, partnership, corporation, and S corporation. A Limited Liability Company (LLC) is a relatively new business structure allowed by state statute. Legal and tax considerations enter into selecting a business entity. (Source: www.irs.gov)*

West End Accounting always recommends that a business owner consult a business lawyer as well as a tax accountant before selecting a business entity. These professionals can explain the advantages and disadvantages of each type of business entity and help select the one that is right for you.

The remainder of this document contains information about different types of business entities.

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### **Sole Proprietorship**

*A sole proprietorship is an unincorporated business that is owned by one individual. It is the simplest form of business organization to start and maintain. The business has no existence apart from you, the owner. Its liabilities are your personal liabilities. You undertake the risks of the business for all assets owned, whether or not used in the business. You include the income and expenses of the business on your personal tax return. (Source: www.irs.gov)*

A sole proprietorship is the simplest and least expensive form of business entity to establish. Simply decide whether you will operate your business under your own name or a fictitious name, obtain a business license and insurance and you are ready to go.

**Note:** If you choose to operate under a fictitious name, such as A+ Computer Technician, your business would be represented as *Owner Name dba A+ Computer Technician*.

There are some definite disadvantages to operating as a sole proprietorship which you should consider when determining if this business form is right for you. Disadvantages include, but are not limited to the following:

- A sole proprietorship is subject to pass-through taxation with profits declared on the owner's personal tax return. The business does **NOT** pay taxes nor is it held liable for taxes accrued. The responsibility lies solely on the individual.
- The owner of a sole proprietorship has no protection against liabilities. Personal assets can be used as payment for business debts and liabilities.
- A sole proprietorship has only one owner. If you have a business partner, you may be a partnership or choose a different form of business entity, but you cannot operate as a sole proprietorship. An owner of a sole proprietorship files a Schedule C on their personal tax return.

The sole proprietor pays taxes through estimated tax payments. The owners may **NOT** pay themselves through payroll, although they are permitted to hire employees.

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## Partnership

*A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business.*

*A partnership must file an annual information return to report the income, deductions, gains, losses etc., from its operations, but it does not pay income tax. Instead, it 'passes through' any profits or losses to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return.*

*Partners are not employees and should not be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions. (Source: [www.irs.gov](http://www.irs.gov)) Schedule K-1 will flow into partners' personal tax return.*

Partnerships are incorporated businesses. Like corporations, partnerships are separate entities from the shareholders. Unlike corporations, partnerships must have at least one General Partner who assumes unlimited liability for the business.

In addition, a partnership:

- Must have at least two shareholders
- Distributes all profits and losses to their shareholders without regard for any profits retained by the business for cash flow purposes

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## Corporation

*In forming a corporation (aka a C Corporation or C Corp), prospective shareholders exchange money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions.*

*The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. However, shareholders cannot deduct any loss of the corporation. (Source: [www.irs.gov](http://www.irs.gov))*

A corporation is taxed as a separate business entity. In addition, corporations:

- Have their own tax form, Form 1120, and their own tax rates
- May choose to retain their profits and earnings as part of their operating capital, or they may choose to distribute some or all of their profits and earnings as dividends paid to shareholders

Dividends paid to shareholders are essentially taxed twice. They are taxed once at the corporate level on Form 1120 and again at the individual level on the Form 1040.

## **S Corporation**

*An eligible domestic corporation can avoid double taxation (once to the shareholders and again to the corporation) by electing to be treated as an S corporation (aka an S corporation or S corp). Generally, an S corporation is exempt from federal income tax other than tax on certain capital gains and passive income. On their tax returns, the S corporation's shareholders include their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of non-separately stated income or loss. (Source: www.irs.gov)*

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## **Limited Liability Company**

*A Limited Liability Company (LLC) is a relatively new business structure allowed by state statute.*

*LLCs are popular because, similar to a corporation, owners have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation.*

*Owners of an LLC are called members. Since most states do not restrict ownership, members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit 'single member' LLCs, those having only one owner.*

*A few types of businesses generally cannot be LLCs, such as banks, insurance companies and nonprofit organizations. (Source: www.irs.gov)*

An LLC is a pass-through taxation, which means that profits will be shown as income on their personal tax returns. LLCs file a Schedule C on their individual tax returns.

The LLCs taxes flow through to the owner who pays taxes through estimated tax payments. The owners may **NOT** pay themselves through payroll, although they are permitted to hire employees.

LLCs are designated by the state. The IRS does not have a separate taxable entity or separate tax form for an LLC. Therefore, LLCs can be taxed by the IRS as a sole proprietorship (Schedule C), an S corporation (Form 1120S) or a partnership (Form 1065).

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**Table**

The following table shows a comparison of the business entities.

	<b>Sole Proprietorship</b>	<b>Partnership</b>	<b>Corporation</b>	<b>S Corporation</b>	<b>Limited Liability Company</b>
<b>Legal Liability</b>	Unlimited	Unlimited for general partners Limited for limited partners	Limited	Limited	Limited
<b>Continuity of Entity</b>	Limited to life of proprietor	Limited unless provided for in partnership agreement	Unlimited	Unlimited	Varies; can affect tax status of entity
<b>Transfer of Interest</b>	Difficult	Difficult unless provided for in partnership agreement	Readily accomplished through stock transfer	Readily accomplished through stock transfer	Varies; can affect tax status of entity
<b>Acquisition of Capital</b>	Limited to what proprietor can secure	Easier than sole proprietorship since shared partners	Acquired by issuing stocks or bonds	Acquired by issuing stock	Shared by members
<b>Tax Filing Required</b>	Schedule C with Form 1040	Form 1065; distributes K-1s to partners	Form 1120	Form 1120S; distributes K-1s to shareholders	Depends on classification of LLC
<b>Taxation of Income</b>	Directly to owner	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)	Generally taxed as a partnership (though classification may result in corporate taxation)
<b>Administrative and Legal Costs</b>	Lowest	Medium	Highest	Highest	Similar to corporation
<b>Fringe Benefits</b>	Generally not deductible	Generally not deductible for partners	Deductible, but subject to many rules (mainly non-discrimination)	Generally not deductible for over 2% shareholders	Depends on tax status
<b>Recommended Pension Plans</b>	IRA, Keogh, SEP, SIMPLE	IRA, Keogh, SEP, SIMPLE	Qualified plans	Qualified plans	Depends on tax status
<b>Major Advantage(s)</b>	Independence, flexibility, minimum red tape	Chance of business success enhanced if right combination of partners	Limited liability	Limited liability without the double taxation of regular corporation	Limited liability with partnership tax treatment; fewer ownership restriction than S corporation
<b>Major Drawback(s)</b>	Unlimited liability – a problem if business has financial difficulty	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	Inconsistent state tax treatment

## **Business Owner Resources**

There are numerous resources that small business owners can draw upon to help make their businesses a success. These resources include:

- The Internet
- The Henrico County Business Library

## **Internet Resources**

Helpful resources on the Internet include the following:

- The Internal Revenue Service Web site at [www.irs.gov](http://www.irs.gov)
  - *Publication 583 Starting a Business and Keeping Records* available at [www.irs.gov/pub/irs-pdf/p583.pdf](http://www.irs.gov/pub/irs-pdf/p583.pdf)
- The business section of the Commonwealth of Virginia Web site at [http://www.state.va.us/cmsportal2/business\\_4096/index.html](http://www.state.va.us/cmsportal2/business_4096/index.html)
- The U.S. Small Business Administration Web site at [www.sba.gov](http://www.sba.gov)
- The Department of Minority Business Enterprise Web site at <http://www.dmb.e.virginia.gov/>

## **The Henrico County Business Library**

The Henrico County Business Library is located at 4060 Innslake Drive, Glen Allen, VA 23060. The entire second floor is a business center that contains resources for business owners.

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## **Suggested Reading**

Suggested reading for the small business owner includes the following:

- *The Small Business Start-up Guide* by Hal Root and Steve Koenig
  - *Capitalize on Being Women Owned* by Janet Christy
  - *Black Enterprise: Guide to Starting Your own Business* by Wendy Beach
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## **Disclaimer**

Information provided is for general purposes and not intended to be advice for specific situations. West End Accounting suggests that you seek professional advice for your specific situation.

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