FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Choosing a Business Structure

Before you start your business, determine which structure will be the most beneficial to your business

Learning Objectives

- At the end of this module, you will be able to:
  - Know about various business structures available.
  - Discern the legal and tax implication of the various business structures.
  - Identify the business structure best suited for your business.

About FDIC Small Business Resource Effort

- The Federal Deposit Insurance Corporation (FDIC) recognizes the important contributions made by small, veteran, and minority and women-owned businesses to our economy. For that reason, we strive to provide small businesses with opportunities to contract with the FDIC. In furtherance of this goal, the FDIC has initiated the FDIC Small Business Resource Effort to assist the small vendors that provide products, services, and solutions to the FDIC.
- The objective of the Small Business Resource Effort is to provide information and the tools small vendors need to become better positioned to compete for contracts and subcontracts at the FDIC. To achieve this objective, the Small Business Resource Effort references outside resources critical for qualified vendors, leverages technology to provide education according to perceived needs, and offers connectivity through resourcing, accessibility, counseling, coaching, and guidance where applicable.
- This product was developed by the FDIC Office of Minority and Women Inclusion (OMWI). OMWI has responsibility for oversight of the Small Business Resource Effort.

Executive Summary

- Consideration should be given to choosing a suitable company structure to provide the maximum legal and tax protections for your operations.
- Each company structure has its own unique positive and negative attributes.
- Examine each of the six major types of structures for their suitability to your operational structure:
  1. Sole Proprietorship
  2. Limited Liability Company (LLC)
  3. Cooperative
  4. Corporation
  5. Partnership
  6. S Corporation

1. Sole Partnership *(Slide 1 of 3)*

- A sole proprietorship is the simplest and most common structure available for a business. It is an unincorporated business owned and operated by one individual with no distinction between the business and you, the owner. You are entitled to all profits and are responsible for all your business's debts, losses, and liabilities.
- How to form a sole partnership:
  - No formal action is required as long as you are the only owner.
  - Depending on industry, state, and locality regulations, licenses and permits may be required.
  - If you choose to operate under a name different than your own, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or doing business as (DBA)).
  - You must choose an original name; it cannot already be claimed by another business.

1. Sole Partnership *(Slide 2 of 3)*

- Sole partnership taxes:
  - Because you and your business are considered one in the same under this structure, the business itself is not taxed separately. Your business' income is your income.
  - You must report income and/or losses and expenses to the IRS with a standard Form 1040 and a Schedule C.
  - The total from your Schedule C transfers to your personal tax return (Form 1040).
  - It's your responsibility to withhold and pay all income taxes, including self-employment and estimated taxes.

1. Sole Partnership *(Slide 3 of 3)*

- Positive attributes:
  - **Easy and inexpensive to form.** A sole proprietorship is the simplest and least expensive business structure to establish.
  - **Complete control.** Because you are the sole owner of the business, you have complete control over all decisions.
  - **Easy tax preparation.** Your business is not taxed separately, so it's easy to fulfill the tax reporting requirements for a sole proprietorship. The tax rates are also the lowest of the business structures.
- Negative attributes:
  - **Unlimited personal liability.** Because there is no legal separation between you and your business, you can be held personally liable for the debts and obligations of the business. This risk extends to any liabilities incurred as a result of employee actions, such as law suits.
  - **Hard to raise money.** Because you can't sell stock in the business, investors won't often invest. Banks are also hesitant to lend to a sole proprietorship because of a perceived lack of credibility when it comes to repayment if the business fails.

2. Limited Liability Company

(Slide 1 of 4)

- A limited liability company (LLC) is a hybrid-type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.
- The "owners" of an LLC are referred to as "members." Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations, or other LLCs.
- Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are "passed through" the business to each member of the LLC.
- LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

2. Limited Liability Company

(Slide 2 of 4)

- How to form an LLC:
  - **Choose a Business Name.** You must follow these three rules: 1) it must be different from an existing LLC in your state, 2) it must indicate that it's an LLC or Limited Company, and 3) it must not include words restricted by your state (such as "bank" and "insurance").
  - **File the Articles of Organization.** Articles of Organization is a simple document that legitimizes your LLC and includes your business name, address, and the names of its members and is typically filed with the Secretary of State.
  - **Create an Operating Agreement.** Not always required, however an operating agreement is highly recommended for multi-member LLCs because it structures your LLC's finances and organization, and provides rules and regulations for smooth operation.
  - **Obtain Licenses and Permits.** Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.
  - **Hire Employees.** If you are hiring employees, ensure you follow federal and state regulations for employers.
  - **Announce Your Business.** Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLC formation.

2. Limited Liability Company

(Slide 3 of 4)

- LLC taxes:
  - The federal government does not recognize an LLC as a separate tax entity, so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC's members and are paid through their personal income tax.
  - Since an LLC is not recognized as a taxable business entity, all LLCs must file a tax return as a corporation, partnership, or sole proprietorship. Certain LLCs are automatically classified and taxed as a corporation by federal law.
  - LLCs that are not automatically classified as a corporation can choose their business entity classification. To select a classification, an LLC must file Form 8832. This form is also used if an LLC wishes to change its classification status.
  - You should file the following tax forms depending on your classification:
    - **Single Member LLC.** File Form 1040 and Schedule C like a sole proprietor.
    - **Partners in an LLC.** File Form 1065 as a traditional partnership.
    - **LLC filing as a Corporation.** File Form 1120, the corporation income tax return.

2. Limited Liability Company

(Slide 4 of 4)

- Positive attributes:
  - **Limited Liability.** Members are protected from personal liability for business decisions or actions made by the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt.
  - **Less Recordkeeping.** Operational ease is one of its greatest advantages. There is less registration paperwork and smaller start-up costs.
  - **Sharing of Profits.** There are fewer profit sharing restrictions, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity.
- Negative attributes:
  - **Limited Life**. When a member leaves, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members start a new LLC or part ways. However, you can include provisions in your operating agreement to prolong the life of the LLC if a member decides to leave the business.
  - **Self-Employment Taxes.** LLC members are considered self-employed and must pay taxes toward Medicare and Social Security. The entire net income of the LLC is subject to this tax.

3. Cooperative *(Slide 1 of 4)*

- A cooperative is a business or organization owned and operated for the benefit of those using its services. Profits and earnings generated by the cooperative are distributed among the members, also known as user-owners.
- Typically, an elected board of directors and officers manage the cooperative while regular members have voting power to control the direction of the cooperative. Members can become part of the cooperative by purchasing shares, though the amount of shares they hold does not affect the weight of their vote.
- Cooperatives are common in the healthcare, retail, agriculture, art, and restaurant industries.

3. Cooperative *(Slide 2 of 4)*

- How to form a cooperative:
  - Forming a cooperative is unique. Potential members must agree on a common need and strategy to meet that need. A committee conducts exploratory meetings, surveys, and cost and feasibility analyses before members agree with the business plan. Not all cooperatives are incorporated, though many choose to do so. If you decide to incorporate, you must complete the following general steps:
    - **File Articles of Incorporation.** This legitimizes your cooperative and includes the name of the cooperative, business location, purpose, duration of existence, names of the incorporators, and capital structure
    - **Create Bylaws.** While not required by law, they do need to comply with state law and are essential to the success of your cooperative. Bylaws list membership requirements, duties, responsibilities, and other operational procedures that allow your cooperative to run smoothly.
    - **Create a Membership Application.** To recruit members and legally verify cooperative members, you must create and issue a membership application, including names, signatures from the board of directors, and member rights and benefits.
    - **Conduct a Charter Member Meeting and Elect Directors.** Charter members meet to discuss, vote on, and amend proposed bylaws. If the board of directors were not named in the articles of incorporation, you must designate them during this meeting.
    - **Obtain Licenses and Permits.** You must obtain relevant business licenses and permits.

3. Cooperative *(Slide 3 of 4)*

- Cooperative taxes:
  - A cooperative operates as a corporation and receives a "pass-through" designation from the IRS. More specifically, cooperatives do not pay federal income taxes as a business entity.
  - Instead, the cooperative's members pay federal taxes when they file their personal income tax. Members pay federal and state income tax on the margins earned by the cooperative, though the amount of taxation varies slightly by state. Cooperatives must follow the rules and regulations of the IRS's Subchapter T Cooperatives tax code to receive this type of tax treatment.
  - Some cooperatives, like credit unions and rural utility cooperatives, are exempt from federal and state taxes due to the nature of their operations.

3. Cooperative *(Slide 4 of 4)*

- Positive attributes:
  - **Less Taxation.** Cooperatives that are incorporated normally are not taxed on surplus earnings (or patronage dividends) refunded to members.
  - **Funding Opportunities.** There are a variety of government-sponsored grant programs to help you start.
  - **Reduce Costs and Improve Products and Services.** By leveraging their size, cooperatives can obtain discounted supplies, materials, and services.
  - **Perpetual Existence**. Members can join or leave without causing dissolution.
  - **Democratic Organization.** The democratic structure ensures that it serves its members' needs.
- Negative attributes:
  - **Obtaining Capital through Investors.** Cash flow depends on a member's incentive to use the cooperative's services and products.
  - **Lack of Membership and Participation.** If members don’t perform their duties, either voting or daily operations, the business cannot operate at full capacity.

4. Corporation *(Slide 1 of 5)*

- A corporation (sometimes referred to as a “C” corporation) is an independent legal entity owned by shareholders. This means that the corporation itself is held legally liable for the actions and debts the business incurs and not the shareholders that own it.
- Corporations are more complex than other business structures because they tend to have costly administrative fees and complex tax and legal requirements. Because of these issues, corporations are generally suggested for established, larger companies with multiple employees.
- A corporation offers the ability to sell ownership shares in the business through stock offerings. “Going public” through an initial public offering (IPO) is a major selling point in attracting investment capital and high-quality employees.

4. Corporation *(Slide 2 of 5)*

- How to form a corporation:
  - A corporation is formed under the laws of the state in which it is registered. To form a corporation you'll need to establish your business name and register your legal business name with your state government. If you choose to operate under a name different than the name officially registered, you'll most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA). State laws vary, but generally corporations must include a corporate designation (Corporation, Incorporated, Limited) in the business name.
  - To register your business as a corporation, you need to file certain documents, typically articles of incorporation, with your state's Secretary of State office. Some states require corporations to establish directors and issue stock certificates to initial shareholders in the registration process. Contact your state business entity registration office to find out about specific filing requirements in the state where you form your business.
  - Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

4. Corporation *(Slide 3 of 5)*

- Corporation taxes:
  - Corporations are required to pay federal, state, and in some cases, local taxes. Most businesses must register with the IRS and state and local revenue agencies, and receive a tax ID number or permit.
  - When you form a corporation, you create a separate tax-paying entity. Regular corporations are called “C” corporations because general tax rules affecting corporations and their shareholders are found in Chapter 1, Subchapter C of the Internal Revenue Code.
  - Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice: 1) when the company makes a profit and 2) when dividends are paid to shareholders on their personal tax returns.
  - Shareholders who are also employees pay income tax on their wages. The corporation and the employee each pay one half of the social security and Medicare taxes, but this is usually a deductible business expense.

4. Corporation *(Slide 4 of 5)*

- Positive attributes:
  - **Limited Liability.** When it comes to taking responsibility for business debts and actions of a corporation, shareholders' personal assets are protected.
  - **Ability to Generate Capital.** Corporations have an advantage when it comes to raising capital. They can sale stock.
  - **Corporate Tax Treatment.** Corporations file taxes separately from their owners. Owners of a corporation only pay taxes on corporate profits paid to them in the form of salaries, bonuses, and dividends.
  - **Attractive to Potential Employees.** Corporations attract and hire high-quality and motivated employees because they offer competitive benefits and possible stock options.

4. Corporation *(Slide 5 of 5)*

- Negative attributes:
  - **Time and Money.** Corporations are costly and time-consuming ventures to start and operate. Incorporating requires start-up, operating, and tax costs that most other structures do not.
  - **Double Taxing.** In some cases, corporations are taxed twice: 1) when the company makes a profit and 2) when dividends are paid to shareholders.
  - **Additional Paperwork.** Because corporations are highly regulated by federal, state, and, in some cases, local agencies, there are increased paperwork and recordkeeping burdens associated with this entity.

5. Partnership *(Slide 1 of 6)*

- A partnership is a single business where two or more people share ownership.
- Each partner contributes to all aspects of the business, including money, property, labor, or skill. In return, each partner shares in the profits and losses of the business.
- Because partnerships encompass more than one person in the decision-making process, it's important to discuss a wide variety of concerns upfront and develop a legal partnership agreement. These may include:
  - Determining the ownership split, e.g., 60/40, 70/30, etc. Every business needs a leader or point person for accountability, thus avoiding the 50/50 split.
  - Including exit strategy terms allowing owners to walk away or be bought out.
  - Agreeing to decisions regarding money, e.g., profit and loss sharing and compensation.
  - Having regular partnership meetings.

5. Partnership *(Slide 2 of 6)*

- There are three general types of partnership arrangements:
  1. **General Partnerships** assume that profits, liability, and management duties are divided equally among partners. If you opt for an unequal distribution, the percentages assigned to each partner must be documented.
  2. **Limited Partnerships** are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner’s investment percentage. Limited partnerships are attractive to investors of short-term projects.
  3. **Joint Ventures** act as general partnership, but for only a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

5. Partnership *(Slide 3 of 6)*

- How to form a partnership:
  - To form a partnership, you must register your business with your state, a process generally done through your Secretary of State's office.
  - You'll also need to establish your business name. For partnerships, your legal name is the name given in your partnership agreement or the last names of the partners. If you choose to operate under a name different than the officially registered name, you will most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA).
  - Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

5. Partnership *(Slide 4 of 6)*

- Partnership taxes:
  - Most businesses must register with the IRS, state and local revenue agencies, and obtain a tax ID number or permit.
  - A partnership must file an “annual information return” to report the income, deductions, gains, and losses from the business’ operations, but the business itself does not pay income tax. Instead, the business "passes through" any profits or losses to its partners. Partners include their respective share of the partnership's income or loss on their personal tax returns.
  - Partnership taxes generally include:
    - Annual return of income
    - Employment taxes
    - Excise taxes
  - Partners are responsible for several additional taxes, including:
    - Income tax
    - Self-employment tax
    - Estimated tax

5. Partnership *(Slide 5 of 6)*

- Positive attributes:
  - **Easy and Inexpensive.** Partnerships are generally an inexpensive and easily formed business structure.
  - **Shared Financial Commitment.** Each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital.
  - **Complementary Skills.** A good partnership should reap the benefits of being able to utilize the strengths, resources, and expertise of each partner.
  - **Partnership Incentives.** Partnerships offer employees the opportunity to become a partner. Partnership incentives often attract highly-motivated and qualified employees.

5. Partnership *(Slide 6 of 6)*

- Negative attributes:
  - **Joint and Individual Liability.** Partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
  - **Disagreements Among Partners.** When multiple people are involved, you will have multiple opinions that could lead to disagreements.
  - **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

6. S Corporation *(Slide 1 of 4)*

- An S corporation (or S Corp) is:
  - A special type of corporation created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S Corp.
  - A corporation with the Subchapter S designation from the IRS. To be considered an S Corp, you must first charter a business as a corporation in the state where it is headquartered. According to the IRS, S Corps are "considered by law to be a unique entity, separate, and apart from those who own it." This limits the financial liability and responsibility for owners or shareholders. S Corps do not shield you from all litigation such as an employee's tort actions as a result of a workplace incident.
  - Different from a traditional corporation in that profits and losses can pass through to your personal tax return. Consequently, the business is not taxed itself. Only the shareholders are taxed. There is an important caveat, however; any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

6. S Corporation *(Slide 2 of 4)*

- How to form an S Corporation:
  - Before you form an S Corporation, determine if your business will qualify under the IRS stipulations.
  - To file as an S Corporation, you must first file as a corporation. After you are considered a corporation, all shareholders must sign and file Form 2553 to elect your corporation to become an S Corporation.
  - Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

6. S Corporation *(Slide 3 of 4)*

- S Corp taxes:
  - Most businesses need to register with the IRS, register with state, and local revenue agencies, and obtain a tax ID number or permit.
  - All states do not tax S Corps equally. Most recognize them similarly to the federal government and tax the shareholders accordingly. However, some states (like Massachusetts) tax S corps on profits above a specified limit. Other states don't recognize the S Corp election and treat the business as a general corporation with all of the tax ramifications. Some states (like New York and New Jersey) tax both the S Corps’ profits and the shareholder's proportional share of the profits.
  - Your corporation must file Form 2553 to elect "S Corp" status within two months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

6. S Corporation *(Slide 4 of 4)*

- Positive attributes:
  - **Tax Savings.** One of the best features of the S Corp is the tax savings. While members of an LLC are subject to employment tax on the entire net income of the business, S Corp shareholders/employees are subject to employment tax only on their wages. The remaining income is paid to the owner as a "distribution," which is taxed at a lower rate, if at all.
  - **Business Expense Tax Credits.** Some expenses that shareholder/employees incur can be written off as business expenses.
  - **Independent Life.** If a shareholder leaves the company or sells his or her shares, the S Corp can continue doing business relatively undisturbed.
- Negative attributes:
  - **Strict Operational Processes.** As a separate structure, S Corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers, and records maintenance.
  - **Shareholder Compensation Requirements.** A shareholder must receive reasonable compensation. The IRS takes notice of low salary/high distribution combinations, and may reclassify your distributions as wages.

Key Takeaways from This Module

- Of all the decisions you make when starting a business, probably the most important one relating to taxes is the type of legal structure you select for your company.
- Not only will this decision have an impact on how much you pay in taxes, but it will affect the amount of paperwork your business is required to do, the personal liability you face, and your ability to raise money.
- Each type of business structure affords unique advantages and disadvantages compared to the other types.
- There is no business structure that will ideally suit all businesses.

Sources and Citations

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