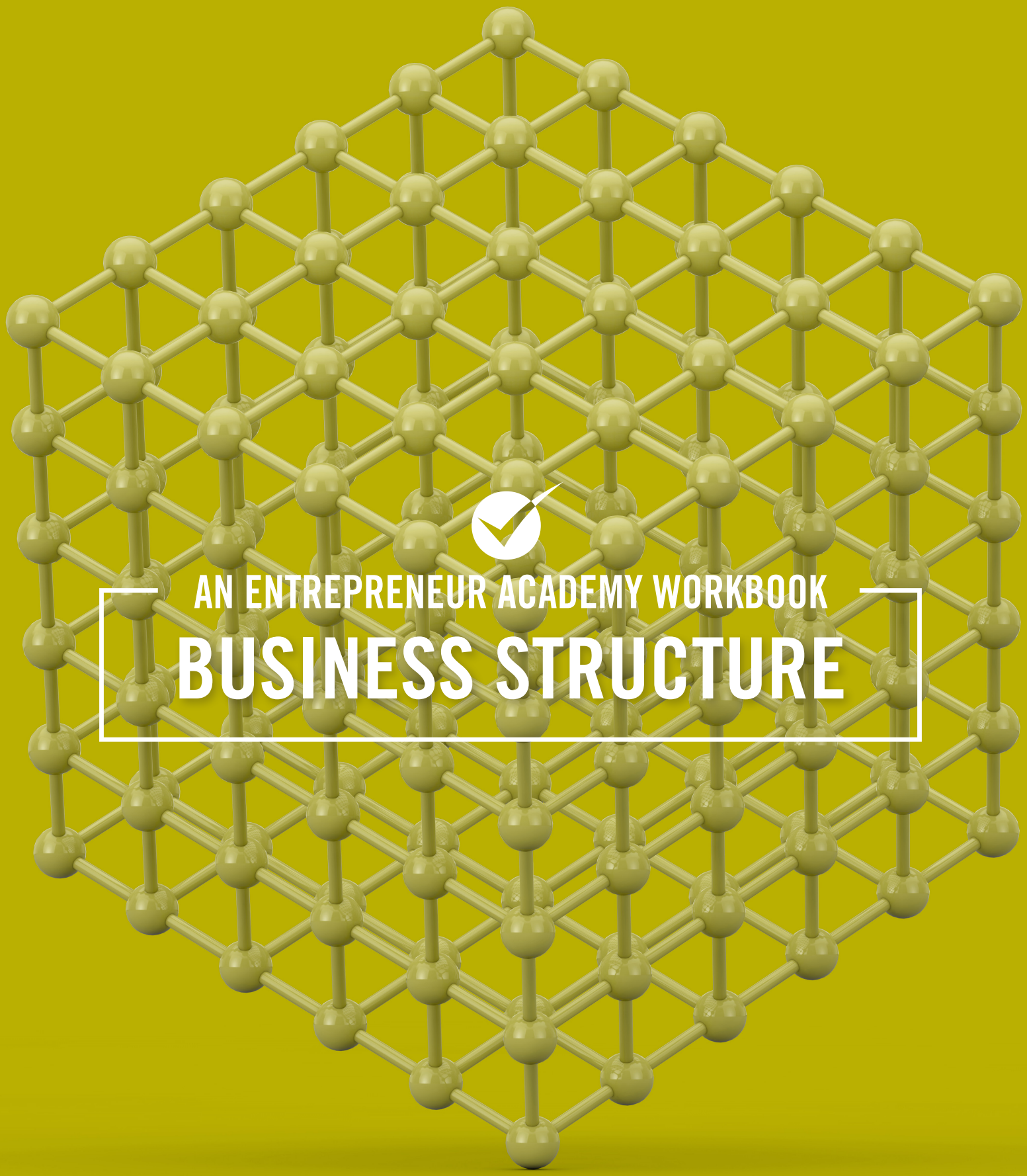

AN ENTREPRENEUR ACADEMY WORKBOOK

BUSINESS STRUCTURE

Lesson 5: Business Structure

“A big business starts small.”
- Sir Richard Branson

Choosing the right business structure is one of the most important decisions you can make as you start a business, since it affects your tax liabilities, legal exposure, and potentially, your personal assets. This workbook will take you through the options along with the advantages and disadvantages of each

Before you ever get to the point of hanging an "Open for Business" sign out front, you need to decide what structure your business is going to be. Each has its own advantages and disadvantages related to taxation, liability, insolvency, filings and reporting.

This tutorial is by no means all-inclusive nor do we make any attempt to offer advice or recommendations. Every business is different, as is the owner or operators. As such, you really want to consult with an attorney, mentor or CPA to get a better handle on which structure suits your needs and situation best. An attorney can help you do all the necessary filings to make sure you've covered all the bases with city, county, state and federal agencies.

Legal liability. Different structures expose you to different levels of personal and professional liability in the event you are sued or the business becomes insolvent. You will want to factor in your own circumstances when considering the best structure for your new enterprise.

Tax implications. Taxes have to be paid no matter what. The real question is how they are reported and what tax benefits are offered within a particular business structure. Corporations typically get better tax breaks than sole proprietorships or partnerships.

Administration: Corporations require more record keeping and paperwork compared to other structures, which is why many new business owners choose the sole proprietorship, partnership or limited liability corporation for their structure.

Future needs: It's a lot easier to purchase a home if you incorporate, as you are considered an employee of the business and as such, have verifiable income in the form of draws and salary. Some lenders are reluctant to lend to a sole proprietorship because the assets of the business and the owner are so tightly interwoven. A corporation can also simplify the transfer of the business to family members and make it easier to raise funds by selling shares of stock.

Keep in mind that you're not stuck with the initial choice you make. Many sole proprietorships have become a partnership, LLC or corporation as the years go by and the needs of the company change. Still, you'll want to give this some thought as the additional cost and paperwork of changing structures can be time consuming.

Regardless of the structure you choose, you will need to follow the same steps to register your business initially. Missing any of these steps or not doing them in the correct order can cause delays. Steps 5 & 6 are industry-specific and won't apply to all businesses.

Here are the eight steps the state requires to set up and operate a business:

1. Research and make a plan
2. Register your business with the Secretary of State (SOS)
3. License your business with the Department of Revenue (DOR)
4. Report your new employees to the Department of Social and Health Services (DSHS)
5. Apply for a Reseller Permit with the Department of Revenue (DOR) Register as a contractor with Department of Labor & Industries (L&I)
6. Contact your local health department for food handling requirements
7. Check with your City and/or County for their requirements

Business structures

Sole Proprietorship

This is the simplest structure. You and the company are one. The income and expenses of the business are reported on your personal income tax filings (Form 1040). The profits and losses from the company are reported on Schedule C, which you file with the 1040. You also need to file Schedule SE which reports how much you owe in self-employment taxes. These taxes need to be paid quarterly to the IRS. Basically, you pay a quarter of your estimated tax every three months. There is some art to getting the estimated payments correct. If you're under, you may owe a penalty for underpayment.

There are some disadvantages with this structure. First, you may be personally liable for your company's liabilities, such as a lawsuit or a workplace accident due to negligence. Your assets – cars, real estate, etc. – are at risk. Raising money as your business grows can also be problematic as your business and you are one. If you have poor credit or a less than optimal credit-to-debt ratio, you may find it hard to get a loan.

Partnership

If your business will have several owners, you'll want to consider creating a partnership. These come in two varieties: general partnerships and limited partnerships.

In a general partnership, the partners manage the company and assume the responsibility for the debts and obligations according to the percentage of ownership outlined in the partnership agreement. If you have a business where there are both active owners and individuals who are investors only and have no control over the company, you may want to form a limited partnership instead, which provides specific protections to the investors in terms of liability.

One of the major tax advantages with a partnership is that taxes aren't paid by the business. Profits and losses are passed through to the partners on their individual tax returns. Taxes are reported on the Schedule K-1 form, which indicates his or her share of partnership income, applicable deductions and tax credits. A separate form, Form 1065, is used to compute income.

There are a couple of drawbacks to a partnership. First, the partners are liable for all obligations and debts as a percent of ownership as articulated in the partnership agreement. In addition, each individual partner can act on behalf of others in the partnership, including making business decisions and taking out loans.

It's highly recommended that you consult with an attorney about a partnership agreement. Before you do, consider these questions.

- What is each partner's investment level? This could be in the form of cash investment or energy and expertise. It can also include the equipment that each partner is bringing with them into the new endeavor.
- What are the responsibilities and duties of each partner? Be as specific as you can. Detail is important here since any ambiguity can become points of contention down the road.
- How will disagreements be handled? How will you resolve situations where there is a deadlock and a decision must me made? And yes, a coin flip has ended up in more than one partnership agreement.
- If a partner becomes disabled, how will the share of profits or losses be shared? To address this, you may want to discuss and agree upon life insurance for each partner.
- How will outside partnerships be handled? Can a partner have an interest in a business that is or may become a competitor?
- How is the partnership ended or altered? Detail the process for dissolving the partnership or what a buyout agreement would look like, which may include a non-compete clause. You will also want to address the transfer of ownership

to another party and the framework for transferring ownership.
- How will any cash infusions be handled? If the company needs capital, will the partners be expected to put the money in, and if so, how will it be apportioned?

A well-crafted partnership agreement will ensure that you adhere to the same vision for the company.

Corporation

A corporation is a more complex structure, and more expensive to form and administer than a sole proprietorship or partnership. That said, a corporate structure does offer you more protections, in part because a corporation is considered to be an independent entity that is separate from its owners.

The biggest benefit of incorporating as an S, C, LLC or Social Purpose Corporation is liability protection. First, the debt of the corporation is not considered that of its owners. So you aren't putting your personal assets at risk, except in rare instances, such as malfeasance. A corporation can also retain profits so you don't have to pay taxes on them. You are able to raise money more easily since you can sell stock.

The downside is increased regulation. You'll probably want to consult with an attorney to guide you through the incorporation process as there are specific filings that need to be made with the Secretary of State and with the IRS. You will need to make sure that you file the required forms annually to demonstrate that your corporation is active and conducting business.

Corporations need some additional paperwork. This includes your articles of incorporation and bylaws that outline things like when your annual meeting will be held, how officers are elected and terms, etc.

Following are the different types of corporations:

Limited Liability Corporation (LLC)

Think of an LLC as a hybrid of some of the best features of partnerships and corporations. Earnings and losses are passed through to the owners on their personal tax returns, much like an S Corporation. Every member or owner of the LLC can participate in the operations of the company, in contrast to a partnership where investors may not be active in the decision-making of the company. LLCs can have an unlimited number of shareholders; an S Corporation can't have more than 75.

LLCs offer owners limited liability, including protecting personal assets. Tax preparation is fairly straightforward. Profits and losses are reported on the personal returns of the individual owners. The business does not file a separate return. Like a partnership, profits and losses can be distributed according to a percentage distribution.

Stock is not an option in an LLC, so raising money from investors can be more difficult than with an S Corporation and you can't offer stock options to a new hire in lieu of salary. Also, you must file an operating agreement to list the members' rights and responsibilities, similar to what you need to file with a partnership. Members of the LLC may have to pay self-employment taxes as well as Medicare/Social Security taxes.

S Corporation

Many small businesses prefer an S Corporation, in part because it offers the additional tax benefits and liability protections larger C Corporations enjoy. Income and losses are passed through to the shareholders and reported on their individual tax returns. Personal assets are protected as an S Corp is considered a separate entity. Owners can also receive paychecks, which makes it a little easier to get financing for a new car or

home, assuming your credit is good. If you don't maintain inventory, you can use the cash method for accounting, which means income is taxable when it's received and expenses are deductible when they are paid.

Because they have to follow the same rules as larger C Corporations, there are more filing requirements, including holding an annual meeting, maintaining minutes and voting on major corporate decisions.

Social Purpose Corporation

Washington State is one of only 10 states that allow the formation of a social purpose corporation (SPC). This is a corporation that is organized to support a social purpose that involves:

- The corporation's employees, suppliers or customers.
- A local, state, national or world community.
- The environment.

It allows the organization's directors to weigh and consider social purposes before making decisions, even if it results in a lower shareholder return. Directors are legally protected if they decide to choose environmental or social impact over economic gain. The Secretary of State handles SPC applications.

Nonprofit Corporation

A nonprofit corporation is a legal entity that is usually tied to some larger ideal or goal rather than the interests of making a profit. If the nonprofit is formed to raise funds from the public, it may need to be registered as a charity with Washington's Secretary of State. The state has a great guide that covers everything you need to know about starting a nonprofit in Washington State.

Characteristics of each structure

Considerations	Sole Proprietorship	Partnership	LLC	Corporation
File With Secretary of State	No	No	Yes	Yes
Formation Difficulty	Low	Low	Medium	Medium/High
Liability	Unlimited liability for debts and taxes.	Unlimited liability for debt and taxes.	Members are not typically liable for debts other than taxes.	Board of directors, annual meetings, annual reporting required.
Operational	Relatively few.	Relatively few.	Some formal requirements such as operating agreements and annual reporting.	Board of directors, annual meetings, annual reporting required.
Management	Sole proprietor has full control of management and operations.	Typically each partner has an equal voice, unless otherwise arranged.	Members have an operating agreement that outlines management structure/ responsibilities.	Managed by the directors who are elected by the shareholders.
Federal Taxation	Not a tax entity. Sole proprietor reports and pays all taxes.	Not a taxable entity. Each partner pays on his/her share of income and can deduct losses against sources of income.	Depending on the structure there is no tax at the entity level.	Taxed at entity level. Any dividends are taxed at the individual level.
Washington Taxation	Taxes based on business entity gross income.	Taxes based on entity income. General partners have limited liability.	Taxes based on business entity income. Responsible parties may have liability for trust funds.	Taxes based on business entity income. Responsible parties may have liability for trust funds.

Assignments

1. Think about your own personality, work style and goals. Write them down in a notebook. As you write them down, think about how they would fit in a specific business structure.

2. Inventory your personal assets. Each structure offers different levels of protections should your company experience bankruptcy or a successful lawsuit.

3. When it comes to decision-making, are you more authoritative or collaborative? Be honest, as this will help inform you in picking a structure that matches your personality.

4. Consult an account and/or attorney to find out more about the implications of the specific structure you're interested in to review your own situation.

Washington State Department of Commerce

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