When beginning a business, you must decide what form of business entity to establish. Your form of business determines which income tax return form you have to file. The most common forms of business 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 structure.

•Sole Proprietorships

•Partnerships

•Corporations

•S Corporations

•Limited Liability Company (LLC)

Sole Proprietorship

A sole proprietorship is the simplest and most common structure chosen to start a business. It is an unincorporated business owned and run 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.

Forming a Sole Proprietorship

You do not have to take any formal action to form a sole proprietorship. As long as you are the only owner, this status automatically comes from your business activities. In fact, you may already own one without knowing it. If you are a freelance writer, for example, you are a sole proprietor.

But like all businesses, you need to obtain the necessary licenses and permits. Regulations vary by industry, state and locality. Use the Licensing & Permits tool to find a listing of federal, state and local permits, licenses and registrations you'll need to run a business.

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 DBA name, short for "doing business as"). You must choose an original name; it cannot already be claimed by another business.

Sole Proprietor Taxes

Because you and your business are one and the same, the business itself is not taxed separately-the sole proprietorship income is your income. You report income and/or losses and expenses with a Schedule C Download Adobe Reader to read this link content and the standard Form 1040 Download Adobe Reader to read this link content. The "bottom-line amount" from Schedule C transfers to your personal tax return. It's your responsibility to withhold and pay all income taxes, including self-employment Download Adobe Reader to read this link content and estimated taxes Download Adobe Reader to read this link content. You can find more information about sole proprietorship taxes and other forms at IRS.gov.

Advantages of a Sole Proprietorship

•Easy and inexpensive to form: A sole proprietorship is the simplest and least expensive business structure to establish. Costs are minimal, with legal costs limited to obtaining the necessary license or permits.

•Complete control. Because you are the sole owner of the business, you have complete control over all decisions. You aren’t required to consult with anyone else when you need to make decisions or want to make changes.

•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.

Disadvantages of a Proprietorship

•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.

•Hard to raise money. Sole proprietors often face challenges when trying 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.

Heavy burden. The flipside of complete control is the burden and pressure it can impose. You alone are ultimately responsible for the successes and failures of your business.

Partnership

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 entail more than one person in the decision-making process, it’s important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners) and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended and it is considered extremely risky to operate without one.

Types of Partnerships

There are three general types of partnership arrangements:

•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 in the partnership agreement.

•Limited Partnerships (also known as a partnership with limited liability) 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.

•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.

Forming 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 name, short for "doing business as").

Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality. Use our Licensing & Permits tool to find a listing of federal, state and local permits, licenses and registrations you'll need to run a business.

If you are hiring employees, read more about federal and state regulations for employers.

Partnership Taxes

Most businesses will need to register with the IRS, register with 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’s 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 in the partnership are responsible for several additional taxes, including:
•Income Tax
•Self-Employment Tax
•Estimated Tax

Corporation (C Corporation)

A corporation (sometimes referred to as a C corporation) is an independent legal entity owned by shareholders. This means that the corporation itself, not the shareholders that own it, is held legally liable for the actions and debts the business incurs.

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.

For businesses in that position, corporations offer 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.

Forming 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 name with your state government. If you choose to operate under a name different than the officially registered name, you’ll most likely have to file a fictitious name (also known as an assumed name, trade name, or DBA name, short for "doing business as"). State laws vary, but generally corporations must include a corporate designation (Corporation, Incorporated, Limited) at the end of 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. Use our Licensing & Permits tool to find a listing of federal, state and local permits, licenses and registrations you'll need to run a business.

If you are hiring employees, read more about federal and state regulations for employers.

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 Subchapter C of Chapter 1 of the Internal Revenue Code is where you find general tax rules affecting corporations and their shareholders.

Unlike sole proprietors and partnerships, corporations pay income tax on their profits. In some cases, corporations are taxed twice - first, when the company makes a profit, and again when dividends are paid to shareholders on their personal tax returns. Corporations use IRS Form 1120 or 1120-A, U.S. Corporation Income Tax Return to report revenue to the federal government.

S Corporation

An S corporation (sometimes referred to as an 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 corporation.

An S corp is 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 corporations are "considered by law to be a unique entity, separate and apart from those who own it." This limits the financial liability for which you (the owner, or "shareholder") are responsible. Nevertheless, liability protection is limited - S corps do not necessarily shield you from all litigation such as an employee’s tort actions as a result of a workplace incident.

What makes the S corp different from a traditional corporation (C corp) is that profits and losses can pass through to the 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."

Forming an S Corporation

Before you form an S Corporation, determine if your business will qualify under the IRS stipulations Download Adobe Reader to read this link content.

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 Download Adobe Reader to read this link content 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. Use the Licensing & Permits tool to find a listing of federal, state and local permits, licenses, and registrations you'll need to run a business.

If you are hiring employees, read more about federal and state regulations for employers.

Combining the Benefits of an LLC with an S Corp

There is always the possibility of requesting S Corp status for your LLC. Your attorney can advise you on the pros and cons. You'll have to make a special election with the IRS to have the LLC taxed as an S corp using Form 2553. And you must file it before the first two months and fifteen days of the beginning of the tax year in which the election is to take effect.

The LLC remains a limited liability company from a legal standpoint, but for tax purposes it's treated as an S corp. Be sure to contact your state's income tax agency where you will file the election form to learn about tax requirements.

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 C corp 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 shares of the profits.

Your corporation must file the Form 2553 to elect "S" 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.

Read more about IRS filing requirements for S Corporations.

Advantages of an S Corporation

Tax Savings. One of the best features of the S Corp is the tax savings for you and your business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S Corp shareholder who is an employee are subject to employment tax. 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. Nevertheless, if such an employee owns 2% or more shares, then benefits like health and life insurance are deemed taxable income.

Independent Life. An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

Disadvantages of an S Corporation

Stricter 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 shareholder red flags like low salary/high distribution combinations, and may reclassify your distributions as wages. You could pay a higher employment tax because of an audit with these results.

Limited Liability Company

A limited liability company 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.

Forming an LLC

While each state has slight variations to forming an LLC, they all adhere to some general principles:

Choose a Business Name. There are 3 rules that your LLC name needs to follow: (1) it must be different from an existing LLC in your state, (2) it must indicate that it's an LLC (such as "LLC" or Limited Company") and (3) it must not include words restricted by your state (such as "bank" and "insurance"). Your business name is automatically registered with your state when you register your business, so you do not have to go through a separate process. Read more here about choosing a business name.

File the Articles of Organization. The "articles of organization" is a simple document that legitimizes your LLC and includes information like your business name, address, and the names of its members. For most states, you file with the Secretary of State. However, other states may require that you file with a different office such as the State Corporation Commission, Department of Commerce and Consumer Affairs, Department of Consumer and Regulatory Affairs, or the Division of Corporations & Commercial Code. Note: there may be an associated filing fee.

Create an Operating Agreement. Most states do not require operating agreements. 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. The operating agreement usually includes percentage of interests, allocation of profits and losses, member's rights and responsibilities and other provisions.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state and locality. Use the Licensing & Permits tool to find a listing of federal, state and local permits, licenses and registrations you'll need to run a business.

Hiring Employees. If you are hiring employees, read more about 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. Check with your state's business filing office for requirements in your area.

LLC Taxes

In the eyes of the federal government, an LLC is not 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. While the federal government does not tax income on an LLC, some states do, so check with your state's income tax agency.

Since the federal government does not recognize LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law. For guidelines about how to classify an LLC, visit IRS.gov.

LLCs that are not automatically classified as a corporation can choose their business entity classification. To elect a classification, an LLC must file Form 8832. This form is also used if an LLC wishes to change its classification status. Read more about filing as a corporation or partnership and filing as a single member LLC at IRS.gov.

You should file the following tax forms depending on your classification:

•Single Member LLC. A single-member LLC files Form 1040 Schedule C like a sole proprietor.

•Partners in an LLC. Partners in an LLC file a Form 1065 Download Adobe Reader to read this link content partnership tax return like owners in a traditional partnership.

•LLC filing as a Corporation. An LLC designated as a corporation files Form 1120, the corporation income tax return.

The IRS guide to Limited Liability Companies provides all relevant tax forms and additional information regarding their purpose and use.

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