

CHOOSING THE RIGHT LEGAL FORM FOR YOUR BUSINESS

The legal form that you choose for your business can make a difference in the taxes you pay, the costs of doing business and the amount of paperwork and red tape you will have to prepare. Here is a quick look at the main legal entities that businesses can choose for their operations.

Sole Proprietorship

A sole proprietorship is owned and operated by one individual. It is the least complicated and usually the least expensive way to set up and run a business.

A sole proprietor is personally liable for all debts and business ownership is nontransferable. Under a sole proprietorship, the life of a business is limited to the life of the individual proprietor. The sole proprietorship makes no legal distinction between personal and business debts and it does not require a separate income tax return. A sole proprietorship is often operated under the same name of the owner. Whenever operating a business under a name other than the sole proprietor, an Assumed Name Certificate must be filed with the county clerk.

The business income is taxed to the owner on Schedule C of his or her personal tax return. Income taxes are not withheld on business income,

though quarterly estimated taxes may be required. Payroll taxes apply to any employees of the business. The sole proprietor pays self-employment tax rather than social security tax (and gets a tax deduction for 50% of the tax paid).

A major disadvantage to a sole proprietorship is unlimited liability, not only for debts of the business, but for lawsuits brought against the business. Liability extends to the proprietor's personal as well as business assets.

The ability to raise capital for the business is limited to the amount the individual can secure personally. Since under capitalization is a major cause of business failure, this factor can be significant.

The deductibility of fringe benefits is very limited in a sole proprietorship. In fact, this area comes under close scrutiny by the IRS because of concern that personal expenditures might be deducted as business expenses.

General Partnership

A partnership can have any number of partners. Partners bring to a business more creativity, skills, capital base and experience than any one person is likely to have.

Under a general partnership, a separate business entity exists, but creditors can still look to the partners' personal

assets for satisfaction of debts. General partners share equally in assets and liabilities. A general partnership requires an annual partnership income tax return (separate from the partners' person returns). A general partnership may be operated under the names of the owners or a different name. In either case, an Assumed Name Certificate must be filed with the county clerk.

A partnership files an information tax return (Form 1065), but pays no income tax itself. The income or losses are passed through to the partners who report them on their individual tax returns in shares agreed upon by the partners – not necessarily equally. Partners, like sole proprietors, pay self-employment tax on net income rather than social security taxes on wages.

A major drawback to a partnership is that liability is unlimited. In fact, partners can be held liable for the actions of fellow partners.

Partners have similar options in the area of fringe benefits and retirement plans as those available to sole proprietors.

Limited Partnership

A limited partnership is a partnership formed by two or more persons or entities under the laws of Texas and having one or more general partners and one or more limited partners. General partners share equally in

debts and assets, while limited partners have limited debt obligations. A limited partnership must be registered with the Secretary of State.

Registered Limited Liability Partnership

A registered limited liability partnership is a general partnership that has been registered with the Secretary of State. A partner's liability in a registered limited liability partnership differs from that of an ordinary partnership. In a registered limited liability partnership, a partner is not individually liable, under some circumstances, for debts and obligations of the partnership arising from errors, omissions, negligence, incompetence or malfeasance committed in the course of business by others in the partnership.

Corporation

A corporation, the most complex of the business structures, is a distinct legal entity apart from the shareholders who own it. Formed under the requirements of the state in which it will do business, a corporation limits its owners' liability to their investment in the company; personal assets are generally not at risk. The corporate form does not provide complete protection where personal services are involved.

A corporation (Subchapter C or S) is created when two or

more individuals, partnerships or other entities join together to form a separate entity for the purpose of operating a business in the state. A corporation has its own legal identity, separate from its owners. The corporation offers protection to the business owners' personal assets from debts and liabilities relating to the operation of the corporation. Taxation of the corporation varies depending on the *type* of corporation formed. A corporation must be registered with the Secretary of State.

A Subchapter C Corporation is taxed at a higher rate than an individual. The owners are not taxed personally for profits; however, the owners do pay personal taxes on any salaries and/or dividends, and the corporation is also taxed on the profits.

If you set up a corporation and are employed by it, the corporation must withhold and pay payroll taxes on your wages.

A corporation files its own tax return (Form 1120) and pays its own income tax. Therein lies the major drawback to the corporate form. Business profits may be taxed twice – once at the corporate level and again at the shareholder level when paid out as dividends or a liquidating distribution.

The corporate form allows for fringe benefits, deductible by the corporation and tax

free to employees (including shareholder -employees).

A major drawback to the corporate form is the complexity of rules and regulations governing the operations of the corporation (including the tax laws). A special kind of corporation known as the personal service corporation (PSC) has the added drawback of being taxed at a flat rate (the top corporate rate) rather than at the graduated rates available to other corporations.

Owners of Subchapter S Corporations may deduct business losses on personal income tax returns, similar to a partnership. The Subchapter S Corporation also offers alternative methods for distributing the business income to the owners.

A corporation is allowed to elect S status only if it meets certain qualifications. An S corporation generally does not pay its own income tax. It files Form 1120S and distributes K-1s to shareholders. Shareholders then report their pro rata share of income, losses and credits on their individual tax returns. The double taxation that regular corporations face is thereby avoided with an S corporation.

The big advantage of S status is that it combines the limited liability of a regular corporation with tax treatment similar to that of a partnership. A disadvantage is that S corporations have

some fringe benefit restrictions for owner - employees.

Limited Liability Company

A limited liability company (LLC) is an unincorporated business entity which shares some of the aspects of Subchapter S Corporations and limited partnerships and yet has more flexibility than more traditional business entities. The LLC is designed to provide its owners with limited liability and pass-through tax advantages without the restrictions imposed on Subchapter S Corporations and limited partnerships. A LLC must be registered with the Secretary of State.

In sum, the LLC combines the general flexibility and income tax treatment of a partnership with the limited liability of a corporation.

BUSINESS NAME

Once the legal structure of the business has been determined, and if a separate business name will be used, the business name must be registered with the county clerk's office and/or the Secretary of State.

It is very important to do a thorough search when considering a business name. If a corporation and an unincorporated company have very similar names, neither automatically has the right to the name. If both parties have properly filed the Assumed Name Certificate,

the courts will most likely have to decide this matter. Taking the time necessary to conduct the name research up front will help avoid legal costs after the business is opened and operating.

State Registration

All businesses operating in Texas as limited partnerships, registered limited liability partnerships, limited liability companies, corporations, professional corporations, nonprofit corporations and professional associations, must register with the Secretary of State.

Corporations, limited partnerships and limited liability companies organized in other states or countries may transact business in Texas by obtaining a certificate of authority through the Secretary of State.

If a corporation will transact business under names other than that sated in the articles of incorporation, the corporation must file an Assumed Name Certificate with the Secretary of State and with the county clerk in which the principal office and registered office of the corporation are located.

Local Registration (Assumed Name Certificate)

If the business will operate as a sole proprietorship or a general partnership, an Assumed Name Certificate or d/b/a (doing business as) for

each name (or deviation of that name) the business will use must be on file with the county clerk in each county where a business premise will be maintained. If no business premise will be maintained, it should be filed in each county where business will be conducted.

If the business will operate as a corporation, limited partnership or limited liability company, and the business will be identified by a name other than the name on file with the Secretary of State, an Assumed Name Certificate must be filed with the Secretary of State and each county in which the business will have a registered or principal office.

Neither the filing of an Assumed Name Certificate nor the reservation or registration of a company name imparts any real protection to the party filing the certificate. It is merely a formal process that informs the general public of the registered agent for a business and where official contact with the business can be made.

Filing the Assumed Name Certificate

The information required to be submitted to each county clerk office is the following: business name, mailing address, city, state, zip, expected period of operation, business type and owner information. Ten years is the maximum length of time an assumed name filing is valid.

The Mack Law Office, PLLC
1333 W. McDermott Dr., Suite 200, Allen, Texas 75013
(469) 519-1020
www.macklawoffice.com
