Business Structures

Before you can decide how you want to structure your business, you'll need to know what your options are. Here's a brief rundown on the most common ways to organize a business:

- sole proprietorship
- partnership
- limited partnership
- limited liability company (LLC)
- corporation (for-profit)
- nonprofit corporation (not-for-profit), and
- cooperative

Sole Proprietorships and Partnerships

For many new businesses, the best initial ownership structure is either a sole proprietorship or -- if more than one owner is involved -- a partnership.

Sole Proprietorships

A sole proprietorship is a one-person business that is not registered with the state like a limited liability company (LLC) or corporation. You don't have to do anything special or file any papers to set up a sole proprietorship -- you create one just by going into business for yourself.

Legally, a sole proprietorship is inseparable from its owner -- the business and the owner are one and the same. This means the owner of the business reports business income and losses on his or her personal tax return and is personally liable for any business-related obligations, such as debts or court judgments.

Partnerships

Similarly, a partnership is simply a business owned by two or more people that haven't filed papers to become a corporation or a limited liability company (LLC). You don't have to file any paperwork to form a partnership -- the arrangement begins as soon as you start a business with another person. As in a sole proprietorship, the partnership's owners pay taxes on their shares of the business income on their personal tax returns and they are each personally liable for the entire amount of any business debts and claims.

Sole proprietorships and partnerships make sense in a business where personal liability isn't a big worry -- for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money for inventory or other costs.

Limited Partnerships

Limited partnerships are costly and complicated to set up and run, and are not recommended for the average small business owner. Limited partnerships are usually created by one person or company (the general partner), who will solicit investments from others (the limited partners).
The general partner controls the limited partnership's day-to-day operations and is personally liable for business debts (unless the general partner is a corporation or an LLC). Limited partners have minimal control over daily business decisions or operations and, in return, they are not personally liable for business debts or claims. Consult a limited partnership expert if you're interested in creating this type of business.

**Corporations and LLCs**

Forming and operating an LLC or a corporation is a bit more complicated and costly, but well worth the trouble for some small businesses. The main benefit of an LLC or a corporation is that these structures limit the owners' personal liability for business debts and court judgments against the business.

What sets the corporation apart from all other types of businesses is that a corporation is an independent legal and tax entity, separate from the people who own, control and manage it. Because of this separate status, the owners of a corporation don't use their personal tax returns to pay tax on corporate profits -- the corporation itself pays these taxes. Owners pay personal income tax only on money they draw from the corporation in the form of salaries, bonuses, and the like.

Like corporations, LLCs provide limited personal liability for business debts and claims. But when it comes to taxes, LLCs are more like partnerships: the owners of an LLC pay taxes on their shares of the business income on their personal tax returns.

Corporations and LLCs make sense for business owners who either run a risk of being sued by customers or of piling up a lot of business debts, or have substantial personal assets they want to protect from business creditors.

**Nonprofit Corporations**

A nonprofit corporation is a corporation formed to carry out a charitable, educational, religious, literary, or scientific purpose. A nonprofit can raise much-needed funds by soliciting public and private grant money and donations from individuals and companies. The federal and state governments do not generally tax nonprofit corporations on money they take in that is related to their nonprofit purpose, because of the benefits they contribute to society.

**Cooperatives**

Some people dream of forming a business of true equals -- an organization owned and operated democratically by its members. These grassroots business organizers often refer to their businesses as a group, collective, or co-op -- but these are often informal rather than legal labels. For example, a consumer co-op could be formed to run a food store, a bookstore, or any other retail business. Or a workers' co-op could be created to manufacture and sell arts and crafts. Most states do have specific laws dealing with the set-up of cooperatives, and in some states you can file paperwork with the secretary of state's office to have your cooperative formally recognized by the state. Check with your secretary of state's office for more information.
**So which structure is right for your cooperative?** For the right cooperative structure -- corporation, LLC, partnership, or sole proprietorship -- it depends on who will own your business and what its activities will be. When you start a business, you must decide whether it will be a sole proprietorship, partnership, corporation, or limited liability company (LLC). Which of these forms is right for your business depends on the type of business you run, how many owners it has, and its financial situation. No one choice suits every business: Business owners have to pick the structure that best meets their needs. Several of the most important factors to consider are the potential risks and liabilities of your business, the formalities and expenses involved in establishing and maintaining the various business structures, your income tax situation, and your investment needs. To learn more about the pros and cons of each business structure, read the Business Structures: the Pros and Cons Chart (separate document).

**Risks and Liabilities**

In large part, the best ownership structure for your business depends on the type of services or products it will provide. If your business will engage in risky activities -- for example, trading stocks or repairing roofs -- you'll almost surely want to form a business entity that provides personal liability protection (limited liability), which shields your personal assets from business debts and claims. A corporation or a limited liability company (LLC) is probably the best choice for you.

**Formalities and Expenses**

Sole proprietorships and partnerships are easy to set up -- you don't have to file any special forms or pay any fees to start your business. Plus, you don't have to follow any special operating rules.

LLCs and corporations, on the other hand, are almost always more expensive to create and more difficult to maintain. To form an LLC or corporation, you must file a document with the state and pay a fee, which ranges from about $40 to $800, depending on the state where you form your business. In addition, owners of corporations and LLCs must elect officers (usually, a president, vice president, and secretary) to run the company. They also have to keep records of important business decisions and follow other formalities.

If you're starting your business on a shoestring, it might make the sense to form the simplest type of business -- a sole proprietorship (for one-owner businesses) or a partnership (for businesses with more than one owner). Unless yours will be a particularly risky business, the limited personal liability provided by an LLC or a corporation may not be worth the cost and paperwork required to create and run one.

**Income Taxes**

Owners of sole proprietorships, partnerships, and LLCs all pay taxes on business profits in the same way. These three business types are "pass-through" tax entities, which means that all of the profits and losses pass through the business to the owners, who report their share of the profits (or deduct their share of the losses) on their personal income tax returns. Therefore, sole proprietors, partners, and LLC owners can count on about the same amount of tax complexity, paperwork, and costs.

Owners of these unincorporated businesses must pay income taxes on all net profits of the business, regardless of how much they actually take out of the business each year. Even if all of the profits are
kept in the business checking account to meet upcoming business expenses, the owners must report their share of these profits as income on their tax returns.

In contrast, the owners of a corporation do not report their shares of corporate profits on their personal tax returns. The owners pay taxes only on profits they actually receive in the form of salaries, bonuses, and dividends.

The corporation itself pays taxes, at special corporate tax rates, on any profits that are left in the company from year to year (called retained earnings). Corporations also have to pay taxes on dividends paid out to shareholders, but this rarely affects small corporations, which seldom pay dividends.

This separate level of taxation adds a layer of complexity to filing and paying taxes, but it can be a benefit to some businesses. Owners of a corporation don’t have to pay personal income taxes on profits they don’t receive. And, because corporations enjoy a lower tax rate than most individuals for the first $50,000 to $75,000 of corporate income, a corporation and its owners may actually have a lower combined tax bill than the owners of an unincorporated business that earns the same amount of profit.

**Investment Needs**

Unlike other business forms, the corporate structure allows a business to sell ownership shares in the company through its stock offerings. This makes it easier to attract investment capital and to hire and retain key employees by issuing employee stock options.

But for businesses that don’t need to issue stock options and will never "go public," forming a corporation probably isn’t worth the added expense. If it’s a limited liability that you want, an LLC provides the same protection as a corporation, but the simplicity and flexibility of LLCs offer a clear advantage over corporations.

**Changing Your Mind**

Your initial choice of a business structure isn’t set in stone. You can start out as sole proprietorship or partnership and later, if your business grows or the risk of personal liability increases, you can convert your business to an LLC or a corporation.

**Next Steps**

After learning the basics of each business structure and considering the factors discussed above, you may still find that you need help deciding which structure is best for your business. A good small business or tax lawyer can help you choose the right one, given your tax picture and the possible risks of your particular situation.