

Considerations When Selecting an Organizational Structure for Your Business

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A business is something you do with the objective of making a profit. You may be raising something to sell—apples, livestock, or Christmas trees; you may be performing services for someone—altering clothes, trucking cattle, or repairing lawnmowers; or you may be manufacturing or making something—fence posts or wedding gowns. If you have a business, you have some form of business organization—a sole proprietorship, a partnership, a corporation, or a limited liability company.

When starting a business, or when changing from one organizational structure to another, business owners should know the relative advantages and disadvantages of each business structure and how the structure they select will help them meet business, personal, and family goals. The best structure for one business may not be the best for another. The best structure for a new business may not be suitable as the business expands.

A business may be owned by one person or more than one person. Before going into business with someone else, take a good hard look at both the business and the potential business owners. Can the people work together? Is the business financially strong enough to support two or more families? And if the people are in business together, what form of business organization is most appropriate?

Some issues to consider in choosing a form of business organization are:

- The source of funds needed for the business
- Liability for personal injury, product liability, contracts, and taxes
- Taxation issues including the tax treatment of profits/losses and the

deductibility of employee benefits such as health insurance, group term life insurance, and retirement plans

- The desire for the business to continue after the death of the current owner
- The time, effort, and cost of setting up and maintaining the business organization

There are four basic forms of business organization: the sole proprietorship; the partnership, which may be a general or a limited partnership; the corporation, which for tax purposes may be a "C" or an "S" corporation; and the limited liability company.

Sole proprietorship

A common form of business ownership is the sole proprietorship. It is the least complicated form of business ownership and is the easiest to set up and to terminate. The business is owned and controlled by one person; the owner is the business. The funds for the business come from the owner's personal investments, loans, and sometimes from friends or family members.

All of the owner's personal assets can be made available to satisfy debts and taxes owed by the business or any legal damages resulting from lawsuits filed against the business. This means the owner's personal assets—car, home, bank accounts—are subject to claims by creditors for satisfaction of business loans, contracts, and legal judgments. Often, the business is a sole proprietorship, but assets used in the business—land, vehicles, equipment—are owned jointly by husband and wife. Therefore, even though the business is owned by one, the assets of both may be subject to business liabilities. Liability insurance for business activities is important for all

business owners, including the sole proprietor.

The sole proprietorship files a tax form, either IRS Schedule C or C-EZ, reporting income or losses, but the income or losses appear on the owner's federal income tax return and are taxed as personal income. The owner pays Social Security tax on his or her income from self employment.

While no paper work is necessary to establish a sole proprietorship, professional help is recommended to assist in setting up the bookkeeping system, employee payroll systems, etc.

Partnership

A partnership is the voluntary association of two or more people for the purpose of making a profit. Each person contributes money, property, labor, or skills, and each expects to share in the profits and losses.

A partnership is the same as a sole proprietorship with respect to taxes and liability. Each general partner has unlimited personal liability for all debts and obligations of the partnership and acts of the partners. A partnership is not a taxable entity. However, it must figure its total income and file IRS Form 1065, which provides information on partnership income or losses for the year. Each of the partners must report on his or her individual tax return his or her share of the partnership income—gains, losses, deductions, or credits—even if the partnership income is reinvested in the business rather than distributed to the partners.

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A partnership is formed with an oral or written agreement. A written agreement, prepared with advice from an attorney, is recommended. Following are some of the items that should be covered in the partnership agreement:

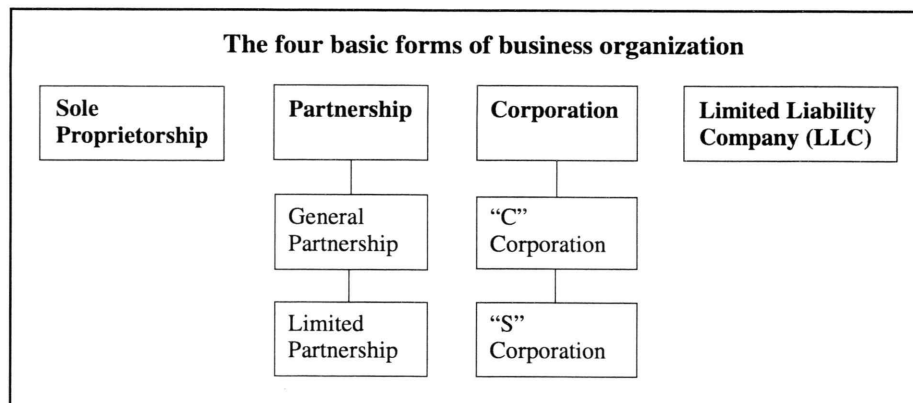
- Names and addresses of the partners and the name of the partnership
- Purpose of the partnership
- Duration of the agreement and method of review and termination of the agreement
- Who is contributing what resources (cash, personal property, real estate, labor, and services) and how they will be contributed (outright to partnership, on a use only basis, or rental)
- How profits will be calculated and shared
- How decisions are to be made
- Limitations on the activities of the partners
- How partnership assets are divided when the partnership is terminated

There are two kinds of partnerships—general and limited. In a general partnership, two or more people contribute assets to the partnership and these general partners share the management, profits, and losses. The general partners are personally liable for all partnership debts and liabilities and acts of any of the partners.

A limited partnership must have at least one general partner and one or more limited partners. The limited partnership is a way for the general partner(s) to get additional capital without giving up management control. General partners manage the business and have unlimited liability for the debts of the business and acts of the partners. Limited partners take no active role in the management of the business, and their liability is limited to the extent of their partnership investment.

Corporation

A corporation has a legal and tax identity separate from its owners. The owners are called *shareholders*. A corporation is chartered by the state, and articles of incorporation must be filed with the secretary of state. The articles of incorporation include such things as the name of the corporation, purpose of the corporation, names and addresses of



directors and incorporators, location of the main office, duration of the corporation, amount and kinds of capital stock issues at the outset, and description of the voting rights of shareholders. The articles of incorporation should be prepared with legal counsel.

Once formed, a corporation must have annual business meetings; keep minutes and records of its activities; specify policies concerning salaries and fees, dividends, etc.; and file tax and other required reports. It is extremely important to get legal and accounting advice.

The primary advantage of the corporation is its “limited liability.” The corporation is fully liable for all its business obligations; individual shareholders are liable only to the extent of their investment. In practice, however, owners of small, closely held corporations often are required to personally guarantee the debts of their corporation. The corporation does offer shareholders some protection from liability claims. However, it is not a substitute for a formal comprehensive business and personal liability insurance program.

For tax purposes, a corporation must choose whether it is a “C” corporation or an “S” corporation. A “C” corporation pays taxes on its income. When income is passed on to the shareholders in the form of dividends, it is taxable income to the shareholders. This double taxation is a disadvantage.

A special form of the corporation, called the tax-option or Subchapter S corporation, can be used for tax purposes (chiefly for corporations with 35 or fewer shareholders). The “S” corporation

is not a separate taxable entity; income is allocated to the shareholders and is taxed at their personal rates.

Limited liability company

A limited liability company (LLC) is a new form of business organization available in some states, including Oregon, Idaho, and Washington. When properly formed and maintained, the LLC has the limited liability features of the corporation and the tax features of the partnership.

The owners of the LLC are called *members*, and the LLC must have at least two members. The organizer(s) of the LLC file the articles of organization with the secretary of state. Because this is a new form of business organization, and because there are differences from state to state, extreme care is needed in drafting the documents for the LLC. Creating an LLC is not a do-it-yourself job; legal help is essential.

Any business, regardless of its structure, needs its own separate bank accounts and bookkeeping system. Any business owner, regardless of the business structure, needs a comprehensive business and personal liability insurance program. Work closely with your accountant, attorney, and management and insurance consultants on specific issues related to your particular situation.

Your choice of business organization depends in part on the characteristics of each type of business organization and on your situation, preferences, and objectives. Do not make a decision without careful study.

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