Business Structures

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OBJECTIVES

- Discuss the various types of business entities and their general tax attributes
- Discuss choice of entity
- Discuss state of formation
TYPES OF BUSINESS ENTITIES

- Sole proprietorship
- General partnership
- Limited partnership
- Corporation
- Limited liability company or "LLC"
KEY FACTORS TO CONSIDER WHEN CHOOSING AN ENTITY

- Personal Liability
  - Will the entity protect owners from personal liability?

- Tax Attributes
  - Will the entity create one or two levels of taxation?
    - (i.e., will the income stream of the business be taxed once or twice)
  - Other tax attributes (e.g., partnership tax law vs. corporation tax law)
KEY FACTORS TO CONSIDER WHEN CHOOSING AN ENTITY [CONT..]

- Administrative Requirements
  - What administrative requirements do the laws governing a particular entity require?
    - (i.e., does the entity have to comply with specific capitalization, management structure, voting, notification, and meeting requirements)

- Angel Investor (“Angels”) and Venture Capitalist (“VC”) Considerations
  - What types of entities do Angels and VCs prefer?
SOLE PROPRIETORSHIP

- Business that is owned by one person
- Cannot have more than one owner
- Not a separate legal entity from its owner
- Owner has unlimited personal liability for all debts of the business
SOLE PROPRIETORSHIP [CONT..]

- One level of taxation
  + Sole proprietor files Schedule C with Form 1040 and pays all income tax on the profits of the business and deducts all losses of the business

- No administrative requirements other than filing DBA

- Life of sole proprietorship is tied to sole proprietor
  + Can only sell the assets of the business

- Angels and VCs will not typically invest in sole proprietorships
GENERAL PARTNERSHIP

- Must have more than one owner, known as partners
- The partnership is a separate legal entity from its owners
- The partners have unlimited personal liability for the debts of the partnership
One level of taxation
- Partnership files an information return known as Form 1065
- Partners file Schedule E with their Form 1040 and *pay income tax on any profits of the partnership or deduct any losses of the partnership in proportion to the percentage of the partnership that they own* whether or not they take any cash out of the partnership

Few administrative requirements required by law
- Partners can set the level of administrative requirements in partnership agreement

Angels and VCs will not typically invest in general partnerships
LIMITED PARTNERSHIP

- Must have more than one owner
- Separate legal entity from its owners
- Two Types of Partners:
  + general partners; and
  + limited partners

*General partners manage the business and have unlimited personal liability for all debts of the limited partnership*

*Limited partners are merely investors and cannot take part in managing the business; they have limited personal liability*
LIMITED PARTNERSHIP [CONT..]

- One level of taxation
  - Limited partnership files an information return known as Form 1065
  - General and limited partners file Schedule E with their Form 1040 and pay income tax on any profits of the limited partnership or deduct any losses of the limited partnership in proportion to the percentage of the limited partnership that they own whether or not they take any cash out of the limited partnership

- Some formal administrative requirements required by law

- Angels and VCs will not typically invest in limited partnerships

- Primary Purpose: specialized investment and estate planning vehicle
CORPORATION

- Can have one or more owners, known as shareholders
- Separate legal entity from owners
- Shareholders have limited personal liability
- Numerous formal administrative requirements required by law
- Unlimited life unless dissolved
Taxation: Corporations can be taxed as “C Corporations” or “S Corporations”

**Taxation of C Corporations**

- **C Corporations** have two levels of taxation
  - Corporate level
    - C Corporations file Form 1120
  - Shareholder level on dividends that are paid
Shareholders are not liable for paying tax on C Corporation's profits and it can’t deduct C Corporation's losses.

State Franchise Tax for C Corporations

- Varies by state:
  - Wisconsin franchise tax for C Corporations is determined by calculating four distinct taxes - the tax that results in the largest amount is the franchise tax.
S Corporations

- S Corporations have one level of taxation
  - profits and losses of S Corporations pass through to its shareholders
    - S Corporations file Form 1120s, which is an information return

- Shareholders file Schedule E with their 1040 and pay income tax on any profits of the S Corporation or deduct any losses of the S Corporation in proportion to the percentage of the S Corporation that they own whether or not they take any cash out of the S Corporation
State Franchise Tax for S Corporations

- Varies by state
  - *Wisconsin* franchise tax for S Corporations ranges between $25 to $4,500 depending on S Corporation’s NY derived receipts

- Angels and VCs will invest in C Corporations, but not typically S Corporations
LIMITED LIABILITY COMPANY

- Can have one or more owners, known as members
- Separate legal entity from its owners
- Members have limited personal liability
- Unlimited life unless dissolved
- Few administrative requirements required by law
  + Members can set the level of administrative requirements they desire in LLC’s operating agreement
  + Members can run the business directly or they can elect one or more managers to run the business
Taxation of LLCs

- Single Member LLCs are treated as sole proprietorships for income tax purposes, unless they elect to be taxed as a corporation (either S or C Corporation)

- Multi-Member LLCs are treated as partnerships for income tax purposes, unless they elect to be taxed as a corporation (either S or C Corporation)

- As a result, profits and losses pass through to the members for income tax purposes; so LLCs can have only one level of taxation

- Angels and VCs will not typically invest in LLCs, but this is changing
State Tax for LLCs

- Most states charge LLCs an annual state filing fee or tax amount
  - Wisconsin charges the following:
    - Multi-Member LLC taxed as partnership: the tax ranges between $25 to $4,500 depending on LLC’s NY source gross income (similar to franchise tax calculation for NY S Corporations)
    - Single Member LLC taxed as sole proprietorship: $25 per year
    - LLC taxed as a corporation: calculated the same as for a NY corporation
Seeking professional assistance reduces chances of making costly errors.

But more importantly, reducing costs of accessing professional assistance is much more beneficial. It allows you to conduct your own research and get familiarized with the technicalities of your business.

Ever heard of a joke about the doctor and a plumber?

You would consult with professionals in these areas:
1. Legal
2. Taxes
Do you need a lawyer?
http://www.wmnet.org.uk/wmnet/custom/files_uploaded/uploaded_resources/503/clock.swf
STATE OF WISCONSIN WEBSITE

- https://www.wdfi.org/apps/CorpFormation/name.aspx
2. ACCOUNTING

What is important to know
Sole Proprietorship, General Partnership, and Limited Partnership are typically used only in special circumstances.

For most businesses, the choice will be a C Corporation, S Corporation, or LLC.
- Name of your business:
- What form fits you?
- What advantages does the form present to you?
CHOOSING AN ENTITY [CONT..]

- The choice of C Corporation, S Corporation, or LLC depends on the circumstances

  + If the Company plans a significant Angel or VC funding, those investors will likely invest only in a C Corporation
    - The company can begin as an S Corporation or LLC and change to a C Corporation later, but tax considerations should be discussed with attorney and accountant

  + Absent significant Angel or VC investment, LLC may be the best choice
S CORPORATIONS VS. LLCS

- Choice between S Corporation and LLC will depend on the circumstances
- Differences between S Corporations and LLCs include the following:
  - LLCs have fewer administrative requirements and permit a more flexible management structure
S CORPORATIONS VS. LLCS [CONT..]

- LLCs can obtain pass through taxation without complying with the S Corporation election requirements

  ✗ For example:
  - LLCs can have more than 100 members
  - LLCs can have members of any entity type, rather than just individuals, estates, certain trusts, or certain tax-exempt organizations
  - LLCs can have members that are nonresident aliens, rather than just US citizens and resident aliens
  - LLCs can have more than one class of membership interest (i.e., can have preferred membership interests)
There are particular tax benefits that apply to LLCs taxed as partnerships or sole proprietorships that don’t apply to S Corporations, and vice versa.

- The benefits that apply to LLCs taxed as partnerships or sole proprietorships are generally considered more beneficial in the aggregate than the benefits that apply to S Corporations.
LLC state taxes are typically less than or equal to S Corporation state taxes

- LLC and S Corporation formation costs (including legal fees and disbursements) are about the same

- For these reasons, LLC is typically considered the best choice absent significant Angel or VC investment
CONCLUSION

- As we have seen, choice of entity and state of formation involve numerous complex considerations.

- As a result, choice of entity and state of formation should always be reviewed with lawyer and accountant.
RESOURCES

Video#1:
- http://www.youtube.com/watch?v=6bgviR3c8Ig&feature=related
- Wisconsin Department of Financial Institutions

Video#2:
- http://www.youtube.com/watch?v=Y6UNHyD9GSw&feature=related
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