

BUILDING BLOCKS

Laying a Solid Foundation for Your Business

By: Casey Winebarger, Esq.

We've all heard that small businesses are the backbone of America's economy. According to the most recent numbers published by the Small Business Administration, there are over 818,000 small businesses in North Carolina, 38% of which are wholly or jointly owned by women.*

Perhaps you have considered starting a small business of your own. As you know, business planning involves a significant investment of time and money. You must determine your product or service, perform market analysis, develop a marketing strategy, and obtain financing. During this process, you should also take time to consider the appropriate legal structure for your business. Whether you are a sole proprietor, partnership, corporation, or limited liability company, the form you choose will significantly impact taxation, the ongoing costs of doing business, and the liability risks to the owners.

A sole proprietorship is the simplest form of business. From a legal perspective, the owner and the business are one and the same. All profits and losses flow through to the owner and are reported on the owner's Form 1040. The ongoing costs of doing business are minimal, as there are no separate tax returns or business filings that need to be prepared. However, the owner of a sole proprietorship has unlimited personal liability for the business's debts, meaning creditors can reach the owner's personal assets.

A general partnership is very similar to a sole proprietorship, except it involves two or more people. Although profits and losses also flow through to the owners, the partnership tax laws are complex, so it will be more costly for preparation of tax returns. In addition, the partners should have a Partnership Agreement that spells out, among other things, profit and loss sharing and management procedures. As with the sole proprietorship, the partners of a general partnership have unlimited personal liability for the debts of the business. This risk is somewhat magnified in a partnership, as each individual partner has the power to enter into business transactions that are binding upon the other partners.

Corporations are the most complex and formal business structure. Unlike a sole proprietorship or partnership, a corporation is a separate legal entity from its owners. As a separate entity, the corporation itself is taxed on its profits. Then, when profits are distributed, they are again taxed to the owners as income. This double-taxation is a major disadvantage of the corporate form. Corporations must also comply with more formalities. To form a corporation, articles of incorporation are filed with the Secretary of State and shares of stock are issued. The corporation must also obtain shareholder and director approval for its actions and make annual business filings. These requirements translate into increased costs of doing business. In exchange for following the formalities, though, the owners of the corporation enjoy limited liability, meaning the most they stand to lose is the amount of their investment in the corporation. Furthermore, corporations may take certain tax deductions that proprietorships and partnerships cannot.

Finally, a limited liability company, or LLC, is a hybrid of the proprietorship and the corporation. Like a proprietorship, the LLC can be a flow-through entity for tax purposes, meaning profits are taxed only once at the owner level. Like a corporation, the LLC is a separate legal entity that provides limited liability to its owners. Similarly, the LLC must comply with certain formalities, such as filing articles of organization at formation and annual reports each year, and obtaining member consent for company actions. In addition, for LLCs with two or more members, an Operating Agreement should be used to dictate the terms of how decisions are made and how profits and losses are shared. All of this increases the cost of doing business as an LLC.

In addition to the four basic structures just discussed, there are several other options for your business structure, including an S-Corporation, limited partnership, or non-profit organization. However, there is no “one-size-fits-all” structure. The right choice depends on the desires and goals of each specific owner. For one concerned about control and taxes, an LLC or sole proprietorship might be an ideal choice, while a corporation might be right for the owner who is concerned about liability and the ease of raising capital.

If you are planning to start your own business, a knowledgeable attorney and CPA can help you to determine the right structure. You should consider not only your current goals, but also your visions for future growth in the next five to ten years. Although business structures can be changed, making the right choice now will create a solid foundation for your venture, saving time, money, and headaches down the road.

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*Source: SBA Office of Advocacy, 2009 North Carolina Small Business Profile

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