

# KRISHNAN COMPANY

— CERTIFIED PUBLIC ACCOUNTANT —

## **Forms of Corporate Structure**<sup>i</sup>

One of the first decisions that you will have to make as a business owner is how the company should be structured. Krishnan Company, P.C., CPA, can help you select the form of ownership that is right for you. In making a choice, you will want to take into account the following:

- Your vision regarding the size and nature of your business.
- The level of control you wish to have.
- The level of structure you are willing to deal with.
- The business' vulnerability to lawsuits.
- Tax implications of the different ownership structures.
- Expected profit (or loss) of the business.
- Reinvestment of earnings into the business.

Various basic structures are -

### **Sole Proprietorships**

The sole proprietorship is a simple, informal structure that is inexpensive to form; is usually owned by a single person or a marital community. The owner operates the business, is personally liable for all business debts, can freely transfer all or part of the business, and can report profit or loss on personal income tax. In the eyes of the law and the public, sole proprietors are one and the same with the business.

#### *Advantages of a Sole Proprietorship*

- Easiest and least expensive form of ownership to organize.
- Sole proprietors are in complete control, and within the parameters of the law, may make decisions as they see fit.
- Sole proprietors receive all income generated by the business to keep or reinvest.
- Profits from the business flow directly to the owner's personal tax return.
- The business is easy to dissolve, if desired.

#### *Disadvantages of a Sole Proprietorship*

- Sole proprietors have unlimited liability and are legally responsible for all debts against the business. Their business and personal assets are at risk.
- May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.
- May have a hard time attracting high-caliber employees or those that are motivated by the opportunity to own a part of the business.

#### *Federal Tax Forms for Sole Proprietorship*

(only a partial list and some may not apply)

- Form 1040: Individual Income Tax Return



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- Schedule C: Profit or Loss from Business (or Schedule C-EZ)
- Schedule SE: Self-Employment Tax
- Form 1040-ES: Estimated Tax for Individuals
- Form 4562: Depreciation and Amortization
- Form 8829: Expenses for Business Use of your Home
- Employment Tax Forms

## Partnerships

Partnerships are inexpensive to form; they require an agreement between two or more individuals or entities to jointly own and operate a business. Profit, loss, and managerial duties are shared among the partners, and each partner is personally liable for partnership debts. Partnerships do not pay taxes, but must file an informational return; individual partners report their share of profits and losses on their personal return. Short-term partnerships are also known as joint ventures.

The partners should have a legal agreement that sets forth how decisions will be made, profits shared, disputes resolved, future partners inducted to the partnership, buyout of partners, steps to take to dissolve the partnership when needed. Yes, it's hard to think about a breakup when the business is just getting started, but many partnerships split up at crisis times, and unless there is a defined process, there will be even greater problems. They also must decide up-front how much time and capital each will contribute, etc.

### *Advantages of a Partnership*

- Partnerships are relatively easy to establish; however time should be invested in developing the partnership agreement.
- With more than one owner, the ability to raise funds may be increased.
- The profits from the business flow directly through to the partners' personal tax returns.
- Prospective employees may be attracted to the business if given the incentive to become a partner.
- The business usually will benefit from partners who have complementary skills.

### *Disadvantages of a Partnership*

- Partners are jointly and individually liable for the actions of the other partners.
- Profits must be shared with others.
- Since decisions are shared, disagreements can occur.
- Some employee benefits are not deductible from business income on tax returns.
- The partnership may have a limited life; it may end upon the withdrawal or death of a partner.

### *Types of Partnerships that should be considered:*

1. General Partnership  
Partners divide responsibility for management and liability as well as the share of profit



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or loss according to their internal agreement. Equal shares are assumed unless there is a written agreement that states differently.

2. Limited Partnership and Partnership with limited liability

Limited means that most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions, which generally encourages investors for short-term projects or for investing in capital assets. This form of ownership is not often used for operating retail or service businesses. Forming a limited partnership is more complex and formal than that of a general partnership.

3. Joint Venture

Acts like a general partnership, but is clearly for a limited period of time or a single project. If the partners in a joint venture repeat the activity, they will be recognized as an ongoing partnership and will have to file as such as well as distribute accumulated partnership assets upon dissolution of the entity.

### *Federal Tax Forms for Partnerships*

(only a partial list and some may not apply)

- Form 1065: Partnership Return of Income
- Form 1065 K-1: Partner's Share of Income, Credit, Deductions
- Form 4562: Depreciation
- Form 1040: Individual Income Tax Return
- Schedule E: Supplemental Income and Loss
- Schedule SE: Self-Employment Tax
- Form 1040-ES: Estimated Tax for Individuals
- Employment Tax Forms

### **Corporations**

A corporation chartered by the state in which it is headquartered is considered by law to be a unique entity, separate and apart from those who own it. A corporation can be taxed, it can be sued, and it can enter into contractual agreements. The owners of a corporation are its shareholders. The shareholders elect a board of directors to oversee the major policies and decisions. The corporation has a life of its own and does not dissolve when ownership changes.

#### *Advantages of a Corporation*

- Shareholders have limited liability for the corporation's debts or judgments against the corporations.
- Generally, shareholders can only be held accountable for their investment in stock of the company. (Note however, that officers can be held personally liable for their actions, such as the failure to withhold and pay employment taxes.)
- Corporations can raise additional funds through the sale of stock.
- A corporation may deduct the cost of benefits it provides to officers and employees.
- Can elect S corporation status if certain requirements are met. This election enables company to be taxed similar to a partnership.

#### *Disadvantages of a Corporation*



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- The process of incorporation requires more time and money than other forms of organization.
- Corporations are monitored by federal, state and some local agencies, and as a result may have more paperwork to comply with regulations.
- Incorporating may result in higher overall taxes. Dividends paid to shareholders are not deductible from business income; thus it can be taxed twice.

## *Federal Tax Forms for Regular or "C" Corporations* (only a partial list and some may not apply)

- Form 1120 or 1120-A: Corporation Income Tax Return
- Form 1120-W Estimated Tax for Corporation
- Form 8109-B Deposit Coupon
- Form 4625 Depreciation
- Employment tax forms
- Other forms as needed for capital gains, sale of assets, alternative minimum tax, etc.

## **Subchapter S Corporations**

This structure is identical to the C Corporation in many ways, but offers avoidance of double taxation. This is purely a tax election. This election enables the shareholder to treat the earnings and profits as distributions and have them pass through directly to their personal tax return. The important point to watch in these types of entities is that the shareholder pays himself/herself a salary and must meet standards of "reasonable compensation". This can vary by geographical region as well as occupation, but the basic rule is to pay oneself salary as long as there is enough profit. If shareholder salaries are avoided in an S corporation, the IRS can reclassify all of the earnings and profit as wages, and you will be liable for all of the payroll taxes on the total amount.

## *Federal Tax Forms for Subchapter S Corporations* (only a partial list and some may not apply)

- Form 1120S: Income Tax Return for S Corporation
- 1120S K-1: Shareholder's Share of Income, Credit, Deductions
- Form 4625 Depreciation
- Employment Tax Forms
- Form 1040: Individual Income Tax Return
- Schedule E: Supplemental Income and Loss
- Schedule SE: Self-Employment Tax
- Form 1040-ES: Estimated Tax for Individuals
- Other forms as needed for capital gains, sale of assets, alternative minimum tax, etc.

## **Limited Liability Company (LLC)**

The LLC is a relatively new type of hybrid business structure that is now permissible in most states. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership. The owners are members, and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued, if desired, by a vote of the members at the time of



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expiration. LLCs must not have more than two of the four characteristics that define corporations: Limited liability to the extent of assets, continuity of life, centralization of management, and free transferability of ownership interests.

LLCs can be taxed as a sole proprietorship, partnership, C corporation or S corporation.

### *Federal Tax Forms for LLC*

Taxed as partnership in most cases; corporation forms must be used if there are more than 2 of the 4 corporate characteristics, as described above.

In summary, deciding the form of ownership that best suits your business venture should be given careful consideration. Call or email us at [incorporations@krishnanco.com](mailto:incorporations@krishnanco.com) to assist you in the process.

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<sup>1</sup> Source: U. S. Small Business Administration (SBA) - <http://www.sba.gov>



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