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Selecting a Business Entity

A business is an organization founded by one or more persons for the purpose of conducting business activities and trade. When a business is starting up, one of the first (and perhaps the most important) decisions is the selection of a business entity. The business entity type establishes the legal structure of your company and has a profound influence on many factors not the least of which are reporting requirements, liability considerations, protection of assets, and how income taxes are calculated and reported.

There are three basic types of entities: sole proprietorship, partnership, and corporation. Within the categories of partnership and corporation, there is a variety of specific types.

Sole Proprietorship

A sole proprietorship is, as the name implies, a company that is owned by one individual. The company is not a separate legal entity and therefore there is no requirement for separate tax accounting. The proprietor is regarded as being self-employed and the income and expenses of the enterprise are reported on the proprietor's income tax return.



The sole proprietor may be required to collect and relay state taxes; the requirement varies from state to state.

All of the assets of the company belong to the proprietor, as do all of its liabilities. The proprietor is personally fully responsible for any debt and legal liability incurred by the business.



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Partnerships



A partnership exists when two or more individuals have an unincorporated business. The partners report the income and expenses of the company on their personal tax returns, proportioned according to each of the partners' percentage of ownership in the company. IRS Form 1065,

Schedule K-1 is used to summarize and report a partner's share of earnings, losses, deductions, and credits.

There are different types of partnerships. The difference between the various types is, generally, how the assignment of liability is distributed among the partners.

General Partnership. In a general partnership, each of the partners is an agent of the company with equal rights in the management and control of the company. Unless stated otherwise, the assumption is that each of the partners is entitled to an equal share in the profits and that each of the partners has an equal degree of personal liability for the debts of the company.

Limited Partnership. In this structure, a general partner may collaborate with a limited partner. The limited partner has no managerial authority nor, in most cases, is the limited partner entitled to an equal share of the profits. The limited partner likewise does not have an equal share of the liabilities of the company. The limited partner's personal assets are not impacted by the debts of the company.



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Joint Liability Partnership. A joint liability partnership holds each of the partners equally responsible for financial and legal liabilities.

Several Liability Partnership. Similar to a joint liability partnership, each of the partners is responsible for liabilities but not to an equal degree. Under a several liability partnership agreement, the partner who was primarily responsible for the company incurring the liability bears a greater portion of the liability.

Limited Liability Partnership. In a limited liability partnership, some of the partners have limited liability for debts incurred by the company. In most cases, however, there is a requirement for at least one general partner to assume unlimited liability.

Corporations

A corporation, unlike a sole proprietorship or a partnership, establishes a legal entity that is separate from and independent of the owners. Corporations may be for-profit businesses, non-profit organizations, municipalities, and other activities and purposes. A corporation is owned by its shareholders.



One of the key differences between corporations and sole proprietorships or partnerships is that the owners of the corporation (the shareholders) are not personally liable for the corporation's debts and obligations. The shareholders' personal assets cannot be seized to satisfy the debts of the corporation and they therefore cannot lose



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any more than the price they paid for the shares if the corporation fails. The factor of limited liability makes a corporation much more attractive to potential investors.

Corporations also enjoy perpetual existence which means to say that the corporation can continue indefinitely, regardless of changes in individual managers, directors, officers, or shareholders.

The taxation structure of corporations varies with the type of corporation.

C Corporations. A C corporation is taxed separately from its owners, and at the rate applicable to corporations (which is generally lower than that of individual persons). Any dividends paid to shareholders from the corporation become a part of the individual shareholders' taxable income.

S Corporations. In an S corporation, the profits and losses flow through to the shareholders for income tax purposes, where it is taxed at the shareholder rate rather than the corporate rate. As in a partnership, shareholders file a Schedule K-1 as provided by the corporate entity.

Limited Liability Companies. The income from an LLC with a single shareholder (owner) is reported on the shareholder's tax return because the IRS does not regard a single member LLC as being a separate entity for tax purposes. In the case of more than one person owing an LLC, it may be regarded as a partnership by the IRS, in which event the individual partners pay tax according to their share of ownership in the company.

Non-Profit Organizations. Registered non-profit organizations are those engaged in activities that further a social cause such as those



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exercised by charitable, educational, religious and other organizations whose purpose is not to generate profit. Non-profit organizations are not subject to federal taxation. A non-profit organization is not prohibited from generating surplus revenue, but that surplus must be retained by the organization. The retained surplus must be used for the continuation of the organization or for its expansion.

The Best Type of Business Entity

The selection of the best business entity type for your enterprise is critical, not only at start-up, but throughout the lifespan of your company. As your business needs change, your entity type may also need to change.

What is the best type of entity for your business? Like so many other things, it depends on many factors. A thorough examination of the pros and cons of each type and an assessment of how each type fits your present and future needs is a sound approach to take when selecting a business entity type.

Business entity selection is best done in consultation with a business consultant who is not only fully conversant with tax requirements and regulations and with other aspects of successfully operating a business, but who also understands your goals and how to help you achieve them.

The experienced professionals at Garza Gump Group will guide you through the maze of entity types and help you select the one that best enables you to achieve your goals! Call us at (214) 352-6198 or email contact@ggcpaadvisors.com. We're here to help.