FACTORS TO CONSIDER WHEN CHOOSING A BUSINESS STRUCTURE

One of the most important decisions to make when establishing a new business, or when reviewing the state of your current business, is what form of business entity to use. Each form offers advantages and disadvantages, so review the following factors carefully before making your decision.

Tax issues. This is one of the biggest factor for many owners. C corporations typically are viewed as a poor choice because the corporation pays taxes on the profits and shareholders are again taxed on the dividends paid out. All other business entities generally are taxed only at the personal or shareholder level.

Still, differences between corporate and individual tax rates may make C corporations the better choice. C corporations sometimes have a tax advantage over S corporations regarding accumulated earnings. Fringe benefits are deductible at the C-corporation level and not at the shareholder-employee level, which generally is not the case with other entities. Furthermore, you have no choice but a C corporation structure if you want to take your business public.

Don't overlook state income-tax issues, either. For example, some states tax S corporations and limited liability companies (LLCs) at the corporate level. From an estate planning perspective, minority discounts may be higher for S and C corporations than LLCs.

Converting from one type of entity to another also may limit what new structure you choose, because conversions can raise significant tax issues. S corporations have a difficult time converting to a C corporation without tax consequences, but not vice versa. On the other hand, an LLC can convert to a C or S without tax consequence (again, there are exceptions).

Liability issues. Sole proprietors and general partners usually are personally liable for all debts and expenses, including those resulting from lawsuits or the actions of other partners. Insurance can mitigate some of this risk, and the new limited liability company format can help here. However, if personal liability is a concern, you're probably better off using other structures.

S corporations have the advantage of being taxed only at the shareholder level, yet the shareholders are shielded from liabilities beyond their personal investments. C corporations also shield shareholders from liability beyond their own investments. However, these shields are not invulnerable. Courts have held shareholders-particularly 100 percent shareholders-liable in the event of fraud and bad faith, and where a shareholder personally guarantees a loan or rents equipment to the corporation.

Newest on the block are the LLC and the limited liability partnership (LLP), which are principally used for professional businesses. These offer limited personal

liability for all partners while treating tax issues like partnerships. In some states, even a single person can set up a LLC. This arrangement offers better liability protection than a limited partnership, for example, where the general partner has no personal liability protection, and where even a limited partner can be exposed to liabilities.

Simplicity issues. Although taxes and liability are commonly the major factors in choosing an entity, there's something to be said for simplicity. Unless liability is a real concern for a small business, a sole proprietorship or small partnership might make better sense because it's easy to set up. (Again, having adequate liability insurance is important.) A business with numerous partners can be a real headache when it comes to adding or buying out existing partners-something that's a lot easier to do in a corporate structure.

Other factors. Beyond these three major factors, you may have additional reasons for choosing a particular structure. For example, S corporations are limited to 75 shareholders (none of whom can be a nonresident alien) and only a single class of stock, while LLCs are not as restricted. LLCs can't use incentive stock options, and because states vary in their LLC statutes, companies wanting to operate in more than one state may find this structure unwieldy. Obviously, choosing the correct business entity is not a casual decision. Even after you've begun operating as a specific type of business, periodically review your current structure with your financial advisors to be sure it's still the right one for you. Tax laws or your business circumstances may have changed enough to make a switch worth the expense.