BUSINESS ENTITIES

INTRODUCTION

The following is a brief outline prepared by the Maine Small Business Development Center (Maine SBDC) of the various types of business entities. The only purpose of the handout is to introduce the new entrepreneur to very broad definitions of business entities. What is best for your situation may depend on a more in-depth analysis. Contact the Maine SBDC at (207) 780-4949 for more information.

SOLE PROPRIETORSHIP

DEFINITION: A business that is owned and usually operated by one person. It is not a separate legal entity; therefore, it may involve some ownership risk. Liability risk can be minimized through adequate insurance coverage. The owner, generally, is solely responsible for business risk. More businesses are operated as a proprietorship than in any other form (at least initially).

- Revenues and expenses are reported on Schedule C - which is a supplemental schedule of Form 1040 Individual Federal Tax Return.
- Taxes are based at the individual marginal tax rate.
- Income (revenue minus expenses) is subject to a self-employment tax of 12.4% (OASDI – Old Age, Survivors and Disability Insurance) on the first $84,900 (2002) and 2.9% (Medicare) with no cap of income.
- May be liable for filing 1040 estimates depending on circumstances.
- If the business employs outside help, you will be subject to other reporting requirements for both state and federal agencies.

PARTNERSHIP

DEFINITION: Similar to a proprietorship in most ways except that it involves more than one owner. A partnership is not a legal economic unit separate from the owners but an unincorporated association that brings together talents and resources of two or more people. Partners have to share both liability and business risk. Additionally, each partner is personally liable for the actions of the other partner(s).

- Revenue and expenses are reported on Form 1065 (information only, no taxes paid).
- Each owner’s share of income or loss is reported on his or her personal tax return subject to the individual marginal tax rate.
- Income is also subject to self-employment tax.
- If the business employs outside help, you will be subject to other reporting requirements for both state and federal agencies.
- Although not required, a partnership agreement is strongly recommended.

Limited Liability Company

DEFINITION: A limited liability company is one in which the members (owners) have a liability limited to their investment in the entity. It allows for structural flexibility in planning distributions and allocations. All members of an LLC can participate in the management, without risking loss of liability protection.

- No income tax at entity level; tax items passed through to members just as with S corporation shareholders and partners in partnerships.
- None of the ownership limits of S corporations in terms of numbers or types of owners (members).
- Governance and financial terms may be customized through operating agreement, subject only to tax constraints.

CORPORATIONS

C CORPORATIONS

DEFINITION: A separate legal entity "in the eyes" of the Internal Revenue Service (IRS) and is taxed at the corporate rates, which differ from the individual rates. The C Corporation will have a double taxation effect, one at the corporation level and then one at the individual level upon distribution of dividends.

To incorporate you must file an application with the Secretary of State.

- Any distribution from the corporation to the individual, after the payroll deduction, is treated as dividends and is subject to state and federal income taxes, but not self employment taxes.
- Income, expenses, gains and losses that affect taxable income are reported on Form 1120.
- Employer salaries are deductible corporate expenses that are subject to withholding requirements.
- There are many other differences between a "C" and "S" corporation beyond the scope of this paper.
- Earnings can be retained (within limits) by the corporation and are taxed only at the corporate level.

SUBCHAPTER S

DEFINITION: Separate legal entity that provides shareholders with some limited liability and has non-tax attributes at the corporate level. S Corporations are regular corporations, whose shareholders have elected to be taxed under Subchapter S. To qualify a corporation must:

(1) have only one class of stock outstanding (voting rights may differ)
(2) have no more than *75* eligible shareholders (primarily individual estates and certain trusts)
(3) be an eligible corporation

To incorporate you must file an application with the Secretary of State and file a timely election for a Subchapter S corporation.

- S Shareholders are taxed much like partners and sole proprietors

- Ordinary income and deductions are reported on Form 1120S (no taxes are paid) and each stockholder’s share of the net ordinary income or loss and other items are reported on his or her personal return in the same manner as the partner’s share is reported.
- Because the shareholders (owners) that actively participate in the business are treated as employees, they are subject to payroll withholding requirements. The gross payroll is deductible in arriving at income or loss. Any residual income is divided among the shareholders and is subject to federal and state income tax, but not self-employment tax.