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## Small Business Entities

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What type of legal business entity should I choose?

There are four primary legal forms of business from which to choose from: sole proprietorship, partnership, limited liability company, and incorporation (both C-corp and Subchapter S.)

### Sole Proprietorship

A sole proprietorship is owned by an individual (or a married couple) and it may have one or more employees. Operating a sole proprietorship means that the owner is personally responsible for all liabilities of the business. Also, the owner is taxed on a personal level for all profits generated by the business.

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.

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

A partnership occurs when two or more people agree to share ownership of a business. This form of business allows the partners to share complimentary skills and resources. The owners share, and pay personal taxes on, the profits of the business. Additionally, each partner is individually responsible for the liabilities of the business.

Revenues 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 the 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

Another option is to form a Limited Liability Company (LLC). This legal form, which became effective in Maine on January 1, 1996, is a combination of the corporate form (providing limited liability) and the partnership form (allowing you to be taxed as in a partnership).

No income tax at entity; 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 agreements, subject only to tax constraints.

### Corporations

The corporate entity is created when your business registers with the Secretary of State's Bureau of Corporation. This enables the owners to take advantage of the limited liability aspect of the corporate ownership and to raise equity by selling shares of the company. For profit entities have the option to chose either a C-corporation or Subchapter S-corporation status.

### C Corporation

If you become a C-corporation, the corporate profits are taxed, and then the owners will be taxed on their share of the profits and compensation (i.e. dividends and wages) received from the corporation.

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

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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 bewteen a "C" and "S" corporation beyond the scope of this article.

Earnings can be retained (within limits) by the corporation and are taxed only at the corporate level.

#### Subchapter S Corporation

A Subchapter S-corporation does not pay a corporate tax. It is a Seperate legal entity that provides shareholders with some limited liability and has non-tax attributes at the corporate level. To qualify a corporation must:

Have only once class of stock outstanding (voting rights may differ)

Have no more than 75 eligible shareholders (primarily individual estates and certain trusts)

Be an eligible corporation

#### Notes

If you have any questions regarding the types of business entities, please feel free to call your local Small Business Development Center and/or seek advice from an attorney.

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