

Business Structure and Registration

Determine the form of ownership that best suits your business venture

Overview

Many factors must be considered when choosing the best form of business ownership or structure. The choice you make can have an impact on multiple aspects of your business, including taxes, liability, ownership succession, and others.

This document is an overview of the various forms of business ownership including sole proprietorship, partnering, corporations, and limited liability companies. It includes excerpts from the Small Business Administration (SBA) Program Office guide on business structure.

Why is this important?

One of the first decisions that you will have to make as a business owner is how the company should be structured. This decision will have long-term implications, so consult with an accountant and attorney to 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's vulnerability to lawsuits.
- Tax implications of the different ownership structures.
- Expected profit (or loss) of the business.
- Whether or not you need to re-invest earnings into the business.

- Your need for access to cash out of the business for yourself.

Sole Proprietorships

The vast majority of small businesses start out as sole proprietorships. These firms are owned by one person, usually the individual who has day-to-day responsibilities for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debts. In the eyes of the law and the public, you are one in 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.
- Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income).

Partnerships

In a Partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, and what steps will be taken 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:

- *General Partnership*
Partners divide responsibility for management and liability as well as the shares of profit or loss according to their internal agreement. Equal shares are assumed unless there is a written agreement that states differently.
- *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.
- *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.

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:

- 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.

Subchapter S Corporations

A tax election only; 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 catch here is that the shareholder, if working for the company, and if there is a profit, must pay him/herself wages, and must meet standards of "reasonable compensation". This can vary by geographical region as well as occupation, but the basic rule is to pay yourself what you would have to pay someone to do your job, as long as there is enough profit. If you do not do this, 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.

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 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.

Special Structures

The following business structures are available in some states, but not all.

- **Limited Liability Partnerships (LLP)** are organized to protect individual partners from personal liability for the negligent acts of other partners or employees not under their direct control. LLPs are not recognized by every state and those that do sometimes limit LLPs to organizations that provide a professional service, such as medicine or law, for which each partner is licensed. Partners report their share of profits and losses on their personal tax returns. Check with your Secretary of State's office to see if your state recognizes LLPs and if so, which occupations qualify.
- **Professional Service Corporation (PS)** must be organized for the sole purpose of providing a professional service for which each shareholder is licensed. The advantage here is limited personal liability for shareholders. This option is available to certain professionals, such as doctors, lawyers, and accountants. Check with your Secretary of State's office to find out which occupations qualify.
- **Limited Partnership (LP)** have complex formation requirements, and require at least one general partner who is fully responsible for partnership obligations and normal business operations. The LP also requires at least one limited partner, often an investor, who is not involved in everyday operations and is shielded from liability for partnership obligations beyond the amount of their investment. LPs do not pay tax, but must file a return for informational purposes; partners

report their share of profits and losses on their personal returns.

- **Non-Profit Corporations** are formed for civic, educational, charitable, and religious purposes and enjoy tax-exempt status and limited personal liability. Non-profit corporations are managed by a board of directors or trustees. Assets must be transferred to another non-profit group if the corporation is dissolved.

Next Steps and Resources

Deciding the form of ownership that best suits your business venture should be given careful consideration. Use your key advisors to assist you in the process.

The following resources provide information and forms for starting a business in the State of Hawaii. Many services are available online.

Dept. of Commerce and Consumer Affairs Business Registration Division

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Hawaii Business Express

An online registration service provided by the state that covers all the forms required for business registration with all the state agencies and partners. It

provides easy to read instructions and
context sensitive help.

<http://hbe.hawaii.gov/BizEx/home.eb>

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