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What Type of Business Structure is Right for You?

Pamela Ferrante, CSP, CHMM

While many of the readers of *The Advisor* have been in the business of consulting for several years or more, we know that there are numerous ASSE members who have joined this Practice Specialty because they are thinking about starting a consulting practice, have recently started a practice or are doing some free-lance work on the side with the hopes of building the work into a more formal business in the future. In keeping with the legal theme of some of the articles in this issue, we decided to write a summary of the various forms of business structures that are available and provide some general information about the pros and cons of each type.

If you haven't yet formalized your consulting practice, it is a good idea to look closely at your options and decide which best meets your needs. Like anything, there are numerous factors that should influence your decision. It isn't a bad idea to get some advice from a lawyer and an accountant, although be forewarned, they may not agree. (Mine didn't!) But if you listen carefully to their reasons for their recommendations, you'll be in a better position to "pick a side".

Once you have decided which route to go, you may need to spend some money to finalize the process. It isn't very expensive under most circumstances; just about any lawyer can do the legal paperwork for you for less than \$1,000.00. You can also visit the "do-it-yourself" sites; I know several consultants who have taken that route successfully. It just depend upon you own comfort level.

It's probably easiest to start this article with a quick description of the various options:

Sole Proprietorships

This is the simplest business structure and the one that many businesses start out as and some continue to use this structure quite successfully for the long term. This structure requires no formal legal paperwork and is the easiest to organize. There can only be one owner in a sole proprietorship and that person is able to keep all profits from the business, which is reported on the owner's personal income tax form on a Schedule C. The owner also retains the ability to control everything that happens to the business and makes any decisions about it that they wish.

Sole proprietors also retain the full liability for anything that happens to the business and as a result of the operations of the business, including debts and lawsuits. The sole proprietor's personal assets are not protected by the structure of the business. This generates some level of risk for someone who advises companies how to keep workers safe. Although you can transfer some of the risk through insurance or by how you word your contracts and reports, your personal liability is essentially unlimited.

Other disadvantages include the limited ability to attract any investments to the business or ability to raise funds. Some sole proprietors are able to secure small loans and obtain credit cards, if needed.

And sometimes that is all that is needed for many years, but if the business is to grow and attract key people, most will not be interested in joining onto a business being run under this type of structure.

Partnerships

As the word indicates, in a partnership more than one person shares the business, including its assets, profits and liabilities. This type of structure works when several people want to share in the work of making a business succeed, often because each partner brings a valuable set of skills to the union that the other doesn't have. It may be clients, business knowledge, financial acumen or any number of factors, but partnerships exist to share some function that couldn't be done as well otherwise.

It is never, ever a good idea to entertain this type of business structure without a very clear and specific written agreement that spells out all of the possible scenarios and how each will be handled. This includes sharing decision-making and of profits and the responsibility for liabilities as well as what happens when one partner wants to leave. The agreement should also discuss such details as how much time each partner will spend on the business and how much capital, both up front and ongoing each partner will bring to the table.

This type of business structure can be very profitable if two people know in advance that they work well together and have something the other needs in order to succeed. Partnerships are also easy to set up, once the agreement has been finalized. Like sole proprietorships, profits from the business flow into personal income tax returns and are reported on a Schedule C. If the business does well, others may be interested in joining in and the business can flourish with the time and talents of multiple partners.

On the downside, if one of your partners does something illegal or unethical, the business is liable as are all of the partners. You need to be sure you know the person really well and have a clear written agreement that details the outcomes in some specific scenarios. While you can purchase professional liability insurance for yourself, the actions of any partner are considered to be the actions of the full partnership and there is only so much liability that can be transferred through insurance policies. In most scenarios, it is the business that will suffer the biggest brunt of any losses. And partnerships depend upon the willingness of all partners to keep at it. If one of the partners decides to leave, the business may no longer be able to function.

Corporations

This is the structure about which we are most familiar and has the most complicated legal structure. It is often called a "C Corp." and the business name typically ends in an "Inc." or an "Ltd." The uniqueness of any corporation is that it is considered separate and apart from the parties who own it; the corporation is what performs the services, not the people affiliated with it. The corporation as an entity can make contracts, can owe taxes and can be sued. A corporation is chartered by a state follows the laws of that specific state in which it was incorporated.

Corporations are owned by shareholders who are elected by the corporation's Board of Directors. The shareholders make decisions and share in the profits, but the corporate structure limits their liability in a way that the previous two structures discussed do not. But don't be misled; many a solo safety consultant has a corporate structure behind him/her. The Board of Directors can be anyone and they can (and often do) own all of the company's shares. Finally, because it is a separate entity apart from

those who run it and work for it, a corporation remains in place when key people leave, for whatever reason. Corporations can only be dissolved legally, by a vote of the Board of Directors.

The disadvantages to corporations are that they are more difficult and time consuming to set up, although as mentioned above, do not necessarily require the services of a lawyer. They also have more complicated tax laws and will require assistance from an accountant at tax time. In addition, each state also has a unique set of laws that are required to be followed by corporations.

Subchapter S Corporation

This structure is a variation of a corporation in which a shareholder can allow earnings and profits of the business to be passed through onto their personal income tax return instead of showing them on a separate tax return for the corporation. In order to elect this option, the shareholder must pay him or herself wages that meet the standards of what is called “reasonable compensation”. What is reasonable must be derived from the type of occupation the shareholder is performing and the geographic area where the work is being performed. It is a good idea to get some advice from a tax accountant before determining how much the wages will be to make sure that the proposed wage meets the “reasonableness” standard. Also be aware that if your calculation is too low, all of the earnings and profits of the business have the potential to be classified as wages; therefore you will owe payroll taxes on the entire amount. This measure is in place to assure that Subchapter S Corporations are not used as a means to creatively pay shareholders very low salaries in order to avoid paying payroll taxes and then finding other means to use the profits to benefit a shareholder.

Limited Liability Corporation (LLC)

This business structure has enjoyed significant popularity in recent years and is essentially a combination of the benefits of a corporation and a partnership. LLCs retain some of the liability limitations of traditional corporations along with the flexibilities of partnerships. Among its other unique features is that an LLC is formed with a limited duration; the time for closing the business is set ahead of time by the members who start the business. However, it can easily be renewed by a simple vote of the members and often is.

Not everyone can start an LLC as their structure must be dissimilar enough from a corporation; otherwise they have to be classified as a corporation. Using this structure may require more legal advice upfront to see if you are willing to live within the limitations and requirements and to determine whether or not the tax advantages are sufficient enough to make a difference. In general LLCs are not meant for businesses that are held and run by one person; they are supposed to be a variation of partnerships. In practice this is not always the case and many solo practitioners are able to (and are currently) use this structure to their advantage.

Making the Choice

Now that you have a better handle on which option has which features, how do you choose? According to the Small Business Administration website, the following list details those factors which should be taken into account when making your business structure decision:

- 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' vulnerability to lawsuits.
- Tax implications of the different ownership structures.
- Expected profit (or loss) of the business.
- Whether or not you need to reinvest earnings into the business.
- Your need for access to cash out of the business for yourself.

The bullet point on tax implications is a significant issue and should be given sufficient consideration. For example, if you choose a Corporation, you might be motivated by the thought that the income is not taxed as long as it remains within the corporation as retained earnings and is only taxed by laws pertaining to business income. However, when you do finally take some of the income and give it to yourself, you will be taxed again. Unless you are very careful about how you manage the distributions to your personal account, you may end up in a higher tax bracket than you would have been if you had elected one of the options that allow the income to be passed directly onto your personal income tax return via a Schedule C.

Should you elect any of the various corporate forms of business structures, you also have more options on how you pay yourself and others. With a little knowledge and advice from a competent accountant, your tax savings can be significant if you do what is called “income splitting”. That’s because you are not limited to the “net profit” of a non-corporate structure; you can pay via wages, dividends, stock, stock options or any combination you choose.

And though you may not want to think along this line, be prepared for the possibility that you may end up losing money in the first year or two of your business adventure. Or perhaps you will have a bad year for one reason or another (Haven’t we been hearing a lot about a forthcoming recession?). What impact will your business structure decision have in this event? Many times corporate structures have more options for how you treat business losses and for how you may be able to use them to your advantage in the early years.

Finally, what if you make a choice that you later regret? Or what if your business changes in such a way that a different choice is now more to your advantage. The good news is that you are not locked into any business structure. Some take more work and money to dissolve, but nothing is irrevocable.

As a final note, there is no reason to make this choice without sufficient of information. There are plenty of easy-to-reach resources that will guide you. As indicated above, lawyers and accountants are a good place to start (And you should have one of each at your disposal before you begin any business enterprise anyway.). There are also several good websites that offer detailed explanations and articles. Start with the U.S. Small Business Administration (www.sba.gov), Entrepreneur Magazine (www.entrepreneur.com), the Service Core of retired Executives (www.score.org), and the Internal Revenue Service (www.irs.gov).

It’s not hard to make this very important decision, but it obviously takes some forward thinking and decisions about how you envision the business will run and what types of operations in which you will engage. Take the time up front to learn before you decide and avoid regretting it later.