



Should You Incorporate?

By Thomas Vale

Many businesses start out as a small, one-person operation. As a successful business grows, the owner must make decisions about alternate methods of structuring the business ownership. The basic forms of business ownership are a sole proprietorship, a partnership, and a corporation. There are important differences in the legal obligations and liabilities arising out of each type of ownership as well as important differences in how those business entities will be taxed for income tax purposes.

The simplest type of business structure is the sole proprietorship. It is not necessary to have any formal business documents drafted to start such a business and an owner operates the business in his own name. The owner is responsible for the debts and obligations of the business and the income or loss generated by the business is reported on the individual owner's resources and his ability to borrow money.

A partnership is the association of two or more persons organized to carry on a business enterprise. While a written partnership agreement is not always used, it is best to have a formal agreement between the parties so that each individual clearly understands his rights and obligations in the partnership structure. Each partner does not necessarily have to share equally in the ownership of the business or in the work involved with the operation of the business. A partnership quite often is formed when one individual has money to invest in a business and another individual has the experience and know-how to operate the business. Having several individuals pool their resources gives the business a stronger base from which to operate.

A partnership tax return is filed for the business. However, the partnership itself is not taxed and the income flows through the partnership and is taxed in the hands of the individual partners. In terms of owner liability, it is important to note that a general partner normally will be held responsible for the payment of partnership debts incurred by another partner even though he or she may not have been directly involved in incurring the debt. It is easy to see that it is important for a successful partnership to have a clear agreement and understanding about the operation of the business.

Unlike a partnership, a corporation has its own legal identity and can sue and be sued in its own name. One of the most important benefits of the corporate structure is providing some protection for owners from personal liability for the obligations of the business. While a shareholder may risk his investment in a corporate venture, he or she does not have to worry about risking liability for other business obligations.

There are formal requirements for the organization of a corporation including the filing of articles of incorporation with the State of Wisconsin. Normally, by-laws are drafted and approved by the corporate officers and formal written records are maintained of corporate meetings. There is normally going to be more work associated with maintaining the corporate structure compared to the other types of business organizations. Another consideration is the tax imposed on the corporation itself. The corporation will normally pay salaries to those individuals engaged in the operation of the





business and dividends (if profitable) to the shareholder. In essence, the corporation is taxed on its profits and those profits are taxed again in the hands of the shareholder.

Because there can be some disadvantages from a tax standpoint to using the corporate structure, many businesses consider another option called the Subchapter S corporation. A Subchapter S corporation is a hybrid that provides some benefits of the corporation and some benefits of the partnership structure. Under the rules of the Internal Revenue Service, a corporation which follow certain guidelines can be granted status to be taxes essentially in the same manner as a partnership. In that way, the business owners could have some protection from personal liability by organizing as a corporation, but would still have the advantages of being taxed as a partnership. There are specific limitations as to how many shareholders a Subchapter S corporation can have and other regulations regarding its formation. But it is an option that many small business use.

There are a great many more details that should be considered and discussed when you look at alternative ways of structuring your business. If you have not seriously considered some of these options, you should consult with your accountant as well as your attorney about the options that will best suit the needs of your business.

