Business Formation and Start-Up

Tax and
Business Update

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Entity Comparison

Advantages	Disadvantages
Proprietorship	
• Easy to form. • Simple to operate. • Easy to sell the assets of the business. • Few administrative burdens. • No separate tax filings.	• Limited sources of capital. • No limited liability. • No continuity beyond the proprietor. • All business net income is subject to self-employment tax.
Partnership	
• More sources of initial capital than proprietorships. • Generally more management resources available than for proprietorships. • Fewer administrative burdens than corporations. • Income is generally taxed only at personal level. • Income and loss allocations can be flexible.	• Transferring interests difficult. • No liability limitation unless a limited partner or a limited liability partnership. • Generally, all business net income is subject to self-employment tax, even if the partner is not personally active in the partnership. However limited partners are subject only to SE tax on guaranteed payments for services. • Income tax and basis adjustment rules are complex. • Partners are entitled to few tax-deductible employee fringe benefits.
Limited Liability Partnership	
• Favorable pass-through taxation status. • Flexibility to structure ownership interests.	• Partners may be personally liable for entity obligations, their own acts and omissions and those of persons they supervise.
Limited Liability Company (Classified as Partnership) for Tax	
• Members have limited liability. • Number of members unlimited. • Members may be individuals and all types of entities. • Double taxation is avoided. Income is passed through to members under partnership tax principles. • Members can participate in management. • Members generally not personally liable for LLC debt (but lenders often require personal guarantees). • Distributions do not have to be proportional to ownership percentages. • Different ownership classes.	• Limited life, often terminates on the death or bankruptcy of a member. • Transferring interests is difficult. • Not all industries or professions can use LLCs. • LLC laws vary by state. • The various state LLC laws are relatively new and less tested in nontax matters compared to state corporation laws. • For tax purposes, the complex partnership rules apply. • Members will often be subject to self-employment tax.

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Entity Comparison (Continued)

Advantages	Disadvantages
Corporation	
• Can raise capital through the sale of stock. • Owners have limited liability. • Unlimited corporate life. • Relatively easy to transfer ownership interests. • Generally have more management resources. • S corporation income passed through to owners and taxed at the individual level. • For C corporations, most dividends are taxed at a favorable 15%/20% (or lower) federal rate at the individual level. However, dividends may be subject to an additional 3.8% net investment income tax. • C corporation owner-employees may receive the full array of employer-provided tax-free fringe benefits. • Distributions from S corporations usually payroll tax free.	• C corporation income is taxed and dividends are taxed to owners. • Administrative burdens. • Difficult to form. • Dissolution can trigger tax. • Borrowing may be hard unless stockholders guarantee debt. • S corporations limited to 100 shareholders. • S corporations can have only one class of stock. • S corporations can't have corporate, partnership or nonresident alien shareholders. • S corporations generally must choose a calendar year. • More-than-2% S shareholders pay taxes on certain fringe benefits. • Tax rate on S corporation income may be higher than applicable C corporation rate.

Leasing vs. Buying

Item	Leasing	Buying
100% financing	Leases usually provide 100% financing, but a security deposit may be required.	Loans generally require a down payment.
Cash flow	Lower initial cash requirements and lower periodic payments.	Larger initial cash requirements and periodic payments.
Cancellation option	May grant the lessee the option to cancel, passing the risk of obsolescence of the asset to lessor.	Purchases can only be canceled by selling the asset.
Fixed payments	Lease payments typically are fixed.	Loans may have variable interest rate.
Maintenance costs	Lessee can often obtain a maintenance contract as part of an equipment lease—the lessor assumes responsibility for maintenance.	Purchasers may be able to obtain maintenance contracts, but they usually pay an additional fee.
Operating restrictions	Leases typically do not have restrictive operating covenants.	Loans may contain covenants that impose operating restrictions.
Access to funds	Leasing companies often evaluate a lessee's credit history on shorter terms than banks.	Banks may require several years of financial information and operating history before granting a loan.
Borrowing capacity	Operating leases are an off-balance-sheet financing technique. They do not affect the lessee's working capital or debt to equity ratios.	Loans usually affect financial ratios and borrowing capacity.
Residual value benefits	Residual values usually accrue to benefit the lessor. If residual value is conservatively estimated, lessor can profit from selling the asset at a price above the residual value.	All benefits from residual values (that is, salvage value) are acquired by the purchaser.
Residual value risk	In open-end leases, the lessee incurs the risk of a decline in value.	There are no residual value guarantees with purchases.
Interest rates	The implicit interest rates usually are higher than comparable loan rates because lease payments include a profit component.	Loans usually have lower interest rates.

Business Plan Uses

- Obtain financing (whether from loans or equity investments).
- Provide a yardstick against which future performance will be measured (especially by lenders and investors).
- Keep management and employees focused when the inevitable problems and distractions arise (by identifying critical goals and implementation tasks—thereby providing a framework for decision making and activity coordination).
- Define the business culture that will be communicated to employees, customers, suppliers, etc.

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