



Selecting an Organizational Structure for Your Business

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This MontGuide explains the main characteristics of each organizational structure. Before reaching a decision you may want to seek additional information and discuss your specific circumstances with an attorney and/or certified public accountant.

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SELECTING THE BEST ORGANIZATIONAL STRUCTURE

for a new business is only one of the many challenges that business owners will face. The type of business and the needs of the owner often will influence the selection. No one organizational structure is best for all businesses, because each business and business owner is unique. The four common types of organizational structure in Montana include (Montana Census of Agriculture, 2002):

1. Sole Proprietorship (individual, family), 81 percent
2. Partnership, 8 percent
3. Corporation (S or C), 10 percent
4. Limited Liability Company, data not available

Prioritize Needs

The most important step to choosing the appropriate organizational structure is to determine the needs of your business and prioritize them. Each business has unique needs that will help determine which structure is most appropriate.

- What type of decision making or management structure is needed?
- How important is liability for personal injury and product liability?
- How important are taxation issues? (for example: treatment of profits/losses and deductibility of employee benefits -- health insurance, group term life insurance)
- How important is the transfer of the business to new owners or heirs?

1. Sole Proprietorships

A sole proprietorship is the most common type of business structure. A sole proprietorship is owned and controlled by one person. The business is not distinguished from the owner, so in many ways the owner is the business.

The funds to establish and operate a sole proprietorship come from the owner's personal funds. The owner may obtain funds from a variety of sources such as personal

savings, a personal loan or from a credit card to finance the business. Any revenue or debts generated by the business are not distinguished from the owner's personal assets. Personal assets include an owner's home, land, vehicles, investments and bank or credit union account balances. All of the owner's personal assets can be used to satisfy the debts and any type of tax liability incurred by the sole proprietorship. The owner's personal assets may also be used to pay any legal damages resulting from activities of the business. Liability insurance for business activities is an important risk management tool for sole proprietors.

Income or losses generated by a sole proprietorship are reported annually as part of the owner's personal federal income tax return on a Schedule C, C-EZ or Schedule F. Sole proprietors are required to pay self-employment taxes on their "before-tax" income. The self-employment tax rate is equal to one-half of the social security tax rate (12.4 percent in 2008) and the Medicare tax (2.9 percent in 2008). For example, a sole proprietor with before-tax income of \$20,000 would pay \$1,530 in self employment taxes ($12.4\% + 2.9\% = 15.3\% \times \frac{1}{2} = 7.65\%$; $\$20,000 \times 7.65\% = \$1,530$).

A sole proprietor is eligible to establish an "employer" sponsored retirement plan. Retirement plans that are available to sole proprietors include Simplified Employee Pensions (SEP), SIMPLE 401(k) Plans, Profit Sharing Plans, 401(k) Plans and Defined Benefit Plans. Information on retirement plans is available from the Employee Benefits Security Administration at www.dol.gov/ebsa, by phone at (866) 444-3272, or by mail at Kansas City Regional Office, 2300 Main Street, Suite 1100, Kansas City, Missouri 64108.

A sole proprietorship limits the options an owner has for estate planning and business continuity decisions. Because the owner is the business, the business ends when the owner dies. The business assets are considered part of the owner's estate when he or she dies and are subject to probate and federal estate taxes. Selling or transferring the business may also be difficult because the business assets are not distinguished from the owner's personal assets.

2. Partnerships

A partnership is a voluntary association of two or more individuals for the purpose of operating a business. Each individual (partner) contributes his or her money, property, labor or other skills to the new business and has an interest in the financial profits or losses generated by the business.

Although a partnership is not a taxable entity, the partnership is required to file an information return (Form 1065) annually with the IRS. This form reports the partnership's profits or losses for the year. Each partner reports his or her share of the profits or losses from the partnership on his or her individual state and federal tax returns. A partner is required to pay self-employment taxes on his or her "before-tax" income in the same manner as a sole proprietor (see page 1).

A partnership can be formed with a written or oral agreement. A written agreement is a legally binding document that helps avoid misunderstandings and conflicts among the partners. The following items are often included:

- Name and address of each partner
- Purpose of the partnership
- Duration of the partnership (the events that will result in termination of the partnership and how the partnership assets will be divided upon termination)
- Name of who is contributing the resources (cash, personal property, land, labor, etc.) , amount of the resources and how they will be contributed (transfer of ownership, rental, use-only basis)
- Method of how profits and losses will be calculated and shared
- Description of how decisions will be made
- Limitations on partners' activities
- Procedures to add or remove partners (including procedures for dealing with the death of a partner, such as an option for current partners to buyout the former partner's interest in the partnership).
- Plan outlining how to resolve disagreements among the partners

Several types of partnerships are available in Montana.

- General Partnership
- Joint Venture
- Limited Liability Partnership

A **general partnership** is similar to a sole proprietorship for tax and liability purposes. Each partner has unlimited personal liability for all debts and obligations of the partnership and acts of all partners, even if he or she was not directly involved in a particular debt or decision.

General partners share the management, profits and losses of the partnership. If a general partner dies or withdraws the partnership may be subject to dissolution. If a partner

dies, that partner's interest is subject to probate and federal estate taxes. If however, the deceased's estate is valued at less than \$2 million in 2008 (or \$3.5 million in 2009) then there is no federal estate tax due.

The partnership agreement may include provisions to assist the remaining partners in continuing the business. These provisions may include buy-sell agreements that allow or require the surviving partners to purchase the deceased partners interest in the business. Basic partnership provisions for issues not addressed by the partnership agreement are provided in Title 35 of the Montana Code Annotated (http://data.opi.state.mt.us/bills/mca_toc/35.htm).

A **joint venture** is a specific type of partnership that is similar to a general partnership. However, the scope of the partnership is limited to a specific project or time period. Upon completion of the project or time period, the joint venture is dissolved.

Another type of partnership is a **limited liability partnership** (LLP). LLP partners are not subject to unlimited personal liability for actions of the partnership. This limited personal liability is a major advantage to a LLP as compared to a general partnership. Partners in a LLP are still liable for their own negligence and the negligent acts of those under their direct supervision. Other aspects of a LLP are similar to that of a general partnership.

An application for registration or renewal of a limited liability partnership must be filed with the Montana Secretary of State to establish a limited liability partnership. Contact the Secretary of State at 406-444-2034 or by email at sos@mt.gov or at www.sos.mt.gov.

A partnership may also be a **limited partnership**. There are two types of partners in a limited partnership. A limited partnership must have one or more general partners. The general partners in a limited partnership have similar responsibilities to the partners in a general partnership. A limited partnership also allows for limited partners. Limited partners are typically investors in the partnership and do not take an active role in the management of the business. Their liability is limited to the amount of their investment. The partnership agreement limits their share in the profits and losses incurred by the business. A certificate of domestic limited partnership must be filed with the Montana Secretary of State to establish a limited partnership. Contact the Secretary of State at 406-444-2034, by email at sos@mt.gov or at www.sos.mt.gov.

3. Corporations

A **corporation** has a legal and tax identity separate from its owners, who are called shareholders. Montana law requires that corporations be chartered by the state and that articles of incorporation be filed with the Secretary of State. The articles of incorporation should include the following items:

- Name of the corporation
- Names and addresses of the incorporators

- Location of the registered office
- Name of the registered agent
- Duration of the corporation
- Amount and kinds of stock (such as common or preferred stock) that may be issued
- Description of voting rights of shareholders

The articles of incorporation form for domestic for-profit corporations is available from the Secretary of State (at 406-444-2034, by email at sos@mt.gov or http://sos.mt.gov/BSB/Business_Forms.asp). Legal counsel, familiar with articles of incorporation and Montana corporate law, is commonly involved in the drafting of the articles of incorporation.

Once the corporation has been established, annual meetings of directors and shareholders are required. Written minutes reflecting important transactions or decisions are also necessary. Montana law requires corporations to file an annual report with the Secretary of State. This report lists the names and addresses of the directors and officers. The number of shares outstanding is also reported. This report can be updated on the Secretary of State's website. More information about annual reporting requirements is available from the Secretary of State (at 406-444-2034, by email at sos@mt.gov, or http://sos.mt.gov/BSB/Business_Forms.asp). Corporations are also required to file federal and state tax returns each year.

One of the most attractive features of a corporation is the limited liability that it provides to its shareholders. The corporation itself is fully liable for any obligations or debts incurred by the business, while the shareholders are liable only to the amount of their investment in the corporation. However, many small corporations are unable to obtain financing unless shareholders personally guarantee the debts of the corporation. Although the corporation offers shareholders some protection from liability claims, this type of business structure does not eliminate the need for a comprehensive business and personal liability insurance program.

A corporation offers several options to shareholders for transferring ownership of the business. Shares of stock in the business can be sold, gifted, or bequeathed to individuals or other corporations while allowing the business to continue. The continuity of the business is not linked to the life of the original or current owners. Businesses often change over time and these changes may cause a business to expand, downsize, merge or change ownership. Each of these reasons may necessitate a change in a business structure, thus it is advisable to seek legal and tax advice when considering liquidating a corporation or pursuing major changes.

For income tax purposes, the shareholders must choose whether the corporation will be a "C" or an "S" corporation. Corporations, that elect to be a C corporation, pay taxes on income earned by the corporation. Shareholders of a C corporation do not report the profits or losses incurred by

the business on their personal tax returns. However, they must report the wages and/or dividends paid to them by the corporation on their personal tax returns.

In contrast an S corporation does not pay taxes on income earned by the corporation. Instead each shareholder reports his or her share of the corporate income on his or her personal income tax return. Although the corporation does not pay income taxes directly, the corporation is required to file IRS Form 1120S annually.

Only certain corporations are eligible to be an S corporation. An eligible corporation must have less than 100 shareholders and each shareholder must be a citizen or resident of the United States. The corporation must also have only one class of stock and use the calendar year as its fiscal year. If a corporation meets these requirements and prefers to be an S corporation, Form 2553 needs to be filed with the IRS.

Another benefit of the corporation as an organizational structure is the ability to establish an Employee Stock Ownership Plan or a company stock investment option in other types of retirement plans. Because other types of organizational structures do not have ownership represented by stock, they are unable to offer retirement plans with company stock as investment option.

Establishing a business as a corporation can simplify the transfer of the business to new owners or heirs. A share of stock represents a piece of ownership in the corporation. These shares can be sold, gifted or bequeathed individually or in large quantities. This allows ownership to be transferred to single or multiple owners in small or large amounts at a specific time or over a longer period of time. Other forms of organizational structure do not offer this flexibility.

There may be a significant tax advantage of using an "S" corporation over an LLC or a partnership in certain circumstances. When the owner of a business is also going to perform services for the business (e.g., a plumber who owns a plumbing business), then there may be a reason to choose the "S" corporation rather than an LLC or partnership. The reason is that owners of LLCs and partnerships are considered to be self-employed and therefore must pay a "self-employment tax." The entire net income of the LLC and partnership business is subject to self-employment tax. In contrast, in an "S" corporation only the salary paid to the owner-employee is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules. Therefore, an employee owner of an "S" corporation may realize substantial employment tax savings.

4. Limited Liability Company (LLC)

The **limited liability company** (LLC) blends the limited liability offered by corporations with the operational flexibility and pass-through taxation provide by partnerships, without the restrictions of an S corporation or a limited liability partnership.

In Montana, one or more persons may form an LLC by signing and filing articles of organization with the Secretary of State. The articles of organization must include:

- Name of the LLC
- Latest date on which the LLC is to dissolve
- Address of its principle place of business in Montana and, if different, its registered office and the name and address of its resident agent at the Montana registered office
- Statement of whether the LLC is to be managed by a manager or its members
- Names and addresses of managers (if managed by managers) and of the initial members (if managed by members)

The LLC may choose to create an operating agreement, which is an internal document governing an LLC's operations and respective rights and obligations of its members. LLCs in Montana are not required to adopt their own operating agreement. LLCs that do not adopt their own operating agreement are subject to the default provisions contained in Title 35 of the Montana Code Annotated (http://data.opi.state.mt.us/bills/mca_toc/index.htm).

Owners of an LLC are referred to as members and have both economic and management rights (including voting rights) and may constitute the management of an LLC. A manager is the person charged with management responsibility for an LLC. The manager may or may not be a member.

Laws governing limited liability companies differ from state to state. Because of these differences, care should be taken to ensure that the LLC legal documents meet the specific requirements of Montana law.

Summary

When starting a new business or evaluating changing the structure of an existing business, consider the advantages and disadvantages of each type of business structure from a perspective of business, personal, and family goals. The best business structure will not always be the same for different types businesses and the most appropriate business structure may change as business and personal needs change over time. After evaluating the advantages and disadvantages of



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each type of business structure discuss your situation with tax and legal professionals. Their recommendations may assist you in selecting the appropriate business structure for your circumstances.

Additional Information

Montana Secretary of State Office:
PO Box 202801, Helena, MT 59620-2801
(406)444-2034,
http://sos.state.mt.us/BSB/Business_Models.asp

U.S. Small Business Administration:
Phone: (800)827-5722,
email: answerdesk@sba.gov, or
www.sba.gov/smallbusinessplanner/start/choosestructure/index.html

Official Business Link to the U.S. Government:
www.business.gov

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Disclaimer

This MontGuide examined the main characteristics of sole proprietorships, partnerships, corporations and limited liability companies. This guide is not designed to provide all of the information required to select an appropriate business structure, rather to provide a basic understanding the options available in Montana. This information should help prepare you to discuss your specific situation with legal and tax professionals.