



# Business Formation and Start-Up



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Entity Comparison	
Advantages	Disadvantages
<b>Proprietorship</b>	
<ul style="list-style-type: none"> <li>• Easy to form.</li> <li>• Simple to operate.</li> <li>• Easy to sell the assets of the business.</li> <li>• Few administrative burdens.</li> <li>• No separate tax filings.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited sources of capital.</li> <li>• No limited liability.</li> <li>• No continuity beyond the proprietor.</li> <li>• All business net income is subject to self-employment tax.</li> </ul>
<b>Partnership</b>	
<ul style="list-style-type: none"> <li>• More sources of initial capital than proprietorships.</li> <li>• Generally more management resources available than for proprietorships.</li> <li>• Fewer administrative burdens than corporations.</li> <li>• Income is generally taxed only at personal level.</li> <li>• Income and loss allocations can be flexible.</li> </ul>	<ul style="list-style-type: none"> <li>• Transferring interests difficult.</li> <li>• No liability limitation unless a limited partner or a limited liability partnership.</li> <li>• 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.</li> <li>• Income tax and basis adjustment rules are complex.</li> <li>• Partners are entitled to few tax-deductible employee fringe benefits.</li> </ul>
<b>Limited Liability Partnership</b>	
<ul style="list-style-type: none"> <li>• Favorable pass-through taxation status.</li> <li>• Flexibility to structure ownership interests.</li> </ul>	<ul style="list-style-type: none"> <li>• Partners may be personally liable for entity obligations, their own acts and omissions and those of persons they supervise.</li> </ul>
<b>Limited Liability Company (Classified as Partnership) for Tax</b>	
<ul style="list-style-type: none"> <li>• Members have limited liability.</li> <li>• Number of members unlimited.</li> <li>• Members may be individuals and all types of entities.</li> <li>• Double taxation is avoided. Income is passed through to members under partnership tax principles.</li> <li>• Members can participate in management.</li> <li>• Members generally not personally liable for LLC debt (but lenders often require personal guarantees).</li> <li>• Distributions do not have to be proportional to ownership percentages.</li> <li>• Different ownership classes.</li> </ul>	<ul style="list-style-type: none"> <li>• Limited life, often terminates on the death or bankruptcy of a member.</li> <li>• Transferring interests is difficult.</li> <li>• Not all industries or professions can use LLCs.</li> <li>• LLC laws vary by state.</li> <li>• The various state LLC laws are relatively new and less tested in nontax matters compared to state corporation laws.</li> <li>• For tax purposes, the complex partnership rules apply.</li> <li>• Members will often be subject to self-employment tax.</li> </ul>

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## Entity Comparison (Continued)

Advantages	Disadvantages
<b>Corporation</b>	
<ul style="list-style-type: none"> <li>• Can raise capital through the sale of stock.</li> <li>• Owners have limited liability.</li> <li>• Unlimited corporate life.</li> <li>• Relatively easy to transfer ownership interests.</li> <li>• Generally have more management resources.</li> <li>• S corporation income passed through to owners and taxed at the individual level.</li> <li>• 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.</li> <li>• C corporation owner-employees may receive the full array of employer-provided tax-free fringe benefits.</li> <li>• Distributions from S corporations usually payroll tax free.</li> </ul>	<ul style="list-style-type: none"> <li>• C corporation income is taxed and dividends are taxed to owners.</li> <li>• Administrative burdens.</li> <li>• Difficult to form.</li> <li>• Dissolution can trigger tax.</li> <li>• Borrowing may be hard unless stockholders guarantee debt.</li> <li>• S corporations limited to 100 shareholders.</li> <li>• S corporations can have only one class of stock.</li> <li>• S corporations can't have corporate, partnership or nonresident alien shareholders.</li> <li>• S corporations generally must choose a calendar year.</li> <li>• More-than-2% S shareholders pay taxes on certain fringe benefits.</li> <li>• Tax rate on S corporation income may be higher than applicable C corporation rate.</li> </ul>

## Leasing vs. Buying

Item	Leasing	Buying
<b>100% financing</b>	Leases usually provide 100% financing, but a security deposit may be required.	Loans generally require a down payment.
<b>Cash flow</b>	Lower initial cash requirements and lower periodic payments.	Larger initial cash requirements and periodic payments.
<b>Cancellation option</b>	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.
<b>Fixed payments</b>	Lease payments typically are fixed.	Loans may have variable interest rate.
<b>Maintenance costs</b>	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.
<b>Operating restrictions</b>	Leases typically do not have restrictive operating covenants.	Loans may contain covenants that impose operating restrictions.
<b>Access to funds</b>	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.
<b>Borrowing capacity</b>	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.
<b>Residual value benefits</b>	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.
<b>Residual value risk</b>	In open-end leases, the lessee incurs the risk of a decline in value.	There are no residual value guarantees with purchases.
<b>Interest rates</b>	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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