

LIABILITIES AND EQUITY

KINDS OF COMPANIES

More information:

About kinds of companies: <http://www.lemoineandjames.com/gaap/54kinds.html>

If interested in accounting issues in general,

then visit the home page at: <http://www.lemoineandjames.com/gaap/index.html>

Also, at the wikipedia, if you google for "Types of companies".

The type of entity forms the basis of equity accounting. This section covers the major forms a company can take.

Proprietorships

If a company has only one owner and has done nothing else to organize his company, than it is a proprietorship (P). For many companies, this is the best form for them to take.

There are three accounts in the Equity Section for P's:

1. Owner's Capital
2. Draws
3. Current Profit (Loss)

Current Profit (Loss) comes from the Income Statement. This is year to date net income.

Draws are the money the owner takes out of the company. Owners do not take out wages. It is a good idea, however, for owners to budget themselves periodic payments in lieu of wages.

Both of these accounts are closed to the Capital account at the end of the year. Any money that owners invest in the company can go to two areas: capital or loans payable. For P's there are little tax consequences for investing money either way.

P's get hit with two taxes: the income tax and the selfemployment tax.

P's taxes are determined on the Schedule C on the personal 1040 tax return. Net income is adjusted for allowable expense deductions. Taxable net income from the business is transferred to the front page of the 1040 and included in the rest of personal income from other sources. If the business lost money, then that amount gets transferred, too.

Self-employment taxes correspond to the payroll taxes (social security and medicare) on employees. In payroll accounting, the business pays half and the employee pays half of these taxes. But for P's the owner is both. Hence, the self-employment tax. This is the combination of employer and employee payments.

The rate is 15.3%. This rate is computed on Schedule SE. The amount is transferred to page 2 of the 1040.

Partnerships

Partnerships (Ptnr) are like Proprietorships. Ptnr's have more than one owner. Partners should always

have a partner agreement to form a business. This is a practical requirement, not necessarily a legal one.

Experience

Jack once had a car repair outfit for a client. The partners insisted on not having an agreement. One man said, "A handshake is all I need. If I need a signature to trust his word, then I don't want to do business with him." The two men were best friends and had known each other for years. Within a few months they split amid much acrimony. We believe that the two were honest. The problems were misunderstandings of the basis of the business and each partner's obligations to it. An agreement would have dealt with those. Failure to do an agreement cost them not only their business but also their friendship. P.S. They talked Jack out of not doing an agreement for his accounting services, too. Misunderstandings rose from that. (Their own emotional break-up probably contributed.) Anyway, he ended up having to sue them to get his accounting fees.

Moral: always do business in writing!

Each partner needs his own capital and drawing accounts. These accounts represent his ownership position in the company.

Partners may take wages from the company. These enter the Partnership tax return as "Guaranteed Payments". They are deductible to the partnership company and income to the individual partner. The partner pays self employment tax on these.

The partners also pay self employment taxes on their portion of the total net income of the partnership.

Income tax returns are filed thru Form 1065. This form is similar to the tax return for the Sub S Corporation discussed below. Part of this return is a Schedule K. This shows the total income taxes, credits, and other taxable items that flow out to the partner's individual income tax returns. Each partner gets a Schedule K-1. This shows his/hers' share of the Schedule K items.

There is a special kind of partnerships called limited partnerships. These have to have at least one general partner. General partners are fully liable for the business. Limited partners can only loose their capital

investments. Limited partners have no say in the running of the business. They just share in the profits.

Limited partners' share of net income is not subject to self employment tax. If they do work for the business, then their compensation for that is.

Partnerships are automatically dissolved upon the death of partners with 50% or more of ownership.

Corporations (regular)

Corporations are separate "persons" under the law. They can sue and be sued. They are registered with the state. They file income tax returns like a partnership (using Form 1120) but unlike a partnership, they pay income taxes on their net income.

Shareholders control the corporation to the extent that they own shares of voting stock. Corporations may issue different classifications of stock. Common stock is the voting stock. Preferred stock generally is not.

Since corporations are separate "persons" shareholders of the corporation they shield shareholders from legal liability. If a lawsuit drives a company bankrupt, then the shareholders will lose their investment in the company but no more. In order for plaintiffs to go after the owners of the company, they have to sue them individually.

In the equity section the corporation shows "Common Stock" with an amount. Depending on how it is organized the stock may be shown at par or no-par value. If the company has set a par value for the stock, then any money investors put in over that amount is in another line just under "Common Stock" called "Contributed Capital in Excess of Par".

If a company buys back some of its own stock, then it is debited to "Treasury Stock". This is another line item in the equity section.

As corporations earn profits, "Retained Earnings" build up. If the company racks up losses then call the account "Retained Deficits".

Corporations distribute profits to shareholders by declaring dividends. The total amount of money it decides it can pay is divided by the number of shares to determine the dividend per share. The money is paid to shareholders and subtracted from retained earnings.

Form 1120 income tax returns don't issue K-1's like partnerships and Sub-S Corporations. They pay taxes themselves. Shareholders report their dividend income in their 1040's on Schedule B. Corporations must be sure to issue 1099-DIV to the shareholders each year.

Sub S Corporations

Subchapter S refers to a section of the IRS Code. Usually states do not require any special registration

beyond the normal corporate licensing for Subchapter S Corporations.

Subchapter S was adopted by Congress in the 1950's to help small businesses. To qualify for Sub S status with the IRS, the corporation must file Form 2553, have only one class of stock, and only 75 or fewer shareholders. Distribution of profits must be based on ownership.

Further, at least some of the owners must be active in the business. That means the IRS will look for "Officers' Wages" on the 1120S tax return. There had better be some and it had better be reasonable. If there is not, then that can be a huge audit flag.

Small businesses jump through all of these hoops to gain one big advantage: dividend distributions are not taxable!

Shareholders of regular corporations end up having to pay taxes twice:

- at the corporate level, when their corporation pays taxes on its annual net income and
- at the personal level, when they have to pay taxes on the part of net income is distributed to them

Shareholders of Sub S corporations pay taxes only once: when they have to transfer the net income amounts of their K1's into the Schedule E of their 1040's.

Shareholders do not pay self-employment taxes. Very important point!

The payroll taxes are paid through deductions on "Officers' Wages". The corporation pays the employer's share. This substitutes for self-employment taxes.

This is why shareholders want their wages to be as low as possible and their dividend distributions to be as high as possible. The IRS wants the reverse. The question reduces to what is reasonable.

Limited Liability Company

Limited Liability Companies appeared in the 1990's. They are like Sub S Corporations but with more flexibility. They file Form 1065 (or Schedule C if only one owner). They can elect to be taxed as a corporation. They then file Form 1120.

Income can be distributed on a different basis than ownership. For example, if two partners own 50-50 of the business but agree that one partner should get 60% of the profits, they can agree to do that.

Owners are referred to as "members".

The choice of what kind of entity the company will be is one of the most crucial choices entrepreneurs can make.

