

BUSINESS OPTIONS FOR MUSIC TEACHERS SETTING UP A STUDIO

When setting up a studio, one of the first questions a music teacher needs to address is what type of business will he or she operate under? Although there are a variety of business types and subtypes, for music professionals looking to form a business, there are four basic options. As explained below, each has its own advantages and disadvantages.

1. **Sole Proprietorship.** This option is easy to choose because if you do nothing, your business is regarded as a sole proprietorship. What that means is that you and the business are synonymous. Profit made by the business flows directly to you as taxable income and losses generated by the business are personal losses that can be taken as deductions on your tax returns. There is no entity between you and the business.

Any teacher who accepts payments for teaching students is automatically a sole proprietorship unless they choose one of the business formation options below. So, one of the advantages of a sole proprietorship is that it is very easy and inexpensive to set up because if you do nothing, you will be regarded as a sole proprietorship. For some music teachers, this may be the option to select.

What are the disadvantages of a sole proprietorship? The one disadvantage most experts would cite is that there is no shield for your personal assets. If your business is sued, a successful litigant can go after not only your studio assets, but also your personal assets such as your home and personal checking account. As we will see when discussing limited liability companies (LLC) and corporations, these business forms can protect personal assets through the shield limited liability.

SOLE PROPRIETORSHIP

Advantages

- Easy to set up
- No fees or costs to set up or maintain
- Income and losses flows directly to personal tax return

Disadvantages

- No liability shield
- Limited deduction for health insurance

2. **Partnership.** If two or more music teachers joined together to own and operate a studio, they would be regarded as a partnership. While it is always advisable for the partners to enter into a written partnership agreement to formalize their respective rights, interests, and obligations, it is not necessary. If two or more individuals own an enterprise and do not elect to form a corporation or an LLC, the default position is that the business is treated as a partnership.

From a legal perspective, a partnership is very much like a sole proprietorship. The income generated by the business flows directly to the personal income of the partners in the proportion of their ownership interests. For example, if the partnership generated \$100,000 in income and there are two partners with one having a 75% ownership interest and the other at 25% ownership interest, the first partner would have \$75,000 in personal income and the second partner would receive \$25,000 in personal income. Of course, any losses or deductions generated by the partnership would also flow directly to the two partners in the proportion to their percentage ownership.

As with a sole proprietorship, there is no liability shield so if the partnership is held liable in a lawsuit, the personal assets of the partners would be susceptible of being seized to satisfy the lawsuit. Another potential disadvantage that partners should be aware of is that any of the partners may legally bind the partnership. For example, if one partner, without the other partner's knowledge, went out and purchased a vehicle in the partnership's name, the partnership would be responsible for the payment of that vehicle even though the other partner did not consent to the purchase.

PARTNERSHIP

Advantages

- Income and losses flows directly to the personal tax returns of the partners
- Easy to set up
- No fees or costs to set up or maintain

Disadvantages

- No liability shield
- Limited deduction for employee health insurance costs
- All partners responsible for the debts of the partnership

3. **Limited Liability Companies.** A very popular business formation option over the past 25 years for smaller businesses has been the limited liability company or LLC. All of the states have now adopted laws that recognize an LLC as a legal business option. The popularity of the LLC results from its combination of providing the limited liability feature of a corporation with the flow-through income tax benefits of a sole proprietorship or partnership.

In order to set up an LLC, the music teacher needs to file Articles of Organization with the appropriate state agency. Typically, a music teacher organizes the LLC under the laws of the state where the studio is located. However, that is not required. To organize an LLC, the filing of the Articles of Organization is required and a fee must be paid. Filing Articles of Organization may usually be accomplished online or by using forms available through the appropriate state agency. Filing fees for the Articles typically range from \$75 to \$300. Music teachers may want to hire a lawyer to do the setup, although it is certainly a step most could do on their own.

In addition to the Articles of Organization, the members of an LLC will need to enter into an Operating Agreement. This document is the blueprint setting forth how the LLC will be run, what are the rights and obligations of members and managers, how managers are appointed, how members may sell their memberships interest, etc. it would be advisable to have an attorney draft an Operating Agreement, especially for an LLC with multiple members.

An LLC can be set up by a single member or multiple members. When registering the LLC with the IRS, the organizers must make an election on how the LLC will be taxed. Members can elect to have and losses income pass directly through to the members just like a sole proprietorship or a partnership. The other option is to have the LLC taxed as a separate business entity like a corporation. A music teacher may want to consult with his or her tax advisor before making this decision.

As noted above, one of the chief advantages of the LLC is that it provides limited liability. Therefore, if the LLC gets sued or goes broke, the creditors cannot reach beyond the assets of the LLC to seize the personal assets of the members to satisfy the debt obligation. So, when a member invests in an LLC, the only potential loss would be the capital that the member invested in the LLC; the personal assets of the member would be beyond the reach of the creditors of the LLC.

LIMITED LIABILITY COMPANY

Advantages

- Provides personal limited liability for members
- Allows income and losses to flow directly to personal tax returns of members
- Less business regulations than corporations

Disadvantages

- Fees and expenses to organize and maintain the LLC

4. **Corporation.** The traditional business formation option for companies has been to incorporate. While the LLC has become an increasingly popular option, especially for smaller businesses, forming a corporation is still used by most large businesses. Corporate status provides the protection of limited liability and the availability of several business expense deductions, like employee healthcare costs, that other business options do not provide.

Like an LLC, a corporation must be organized by filing documents with the appropriate state agency. In most states, a corporation is organized by the filing of Articles of Incorporation with the Secretary of State's office. Filing fees typically range from \$150 to \$300. The Articles of Incorporation can be fairly easy to file and the use of a lawyer is not required. The corporation will also have Bylaws that spell out the rights and obligations of shareholders, officers and directors. Drafting bylaws usually requires the assistance of a lawyer.

Maintaining corporate status requires various formalities such as regular meetings of shareholders and directors. Also, in order to maintain the personally liability shield that a corporation provides, it is important not to intermingle personal and corporate funds. Therefore, it is necessary to have the corporation set up with its own separate bank accounts for accounting purposes. In addition, shareholders should not use corporate assets for their own personal benefits.

The most significant difference between a corporation and the other business formations discussed above is that the corporation is treated as a separate tax-paying entity by the IRS. Therefore, unless it is formed as an S-Corporation, the corporation pays taxes at the corporate level. Any income left over can then be distributed to shareholders in the form of a dividend. However, since the dividend is taxed to the shareholder, the result is that the distribution of profits to a shareholder amounts to double taxation. This is one of the disadvantages of the corporate forum.

Somewhat offsetting the disadvantages of double taxation are the tax deductions that are available to corporations. This is another area where the music teacher should discuss business formation options with his or her tax advisor. This is especially true if the music teacher is entering into large capital expenditures such as the purchase of real estate for the studio or a large expenditure for equipment.

CORPORATION

Advantages

- Shareholders have limited personal liability
- Health insurance premium and group life insurance are fully deductible by the corporation and nontaxable to employees
- Corporate tax rate may be below the rate of an individual tax rate

Disadvantages

- Double taxation in that corporation pays taxes on its income and the shareholder pays taxes on dividends
- Shareholder cannot deduct the losses of the corporation
- Fees and expenses to set up and maintain corporate status
- Time and expense to follow corporate formalities and prepare corporate tax returns