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Choosing an Entity for Your Business

The three primary categories of entities are:

- partnerships
- corporations
- limited liability companies (LLCs)

Each category offers advantages, disadvantages, and governing rules. Alternatively, you might operate your business as a sole proprietorship, which does not require forming a separate legal entity.

Sole Proprietorships

A *sole proprietorship* is the simplest form of business structure. It is easy to establish, because no legal entity is requiredâ??the business is an extension of the owner.

The sole proprietor is personally liable for all debts and obligations of the business. This exposes personal assets, like your familyâ??s home, to claims from the businessâ??s creditors.

All business income, gains, deductions, and losses are reported on Schedule C of Form 1040. A sole proprietorship is not subject to corporate income tax. However, certain expenses that may be deductible by a corporation might not be deductible for a sole proprietorship.

General Partnerships

When two or more individuals own a business, a *partnership* is a common structure to consider. Partnerships are generally governed by state statutes, but certain arrangementsâ??such as joint venturesâ??may be treated as partnerships for federal income tax purposes regardless of state law.

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In a partnership, two or more people join together to operate a business for mutual profit. A *general partnership* gives all partners authority to act on behalf of the business. However, this also means each partner is personally liable for the actions of the others, as well as for the debts and obligations of the business.

Key points about general partnerships:

- Partners are personally responsible for business liabilities.
- Each partnerâ??s contribution and share of profit does not need to be equal.
- A partnership agreement governs the division of profits and losses.

Legal and Tax Considerations for General Partnerships

Partnerships are recognized entities that can obtain credit, file for bankruptcy, and transfer property. However, the partnership itself is not subject to federal income tax. Instead:

- The partnership must file an informational federal income tax return.
- Income, gains, deductions, and losses pass through to the partners and are reported on their individual tax returns in accordance with the partnership agreement.

If an initial public offering (IPO) is anticipated, a partnership may not be the best choice. While some publicly traded partnerships exist, most businesses planning an IPO organize as corporations instead.

Limited Partnerships

Limited partnerships differ from general partnerships in that they include more than one class of partners. In a limited partnership, at least one partner must serve as a *general partner*.

- General partners actively participate in managing the business and have personal liability for debts and obligations.
- *Limited partners* do not participate in daily management and have liability only up to the amount of their capital investment.

Limited Liability Partnerships (LLPs)

Some states allow the formation of *limited liability partnerships*. An LLP is a general partnership that provides individual partners with protection against personal liability for certain obligations. The scope of this protection depends on state law. Consult with legal counsel to understand the implications of this structure in your state.

Corporations

Compared to sole proprietorships or partnerships, corporations offer both advantages and disadvantages. The two most significant advantages are:

- Corporations shield owners from personal liability.
- Corporations provide the greatest flexibility to raise capital and transfer ownership.

C Corporations

Most incorporated businesses are *C corporations*. Unlike S corporations, C corporations are not subject to the same qualification rules and offer greater flexibility in stock ownership and equity structure. They can also deduct most employee benefits, whereas S corporations may not deduct benefits for shareholders who own 2 percent or more of the company. Most large corporations are C corporations.

C corporations are subject to corporate income tax, and distributed earnings may be taxed twiceâ??once at the corporate level and again at the individual level when dividends are paid.

S Corporations

S corporations are subject to several eligibility requirements. If a business meets these criteria, an S corporation can offer tax benefits that are not available to C corporations. Income, gains, deductions, and losses pass through to shareholders, who report these items on their individual tax returns. This structure eliminates double taxation.

Not all corporations qualify for S corporation status. To elect this treatment, the organization must meet specific requirements and file an election with the IRS. These requirements include limits on the number and type of shareholders and restrictions on who may own stock.

Many employee benefit deductions are unavailable to shareholders who own 2 percent or more of the company.

Limited Liability Company (LLC)

A *limited liability company* combines features of both corporations and partnerships. Like a corporation, an LLC provides limited personal liability for its owners. At the same time, it offers pass-through tax treatment and greater flexibility in governance than a corporation. LLCs are not subject to the qualification requirements that apply to S corporations. If the company anticipates an IPO, a corporation is generally a better choice than an LLC.

Selecting the Right Ownership Structure

There is no universal best ownership structure for a business. Each option offers distinct advantages and limitations. Even after choosing an entity, it is wise to periodically re-evaluate your choice as the

business evolves. Consult with an experienced attorney and tax advisor for help determining the structure that best fits your needs.

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