

Starting A Small Business? Which Entity Type Is Right For You?

Three things to keep in mind when choosing a legal form:

<u>Liability:</u>	<u>Double taxation:</u>	<u>Ownership</u>
Legally, corporations are individual entities. As such, the corporation — not individual shareholders — are responsible for the actions of the business. In other words, if something goes very wrong, and a corporation is sued, only the assets of the corporation are at stake — not the owners' personal assets. (There are some exceptions to this rule, but generally, your personal liability is greatly limited.)	No one likes paying taxes, and you certainly don't want to pay taxes twice — once on income for the business and then again when that income is distributed as profits to you. Instead, look for a legal form that allows for the profits of the company to "pass through" to the owners, without having to pay corporate taxes first.	Certain legal business forms limit the number or type of people who can invest in your company. If you're seeking a large number of investors or international investors, find a corporate structure that permits such stockholders.

The Breakdown:

Sole Proprietorship	Pros	Cons	Summary
Best Fit: • Seasonal or part-time businesses. • Businesses with little liability. • Home based businesses. • Businesses intended to operate for the owner's life only.	• No formal creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • No double taxation of profits.	• No liability protection. • Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners.	The main feature of this form is that it is identified with and intertwined with you. If the business makes a profit, it is income for you. If the business incurs a debt, it is your personal debt as well. If the business gets sued, you will be sued personally. This is both the strength and weakness of the sole proprietorship. You have complete flexibility, and can instantly shift the direction, policies and focus of your company. Yet, if there is a problem, the potential for the damage extending throughout your personal life is ever present. The main feature of this form is that it is identified with and intertwined with you. If the business makes a profit, it is income for you. If the business incurs a debt, it is your personal debt as well. If the business gets sued, you will be sued personally as well. This is both the strength and weakness of the sole proprietorship. You have complete flexibility, and can instantly shift the direction, policies and focus of your company. Yet, if there is a problem, the potential for the damage extending throughout your personal life is ever present. Simply put, it means one owner. It is the "default" form, so if you do nothing else, you will be a sole proprietorship.

Partnership	Pros	Cons	Summary
Best Fit: • Two established businesses who wish to work as one. • Partners wishing to consolidate multiple entities into one entity.	• Easy to create. • No limit on partner number or type. • Can be used to hold investments in other businesses and consolidate multiple lines of business. • Flexible allocation of profit, loss, and distributions. • Favorable tax treatment when liquidated. • No double taxation of profits	• Requires a separate tax return. • Unlimited liability for all partners. • Difficult to dissolve or change ownership without substantial planning. • Requires tracking of basis for partners, both inside and outside the partnership. • Individual partner's share of income is subject to self-employment taxes.	Partnerships can work, when there is a clear division of responsibilities and abilities. If you are a good negotiator, salesperson and "people person," but your paperwork is usually a shambles, and your potential partner is meticulous and detail oriented, but fears selling and meeting strangers, the two of you might be a natural match. One other way partnerships benefit is to raise more capital. Your partner's contribution may be what you need to launch your business. The thing to do, if you do contemplate a partnership, is to have a clearly defined partnership agreement drawn up. Have it checked by a lawyer. The agreement should specify what happens if one of you decides to quit. What if either of you dies? Who will do what functions? How will decisions be made? What if you can't agree? Who will pay for what? These things all should be settled beforehand, before they have a chance to cause disruption in the business. Nothing kills a business faster than feuding partners do.
Limited Liability Partnership - (LLP)			
Best Fit: • Businesses with partners not actively involved in business. • Businesses with equity capital needs. • Businesses with exposure to liability.	• Liability protection for limited partners. • Separate entity from partners. • Ownership can be transferred within the rules of the partnership agreement. • Limited partners' liability is limited to their investment in the business. • Limited partners pay self-employment tax on guaranteed payments only. • No double taxation of profits.	• Must have one general partner with unlimited liability. • Limited liability status for damages can be lost for a variety of administrative reasons. • Restrictions on partners based on entity type. • Requires a separate tax return. • Requires tracking of basis for partners, both inside and outside the partnership.	

C Corporation Sub Chapter C	Pros	Cons	Summary
Best Fit: • Businesses with ownership in multiple other entities. • Businesses with significant exposure to liability. • Businesses intended to exist eternally.	• No liability for non-active stockholders. • No restrictions on ownership. • Ownership can be transferred through the sale of stock. • Separate entity from stockholders. • Fringe benefits for owner-officers. • Can have ownership interest in any other business entity. • Perpetual existence. • Raising capital can be achieved by issuing stock.	• Double taxation of profits. • Complex and expensive to create and maintain. • Require regular board of directors' meetings and minutes. • Requires a separate tax return.	The C Corporation is your "standard" corporation. All the companies listed on the stock exchange are C corporations. You can have unlimited shareholders. If you sell 100,000 shares at \$10 each, you've got a million dollars in capital to work with. The investors can be people, mutual funds, companies, and foreigners. The disadvantage to the C Corporation is that of double taxation. If your business earns \$100,000, the first thing that happens is that a corporate tax is paid. Then, if you want to draw a salary (for in a corporation you are in fact an employee), you must declare that salary and pay personal income tax. The same money gets taxed twice before you get to spend any of it.

S Corporation – Subchapter S	Pros	Cons	
Best Fit: • Businesses with significant exposure to liability.	• Liability protection similar to that of C corporations. • No double taxation of profits. • Ownership is easily transferred through the sale of stock. • Separate entity from stockholders. • Self-employment tax is not assessed on the entire profit of the business. • Losses can offset shareholders' other taxable income.	• Complex and expensive to create and maintain. • Requires a separate tax return. • Requires regular board of directors' meetings and minutes. • Requires tracking of basis for stockholders. • Ownership is limited to specific types of entities. • Deductibility of fringe benefits for owner employees is limited.	S Corporation income “flows through” and the net income is simply reported on the personal income tax returns of the shareholders, just as income from a proprietorship or partnership would be. In exchange for this benefit, there are limits put on S corporation formation and ownership.
Single Member Limited Liability Company – LLC	Pros	Cons	
Best Fit: • Businesses with potential liability in operations. • Businesses intended to operate for the owner's life only.	• Simple creation process. • Easy to operate and dissolve. • No separate tax return. • Easy to integrate business use of home deductions. • Liability protection for member, except for malpractice. • No double taxation of profits	• Self-employment tax is assessed on entire profit of the business. • Transfer of ownership can be complex. • Limited access to fringe benefits for owners. • Laws regulating LLCs vary widely among states.	

Multi-Member Limited Liability Company – LLC	Pros	Cons	
Best Fit: • Businesses requiring equity capital. • Businesses with potential liability in operations. • Businesses intended to exist beyond the lives of the members. • Businesses expecting changes in ownership over time.	• Limited liability for all members, except for malpractice. • Unlimited number of members. • Separate entity from members, allowing for greater flexibility in operations. • Ownership is in the form of membership interest and can be transferred more easily than ownership in a single member LLC. • No double taxation of profits.	• Requires a separate tax return. • Laws regulating LLCs vary widely among states.	