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-SELECTING A BUSINESS ENTITY-

Introduction

One of the most important decisions to make when starting a business is choosing the type of entity or legal structure for your company. This decision will determine the amount of taxes you or your company will be required to pay, the degree of personal liability you may face, the ability for your company to receive funding, and the amount of paperwork your business will be required to do. The most common business entities are: (1) Sole Proprietorships, (2) Partnerships, (3) Corporations, and (4) Limited Liability Companies (LLCs). The following provides brief descriptions, advantages, and disadvantages of each of these business entities.

Sole Proprietorships

A sole proprietorship is the simplest and most common structure chosen to start a business. It is an unincorporated business owned and run by one individual with no distinction between the business and you, the owner. You are entitled to all profits and are responsible for all your business's debts, losses, and liabilities.

Advantages:

- *Easy and inexpensive to form*
A sole proprietorship is the simplest and least expensive business structure to establish. Costs are minimal, with legal startup costs limited to obtaining necessary business license or permits.
- *Complete control*
As sole owner of the business, you have complete control over all decisions. You aren't required to consult with anyone else to make decisions or changes.
- *"Flow Through" Taxation*
Your business is not taxed separately from you, so it's easy to fulfill the tax reporting requirements for a sole proprietorship. The tax rates are also the

lowest out of the business entities.

Disadvantages:

- *Unlimited personal liability*
Because there is no legal separation between you and your business, you can be held personally liable for the debts and obligations of the business. This risk extends to any liabilities incurred as a result of employee actions.
- *Difficult to raise money*
Sole proprietors often face challenges when attempting to raise funds. Because you can't sell stock in the business, investors will often be slow to invest. Banks are also hesitant to lend to a sole proprietorship because of a perceived lack of credibility when it comes to repayment if the business fails.
- *Heavy burden*
The flipside of complete control is the burden and pressure this responsibility can impose. You alone are ultimately responsible for the successes and failures of your business.

General Partnerships

A partnership is a single business where two or more people share ownership. Each partner contributes to all aspects of the business, including money, property, labor or skill. In return, each partner shares in the profits and losses of the business.

Advantages:

- *Easy and Inexpensive to Form*
Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- *Shared Financial Commitment*
Each partner of a general partnership is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This could be beneficial in terms of securing credit, or by simply doubling your seed money.
- *"Flow Through" Taxation*
One of the advantages of a general partnership is that, like a sole proprietorship, the business is not taxed. Rather, income, losses, and gains are passed through to the general partners in accordance with the allocations provided in the partnership agreement.

Disadvantages:

- *Joint and Individual Liability*
Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership's debt.
- *Shared Profits*
Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.
- *Partner Conflict*
With multiple partners, there are bound to be disagreements, which generally requires partners to consult each other on all decisions, make compromises, and resolve disputes as amicably as possible, which can be very burdensome when trying to get business done.

Corporations

A corporation is a separate entity from its owners for both legal and tax purposes. Corporations are formed by filing the Articles of Incorporation with the Secretary of State and creating corporate bylaws. A corporation is owned by its shareholders and run by the board of directors and executive management team (executive officers). The shareholders elect the board of directors, which is responsible for setting major goals of the corporation and making major decisions. The board of directors appoints the executive officers, who manage the day-to-day operations of the business.

Advantages:

- *Limited Liability*
When it comes to taking responsibility for business debts and actions of a corporation, shareholders' personal assets are protected. Shareholders can generally only be held accountable for their investment in stock of the company.
- *Generate Capital*
Corporations have the advantage over other business entities because corporations are able to raise funds easily through the sale of stock.
- *Attract Potential Employees*
Corporations are generally able to attract and hire high-quality and motivated employees because they offer competitive benefits and the potential for partial ownership through stock options.

Disadvantages:

- *Time and Money*
Corporations are costly and time-consuming ventures to start and operate. Incorporating requires start-up, operating, and tax costs that most other structures do not require.
- *"Double" Taxation*
Generally, traditional "C" corporations are taxed twice - first, when the corporation makes a profit, and again when dividends are paid to its shareholders.
- *Additional Paperwork*
Because corporations are highly regulated by federal, state, and in some cases local agencies, there are increased paperwork and recordkeeping burdens.

Limited Liability Companies (LLCs)

A limited liability company is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. The "owners" of an LLC are referred to as "members." Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs. Subject to slight variations in each state, all LLCs adhere to the same general principles: (1) Choose a Business Name; (2) File the Articles of Organization with the Secretary of State; (3) Create an Operating Agreement; and (4) Obtain Business Licenses and Permits.

Advantages:

- *Limited Liability*
Members are protected from personal liability for business decisions or actions of the LLC. Thus, when the LLC incurs debt or is sued, members' personal assets are usually exempt, similar to the corporate form.
- *Minimized Recordkeeping*
An LLC's operational ease is one of its greatest advantages. As opposed to "C" or "S" corporations, LLCs generally require less registration paperwork and smaller start-up costs.
- *Profit Sharing*
There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital equity and services. Thus, it's up to the members themselves to decide who has earned what percentage of the profits or losses.
- *"Flow Through" Taxation*
LLCs offer the members with "pass-through" taxation like a sole proprietorship

or partnership, avoiding the potential of double taxation in a C Corporation.

Disadvantages:

- *Limited Life of Entity*
Generally, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. It is possible, however, to include provisions in the operating agreement to continue with the LLC if a member decides to leave the business.
- *Limited Access to Capital*
Compared to a corporation, an LLC is a less favorable entity choice as far as raising capital from outside investors or offering ownership interests to employees.
- *Reliability*
The corporation structure has been in existence far longer than the LLC and is better understood with respect to its structure and how ownership interests are represented in stock certificates. These characteristics have less certainty and may be more difficult to comprehend in an LLC because of the potential complexity of an LLC operating agreement.

Questions with Answers

- **I have started a company and have not chosen a business entity yet. What type of personal liability do I face?**

You do not have to take any formal action to form a sole proprietorship. As long as you are the only owner, this status automatically comes from your business activities. In fact, you may already own one without knowing it. Thus, as described above, you will face unlimited personal liability for the debts and obligations of your business. Very risky!

- **My associates and I have started a company, but we have not chosen a business entity yet or drafted any agreements amongst ourselves. What type of personal liability do I face?**

Although a formal written partnership agreement is not required to form a general partnership, the partners should ordinarily set forth the rights and duties in a written document. In the absence of a written agreement, however, when two or more people engage in a business together and do not specifically choose any other entity type, they will be treated as a general partnership if there is an understanding between them that they will share profits and losses. Without this,

each associate will likely be deemed a full partner and be joint and severally liable for the obligations and debts of the partnership.

- **Are there any alternative partnership business entities besides a “general” partnership?**

Yes. You may want to choose a limited partnership instead. Limited Partnerships are more complex than general partnerships. Limited partnerships allow partners to have limited liability for the partnership debts and obligations, as well as limited input with management decisions. These limits depend on the extent of each partner’s investment percentage. Limited partnerships are attractive to investors of short-term projects.

- **Are there any corporate entities aside from traditional “C” corporations?**

Yes. One example is the “S” corporation. The S corporation is more attractive to small-business owners than a standard (C) corporation. That's because an S corporation has some appealing tax benefits and still provides business owners with the liability protection of a corporation. With an S corporation, income and losses are passed through to shareholders and included on their individual tax returns. As a result, there's just one level of federal tax to pay. S corporation have disadvantages, however. For example, they are subject to many of the same requirements corporations must follow, and that means higher legal and tax service costs. They also must file articles of incorporation, hold directors and shareholders meetings, keep corporate minutes, and allow shareholders to vote on major corporate decisions. The legal and accounting costs of setting up an S corporation are similar to those of a standard corporation. Additionally, subject to certain limitations, you may be able to convert your LLCs into an S corporation.

- **How can my business become an “S” Corporation?**

To form an “S” corporation, certain requirements must be met and an election form must be filed with the IRS. The main requirements are: (1) no more than 100 shareholders, (2) shareholders must be individuals, estates, or certain types of trusts, and cannot be nonresident aliens, (3) only one class of stock allowed.

Helpful Resources

- Choose a Business Structure
<https://www.sba.gov/business-guide/launch/choose-business-structure-types-chart>

- Choose Your Business Structure - sole proprietorship, corporation, LLC
<http://www.entrepreneur.com/article/38822>
- Business Comparison Chart
https://www.incorporate.com/business_structure_comparison_chart.html
- How to Choose the Right Business Entity
<http://www.nationwide-incorporators.com/article-how-to-choose-right-entity>