

Deciding on the Right Form of Legal Entity for Your Business

There have been many useful articles written on the different options under which a business may be legally formed, Limited Partnerships, Sole Proprietorships, General Partnerships, Corporations, S Corporations and Limited Liability Companies are the most common.

Below is a simple explanation of business structure options for current and prospective business owners.

Limited Partnership

Closely related to a General Partnership is a Limited Partnership. A Limited Partnership is composed of one or more general partners and one or more limited partners.

Although the general partners still have unlimited liability, the limited partners do not, so long as they are passive investors and do not have an active role in the operations of the business. Their liability is generally limited to the amount of their original investment. Many times a separate Corporation is formed to act as the general partner to further reduce the unlimited liability risk. As you can see, a Limited Partnership can quickly become more complicated from an administrative standpoint, but has many benefits, including no double taxation, and elimination of the unlimited liability risk for limited partners.

Sole Proprietorship

A Sole Proprietorship is the simplest business form, and does not even involve a separate legal entity. No complex administrative issues are involved and there is no double taxation. It can be the best form for a small business where it is unlikely that the business will incur any significant debt or could be sued for a business related matter. This is an important point because a separate entity is not being formed, and thus the owner is liable for all of the business's actions.

General Partnership

In many ways, a General Partnership is quite similar to a Sole Proprietorship, except that there may be more than one owner. Like the Sole Proprietorship, it is fairly easy to administer, there is no double taxation. However, there is the risk of unlimited liability to the owners. It is also more complicated in that the arrangements between the owners (the partners) must be defined, usually in a Partnership Agreement. The Partnership Agreement usually specifies, among other things, how income is allocated, and what happens if one of the partners wants to leave the business or dies.

Corporation

Establishing a corporation involves the formation of a separate legal entity under the laws of a particular state. A Certificate or Articles of Incorporation are generally required to be filed with the Secretary of State's office. In addition, annual reports and other technical requirements are generally needed. There are corporate service firms which can help with these filings. Additional corporate formalities include the need for a board of directors, corporate officers and agents, and an annual meeting of

stockholders and directors. The corporate form suffers from double taxation; however, all owners have limited liability so long as the appropriate corporate formalities are observed. In addition, it is generally easier to have many owners, and maintain the existence, of a Corporation.

S Corporation

An S Corporation is very similar to a regular Corporation, except it has elected to be treated under the rules of **Subchapter S** of the Internal Revenue Code. So long as the technical requirements of the Code are met, an S Corporation is not taxed at the entity level, and thus does not suffer from double taxation. Adhering to all of the requirements of the Code can, among other things, limit the types and number of owners of an S Corporation.

Limited Liability Company (LLC)

A new form of business ownership has come into being within the past 10 years which for the most part takes the best of all worlds. The Limited Liability Company provides all of its owners with limited liability, and avoids double taxation. In addition, unlike an S Corporation there are few, if any, restrictions on ownership. Usually, a document must be filed with the state of formation, but other administrative formalities are generally less involved than with a Corporation. The biggest reservation some advisors have about an LLC is that since it is a new business form, some states are still in the process of developing their regulations, and the IRS may still have further pronouncements in the area.

As the buyer of a business you will most often need to make this decision when the business acquisition is being structured. Once you've decided which form is right for you, you'll need to decide which state to form your business in and then actually form your business. You should always consult a business attorney and your accountant before making your final decision so you fully understand the implications of your choice.