CHOOSING A BUSINESS ENTITY
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One of the first decisions that potential business owners must make is to determine how their business should be structured and operated. This crucial decision must be made even before the business has actually begun operations. Many factors influence this decision including time, money, knowledge, experience, as well as the particular situation and the type of business to be undertaken.

There are many basic forms of business operating entities. The five most common forms are:

1. **Sole Proprietorship**
2. **Partnership**
3. **Limited Partnership**
4. **Limited Liability Company (LLC)**
5. **Corporation - C-Corporation & S-Corporation**

Which of these forms you choose will have an effect on financing, taxes, accounting, and most importantly whether your personal assets are at risk. Your initial choice is not final and can be changed as the business grows. The following details many of the advantages and disadvantages of each form of business organization. Remember that this is merely a simplified general guide. To determine what is best for your particular situation, be sure to consult competent legal and tax advisors.

1. SOLE PROPRIETORSHIP

A sole proprietorship is both the simplest and the most prevalent form of business organization. It is also the least regulated. A sole proprietorship is the typical one-person business run by an individual who gets all the profits... and all the liabilities.

Advantages: The greatest advantage of sole proprietorship is total control over the business. The owner is free to operate the business however they choose (subject to legal and tax requirements). Normally, the only license needed is a local business license and perhaps a "doing business as" registration.

Disadvantages: The greatest disadvantage is that *all* of the owner's personal and business assets are at risk if claims or judgments exceed the value of the business. While insurance can lessen these dangers, it cannot protect against all possible claims that may arise. Additionally, sole proprietorships to not indicate business experience and stability and as a result it may be harder to obtain loans to finance growth.

2. PARTNERSHIP

A partnership is two or more persons who join together to carry on a business with each partner contributing money, labor, or other benefits to the business operations. Typically each partner shares in the profits and losses according to their percentage of ownership. A partnership agreement is usually created to define all of the details of the relationship and business.

Advantages: By combining the skills and credit of the various partners, a partnership has a greater likelihood of success. Business formalities are similar to the sole proprietorship and taxation is substantially the same. Plus, with more than one person involved, the credibility of the business in

the public's eye is strengthened. Finally, having partners provides for a natural succession if a partner dies and thus the business can survive providing value to the decedent's heirs.
Disadvantages: The biggest disadvantage of partnership is the potential for conflict between partners. While this disadvantage can be partially overcome with a solid partnership agreement, battles over control and money often arise, regardless of the initial agreement between the partners. Additionally, each partner is liable for all of the debts of the partnership, regardless of which partner may have been responsible for the debt occurring. Further, unless properly provided for, claims against one partner for matters unrelated to the business could allow a stranger to take control of that partner's interest in the business and maybe even force the business to be sold or closed.

3. LIMITED PARTNERSHIP

A limited partnership is the first form of business organization that provides for some degree of liability protection. There are two classes of partners: General Partners that run the business; and Limited Partners that only invest their money or other capital in the business. This type of structure works well when a partnership cannot obtain loans but needs money to operate and grow.
Advantages: The biggest advantage is that the business can obtain capital to grow without having to pay loan costs. Plus, limited partners have no liability for claims against the business beyond the value of their investment.
Disadvantages: The biggest disadvantage is for the general partners who retain personal liability for all claims that go beyond the assets of the limited partnership.
NOTE: An alternative form of entity called **Limited Liability Partnership** exists for use by certain designated professions (lawyers, doctors, accountants, etc.). It is most similar to the limited liability company discussed below.

4. CORPORATION

A corporation is a legal entity created by the law of the state where it is organized. Because it provides liability protection from third party claims as well as numerous tax benefits, it has been the entity of choice for many small businesses. Corporations are more formal and more complex than either a sole proprietorship or partnership, primarily because it is not a living being. Corporations are created by filing Articles of Incorporation and they are operated under corporate Bylaws which provide its rules of operation. Corporate Minutes record the events in the life of the corporation. A corporation is owned by its Shareholders, led by its Directors, and operated by its Officers. Because it is an artificial entity, a corporation can live on theoretically forever. There are two types of corporations: C-corps and S-corps, each of which have distinct advantages and disadvantages.
C-Corporation - by default, all corporations are established as C-corps.
Advantages: The biggest advantages of a C-corp are that it can have unlimited numbers of shareholders (owners); various forms of stock (voting, non-voting); and can retain earnings which are taxed at the lower tax rate of corporations allowing the business to grow faster without having to borrow money or sell ownership interests (shares).
Disadvantages: The biggest disadvantage is the potential of "double-taxation" which occurs when the earnings of the corporation are distributed to shareholders who are then taxed on their personal tax returns for the same money that was previously taxed in the corporation. This is the price of being able to use retained earnings to grow your business.

S-Corporation - the S corp is created by filing an election of tax treatment with the IRS. Its purpose is to allow small corporations to be taxed like a partnership while still gaining many of the benefits of a corporation. This is the most typical corporate structure used by small businesses seeking to maximize their earning potential while minimizing their liability risk. However there are significant differences between this and a C-corp.

Advantages: Because the S-corp is taxed like a partnership, profits and losses pass through to the shareholders without any double-taxation. Plus, unlike a C-corp, shareholders can personally deduct any corporate losses.

Disadvantages: To be an S-corp, the business is essentially small: it is limited to 75 shareholders; only one class of stock; and all shareholders must be U.S. citizens.

5. LIMITED LIABILITY COMPANY

The limited liability company ("LLC") is a relatively new hybrid between a traditional partnership and a corporation. It is created by filing a Articles of Organization and operated pursuant to an Operating Agreement. Minutes are not required although they are recommended. An LLC consists of one or more Members who may also be designated Managers. It offers the limited personal liability of a corporation and the tax benefits of a partnership. Because this as a newer form of entity, the laws governing them may vary from state to state and their taxation options are still evolving.

Advantages

Members have limited liability, similar to shareholders in a corporation and in general, their risk is limited to the amount of their investment. Similarly, they share in the profits and losses of the business similarly to a partnership. Unlike corporations however, LLC's are more flexible and less formal in their operations.

Disadvantages

The newness of the entity type has led to inconsistency in the state laws. Some states (such as California) charge an additional sales tax on LLC operations and many government agencies will not issue licenses to LLC's (such as real estate licenses). Further, because the tax law is still evolving, it can be more difficult to obtain financing and transfer of Member interests, especially through a tax-deferred exchange, can be complex.

SUMMARY

Starting and operating a business can be an exciting, challenging, and rewarding experience. Effective planning at the beginning can help you avoid frustration and needless expense while assisting you to achieve the success you desire. To determine what is best for your particular situation, be sure to consult competent legal and tax advisors.

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