Business Planning

Building a business: Entity selection and forms of organization

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For business owners, the type of entity selected, or not selected, will have far reaching implications for the owners and the business. Serious consideration should be given to this important decision because later modifications or changes may trigger tax or liability issues or even transfer problems for successors, heirs, or loved ones. This article reviews the forms of business organization for entities and non-entities that are commonly encountered doing business in the United States.

SOLE PROPRIETORSHIP. When businesses start small, often the expense and administrative burden of creating an entity separate and apart from the owner is not worth the effort. The income generated by the sole proprietorship is reported on the owner's personal income tax return and is taxed at the owner's personal income tax rate. If the business remains small and the owner's assets remain modest, a sole proprietorship, which is the default non-entity mode of operating a business, may suffice until the business's or owner's assets grow. Once the owner's assets grow past the state's judgment exemption amounts—which is an amount of property set by statute that a judgment debtor may retain in the event of a substantial adverse judgment or bankruptcy—the business owner at this point is no longer "judgment proof." The more property the business owner has, the more he or she becomes an attractive target for predatory litigation and stands to lose as a result of an adverse life or business event. Since no distinction is made between the business and the owner, a sole proprietorship provides no liability protection to the business owner. The owner's personal assets are subject to both personal and business liabilities. A similar scenario exists, but further compounds the liability issues, if the business owner has another person working with him or her as a partner.

GENERAL PARTNERSHIPS. General partnerships are a type of default entity formed by two or more people operating a business together. The income produced by the general partnership is reported on each partner's individual income tax return according to his or her share. In this type of arrangement, each partner is considered a general partner of the business, each has agency for the other, and the personal assets of each are available to cover liabilities generated by the business. Each general partner also has agency for the business, which means each can bind the business to contracts and potential liabilities. Each partner's personal assets are subject to the business's liabilities. Therefore, in the event one partner exercises poor judgment, the other partner may have to pay for it with his or her own personal assets. Such a proposition often leads the owners to seek improved liability protection once the business grows from its infancy.

Before discussing entities that limit an owner's liability to his or her investment in the firm, a brief discussion is in order regarding taxation. An entity may exist under state law and be recognized as being separate and apart from its owners to other businesses, vendors, customers, and the state and local governments; however, the federal government may treat the entity differently for tax purposes than its form suggests. Federal taxation may vary based upon options selected by the business or by the number

of people who own it. This is most clearly shown by limited liability companies.

LIMITED LIABILITY COMPANIES. A limited liability company (LLC) is a type of entity permitted in some states, which is most characteristically known for its simplicity of administration. LLCs do not require the administration maintenance which is typically associated with C corporations. Since C corporations provide a more formal structure for complex companies, the administrative burdens required to address the needs of a large shareholder base do not exist for an LLC. An LLC may opt to be taxed as a C corporation, an S corporation, or as a partnership. An LLC with only one owner is referred to as a single-member LLC, and the federal government disregards the entity for taxation purposes and treats it as a sole proprietorship. Since an LLC has light administration requirements and enjoys flexibility in choosing a taxation structure, this has become a mainstay entity form for small to medium sized businesses. Prior to states adopting the LLC form as a type of entity authorized by their statutes, business owners often formed C corporations to obtain liability protection for their personal assets.

C CORPORATIONS. C corporations, as discussed, provide the framework and flexibility necessary to accommodate large publicly traded firms with enormous shareholder bases and the associated administration burdens that would accompany such numbers. C corporations are subject to their own tax rates under the federal tax laws. Under these laws, when viewed from a shareholder's perspective, the revenue generated by the corporation is taxed twice—once at the corporate level and once again at the shareholder's personal level when the corporation pays that shareholder's portion in the form of a dividend. At one point in time, C corporations were one of the only forms available for business owners to utilize. The double taxation paired with the inability for the corporation to pass-through losses that normally occur in the initial years of a fledgling business made liability protection an expensive proposition for those early business owners choosing this entity form. These hurdles to small to medium sized businesses prompted the subchapter S election.

S CORPORATIONS. The term S corporation is really a misnomer. No state grants charters or organization letters for an S corporation. An S corporation is actually a C corporation (or an LLC) that has filed a subchapter "S" election with the IRS. By filing such an election, the organization agrees to certain restrictions as to ownership and governance in exchange for being taxed as a pass-through entity or taxed at the personal income tax rates of its owners. The owners of the S corporation report their respective portion or share of the company's income or the losses on their personal income tax returns. C corporations with an S election were a common structure form prior to states adopting the use of LLCs as an alternate entity form.

LIMITED PARTNERSHIPS. The unpleasant consequence of being held responsible for a fellow general partner's errors or omissions, as discussed above, gave rise to the adoption of limited partnership forms. A limited partner's liability risk in the organization is limited to his, her, or its investment in the partnership. A limited partnership requires at least one general partner to manage the partnership and remain subject to personal liability for the partnership's liabilities; however, another entity providing liability protection may serve as a general partner and mitigate the risks associated with this requirement.

Partnerships also enjoy great flexibility in allocating income and losses to its partners. Partnerships are pass-through entities having the assets or losses reported and accounted for on each of its partners' personal income tax returns according to their allocated share.

Although liability protection is an essential component to selecting a business organization's form, taxation and structure considerations may make one form a better fit over anonther for differing business and economic realities. Consultation with advisors familiar with your state's business environment is always a smart first step in the planning process.

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