

Jumpstart Your Startup: Entity Selection and Formation

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Practice Area: Business and Corporate Law & Start-up and Next Level
Business Planning

When starting a business, you must decide what form of business entity to establish. The "choice of entity" decision is one of the most important decisions facing new business owners. There are several forms of business to choose from, each of which generates different legal and tax consequences. That said, there is no single form of entity that is appropriate for every type of business owner.

The most common forms of business are the sole proprietorship, partnership, C corporation, S corporation, and limited liability company.

Sole Proprietorship

A sole proprietorship is the simplest business structure. It is an unincorporated entity owned and run by one individual with no distinction between the business and the individual owner. The owner is entitled to all profits and is personally responsible for all the business' debts, losses, and liabilities.

A sole proprietorship needs to obtain the necessary licenses and permits for the industry in which the sole proprietorship does business. If the business operates under a name different than the individual, registering that name (*e.g.*, DBA name, short for "doing business as") with a state agency may be required.

Because the business and the owner are one and the same, the business itself is not taxed separately. The owner is responsible for and reports income, losses and expenses for income tax purposes.

Partnership

A partnership is the relationship between two or more persons who join to carry on a trade or business. Each partner may contribute money, property, labor, and/or skill, and, in return, each partner shares in the profits and losses of the business.

Because partnerships involve more than one person, it is important to develop a partnership agreement. The partnership agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (*i.e.*, bring in new partners or buy out current partners) and under what circumstances the partnership would be dissolved. In addition, owners of a partnership should determine which type of partnership to establish. The three most common types of partnership arrangements are:

- *General Partnership*: Profits, liability, and management duties are presumed to be divided equally among all partners. If an unequal ownership distribution is preferred, the partnership agreement must document that preference. A general partnership ordinarily owns its assets and is responsible for its debts. It is important to note that in a general partnership, the individual partners are personally liable for all partnership debt, obligations and liabilities. No formal state registration and/or filing is required to form a general partnership.
- *Limited Partnership*: A limited partnership requires at least one general partner and one limited partner. Limited partners are generally not liable for the debts and obligations of the limited partnership (though the general partners will be liable), but they must have restricted participation in management decisions. Limited partnerships ordinarily must be filed with a state.
- *Limited Liability Partnership*: A limited liability partnership generally operates and is governed by the same rules as a general partnership, except: (1) its partners have limited liability for partnership debt, (2) it can choose to be taxed as a corporation or a partnership, and (3) it is formed by filing the appropriate documentation with a state.

Generally, a partnership must file an annual information return to report income, deductions, gains, and losses from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership income or loss on his or her individual tax return.

C Corporation

A C corporation is an independent legal entity incorporated in a single state, although it may do business in other states. Because a corporation is an independent legal entity, its existence continues until formally dissolved under the laws of the state in which it is incorporated. Ownership of a corporation is in the form of shares of stock, there is no limit to the number of stockholders, and there is no limit on the number of classes of stock a C corporation can issue. Additionally, the corporation itself, not the stockholders, is generally liable for the debts and obligations of the business.

For corporate governance, a corporation generally has a board of directors and bylaws. The initial directors may be named in the articles of incorporation or elected shortly after filing the articles of incorporation. Thereafter, directors are elected as set out in the articles of incorporation or bylaws.

For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. The profit of a C corporation is taxed to the corporation when earned, and then is taxed to the stockholders if and when distributed as dividends. This creates a double tax. The corporation does not receive a tax deduction when it distributes dividends to stockholders and stockholders cannot deduct any loss of the corporation.

S Corporation

An S corporation is similar to a C corporation, except that an S corporation passes income, losses, deductions, and credits through to its stockholders for federal tax purposes. Stockholders of an S corporation report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. Thus, an S corporation generally avoids double taxation on corporate income.

In order to become an S corporation, the corporation must make appropriate filings with the IRS. To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation;
- Have only allowable stockholders, which are individuals, certain trusts and estates, and may not include partnerships, corporations (unless owned as a qualified subchapter S subsidiary), or non-resident aliens;
- Have no more than 100 stockholders;
- Have only one class of stock; and
- Not be an ineligible corporation (*e.g.*, certain financial institutions and insurance companies).

S corporations file specific tax returns and tax forms with the IRS.

Limited Liability Company

A limited liability company ("LLC") is a hybrid entity that is treated like a corporation for limited liability purposes, but for tax purposes can choose to be taxed either as a corporation, partnership, or, in some cases, a disregarded entity (*i.e.*, single-member LLC). A limited liability company is created under state law by filing articles of organization with a state. The owners of an LLC are referred to as "members" and generally may include individuals, corporations, other LLCs and other types of entities. There typically is no maximum number of members.

LLCs with more than one owner should have an operating agreement. An operating agreement usually includes provisions that address ownership interests, allocation of profits and losses, and members' rights and responsibilities, among others.

Since the federal government does not consider an LLC a separate legal entity, an LLC with at least two members is, by default, classified as a partnership for federal tax purposes unless it files with the IRS and affirmatively elects to be treated as a corporation for tax purposes. An LLC with only one member is referred to as a single-member LLC and is treated as one and the same as its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it affirmatively elects to be treated as a corporation. An LLC may also elect to be taxed as an S corporation.

The business structure you choose will have significant legal and tax implications. In order to identify the best structure for you, it is important to understand your business goals and how the characteristics of each type of business entity can help you achieve those goals.

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