SELECTING YOUR TYPE OF BUSINESS ENTITY

This paper gives an overview of the considerations and tradeoffs in choosing a business entity.

The most common types of business entities
The main types of business entities in the US are:

1. Sole Proprietorships. These are the simplest. No state registration or other formalities are needed. Sole proprietorships consist of one person with total control, liability, and rights to sign contracts.

2. Partnerships with General Partners consist of two or more persons associating to carry on, as co-owners, a business for profit. Partnerships with general partners can be created merely by conduct of the parties without a written agreement. While a partnership agreement need not be in writing, it is better to have it written.

3. General Partnerships with Limited Partners are formed by two or more persons, with the partnership having one or more general partners and one or more limited partners. A general partner is someone who is active in the business and liable for its obligations. A limited partner is an investor who is not involved in day-to-day management and not liable for more than his or her investment in the partnership.

4. Limited Liability Partnerships (LLPs) are formed by two or more persons who file a statement of registration with the State. LLPs should have a partnership agreement. LLPs provide liability protection for both the general and the limited partners.

5. Limited Liability Companies (LLCs) are formed by one or more persons filing articles of organization with the state. LLCs have few required legal formalities. An LLC should have an operating agreement.

6. C Corporations have articles of incorporation filed with State. They also have bylaws, corporate minutes, and may have a shareholders agreement.

7. S Corporations are organized like C corporations, and then elect to be taxed as S corporations, i.e. like a partnership with shareholders liable for entity income and losses and the corporation not liable for taxes.

Considerations in choosing what's best
Consider the following:

A. **Creation and management.** Ease and cost of set up and operation, extent of statutory restrictions and formalities, such as meetings and minutes.

B. Who can **sign contracts** binding the business?

C. **Personal Liability.** Are the owners protected from personal liability for corporation debts and obligations, will owner's house be on the auction block to pay for the business breach of contract? Note that in all cases an owner is personally liable for personal injuries or property damages he/she causes or contracts he/she personally guarantees.

D. **Investors.** Is the structure attractive to private or public investors? Can income and losses be allocated separately from ownership interest?

E. **Taxes.** Is the business's income taxable at the business level or the owner's level? Is one liable for self-employment taxes? Is it possible to have tax-advantaged employee benefits?

Tradeoffs between business forms
The following bullet points show how the above considerations apply to various forms of business:

- Sole proprietorships are easy to create and manage, taxed at an individual level, have no liability protection to owners, cannot have outside equity investors, but can have loans.
- General Partnerships also have no liability protection to owners unless they are a Limited Liability Partnership or similar entity. They also have limited access to passive equity investors and are taxed on individual basis.
- Limited Partners and Limited Liability Partnerships provide personal liability protection, allow equity investors, and are taxed on an individual basis.
- Limited Liability Companies provide personal liability protection, can be taxed either on a personal basis OR on an entity basis, allocate income and losses separately from stock ownership for owners and investors (unlike an S or C corp). Members of an LLC pay self-employment taxes on net income to the LLC, whether or not distributed to members as a salary or a dividend, with limited exceptions for passive members.
- C Corporations are best for entities with numerous owners and public investors. Taxes are paid at the entity level and on shareholder dividends.
- S Corporations save on self-employment taxes like C Corporations, but unlike most others, have

restrictions on who can be shareholders--up to 100 shareholders with no partners or corporations.

The table below further details these tradeoffs.

Conclusion

This paper provides a brief overview of a complex subject. This is not intended to be legal advice but for educational purposes only. This paper is written after reviewing Colorado business laws; laws in different states vary. You should consult a lawyer when creating your business. For more information, you may also want to look at:

- James E. Burk & Richard P. Lehmann, Attorneys at Law, *Financing Your Small Business,* Sphinx Publishing © 2004

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Wayne Wiemerslage is licensed to practice law in Colorado, Illinois, & Texas, with inactive attorney status in Ohio; with an emphasis on business formation and commercial and information technology contracts. See http://www.wiemerslage.com.

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Summary of considerations in selecting your business entity

	A. Creation & Management	**B. Control**	**C. Personal Liability**	**D. Investors**	**E. Taxes**
1. Sole Proprietorship	Simple, all in single owner	Simple, all in single owner	Yes	None	Taxable at individual level
2. Partnership with General Partners	Simple, all in general partners, no formalities required	In general partners and per partnership agreement	Yes	Difficult. Investors are personally liable.	Taxable at individual level. Also pay self-employment taxes.
3. General Partnership with Limited Partners	File certificate with state	General partners only	Yes, for general partners. Limited partners not liable unless in management	Limited partners can be outside investors.	Business income taxable at individual level
4. Limited Liability Partnerships	File articles of association with state. Requires some formalities.	In managers	No, limited partners are shielded.	Limited partners can be outside investors.	Business income taxable at individual level
5. Limited Liability Company	File articles of organization. Need to have an operating agreement.	In members or managers. Protection from shares being seized by creditor, divorced spouse or heir.	No, protection provided	Good for limited number of private investors, can allocate profits and losses.	Elect to be taxed on business income at individual level or at business level
6. C Corp	File articles of incorporation, have bylaws, formal	Shareholders elect directors. Shares can be seized by creditor, divorced spouse, or after death and may be voted contrary to other shareholders	No, shareholders not at risk of company debt.	Good for private and public investors; but no allocation of profits and losses, distributions must be based on stock ownership.	Business income taxed at corporate level. Dividends taxed at individual level. Only salary is subject to self-employment tax. More tax-advantaged employee benefits.
7. S Corp	File articles of incorporation, have bylaws, formal	Shareholders elect Board of Directors; shares can be seized	No, shareholders not at risk of company debt	Restrictions on who can be shareholders, no allocation of profits and losses, distributions must be based on stock ownership.	Business income taxed at individual level. Distributed profits not subject to self-employment tax. More tax advantaged employee benefits.

