CHOICE OF BUSINESS ENTITY

A review of the various legal structures used when conducting business in the United States.

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Why are different legal structures for conducting business chosen by our clients?

Generally the choice of business entity is divided into three different areas of thought.

1. Tax considerations – Will income tax be paid at the entity level or at the individual level?
2. Creditor Protections – Does the business entity provide any protection from my creditors?
3. Ease and cost of set up and ongoing administration.

These three factors are weighed by your client and the decision regarding the choice of business entity is made.

Types of business entities.

In the slides that follow we are going to examine many different forms of doing business using as our framework the three points set forth in the immediately preceding slide.

Remember the goal of this presentation is simply to familiarize you with these various ways of conducting business operations.

Sole Proprietorship

1. All income flows through to the owner and there can only be one owner.
2. There is no creditor protection whatsoever so insurance coverage becomes paramount.
3. This form of business is very easy to establish and maintain on an ongoing basis.

Partnership

1. All income flows through to and is taxed at the owner level. No entity level taxation.
2. There is no creditor protection, all partners are jointly liable for all of the business debts.
3. Easy to establish and maintain, but you do have to file a partnership tax return. Also if you don't adopt a partnership agreement, the Uniform Partnership Act will fill in the gaps for you. You better understand the Uniform Partnership Act.

Limited Partnership

1. Income flows through and is taxed at the owner level. No entity level tax.
2. Limited Partners are not liable for entity debts if they do not participate in management. General partners are liable for business debts.
3. More difficult to establish because you usually need an agreement to insure that limited partners are protected and more issues arise on an ongoing basis. Must have two or more business partners.

Limited Liability Partnership

1. Flow through income taxation for taxation at owner level. No entity level taxation.
2. Creditor protection afforded to other partners for malpractice of the other partners. This is used mainly by service professionals. Partners are still liable for all debts other than malpractice of other partners.
3. This type of business entity requires an effective agreement to limit other partner debt and the preparation of a tax return.

Corporation

1. Taxation at the entity level.
2. Complete creditor protection if corporate formalities are followed.
3. Easy to establish and administer. It does require separate tax returns and financial statements.

Subchapter S Corporation

1. Generally, unless a mistake has occurred, taxation is at the shareholder level. Must make federal and state subchapter S elections.
2. Complete creditor protection if corporate formalities are followed.
3. Subchapter S corporations are administratively difficult to run. There are many traps for the unwary that are extremely costly. **Malpractice abounds for the novice Subchapter S tax advisor!**

Statutory Close Corporation

This is a regular corporation that has elected under the state corporate statute to be treated as a small corporation. Generally limited to one or two shareholders.

1. Taxed according to elections (Sub S or non Sub S).
2. Complete creditor protection if corporate formalities are observed.
3. Easy to set up and administer but it will still need separate federal and state tax returns.

Professional Limited Liability Companies

1. Taxed like regular or Subchapter S corporations depending on elections.
2. Owners not liable for entity's debts or for other shareholder's malpractice. Used only by professional service providers.
3. Relatively easy to set up but administration depends upon tax elections.

Limited Liability Companies

1. Taxed as either a corporation, a subchapter S Corporation, a sole proprietorship or a partnership depending upon the number of owners, and how they decide to be taxed.
2. If corporate formalities are followed, then there is no liability for business debts. (See the article I have provided.)
3. Easy to set up. Administration depends entirely upon the type of entity chosen by the individuals who form the entity.

Nonprofit Corporations

1. Generally, no tax at either the entity or owner level.
2. Complete creditor protection if corporate formalities are followed.
3. Generally easy to establish and contributions are tax deductible if the entity also qualifies as a 501(c)(3). However, no benefit may inure to owner of the entity. Thus assets contributed generally must remain the property of the charity. Coverage of this topic is beyond this presentation.

Massachusetts Business Trust

1. Taxed as either a corporation or partnership for income tax purposes.
2. I am unsure of the credit protection afforded by these business structures. Very little is written about them.
3. They are easy to establish as there is no formal filing with the state and the beneficiary interests are easily transferable.

CONCLUSION

There are many permutations and combinations of business entities that may grow from those presented. As an example, it is not uncommon to see a limited partnership with a corporate general partner.

Also state and local realty, income and franchise tax implications can seriously impact the choice of business entity.