Choosing the Legal Form for Your New Business

By Jacob A. Chodash

One of the first decisions anyone has to make in starting a business is to choose a legal form for the business. Traditionally, you only had three choices: sole proprietorship if you were the only owner, general partnership if you had two or more owners, and corporation if you wanted protection from individual liability. Now, in many states, you have many more choices, including but not limited to: limited partnership, limited liability partnership, S-corporation, and limited liability company. Note, an S-corporation is a tax election for either a corporation or limited liability company. Which is these forms is best for you? It depends on your circumstances and what you want. My advice as a lawyer is to pick the simplest form that will accomplish your goals. The choice is easier to make than you may think.

The simplest form is a sole proprietorship. If you are the sole owner of the business and do not select another form, then you are a sole proprietor by default. This means that you operate your business and buy and sell goods or services in your individual name. You can use a trade name or assumed name for the business, but usually have to register the name with local or state authorities. At the end of the year, you report any income or losses from the business on your individual IRS form 1040.

The advantages of a sole proprietorship are simplicity and low cost. No set-up fees, filing fees, or attorney's fees. You are taxed once on any income from the business, on your personal tax return. The disadvantages are that you are limited to one owner, and that you are personally liable for all of the debts and obligations of the business. I only recommend sole proprietorships for beginning businesses with no liability exposure. For example, a home crafts business that makes decorative towels, or a freelance writer.

If a sole proprietorship is not a good fit, then you need to answer two questions:

Do you want to be personally liable for all of the debts of the business, or do you want your personal assets protected from your business creditors?

Do you want to be taxed once on the earnings from the business, or twice?

Of course, you want protection from personal liability, and you want to be taxed only once on your income. Here is how the remaining forms of business compare on these criteria.

If you have two or more owners, and don't make another choice, then you are a general partnership by default. All of the partners of a general partnership are personally liable for the debts and obligations of the partnership, even a partner who is a silent investor and not active in the partnership. As a general rule, the income of a general partnership is taxed once, at the partner level; the partnership itself pays no federal

income tax, though it may pay a small state income tax. A general partnership is called a pass-through entity for tax purposes because its income is *passed through* to the partners in this manner. Because of the exposure to personal liability, a general partnership is not a good choice for many businesses that might be subject to claims and lawsuits. At the same time, the organization costs for a general partnership can be minimal. While you should have a written partnership agreement prepared by an attorney, none is legally necessary to operate in this form. No filings with governmental offices are necessary unless you operate under an assumed name.

If you want insulation from personal liability, then a limited partnership is a partial solution. The limited partners of a limited partnership do not have personal liability for the partnership's debts and liabilities, so long as they are not active in the business. Every limited partnership must have at least one general partner, though, who is personally liable. Only the general partners can be active in business operations. Like general partnerships, limited partnerships are pass-through entities. Filings with governmental authorities are required. Limited partnerships are not used much anymore; there are better formats.

A limited liability partnership gives some protection from personal liability. This format is most often used by professionals, such as doctors, lawyers, and accountants. Protection from liability is given to a partner for negligence or malpractice committed by another professional in the firm, but not for that committed by the partner himself or by someone under his supervision and control. Limited liability partnerships are generally pass-through entities and require governmental filings.

A corporation provides protection from personal liability. On this point, remember that lenders and trade creditors to your business are savvy; they know that the signature of the corporation alone on the loan papers may mean nothing if the corporation has no assets. Accordingly, you can expect them to insist on personal guarantees from you if your corporation lacks an operating and payment history. Due to this, you may not be able to totally avoid protection from business debts.

Articles of incorporation must be filed with the Secretary of State of your state to start a corporation. Additional documents such as a preorganization subscription agreement, stock certificates, election of the board of directors, and election of the officers are necessary to complete the organization process. Failure to take all of the legal steps could cause you to lose the advantages of the corporation form, so be certain that they get done. You can form a corporation even if your business has only one owner.

The income from a corporation is taxed twice, unless you make another choice. The federal corporate tax rate is 21%. If the income is passed on to you as the shareholder in the form of a dividend, it is taxed again to you individually. This is sometimes not as bad as it seems. Your corporation gets a tax deduction for reasonable compensation paid to you, so you might be able to decrease your corporation's income to zero by increasing your wages. This will cause the income from the business to be taxed only once, to you as compensation. Just make certain that your compensation isn't unreasonable.

An S-corporation (for small business corporations) combines the advantages of a general partnership and a corporation. S-corporations are formed as corporations or limited liability companies under state law, so you have the advantage of protection from personal liability. In addition, S-corporations file a special election under federal tax law which essentially permits their income to be federally taxed once, at the shareholder level (state tax treatment can vary). S-corporations have a few special requirements: no more than 100 shareholders, all shareholders must be individuals or certain kinds of trusts or estates, no shareholder can be a nonresident alien, and only one class of stock is permitted (though voting and non-voting stock is allowed).

As a pass-through entity, S-corporations are an improvement over a regular corporation. This can be particularly helpful down the line, after your business becomes successful, and you want to sell it. A buyer of a business normally wants to buy only the assets of a business (rather than your shares of stock) for two reasons: by purchasing only assets, the buyer doesn't automatically take on the liabilities of the business, and the buyer is allowed to increase the tax basis of the assets to equal the purchase price, within the tax rules (higher tax basis means more depreciation tax deductions in the future). With a regular corporation, when you sell your assets, you are again taxed twice: once at the corporate level, and again at the shareholder level when you receive the liquidating dividend from your corporation. If you elected S-corporation status for your corporation from the beginning, however, you will be taxed only once.

A limited liability company has the same advantages as an S-corporation, but without the shareholder limitations. You get protection from personal liability, and pass-through treatment for income, which is taxed once at the member level (owners are called members, rather than shareholders). Limited liability companies are very flexible and adaptable, and seem to have all of the advantages. For that reason, many attorneys favor them for their clients. Organization costs can be higher, since they require filings with the Secretary of State, and operating agreements can be as long and involved as partnership agreements. Limited liability companied are also one of the newer business forms, and the law is still adapting to them. For example, there are fewer guidelines in the court decisions on interpreting limited liability company laws, and some laws still give advantages to corporations, rather than any other form.

So which form do you choose? You should be able to narrow down the choices, at least, after reading this piece. There are many more things to consider than I can possibly list here. Let your lawyer help you sort this out.

Jacob A. Chodash is a principal at the Chicago law firm of Eckhart Chodash & Strohmeier LLC. The examples in this article represent an aggregate of experiences from several persons. See a lawyer before you take any action involving a legal matter. Jacob can be reached at jchodash@eckhart.com.