Entity Selection:
A Guide to Choosing the Right Entity for Your Business

As attorneys focusing in business and corporate law, we often think of entity selection as the first step when starting a business. However, many people have already started solidifying clients, hiring vendors, and even entering into leases before formalizing their choice of entity. What most people don't realize is that by simply starting a business and making a profit (or taking a loss) they have picked an entity – either a sole proprietorship or partnership (if there is more than one person). These entities do not have a formal registration process with the state, and therefore can happen organically (whether you want them to or not!) But is a sole proprietorship or partnership right for you? What about a limited liability company or corporation? Below we touch on a few advantages, and disadvantages, of each to help guide you in the right direction.

Sole Proprietorship

The most common, and simplest of the entities, a sole proprietorship is one individual, running an unincorporated business, where there is no distinction between the individual and the business. Ever been paid to babysit or mow a lawn for a neighbor? Any instance where an individual is offering goods and services in exchange for a profit is considered a sole proprietorship.

<u>Advantages</u>: Startup costs are low, you don't have to register your entity with the state, you (as the owner) have complete control of the business, including your taxes (but yes, you have to pay them) and most importantly, you are entitled to all of the profits.

<u>Disadvantages</u>: There is no liability protection! Meaning, if something goes wrong, you are on the hook and your personal assets could be at risk. You also may have a difficult time attaining a loan or other capital, and it could be difficult to sell the business when you are ready.

Overall, many people have sole proprietorships just by the nature of providing goods and services, but the lack of liability protection can be risky, especially because your personal assets are not protected.

Partnership

Like a sole proprietorship, there is no formal registration required with a general partnership, such as registering your business with the Secretary of State. A partnership is two people, providing goods and services, making a profit from those goods or services and sharing the profit. With a general partnership, profits and losses are shared equally between the partners. There are some formalized forms of partnerships that are registered with the state, such as Limited Partnerships, and Limited Liability Partnerships. But for this entity discussion, we will focus on the general partnership.

<u>Advantages</u>: General partnerships are flexible, and do not require registration or formal paperwork with the state, so start up costs are low. Each partner is responsible for their own taxes, but like a sole proprietor, taxes are pass through – meaning they pass through to your personal tax return. While you do have to share profits with your partner, this means you also have someone to help with start-up costs, and in the day-to-day running of the business.

<u>Disadvantages</u>: There is no liability protection! Partnerships carry more risk than a sole proprietorship, because in addition to your personal assets at risk to cover any liabilities for your actions, you could be liable for your partners actions as well (yikes!). You will also be liable for half the losses of the partnership.

Overall, many people fall into partnerships when they decide to provide goods and services to make a profit with another. Think side hustle with your best friend. But there is a risk without the liability protection – and your personal assets could be at risk for something your partner does.

Limited Liability Company

Limited liability companies (LLC) are based on state statute, meaning each state has separate rules on how LLC's are formed. The LLC is the new cool kid on the block, giving it's owners, called Members, the flexibility and tax advantages of a sole proprietorship or partnership, but providing the liability protection of a corporation. Having the best of both worlds, the LLC is most commonly what we see and recommend for our clients.

<u>Advantages</u>: A "disregarded entity" the Members of the LLC can decide on their own tax election, whether a pass through to their personal returns or taxed as a s-corporation or c-corporation. LLC's are easy to set up, and don't require the formalities of formal annual meetings, meeting minutes, or a board of directors a corporation requires. And, LLC's provide the liability protection for Members that the sole proprietorship and partnership don't – so Members can have peace of mind that if something happens, the Company will be liable and their personal assets will be protected.

<u>Disadvantages</u>: There is no ability to sell stock and transferring Membership can be cumbersome and expensive. The ability to easily form an LLC may lessen the seriousness with which individuals or partners may run the business. Because LLC's are considered personal property, your LLC may become a part of your business partner's divorce – and left unchecked you could soon be in business with your business partner's ex-spouse.

Overall, the limited liability company is flexible, with the liability protection that will help reduce your risk if something should happen. The LLC is a great choice for most small businesses, and very popular among our clients.

Corporation

Once you have decided a corporation is the right entity for your business, you then have the option of the classic C-Corporation, or the Statutory Close Corporation. When you hear "S-Corp" or "C-Corp" the "S" or the "C" refers to the Internal Revenue Service Code Subchapter you will use to tax your corporation, not its legal structure. Depending on your industry, size, goals, and other factors, one may be more appropriate than the other. The Statutory Close Corporation requires a filing of Articles of Incorporation with the state, and must follow a formal corporate structure, however, the shareholder(s) may elect to eliminate the board of directors. Both Corporations and Statutory Close Corporations must have formal meetings on a regular basis and keep accurate meeting minutes.

<u>Advantages</u>: The Corporation is considered a separate entity than the individual shareholder and therefore has traditionally provided more liability protection than pass through entities. Typically individuals who are interested in investing in a business look at the Corporate structure as being a more secure investment.

<u>Disadvantages</u>: Corporations are more costly than the other entities discussed above. Typically they have higher filing fees with the Secretary of State, an attorney must file the paperwork and there is an increase in administrative work. For smaller businesses where the owner is the same individual as the operator, it becomes confusing to decipher what hat you may be wearing- shareholder, board member or manager.

Overall, the Corporation is a little more cumbersome than other entities, but provides great liability protection, and can be attractive for investors.