

Which Business Entity is Right for You?

There are many different types of business entities, each having their own advantages and disadvantages. This article intends to define and explain some of the most common entities. Since people have different goals and circumstances, it is important for one to know which option is the best fit for his or her business.

Sole Proprietorship

A sole proprietorship is owned and operated by a single individual. It is the simplest and most common form of business organization. All assets, profits and debts are owned by the proprietor. But there are some drawbacks. There is no legal distinction between the company and the proprietor. This means the owner is personally responsible for any legal liability of the company. Since the government views the business and the owner as one and the same, all business income is reported on the owner's personal income tax return. Sole proprietors also must pay a Self Employment tax, which consists of contributions to Social Security and Medicaid, just as a normal employer would. Another disadvantage compared to other entities is that it is often difficult to raise capital as a sole proprietor, since funds are usually limited to the owner's personal savings and loans are based on the owner's creditworthiness.

General Partnership

If one wishes to form a business with other individuals, the general partnership is the most basic form of partnership. Each person becomes a general partner in the business, and each partner is fully and equally responsible for all management and business decisions. They are also **personally** liable for **all** actions of the business. For example, a partner can enter into a contract on behalf of the other partners even if the other partners were unaware of the agreement. Each partner would still be liable for the obligations of the agreement. If the business defaults on the contract and cannot pay for the damages, the opposing party can collect from each partner's personal assets. Similar to a sole proprietorship, any profits or losses are "passed-through" to the partners' personal tax returns and partners must pay a Self-Employment tax. Even though the partnership itself does not pay income taxes, the company must file the appropriate paperwork with the IRS in order to ensure partners are reporting their income correctly.

Limited Partnership

A limited partnership allows for limited partners in addition to at least one general partner. General partners are in charge of decision making and management of the business while limited partners generally take a passive role. The benefit of a limited partnership is that limited partners are not personally liable for the company but still share in the profits of the business. That makes this entity well suited for those looking to take only an passive investment role with a company. For tax purposes, a limited partnership is somewhat

different than a general partnership. Partners still report their share of the profits on their personal tax returns, but limited partners do not have to pay the Self Employment tax.

Limited Liability Company (LLC)

LLC's have become a popular choice because they allow all partners, called members, to have limited personal liability of the company. This entity combines the benefits of a general partner with those of a limited partner. All members can now take an active role in running the company without being personally liable for its debts. It is also not necessary to have multiple owners to create an LLC, as it is possible to form a one-member LLC. Depending on how many members there are, LLC's are taxed either as a sole proprietorship or a partnership.

Limited Liability Partnership (LLP)

An LLP is very similar to an LLC. A major difference is that partners in an LLP are not liable for other partners' business actions. A partner could sign a contract with a third party and the other partners are not necessarily bound to the agreement. It is important to be aware that each state has its own rules regarding LLP's and they generally are only for professionally licensed individuals such as lawyers and accountants. Taxes for an LLP is "passed-through" to the members' personal tax return.

C Corporation

The C Corporation is the standard corporation. It is a separate legal/taxable entity from its owners. Owners are known as shareholders, who elect a board of directors to manage the company. C Corporations have certain obligations they must follow such as creating by-laws, conducting shareholder meetings, and paying annual fees. Publicly traded corporations must also file annual reports to the government and public. Shareholders are typically not personally responsible for business debts and legal liabilities. C Corporations are "double" taxed as the company must pay taxes on income at the corporate level and shareholders must pay personal income taxes on any dividends received.

S Corporation

An S Corporation is very similar to a C Corporation except for differences in taxation and ownership. An S Corporation benefits from being taxed similar to an LLC. No taxes are paid at the corporate level, instead taxes are "passed-through" to the shareholders' personal tax returns. Whereas C Corporations have no restrictions regarding who can be a shareholder, S Corporations only allow certain individuals to become shareholders. There can also only be a maximum of 100 shareholders and shareholders must be US citizens. Shares cannot be owned by any other S Corporation, C Corporation, LLC, LLP or partnership. Many people choose to create an LLC as opposed to an S Corporation because the benefits are similar but an LLC does not

have the ownership restrictions nor the corporate obligations an S Corporation has.

Conclusion

When deciding which business entity fits an individual's needs best, it is important to know the differences and potential pitfalls that come with each organization. Not only is it imperative to compare ownership structure/liability but also the type of taxation on the organization.

Regardless of which organization one chooses, it is arguably even more important to **ALWAYS** develop a solid exit plan in case a partner wants out. Even if the other partners are close friends or family, things do not always go according to plan and if there is no predetermined exit strategy it can get very messy and very expensive. What happens when someone is not pulling their weight? What happens to a partner's ownership if he or she dies? Can a partner sell his ownership to a random stranger? A plan should be in place from the very beginning and it needs to be in **WRITING**. Not only will this protect an individual from potential headaches in the future, it will also save money by avoiding potential legal costs. Due to its great importance and need for detail, it is advisable to have an experienced attorney review the agreement to address any problems that may arise.

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