CHOOSING A BUSINESS ENTITY

If you go into business, you can operate as a sole proprietorship, corporation, or limited liability company (LLC). If your business has multiple owners, two additional entities available are a general partnership and limited partnership.

Before we make a case for a particular type of entity, let's make the case against a sole proprietorship or general partnership.

Sole Proprietorship/General Partnership Disadvantages

A major disadvantage with both the sole proprietorship and general partnership is that they create "inside-out" liability. Proprietorship or partnership creditors can go outside the business to satisfy their claims from the owner's personal assets. There is also "outside-in" exposure. An owner's personal creditors can seize business assets to satisfy the owner's personal debts.

A sole proprietorship exists when you operate your business without creating formal legal entity. If you operate your business as a sole proprietorship and there is no legal separation between yourself and your business, you become personally liable for every business debt.

In these litigious times, why do so many small businesses still function as sole proprietorships? Four out of five small businesses fail within their first several years. The owners of these unincorporated businesses needlessly gamble their family's financial security on the success of their venture. When their business fails – as most do – their owners end in financial ruin, because their business creditors can claim their personal assets. With planning, that could have been easily avoided.

General partnerships are even more dangerous than sole proprietorships. General partners are jointly and individually liable for every partnership liability, regardless of which partner created the liability. Partners in a general partnership can even more easily lose their personal wealth to business creditors if their business or their other partners have too few personal assets to satisfy the partnership obligations. You can lose your wealth – even if your partner created the liability! Also with the general partnership, a partner's personal creditors can force the liquidation of the partnership to claim that partner's equity in the business. Therefore, you should never operate as a general partnership.

Corporation / LLC Advantages

A corporation and LLC are separate legal entities distinct from their owners. That's why a corporation and a LLC can protect your personal assets from the inevitable debts and lawsuits that may arise against your business. As an owner, director or officer, you are not liable for its debts or lawsuits. If your corporation or LLC is sued or becomes insolvent, you'll lose only your investment in the business. Your other assets remain safe.

Business owners frequently start as sole proprietorships or general partnerships and become concerned about losing their personal assets only when their business is sued or suffers financial reversal. If you are sued while operating as a sole proprietor or general partnership, it is too late to convert your company to an LLC or corporation to protect your personal assets.

Situations Where an LLC is Advantageous

The LLC has eclipsed the corporation as the preferred business entity in most circumstances. Though the corporate structure remains useful for larger companies, it has drawbacks over the LLC for the smaller venture.

- **Statutory Inflexibility**. Corporate laws are comprehensive and less flexible than LLC laws. Corporate by-laws rigidly define how a corporation will operate. In contrast, LLC operating agreements may allow LLC members to structure their company to best suit their specific needs.

- **More Cumbersome Operational Requirements.** Corporate decision making must adhere to complex procedural formalities that are often too cumbersome for small and medium-sized businesses. Certain corporate decisions require stockholder votes, and other important decisions must be made through formal corporate board meetings. Failure to observe these formalities may allow creditors to pierce the corporate veil and directors and/or shareholders can then be personally responsible for company debts. LLC managers have broad leeway to make decisions without formality – except in those few instances as defined in the LLC's operating agreement.

- **Limited Choice of Tax Classification.** While a corporation may choose to be taxed only one of two ways: as C corporations or as S corporations, an LLC, owned by multiple owners, may be taxed as a partnership, a C corporation or an S corporation, or, if owned by one owner, as a disregarded entity. Partnership taxation is often seen as preferable to S or C corporate tax status, because it avoids a C corporation's double taxation and the structural limitations required of S corporations.

    - An LLC enjoys both limited liability and the benefits of pass-through taxation. An LLC member's risk, as with a corporation, is also limited to loss of investment. However, an LLC affords more asset protection advantages than a corporation.

- A member's interest in an LLC is creditor protected in the same way a partner's interest in a limited partnership is protected. A member's personal creditor is limited only to a charging order against the LLC interest. This gives the creditor only the right to receive distributed profits due to the debtor partners.

Situations Where Corporations are Advantageous.

Despite the drawbacks of corporations, there are instances where a corporation is preferred over an LLC. The main benefit of corporations is its stock may be freely transferred without the consent of other shareholders or corporate management. This is essential for any publicly traded company. Companies that plan a public offering should be a corporation. Furthermore, any company that wants easy transferability of ownership or that has a complex equity structure may also prefer the corporate form of organization.

An S corporation also has the following advantages over an LLC: 1) An S Corporation can be more tax advantageously acquired by another business; 2) S corporation owners pay employment taxes only on their salaries; and 3) state taxes are sometimes lower for an S corporation.

Where To Form Your Corporation or LLC

Corporations and LLCs are creations of state law. Because state laws differ, there may be advantages and disadvantages of incorporating or forming your LLC in a particular state. If your business is operating in one state, then it is probably best to incorporate or form your LLC in the state where it will do business. An out-of-state corporation or LLC must register as a foreign corporation in your home state. This subjects the corporation to your home state laws and to some extent nullifies the advantages of incorporating elsewhere. If your corporation or LLC has flexibility as to where to be formed, then Delaware and Nevada are good choices.

SCHENKMAN JENNINGS LLC
ATTORNEYS AT LAW
13 Roszel Road Princeton, NJ 08540 (609) 452-0110