

# Which Legal Entity is Right For Your Business?

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LLC, Partnership, S-Corp...Your choice will impact your taxes, management, liability, and more. Here's a primer.

People start business ventures for many reasons. They might want to be their own boss, to pursue a passion, to assist those who are less advantaged, to reap the financial rewards, to get a source of income after being downsized, to create a legacy business for their family, or to create an innovative product or service.

Before jumping into this new business venture, a person should consider the personal, financial and professional sacrifices they will likely encounter. Pay might be low when starting a new business and the hours will likely be long. Starting a new business is costly. Some key questions to consider: Am I ready to take on risks and learn from my mistakes? Do I want to own the business myself or with others? Where will I get financing? Will the business be strictly virtual, or will I need an outside office or manufacturing site?

A key consideration is the legal entity for your business. Careful advanced planning will allow you to select and form the most appropriate legal category. The type of business entity selected can have important long-term consequences for the owner and the business itself. It will affect funding, taxation, management and control, liability, and ownership of the business. Here are the choices.

## Sole proprietorship

This begins when a single entrepreneur starts a business. This “doing business as” entity is very easy to create and might only need a d/b/a form filed in the state where the business is operated. State and local licensing, permits, taxes and other compliance with regulations are required. This is not a separate legal entity, thus the sole proprietor is personally responsible

for any liability of the business and must report the income of the business on the individual's tax returns.

## Partnership

This is technically formed anytime that two individuals or entities operate a business together. State statutes provide legal guidance over general and limited partnership, but a partnership agreement is recommended if deviation from the state partnership statute is desired. A partnership can own property, sue and be sued, and acquire debt. A partnership is a flow-through entity; the taxes go on the tax returns of the partners. Creditors of the partnership must first look for payment from the partnership, but if the assets are not there, individual partners can be held personally liable. A limited partnership must have at least one general partner and the limited partners cannot participate in the day-to-day activities of the partnership because they are really just investors who can personally lose only their investment in the partnership.

## Limited Liability Company

This entity has the same liability protections and tax benefits as an S Corporation, but which enjoys greater flexibility in terms of taxation and ownership. Owners are called members and should enter into a member agreement regarding the rights and responsibilities, rather than relying on the state statutes for limited liability companies. It is usually not formed by a business financed via venture capital funds, due to tax restrictions on the fund's tax-exempt partners; however, the LLC is an attractive entity for corporate investors and wealthy individuals.

## S Corporation

An entrepreneur must make a federal tax election to be an S corporation. Once the election is made, this entity provides the liability protection of a corporation but without its various levels of taxation. Taxation flows through to the owners. There are drawbacks to the S corporation. It is limited to 100 shareholders, all of



whom must be individuals—and some specific organizations—and cannot be foreign; and, it can only issue one class of stock.

## C Corporation

Corporations provide the entrepreneur with personal liability protection and some tax benefits to the business. A corporation is a separate legal entity by law, and separate from its owners. A corporation incurs its own liabilities, including tax, contract, and product or service risks. As long as the corporation is properly managed as distinct from its shareholders, personal assets are not at risk. Ownership is easily transferred if a shareholder decides to exit the business. Corporations, however, face many formalities that are required by state statutes, including: establishment of a board of directors; an annual meeting; state filings; and an article of incorporation. Corporations incur and must pay their own taxes. When shareholders receive dividends, those dividends are taxable to the shareholder.

## Other business entities

There are additional legal entities for businesses, such as the low-profit limited liability company (known as a L3C), series limited liability company, limited liability partnership, limited liability limited partnership, joint venture, professional corporation, close corporation, non-profit corporation and B corporations.

## Learn More

Kathleen Allen, *Entrepreneurship for Dummies* (2000).

Constance E. Bagley and Craig E. Dauchy, *The Entrepreneur's Guide to Law and Strategy*, 5th edition, Cengage Learning, ISBN-13: 978-1-285-42849-9.

T. Brown & A. Luppino, *How to Be Your Own Lawyer...Without Being a Fool*, available at: [www.howtobeyourownlawyer.com](http://www.howtobeyourownlawyer.com) (<http://www.howtobeyourownlawyer.com/>) .

Robert Sprague, *Law for Entrepreneurs and Small Business Owners*, Wolters Kluwer, 2nd edition, ISBN-9781543822953.

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