

Choosing the Right Entity Type

Make Smart Decisions to Protect Your Liability and Tax Status

By DENNIS G. EGAN Jr., Esq.

Protection of assets is never more relevant than in times of economic uncertainty. While the local economy has not been as affected by the burst of the housing bubble as the national and international markets, times of economic uncertainty always force current and prospective business owners to ask themselves which form of business entity best meets their needs. Some of the choices available are: sole proprietorship, general partnership, limited partnership, limited-liability company, and corporation.

So, which entity type is best for your company? The short answer is: It depends.

It depends on factors such as the assets to be held by the business entity, the number of individuals, if any, employed by the company, the type of business to be conducted by the entity, whether the entity will issue shares of stock, and how many, just to name a few. Ask any attorney, and his or her first concern will be limiting the personal liability of the principals of the business. Ask any accountant, and her first concern will be preferred tax treatment.

Fortunately for current and would-be business owners, these two concerns are not mutually exclusive. In fact, the two principles can be combined in a number of different ways, depending on the individual needs of the business.

In addition to the two tax and liability concerns outlined above, other factors that must be considered when deciding which entity is right for your company include ownership structure, capital structure, management structure, ease and cost of formation, and

exit strategies.

Here's a look at the options and what to be thinking about with each one.

Sole Proprietorship

The sole proprietorship is the most common, most cost-efficient, and easiest-to-start form of business entity. To form a sole proprietorship in Massachusetts, one need only file a d/b/a or 'doing business as' certificate in

formation and cost savings, rarely outweigh the potential exposure to unlimited liability.

General Partnership

A general partnership is much like a sole proprietorship in that no organizational documents are required to form a general partnership, and liability is unlimited. In fact, each partner is not only liable for his or her own actions, or inaction, he or she is also liable

partnership.

Limited Partnership

Unlike the sole proprietorship and general partnership, in order to form a limited partnership in Massachusetts, you must file a certificate of limited partnership with the secretary of state's office. Also unlike a general partnership, in which all partners are general partners, the limited partnership is made up of both general partners and limited partners.

While the general partners may have the same personal liability as found in the general partnership model, the liability of each limited partner is limited to the amount of his or her initial investment. The tax treatment of the limited partnership is the same as that of the general partnership — each partner is taxed individually.

Limited-liability Company

In order to form a limited-liability company (LLC), you must file a certificate of organization with the secretary of state's office. In addition, an annual report must be filed with the secretary of state on or before the anniversary of the original filing. With the advent of the LLC came a more complete blending of the limited liability offered by a corporation (discussed later) and the 'pass-through' taxation of the sole proprietorship and various partnership relationships.

In addition, the LLC offers its principals the ability to customize the powers given to its members. For example, the LLC offers the ability to distribute profits and losses disproportionately to the

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the town clerk's office of every city or town in which the sole proprietorship will operate. That said, none of these should be a determining factor when choosing which entity to form.

In fact, a sole proprietor and his or her business are one in the same. That is, the personal liability of the sole proprietor is limited only by the assets he or she owns. In addition, business succession is impossible when dealing with a sole proprietorship because the entity terminates automatically upon the death of the sole proprietor. While there are tax advantages to a sole proprietorship, in that the individual is taxed on his or her personal income, as opposed to the double taxation of corporations as discussed below, this advantage, along with ease of

for the actions, or inaction, or his or her partner(s), also known as joint and several liability. While liability for the acts of one's partners can be limited through the use of a well-crafted partnership agreement, the individual partners will always be liable for their respective actions.

Absent the existence of a partnership agreement to the contrary, each partner in a general partnership will have equal control over the governance and day-to-day operations of the business. In addition, and much like the sole proprietorship, the general partnership does not pay taxes on any of its income; instead, each partner is taxed personally. Normally, withdrawal of a partner, bankruptcy, or death of a partner will terminate a general

respective membership interests of its members. This can be a very effective tax-planning tool. The document that will dictate the voting rights of members, the number of managers, and the roles of each member is the LLC's operating agreement. A well-integrated operating agreement is often the difference between an LLC that reaches its full potential and one that simply exists. The LLC is managed by one or more managers, who need not be members of the LLC.

Corporation

The corporation is perhaps the most widely recognizable business entity. That said, most people do not realize that there are two different types of corporations to choose from — the C corporation and the S corporation. The differences between the two are largely

functions of tax treatment, the number of shareholders each may have, and the classes of stock that may be offered by each.

Both the S-corp and C-corp are owned by the shareholders, managed by a board of directors, and operated on a daily basis by a slate of officers. In order to form a corporation, you must file articles of organization with the secretary of state's office. In addition, annual reports must be filed with the secretary of state's office within two and a half months of the close of the corporation's fiscal year, and annual meetings of the shareholders and directors must occur annually.

The S-corp functions much like an LLC. That is, it offers the tax advantages of pass-through taxation while also offering limited liability to its shareholders, officers, and directors, except in

limited circumstances.

The C-corp, while also offering limited liability to its shareholders, officers, and directors, except in limited circumstances, is double-taxed, meaning the corporation is taxed at the corporate level when income is earned and again when the respective shareholders receive a distribution. The major advantage of the C-corp over the S-corp is that, unlike the S-corp, the C-corp may have an unlimited number of shareholders and different classes of stock. Both of these are important considerations when a business is seeking to raise capital via venture capital or angel investors.

While this article is merely a summary of the most common business entities from which to choose, it's easy to see that one size does not fit all. In fact, you

can only decide which entity will be most beneficial to your business through careful consideration and consultation with your tax-planning professional, attorney, and other business planning professionals.

The good news is that, if you have an existing business, and after reading this article you are questioning whether or not you have chosen the right entity for your business, you are not necessarily locked into your current entity. Many of these entities can be converted, with some exceptions, to a more beneficial entity for your business.❖

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