

Choosing the Right Business Structure

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The form you choose can have significant personal, business and tax implications.

Choosing the right structure can be the single most important decision you make in your business. The choices might seem confusing, but the decision can be made at any stage. The most common entities are sole proprietorships, general partnerships, limited partnerships, limited liability companies, and C and S corporations.

Sole Proprietorships. In a sole proprietorship, the proprietor dedicates his or her assets to a specific business purpose. Sole proprietors have total freedom and flexibility in operations and management, and can make business decisions without any formal restraints. Some states (Missouri, but not Kansas) require sole proprietors to register their business name with the Secretary of State.

Sole proprietors may sell or transfer any portion of the business at will, and death, withdrawal or bankruptcy terminates the entity automatically.

The sole proprietor is personally liable for debts and claims against the company (both business and personal assets may be used), and is subject to self-employment taxes.

General Partnerships. General partnerships offer a high degree of operational and management control, since partners agree on business matters and management is conducted in accordance with the partnership agreement.

General partnerships are formed by oral or written agreement among partners—no formal corporate filings are necessary. However, if no written agreement exists, conduct, claims and controversies among partners are resolved through statutory partnership law.

General partners receive pass-through tax treatment and are taxed on the individual level for personal and business income. They are subject to self-employment tax.

General partners are jointly and severally liable for all partnership liabilities; both business and personal assets are subject to debts and claims against the company. However, a partnership may register as a limited liability partnership (LLP), which, by satisfying certain requirements, limits general partners' liability such that only business assets are vulnerable (absent fraud or bad faith actions).

Limited Partnerships. Limited partnerships (LP) are created under state law and require filing with the Secretary of State. Every LP *must* have at least one limited partner and at least one general partner (either individuals or other corporate entities).

LP management is vested solely in the general partner. LPs are particularly good for business owners who desire to maintain control over the business but need or want investors who do not desire a high level of control.

Limited partners are not liable for debts and liabilities of the partnership in excess of their investment. The general partner, however, is liable for all partnership liabilities. (To circumvent this, the business owner can form a single member limited liability company and have the LLC be the general partner of the limited partnership).

Limited partners may freely assign their partnership interests, except that, without the consent of all limited partners, the assignee will only receive financial, not partnership interest.

Limited partnerships terminate on the general partner's death, withdrawal or bankruptcy.

Limited Liability Companies. A limited liability company (LLC) requires filing articles of organization with the Secretary of State. LLCs may have one or more members (either individuals or another business or not-for-profit).

An LLC with two or more members can be classified as either a partnership or a corporation for tax purposes; one with a single member can be either a corporation or a disregarded entity (i.e., be treated as a "tax nothing" and taxed only on the individual level).

LLCs may be either member or manager managed. Management is vested in members unless agreed otherwise. If management is vested in one or more managers, the power to manage shall be in accord with the operating agreement.

Members and/or managers enjoy limited liability regarding debts and claims against the company (personal assets are not vulnerable).

Unless the operating agreement permits otherwise, a member can transfer only financial interest without consent of the others; entire rights as a member cannot be transferred without the unanimous written consent of all members (unless otherwise stated in the operating agreement).

Under most LLC statutes, the entity is dissolved upon the death, withdrawal or bankruptcy of a member unless the business continues by the consent of all remaining members (if so stated in the articles of organization).

Corporations (C and S). Corporations are created and regulated by state law, by filing articles of incorporation with the Secretary of State. Corporations may be classified, for tax purposes, as either a small business (S) corporation or a C corporation.

Forming an S corporation requires filing special forms with the IRS. For Sub-S status, the corporation cannot have more than 75 shareholders; have anyone other than an individual, an estate or certain trusts, or certain tax exempt entities (including pension plans), as shareholders; have a non-resident alien as a shareholder; have more than one class of stock (different voting rights are permitted); be a financial institution; be an insurance company; be a Domestic International Sales Corporation; or have an I.R.C. § 936 election in effect (involving Puerto Rico and Possession tax credit). Failure to meet ongoing requirements causes a termination of the S status and reclassification as a C corporation.

Management is divided among directors, shareholders and corporate officers. Corporations have low management flexibility and high operation costs because state laws require following many formalities in operating business affairs.

Although a corporation is generally liable for its debts and losses, shareholders generally do not have personal liability.

Unless articles of incorporation specify otherwise, a corporation enjoys an indefinite or perpetual existence that permits avoiding legal dissolution upon a sale/exchange of stock or a shareholder's death, incompetency or insolvency. However, a corporation may terminate for failure to file required information or to pay taxes or fees.

C corporations are subject to double taxation because they are taxable on income and not entitled to deduct dividends paid as an expense. The distribution of dividends to shareholders results in further taxation on the individual level.

Double taxation can be avoided by distributing income to shareholders/employees as salaries, or re-investing after-tax earnings for future business purposes (shareholders receive no distributions).

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