

## **CHOOSING A LEGAL ENTITY FOR YOUR SMALL BUSINESS**

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As a small business owner, you will be faced with many important decisions. One of the first crucial decisions you will make is choosing an entity that fits the needs of the business. Liability and tax issues figure in this decision as well.

One basic structure is a sole proprietorship, which is a business owned by one individual and is not a legally separate entity from its owner. The lack of a separate entity means the owner faces unlimited personal liability for any debts and obligations incurred by the business. However, an advantage to becoming a sole proprietor is that there are no formal organizational or filing requirements besides obtaining any necessary licenses.

The next available option for a small business is to form a partnership, which is simply an association of two or more persons who carry on as co-owners of a business for profit. In a general partnership, like a sole proprietorship, all partners are personally jointly and severally liable for all business related debts and obligations. Further, general partnerships require no filing of formal organizational documents; however, a statement of partnership authority may be filed if the partners choose. A partnership agreement can be oral or written. Also available are limited partnerships, in which there is at least one general and one limited partner. Limited partners are generally investors and incur liability only to the extent of their investment while the general partner is liable for all obligations related to the business. Further, there are limited liability partnerships where all partners are insulated from personal liability under certain circumstances. Both limited and limited liability partnerships have formal filing requirements.

Another option to consider is a corporation. Corporations are separate legal entities apart from its owners and managers and, therefore, those individuals have limited liability as to the debts incurred by the corporation. Because of this separate legal existence, corporations are characterized by longevity and free transferability of ownership in the form of stock. However, stockholders are not involved in day-to-day operations since corporations are managed by a board of directors. Corporations can be for-profit (think General Motors) or not-for-profit (think homeowners association). Further, for-profit corporations may either elect subchapter S (if the corporation meets certain requirements) or subchapter C status depending on the nature of the corporation, each of which carry significant tax implications. The primary difference between these subchapter statuses is that a C-corporation's profits are taxed twice—once corporately, and again when distributions are made to stockholders in the form of dividends—while the S-corporation's profits “pass through” to the individual stockholders and are shown on their individual returns.

Regardless of the type of corporation chosen, in order to incorporate, certain requirements must be met. First, articles of incorporation must be filed with the state office responsible for incorporation (the State Corporation Commission in Virginia) to establish basic information about the corporation. A corporation must also create bylaws and maintain corporate minutes. These formalities are necessary to preserve a corporation's status, which in turn preserves the corporation's limited liability. There are several significant people in a corporation—the stockholders own the corporation, while

officers and directors manage it. The corporation must file an annual report listing the names and addresses of each officer and director, which is public information. Further, a corporation must also maintain a registered agent to accept legal notice or service of process for the corporation, and a corporation must have an Employer Identification Number (EIN).

Finally, a small business owner may choose a Limited Liability Company, or LLC, which provides the limited liability of a corporation, but does not require the annual record-keeping formalities of a corporation. However, LLCs must file articles of organization and pay an annual assessment fee. LLCs must also have registered agents and EINs (unless it is a single member LLC, in which case no EIN is needed). Generally speaking, LLCs are used for passive investments, such as ownership of income-producing real estate.

There are also some important practical tips for potential small business owners. For example, if one forms a corporation or LLC, it is important to remember that the owner is no longer acting on his own behalf, but on behalf of the corporation or LLC, which is a separate legal entity. Thus, when an individual signs on behalf of the corporation or LLC, he should clearly state his title (i.e., president, manager, director, member) to avoid incurring personal liability. Further, all small businesses, regardless of the legal structure, should consider consulting with certain key professionals, such as a lawyer, accountant, and banker to discuss their individual needs.

**Disclaimer:** Each business is unique and the above may not apply to your particular situation. You should consult with your attorney before determining which entity is best suited for you.