

CHOOSING AN ENTITY TO OPERATE A BUSINESS

An individual can use any of three forms to operate a business: sole proprietor, limited liability company, or corporation. Each has its advantages, depending on the type of business and circumstances of the individual involved. This memorandum will summarize some of the key points in choosing an entity.

1. Sole Proprietor. This is the default. If an individual takes no steps at all and operates the business under his or her own name, he or she is a sole proprietor.

1.1. Disadvantages. The primary disadvantage to a sole proprietorship is unlimited personal liability. The person with the claim can seek to recover from the owner's personal assets, in the event that anyone has a claim against the business. Because of the unlimited risk associated with a sole proprietorship, our firm strongly recommends that a business owner select a different business form.

1.2. Advantages. This is the simplest form of business. No separate income tax filing is necessary, and no state registration is necessary, so long as the business consists of the full name of the individual who owns it. (Using any other name, or a name that implies additional owners, requires the sole proprietor to file an assumed business name registration with the state at a cost of \$50 every two years.)

1.3. Variation: Partnership. A partnership is identical to a sole proprietorship, but it has more than one owner and is subject to additional default laws and taxation. Terminating a partnership created by default and without a written agreement can prove complex. Partners can be liable for not only the acts of, but also the debts of those deemed to be his or her partners—even if no written partnership agreement exists. Because of the unlimited risk associated with a partnership, our firm strongly recommends that business owners select a different business form.

2. Single-Member Limited Liability Company (LLC). Formation of a limited liability company requires a registration with the state.

2.1. Disadvantages. Because the LLC is a relatively new business form, statutes and case law continue to evolve. In addition, the simplicity of this business form causes some owners to ignore those few formalities that are required—which could defeat the limitation of liability that is the LLC's primary advantage.

2.2. Advantages. This is the second-simplest form of business. Use of the LLC form limits potential liability to business assets, meaning that the personal assets of the owner are protected. The state requires registration, but few other formalities. Taxation of a single-member LLC is the same as a sole proprietorship: Income and deductions are reflected on the individual owner's personal return.

2.3. Variation: Multi-Member LLC. A multi-member LLC requires state registration identical to a single-member LLC, and as a default is taxed identically to a partnership. Our firm strongly recommends that LLC owners adopt a written operating agreement to clarify management and termination provisions. Otherwise, terminating a multi-member LLC can prove complex.

2.4. Variation: Limited Liability Partnership. Limited liability partnerships may be formed only by groups of two or more professionals (e.g. doctors, dentists, attorneys, and accountants). LLPs are very similar to multi-member LLCs, and are formed by registration with the state. Our firm strongly recommends that LLP owners adopt a written partnership agreement to clarify management and termination provisions.

3. Corporation. Formation of a corporation requires registration with the state. An individual owner wears four hats: shareholder (owner), director (decision-maker), officer (public representative), and employee (service provider). The first three are required by statute; the fourth allows the owner to be paid for his efforts. The typical corporation is a “C Corporation,” so named because of its designation in the Internal Revenue Code.

3.1. Disadvantages.

3.1.1. Corporations are required to comply with more formalities than any other business form.

3.1.2. Obtaining the maximum tax and planning advantages afforded by the form incurs annual expenses that are greater than with the other business forms.

3.1.3. Unlike all other business forms discussed above, corporations are subject to income tax at the entity level. Thus, the corporation pays taxes on all income that exceeds its expenses, and any dividends to the shareholder are subject to income tax at the individual level (often called “double taxation”). However, because the individual owner is also an employee, and because salary paid to employees is deductible as an expense, carefully managed corporations can dramatically limit any corporate income tax.

3.2. Advantages.

3.2.1. This business form limits liability to the assets of the business, protecting its owner’s individual assets.

3.2.2. Corporations are eligible for tax advantages such as deductible fringe benefits and disability insurance. Because these items are deductible to the corporation and are not taxable as income to the individual owner, it amounts to “free money.” (For more on that topic, ask for a copy of our memorandum describing “free money.”)

3.2.3. In certain cases, the owner may be able to take advantage of the corporation's lower tax rate. (The current federal income tax rates for corporations can reach as high as 35 percent while the federal income tax rate for individuals can reach as high as 39.6 percent.)

3.2.4. Some accountants believe a corporation is less likely to be subjected to an IRS tax audit for two reasons. First, high income on an individual return raises attention, whereas the same income distributed through a corporation is much less noticeable. Second, the IRS is less likely to scrutinize a corporation because of corporate formalities imposed by statute.

3.2.5. Medical reimbursement plans (MRPs) are available only to employees, so are not available to sole proprietors or owners of single-member LLCs. MRPs allow the employer to reimburse employees for uninsured medical expenses. The reimbursement is a deductible business expense of the employer and not included as income to the employee. Accordingly, the tax savings could be as high as 39.6 percent (highest individual tax bracket).

3.2.6. Finally, the tendency to put off investment planning for something tangible now can be devastating to the long-term financial security of anyone. The formal structure and requisite involvement of attorneys and accountants brings business and retirement planning that may otherwise be bypassed.

3.3. Variation: S Corporations. Corporations may elect to be taxed federally under subchapter S. The advantage is a different system of taxation—more akin to partnership taxation—that can avoid self-employment tax (paid by sole proprietors, partners, and single members of LLCs). However, owners of S corporations also are not eligible for some of the fringe benefits available to C corporations.

3.4. Variation: Professional Corporations. Corporations organized to provide professional services are required to be professional corporations. They may be taxed as either a C corporations or S corporations.

In summary, the choice of a business entity should be determined in consultation with your accountant and attorney. Limiting liability is critical, so, as noted above, we do not recommend sole proprietorships. Limited liability companies are an excellent business form for business owners in the early years of operation. Once business revenue reaches a sufficient level, incorporation can provide the greatest tax advantages, provided the business owner is prepared to comply with required formalities.

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