

CHOOSING YOUR BUSINESS ENTITY

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The four most common forms of business structure are:

- LLC (Limited Liability Company)
- CORPORATION (Conventional and Subchapter S)
- PROPRIETORSHIP
- PARTNERSHIP

The following outlines provide very general information on some of the main similarities and differences among these business structures in six key areas:

1. What it is – a working definition
2. Liability protection – whether the business structure provides that or not
3. How each business structure is treated for federal tax purposes
4. Advantages of each
5. Disadvantages of each
6. How each is formed

Other, less frequently-used business forms (such as Professional Corporations, Professional Limited Liability Companies) are not discussed here.

**NOTE: This guide is intended only as a broad, general overview.
Business owners should always consult a professional for individual guidance.**

LLC **(Limited Liability Company)**

WHAT IT IS: An alternative to corporations created in 1980s combining partnership-style management flexibility with corporate-style protection against personal liability, plus easier legal maintenance.

- Available in NH to single-owners as well as multiple owners (called “members” instead of corporate “shareholders”). A significant majority of new NH businesses – over 80% -- chose this form of business entity.
- Allows net profits to be transferred to owners (called “distributions” instead of corporate “dividends”).
- Facilitates an informal management structure similar to a general partnership, but with liability protection those structures typically lack.
- Owners are also free to elect corporate-style board management if they prefer, or hybrid variations.
- As with partnership agreements, customized variations in ownership and management structure may be outlined in a written LLC Operating Agreement.

LIABILITY PROTECTION: LLC is a separate entity offering protection against personal liability similar to, and in some ways perhaps greater than, a corporation. A multi-member LLC has slightly greater protection than single-owner LLC.

FEDERAL TAX TREATMENT:

- IRS default rules treat LLCs as a partnership or proprietorship for federal tax purposes, with “pass-through” taxation of the owners, bypassing federal taxation on the business entity (similar to “Subchapter S” corporation).
- Typically, LLC owners report business income and deductions on a Schedule C; in the case of multiple owners, Schedule K-1 partnership return is also filed. However, an LLC may choose corporation taxation instead, including “Subchapter S” tax treatment if advised by their tax professional to do so.

ADVANTAGES:

- Offers corporate-style protection against personal liability without corporate-style documentation of annual meetings and elections. It can also facilitate continued existence beyond the life of the owner(s).
- Owner-members can structure voting power and management authority in a variety of ways. For example, voting power can be linked to the number of dollars invested – as in corporations – or on an equal, per-person basis regardless of financial contribution, which a corporation cannot do.
- Management structure and voting power can be changed any time by owners by amending their LLC Operating Agreement.
- In NH, the LLC entity does NOT dissolve upon the death of an owner; it passes to the estate of that owner or however the LLC Operating Agreement specifies, such as with a Buy-Sell Agreement.

DISADVANTAGES:

- Owners cannot provide Employee Stock Ownership Plans (ESOPs) or other stock options because there is no stock. (However, agreements on gradual or incremental buy-in arrangements can be created.)
- An LLC is always a privately-held business; it can never “go public.”

FEDERAL TAX TREATMENT: Under default rules, there is no federal income tax impact at the entity level; instead there is a “pass through” style individual or partnership federal tax treatment, similar to a Subchapter S corporation. Nevertheless, an LLC business entity can elect corporate tax treatment, including “S-Corp” tax treatment (sometimes done to allow profits to be re-invested back into the business without personal taxation on the re-invested profits).

HOW FORMED: Two-step process:

- Complete and file LLC formation documents with NH Secretary of State, with filing fee. This includes designating a registered agent to receive legal claims, if any, against the LLC.
- Decide on preferred management and voting structure; create an LLC Operating Agreement reflecting those choices (such as percentages of financial rights, management structure, succession issues, and an exit strategy for owner-members).

CORPORATION

WHAT IT IS: This is our oldest form of independent business entity.

- Every corporation has the same prescribed structure, with management, financial, and voting rights linked to number of shares owned. Some variations are possible by issuing different classes of stock.
- It is owned by shareholders who acquire a percentage of ownership evidenced by stock certificates;
- At annual meetings, shareholders must elect a board of directors, directors elect officers, and officers manage the business day-to-day. NH law now allows these steps to be done by written consent, but they still must be done annually.
- Net revenues are paid to owners in the form of dividends;
- Available to single-owner businesses in NH and most (but not all) other states.
- If legally organized as a corporation, an “S-Corp” is the same business entity as a conventional “C” corporation and must follow all the same procedural rules.

LIABILITY PROTECTION: The owners (shareholders) are protected from personal liability for corporate actions, as long as the business conducts itself entirely like a genuine corporation. A lapse in recorded annual meetings and elections can put corporate existence – and thus owners’ liability protection – at risk.

FEDERAL TAX TREATMENT:

- “C” corporations:** Net profits of conventional corporations are taxed at the corporate level; in addition, corporate profits passed on to shareholders are taxed again as personal income.
- “S” Corporations:** Technically, this is not a business entity; “Subchapter S” status is a form of tax treatment elected by a corporation or by an LLC on their tax returns. To avoid having the same dollars taxed twice, owners of a small corporation can elect “Subchapter S” status on their tax forms to eliminate federal taxation at the business-entity level so that net profits are only taxed once – to the owners individually. Deductions for qualified business expenses also “pass through” to owner-shareholders. LLC owners may also elect “Subchapter S” status.
- Not all corporations qualify for Subchapter S status; for example, all “S” Corp shareholders *must* have U.S. citizenship.

ADVANTAGES:

- The corporate business entity offers protection from individual liability.
- Its basic organizational structure tends to be uniform in every state and readily understood everywhere.
- Perpetual existence is a key feature. A corporation can continue unchanged even if owners die or retire.
- Conventional C corporations can create employee stock option plans (ESOPs) and other stock incentives; however, Subchapter S corporations do not qualify for such plans.
- For qualified owners of a small corporation, non-corporate “pass-through” tax treatment similar to an LLC, partnership, or proprietorship is possible with a Subchapter S election.
- A corporation can eventually to be traded publically on recognized stock exchanges.

DISADVANTAGES:

- No flexibility in organizational structure or in distribution of voting rights (apart from creating non-voting or other special classes of stock), so the owners are locked into standard corporate voting and management structure.
- Small businesses are at risk of losing valid corporate status due to lapses in annual meetings and related recordkeeping, thereby losing protection from personal liability (“piercing the corporate veil”).
- Normal, double federal taxation if not all owners qualify for Subchapter S status or if the corporation fails to make that election with the IRS.

HOW FORMED:

- File corporate formation forms with the NH Secretary of State, with filing fee, designate registered agent.
- Conduct organizational meeting of corporation including adoption of bylaws, elections of Board of Directors and officers, and issuance of stock, with minutes reflecting these steps.
- Purchase and maintain corporate record book and corporate seal, issue printed stock certificates to shareholders showing number of shares they own, and maintain permanent records of annual meetings.

PROPRIETORSHIP

WHAT IT IS: A single individual simply starts a business without forming any separate business entity.

- The business is the owner and the owner is the business, so to speak.
- This is true even though the owner reserves a unique business name different from his or her personal name. For example, Chris B. Smith might name the business “Chris’s Hardware” and may register that name with the NH Secretary of State to prevent its use by other businesses in the state. Nevertheless, the business is not separate from the individual unless a separate entity (such as LLC or corporation) is also created.

LIABILITY PROTECTION:

- Because “the owner is the business” and vice versa, there is NO protection from personal liability.
- All of the owner’s personal, non-business assets and accounts are at risk in the event of a lawsuit by an employee, customer, or creditor of the business. At the very least, the owner of a proprietorship should be well-insured.

FEDERAL TAX TREATMENT:

- Because there is no separate business entity, net profits are taxed to the owner as personal income and all qualified business expenses are reportable as deductions against personal income.
- Owner reports business income on a Schedule C, which is filed together with ordinary income tax return.

ADVANTAGES:

- The main advantage is simplicity. There are no formation documents to file; no meetings to record; no corporate bylaws, no LLC operating agreement, no partnership agreement or other organizational documents to create – and none to follow in the future.
- Flexibility is virtually unlimited. The owner can make major business decisions on an *ad hoc* basis, as needed.

DISADVANTAGES:

- In the event of legal claims, the owner’s employees, customers, or creditors sue the owner personally.
- Personal, non-business assets and accounts are at risk if insurance fails to cover all claims adequately.
- The owner is personally liable for all business debts and obligations.
- Proprietorships offer no business continuity. If the owner dies or abandons the business, there is no ongoing entity to transfer to a successor.

HOW FORMED:

There are no formal requirements apart from those that any new business might need such as licensing, permitting, zoning requirements, etc.

Proprietors should file a business name with the NH Secretary of State to ensure that no other business in the state may lawfully use the same name.

GENERAL PARTNERSHIP

WHAT IT IS: A traditional (general) partnership should not be thought of as a separate business entity. As with proprietorships, the owners are the business and the business is the owners, so to speak.

- It is comparable to a proprietorship except that ownership is shared by two or more individuals.
- As with a proprietorship, the owners may reserve a unique business name with the Secretary of State to prevent its use by others in the same state, but that does not create a business entity separate from the owners.

LIABILITY PROTECTION: A general partnership offers NO protection from personal liability.

- In a general partnership, each partner may be personally liable for ALL business debts, obligations, and legal claims against the business.
- In addition, each partner is liable for the actions of every other partner, even though details of those actions may not have been reported to the other partners. This is a unique hazard of traditional partnership arrangements, not to be taken lightly.
- An exception is a Registered Limited Partnership, a more complex partnership arrangement in which passive investors may be protected from personal liability, while general partners remain at risk.

FEDERAL TAX TREATMENT: A general partnership is not federally taxed as a separate entity.

- Co-owners of a general partnership pay federal income tax on their individual shares of net profits and can take their individual share of deductions for qualified business expenses against personal income.
- Partnership income is reported on IRS Form 1065; in addition, partners report their share of partnership income on Schedule K-1; both are filed with each partner's individual tax returns.

ADVANTAGES:

- A traditional partnership allows co-owners some flexibility to structure ownership and management features in a written Partnership Agreement, to suit the needs of the business (such flexibility being unavailable in a corporation). However, virtually all of those same advantages exist within the LLC structure with a written Operating Agreement.
- Today, given the liability protection of an LLC and the availability of very flexible partnership-style ownership and management choices within the LLC structure, there are rarely any advantages to a traditional partnership.

DISADVANTAGES:

- No protection against personal liability, which is why this form of business structure has largely been replaced by LLCs.
- Each partner is personally liable for the actions of other partners – even for actions that may not have been reported fully to the other(s). So each partner must be extremely confident of the other partners' judgment and actions.
- Business property, equipment, and money are equally accessible to all partners.
- No continuity: when one partner leaves, the existing partnership is automatically dissolved; a new one must be created.
- Partnership agreement must provide for smooth transition of the business in the event one partner leaves.
- Partnership agreement must be well-drafted to include as much protection as legally possible for each partner against unforeseen actions by other partners.

HOW CREATED:

- Co-owners of a new business agree on how much each invests and what the responsibilities of each will be.
- A written partnership agreement should be created to avoid confusion and disputes.
- No independent business entity is created, although the partners may register a business name with the NH Secretary of State to protect the name from being used by other businesses in the state.