Business Entity Selection Exercise

Abstract

There are various business entities that can be used to establish a business. Within each of the choices are pros and cons. In this paper, Team C will explore the most popular types of business entities and discuss the benefits and drawbacks of each. Additionally, we will examine two hypothetical businesses and recommend a business entity to best suit the needs of the businesses.

People go into business to make money. Unfortunately, not everyone considers the proper way to structure his or her business so that it can make money in an optimal way while operating within the framework of the law. Failing to select a structure for a business carefully can mean the loss of that business and all of its associated assets. In this paper, Team C will discuss various types of business entities that exist and the pros and cons of each. Specifically, we will explore:

- Sole Proprietorships
- General Partnerships
- Limited Partnerships
- Corporations (and two of their sub forms)
- Limited Liability Corporations

We will also discuss two separate business situations:

- Joe's Lawn Care and Landscape Equipment Rental
- Maury & Sons Oilfield Drilling Contractor

We will determine whether the business is effective in operation, as it currently exists, or if there is a need to make changes to the business entity.

Sole Proprietorship is one individual or married couple in business alone. Sole proprietorships are the most common form of business structure. This type of business is simple to form and operate, and may enjoy greater flexibility of management, less legal regulation, and fewer taxes. Although this is the easiest form of business to start, "the income and losses are treated as personal and will be filed on a Schedule C along with the regular Form 1040 tax return" (www.irs.gov, 2004). If profits are minimal, the owner will actually be paying less in income taxes with this form of business than with a corporation. However, the business owner is personally liable for all debts incurred by the business. Sole proprietorships cannot take advantage of special business income tax rates since all income is considered individual income. In addition, sole proprietors are not protected from personal liability if they get into trouble with a client. If an upset client decides to sue, they sue the proprietor personally. If the proprietor must declare his company bankrupt, he files for bankruptcy personally. Moreover, by definition, a sole proprietorship can have only one owner, and that owner must be a “natural person” (i.e., not a corporation, trust, LLC, or other such entity.) Finally, one cannot sell or inherit a sole proprietorship.

A General Partnership is composed of two or more persons (usually not a married couple) who agree to contribute money, labor, and/or skill to a business. Each partner shares the profits, losses and management of the business and each partner is personally and equally liable for debts of the partnership.

> In terms of asset protection, general partnerships can be even worse than sole proprietorships. Anything that one partner does affects all of the partners, because each partner of the general partnership is personally responsible for all obligations of the partnership. Thus each general partner's exposure to risk is increased by a factor equal to the number of general partners in the business. (business-law.freeadvice.com, 2004)

Formal terms of the partnership are usually contained in a written partnership agreement. The benefits of this type of entity are that it is only slightly more complicated to set up than a sole proprietorship. In addition, business income and tax liability passes through to each partner so no separate tax filings are necessary for the entity. Unfortunately, each partner holds financial liability for the actions or inactions of the other partner in connection to the business. Additionally, the sharing of ownership depends on how the partnership agreement is drawn up, which may result in neither partner having as much control of the business as they might with a sole proprietorship.

A Limited Partnership is composed of one or more general partners and one or more limited partners. The general partners manage the business and share fully in its profits and losses. "Limited partners share in the profits of the business, but their losses are limited to the extent of their investment" (Taylor, 2002). Limited partners are usually not involved in the day-to-day operations of the business. In this structure, there is usually no limit to the number of participating partners and it has the advantage of pass-through taxation. However, the downside of this structure is that it can be complex to manage due to the various levels of partnership participation.

A corporation is an association of individuals created by law and existing as a single entity or individual, with powers and liabilities independent of its stockholders. Management consists of its directors and officers elected by shareholders. The shareholders can and do often change, but the business continues despite any changes in ownership status. It can enter into contracts, pay taxes, and is liable for debts and claims. A corporation's officers and directors are generally shielded from personal liability for the corporation's debts and losses. However, there are certain situations where this is not the case. Additionally, a shareholder's creditors cannot reach the assets of the corporation to satisfy its debts.

Depending on the characteristics, the classification of a business is as one of three types of corporations. The first two are for profit, C-corporation, S-corporation, while the third is a Non-profit corporation. A noteworthy disadvantage of a C-corporation is the "double taxation" factor. A C-corporation is taxed as an entity separate from any of the individuals comprising it. The corporation must pay federal taxes on all profits, and shareholders pay taxes on their dividends.

S-corporations qualify for all advantages of a regular corporation, but are taxed as a partnership. Named after the Internal Revenue Code section that allows it, Subchapter S is ideal for smaller companies that need the liability protection of an S-corporation, but who do not want to worry about multiple shareholders, as the number of shareholders is very limited. Like the C-corporation, an S-corporation provides liability protection, but unlike a C-corporation, avoids double taxation. One advantage of an S-corporation is that it does not pay federal taxes. Business profits pass through to individual stockholders, who then must report them on their individual tax returns. If it does become desirable to terminate status as an "S" corporation, one needs to file a revocation with the IRS.

A Limited Liability Corporation (LLC) is composed of one or more individuals or entities through a special written agreement. The agreement includes provisions for management, ability to assign interests, and distribution of profits and losses. Limited liability companies can engage in any lawful for profit business or activity other than banking or insurance, although filing with the Office of the Secretary of State is required.

An LLC is a"…business structure that is a hybrid between a partnership and a corporation" (www.hotnetprofits.com). Its owners are shielded from personal liability and all profits and losses pass directly to the owners without taxation of the entity itself. An "S" corporation and a limited partnership can also offer these advantages, but unlike an "S" corporation, a limited liability company is actually a non-corporate entity. State laws, which would require a board of directors, officers, and by-laws, do not apply. Furthermore, the owners of an LLC do not lose their limited liability status if they participate in the management of the corporation as they would in a limited partnership. Further, unlike the stringent requirements for an “S” corporation, an LLC can have more than 35 shareholders, can have foreign owners, can have owners who are corporations or partnerships, and can issue more than one class of stock.

Team C will now examine two hypothetical businesses and recommend a business entity to best suit the needs of the businesses. First, we will look at *Joe’s Lawn Care and Landscape Equipment Rental*. Joe is operating a small lawn care business as a sole proprietor. His current assets amount to $25,000, this includes his equipment and his truck. Joe also has three full time employees, with the responsibility for their salary and tax deductions. The labor laws are different in every state, so Joe must know the current law in the state he resides. Since lawn care in some areas may be seasonal, Joe must also know how to budget for the winter months when the work is slow. He may have to pay unemployment tax for his employees when they are not working.

Currently, Joe’s wife is taking care of the books. She has not been involved in any of the daily business operations. Without proper accounting experience and knowledge of the current tax laws, she might not know how Joe can benefit from certain business incentives. Aside from the lawn care portion of Joe’s business, he also manages a small equipment rental service. This side of the business carries extremely high liability. Joe needs to have proper rental agreements and contracts reviewed regularly.

A sole proprietorship can offer Joe some protection, but not as much as if his business were organized as a LLC. The LLC protects Joe’s personal assets from becoming an extension to his business. Currently, Joe files both personal and business tax forms. In some states, you are allowed to declare a loss for three out of your first five years in business. By showing a loss or by putting money back into the business, equipment, etcetera, Joe may be entitled to major tax breaks. As an example, Joe's mileage can be deducted and applied as a car allowance. Equipment financing allows his interest to be written off at the end of the year. There are many creative tax deductions that Joe's wife can discover. Organizing his business as an LLC provides the structure for getting those requirements accomplished.

Based on our analysis, Team C recommends that Joe operate his business as a limited liability company (LLC). This form of business can provide some form of protection of Joe's personal assets. Joe's business carries small overhead but high liability. By working with power equipment and flammable liquids daily, Joe is more exposed to dangerous incidents than an office worker is. He must have some liability insurance for personal and property damage. The rental portion of his business carries extremely high liability. Without incorporating as an LLC, Joe's personal assets are at risk. If someone rents a chain saw from Joe and severe damage is inflicted, they can currently sue Joe beyond the business, attacking his personal possessions. To protect his personal assets, it would be wise for Joe to form an LLC. He is limited in his liability and liable only for the business possessions and not personal ones.

Now Team C will attempt to make a recommendation for *Maury & Sons Oilfield Drilling Contractor*. Maury and Sons is a general partnership with no formal partnership agreement. There are two brothers, Monty and Max, who each own 25% and are actively involved in the day-to-day management of the business. Their aunts, Wilma and Betty, each own 25% and do not take an active part in the operations of the enterprise. Since Maury and

Sons is an oilfield-drilling contracting business with substantial risks and liabilities, the personal assets of all partners could easily be impounded.

This business entity grew out of the original sole proprietorship of the founding individual and evolved over time into a partnership. It is based upon implied agreements rather than a formal agreement with articles of partnership. The advantages of the partnership form of business are that it was easy and inexpensive to form and remains flexible to meet the partner’s management needs, but may easily dissolve. It is not a taxable entity, the profit or losses flow through to the partners, and there is generally less governmental regulation.

Unfortunately, this partnership has several inherent problems. All partners share in the losses of the business. As a result, each partner has unlimited personal exposure for the entire sum of the liabilities of the business. The implied agreements are only as good as the memory and trustworthiness of the partners. In the event of the death of a partner, the business entity may dissolve. Each partner has an equal voice in affairs of the business. Any retained profits by the partnership for expansion are taxed as income to the partners.

Based on our analysis of the business, Team C recommends that Maury and Sons restructure the business from a general partnership to a C-corporation. The specific advantages of a C-corporation are that the liability of the shareholders is limited to the value of their stock in the company. One can transfer or sell stock without jeopardizing the structure of the organization. Stockholders may also be employees with other benefits to include worker’s compensation. The ownership of the company is not limited to a certain number of individuals and another company could hold the ownership cost for creation and maintenance as well as the additional fees and franchise taxes. The corporation must qualify in all states in which it is doing business and it is subject to double taxation and greater governmental regulation.

In addition to the various entity choices, a prospective business owner should consider several other factors as well. They include but are not limited to:

- Place of residence.
- Organizational size.
- Number of proprietors.
- Liability protection.
- Taxation of company.
- Contractual Agreements (if necessary)

In summary, the answer to the question, "Which form of business is right for you?" depends on each individual's personal facts and circumstances. There is no "best" entity choice for a business, so we recommend talking with an attorney and a tax professional for help with specific legal and financial questions that could affect one's decision. Each business entity has pro and cons, thus before selecting which entity to undertake, one should consider all the pertinent factors. It is usually easier to set up your business correctly from the beginning than to try to rectify the results of a poor decision later. Do not take this very important decision lightly, and do not make a choice based on what someone else has done. Carefully consider the unique needs of your business and its owners, and seek expert advice, before settling on a particular business format.

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