Choosing Your Business Entity

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"After all, the chief business of the American people is business." – Calvin Coolidge

So, you've decided to take a more proactive approach to your investing, and have decided to start investing in real estate, or have decided to invest in a business. While the long-term potential is much greater than that of the more traditional investments (stocks, bonds, mutual funds, money markets, etc…), there are also some pitfalls for the unwary investor. Some critical questions you need to ask now are: "How do I protect myself if the investment fails?", "How do I reduce my tax liability?", "How do I manage my investment?", "How do I bring other people into the enterprise?", and "How do I transfer my investment when I'm ready to dispose of it?". The answers to these questions will outline the goals for your business, and will be largely determined by the form of business entity you choose for your new investment. In this article we will briefly examine some of the more common forms available.

The Sole Proprietorship

This business entity is the default choice for individual entrepreneurs; in other words, if you do not choose a business entity, you will end up as a sole proprietorship. In a sole proprietorship, one person owns all the assets, owes all the liabilities, and conducts all the business. The advantages are few, namely: they are easy to set-up (just do nothing), they are inexpensive to maintain (free), and there are no requirements for annual meetings and detailed records like some of the other business entities. The disadvantages are significant: first, there is no limitation on liability whatsoever – creditors owed debts by your sole proprietorship can come after anything and everything you own. Second, many of the tax advantages offered by other entities simply are not available to sole proprietorships. Third, the business has no separate identity – the business is you, and you are the business.

The General Partnership

This business entity is the default choice when two or more entrepreneurs form an enterprise together. As in the sole proprietorship, if you do nothing, this is the entity you will end up with. In a general partnership, all the partners own the assets, owe the liabilities, and participate in the running of the business. The advantages are much like those of the sole proprietorship: it's easy and cheap. The disadvantages are the same – no liability protection and no tax advantages. One important thing to consider about the lack of liability protection is that all partners in a general partnership are fully liable for the partnership's debts – even if those debts are the result of one partner's wrongful actions.

The Limited Partnership

This special form of partnership introduces us to the concept of limited liability (hence, the word "limited" in the title). A limited partnership, like a general partnership has two or more partners who own the assets and owe the liabilities. The difference is that in a limited partnership, there are two different types of partners: general partners run the business, and are fully liable for the debts of the partnership. Limited partners do not participate in the running of the business, so a limited partner's liability for the business's debts is limited to only what that partner has contributed to the business. The advantages are: the general partner(s) have full control over the business, and the limited partners have limited liability. The disadvantages are: the general partners have no liability limitation, and limited partnerships do require some filings and fees to start up.

The Limited Liability Partnership

Limited Liability Partnerships (or LLPs) are a special form of limited partnership that is now available in some states. The most notable difference between a limited partnership and a LLP is that the LLP has no general partner. Each partner's liability is limited to that partner's individual contribution to the partnership. Advantages are limited liability for all partners. Disadvantages are: LLPs are not available everywhere yet, and in some jurisdictions, LLPs are only available for certain types of business, such as law firms or accounting firms.

Corporations

Corporations are probably the most well-know business entity. A corporation is owned by its shareholders, and managed or run by its officers. A corporation has its own identity through which its business is conducted, separate and distinct from the shareholders. Corporations have many advantages: first and foremost, limited liability – an individual shareholder's liability is limited to that shareholder's capital contribution. Second, corporations may offer some tax advantages over other business forms. Third, because a corporation has its own unique identity, it can continue when a shareholder leaves the enterprise – no matter what the reason. Disadvantages are: a corporation has to file with the state(s) it will be doing business in, it must hold (at a minimum) annual meetings, keep careful records, and maintain separate accounts (from its shareholders). There are two specific types of corporations we will consider in more detail: S corporations and C corporations.

The S Corporation

S corporations (from sub-chapter S of the Internal Revenue code) are known as pass through (or flow through) entities because they do not pay federal income taxes. Instead, the taxes (or tax losses) "pass through" to the shareholders who pay them on their individual returns. S corporations are limited in the number and character of shareholders they are allowed to have. Corporations that meet the eligibility requirements (as defined by the Internal Revenue Code) have to elect each year for treatment as a sub-chapter S corporation with the IRS.

The C Corporation

C corporations (from sub-chapter C of the Internal Revenue code) are the corporations that either do not meet the eligibility requirements, or simply do not elect to have special tax treatment under sub-chapter S. C corporations do not have the restrictions on shareholders, but they do have to pay corporate income tax. This means corporate income can be taxed twice (once at the corporate level, and once again at the shareholder level after dividends are paid), but C corporations are allowed more deductions than S corporations.

The Limited Liability Company

Limited Liability Companies (or LLCs) are a relatively new form of business entity. LLCs are very flexible, combining some of the best aspects of both corporations and partnerships. Like corporations, a LLC has its own unique identity through which business is conducted. Like sole proprietorships and partnerships, a LLC does not have the paperwork burden of a corporation and does not pay corporate income tax (unless the LLC elects to be taxed as a corporation). LLCs are owned by members, and run by managers. Advantages of LLCs are: limited liability for the members, flexibility in set-up and operation, low paperwork requirements, and they can elect how to be taxed. Disadvantages are: LLCs are not eligible for all the deductions available to C corporations, all members have a say in who manages the LLC (i.e., you can't have non-voting members like non-voting stock in a corporation), and unless every facet of the LLC is set out in its operating agreement, the default statutory rules will come into effect, which may vary from state to state.

Conclusion

Choosing a business entity for your new investment requires careful consideration of your specific goals and requirements. No single form of business entity will meet the goals of every investment or start-up business. In fact, as needs change over time, many businesses will change from one entity to another that better meets their changing requirements. Hopefully, this article has given you some ideas of which direction to pursue for your new business. For more information on investing and real estate, please visit www.homereplay.com.

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