

Selecting Business Entities Requires Careful Planning

Extension Extra, September 2004

Written by Sandi S. Alswager

Selecting the type of business entity that is right for an individual entrepreneur requires consideration of taxes, estate planning and financial issues.

The most common business is a sole proprietorship, which is run by an individual, often under a trade name, with no outside shareholders. Although it's the simplest business entity and avoids the potential for double taxation assessed on corporations, sole proprietorship exposes entrepreneurs to personal liability for every act and debt of the business and there is no room to expand through new owners and their capital. Also, many tax deductions available to other businesses, such as expenses for health benefits and defined benefit pension plans, are unavailable. Sole proprietorships also terminate at the proprietor's death.

A general partnership is formed when two or more persons enter an agreement to operate a business together. The partnership files an informational tax return, and the partners must report their share of the partnership's profit or loss on their individual tax returns. Partners are jointly and severally liable for all partnership obligations. This means they can be held liable to a third party for all debts and torts of the partnership, even though they may only have a partial interest. Partnerships also terminate upon one partner's death.

In a limited partnership, individuals or corporations operate as general partners, and are in charge of managing the day-to-day activities of the business. Limited partners are silent investors and don't participate in day-to-day management; they may, however, vote to dissolve and wind up the partnership's affairs. Limited partners are only liable for partnership debts to the extent of their investment regardless of the activities of that partnership or the extent of its obligations.

Corporations are legal entities wholly separate from the shareholders who own them. All states have laws describing how corporations may operate within that state. Most large businesses in the U.S. operate as C-corporations. These are usually large, publicly held companies, but they also include small and even single-owner companies. They have more than one class of stock and an unlimited number of shareholders, and the taxes on its profits are paid by the corporation.

S-corporations are different in that their profits and losses aren't reported at the corporate level. Instead, they're reported on the owner's personal tax returns in much the same way as partnerships. S-corporations are limited to one class of stock, must file their tax returns on the calendar year and are restricted to 75 shareholders. These corporations provide substantial tax benefit in that it may allow entrepreneurs to pass the losses of their business through their personal tax return. This often has a significant benefit in the early

years of a business, because the business may generate paper losses, but still make enough money to pay a salary.

#

SOURCES: Marilyn Schlake, Associate Director, Center For Applied Rural Innovation, NebraskaEDGE program; NX Level Guide, 2000