ADVANTAGES AND DISADVANTAGES OF VARIOUS BUSINESS ENTITIES

SOLE PROPRIETORSHIP

Advantages:

- A sole proprietorship is simple to establish and operate; little ongoing documentation is needed.
- The sole proprietor is the only owner of the business, so he or she has complete control.
- It is easy to sell the assets of the business.
- The sole proprietor can take any amount of compensation or withdrawals, and there are no adverse tax consequences from such distributions.
- Since the sole proprietor does business in his or her own name or under an assumed name, no real difference exists between the individual and the business.
- For tax purposes, income is passed through to the owner, reported on the personal tax return, and taxed at personal income tax rates.

Disadvantages:

- The sole proprietor generally has unlimited personal liability for all business activities, debts, obligations, and other liabilities. Most of the owner's personal and business assets may be taken by a creditor to satisfy a court judgment against the business.
- If there are employees or others working under the sole proprietor's direction, he or she can be held legally responsible for their acts.
- Assets used in the business are not protected from the sole proprietor's personal creditors, other than through insurance.
- Insurance is limited to individual coverage unless there are employees.
- All income is subject to self-employment tax, a 15.3% tax.
- Retirement plans are limited to SIMPLE and SEP plans.
- As the sole owner, the proprietor can obtain capital for the business only from his or her own money or through personal loans.
- Sole proprietorships are often perceived as amateurish and lacking credibility.

- A sole proprietorship terminates at the death of the owner; there are no options for continuing the business.
- Transferring a sole proprietorship from one person to another is cumbersome. Because the owner holds title individually to each business asset, he or she must transfer each asset separately.

GENERAL PARTNERSHIP

Advantages:

- A general partnership is simple to form; most states do not require a written partnership agreement (but we recommend it).
- No ongoing formalities are required (but regular meetings are advisable).
- Relations between partners are largely left to their own agreement, subject to the principle that each partner must refrain from actions detrimental to the other partners.
- The partners can specify how they will share and distribute profits and losses and what events will trigger a termination or dissolution of the enterprise.
- For tax purposes, income is passed through to the partners and taxed at the individual level on personal income tax returns.
- Partnership assets are usually protected from the personal liabilities of the general partners.
- Partnerships have more sources of initial capital than sole proprietorships.
- Partnerships have less administrative burdens than corporations.

Disadvantages:

- Each partner is liable for the debts and obligations of the partnership and for liabilities incurred by other partners while engaged in partnership activities.
- In community property states, the community property of both spouses may be at risk even if the non-owner spouse takes no part in the business.
- Unless a written partnership agreement states otherwise, there is no centralized management.
- Each general partner has equal authority to manage the business and thus can bind the partnership and partners to any transaction related to the business.
- Any distributions to general partners are treated as ordinary income and subject to self-employment tax.
- General partners must report partnership profits as income on their individual income tax returns even if they do not take the profits as distributions.
- Partnership income tax and basis adjustment rules can be very complex, particularly with respect to transactions between a partner and a partnership.

- There is limited opportunity to expand the business since financing primarily depends on contributions from general partners and loans obtained through the partnership.
- Transfer of a general partnership interest is subject to the approval of all the other partners, unless otherwise specified in a partnership agreement.
- The partnership will terminate on the death, disability or bankruptcy of a general partner unless the remaining partners agree to continue the partnership.

LIMITED LIABILITY PARTNERSHIP

Advantages:

The advantages of an LLP are the same as those listed above for a general partnership, with one important exception:

- All partners have limited liability protection from the debts, obligations, and judgments of the LLP.

Disadvantages:

An LLP has the same disadvantages as a general partnership (other than unlimited liability), plus:

- The rules and laws governing LLPs are relatively untested, so there is uncertainty regarding how they will be enforced.
- Not all jurisdictions allow LLPs; in those that do not, an LLP may be treated as a general partnership.
- An LLP limits the opportunities for business continuity and estate planning.

LIMITED PARTNERSHIP

Advantages:

- A limited partnership is easy to form; states require only a certificate of limited partnership (but we recommend a written partnership agreement).
- There are no requirements for ongoing documentation of operations.
- Only general partners can manage the partnership.
- Limited partners may be employees of the business.
- General partners can take a salary for day-to-day management of the business.
- Both general and limited partners can receive distributions.

- General partners have the authority to make distributions or to retain profits in the business.
- The partnership is not subject to federal taxation; all income, deductions, and losses pass through to the partners.
- General partners may restrict transfers of partnership rights, under the terms of the partnership agreement.
- The limited partners' assets are protected from the liabilities of the partnership.
- Partnership assets are usually protected from the personal liabilities of the general and limited partners.
- Limited partners can invest in the partnership without being involved in management and with limited exposure to the partnership's liabilities; this facilitates expansion.
- The partnership can continue after the death, disability, or retirement of a general partner if the written partnership agreement provides for the selection of a new general partner.
- The partnership can continue after the death, disability, or retirement of a limited partner.

Disadvantages:

- The general partner has unlimited liability for the debts and activities of the partnership (unless the general partner is a company with limited liability protection).
- Limited partners may consider any restriction on their right to transfer their ownership interests to be a disadvantage.
- There is limited opportunity to expand the business since financing primarily depends on contributions from partners and loans obtained through the partnership.
- Any distributions or guaranteed payments to general partners are treated as ordinary income and subject to self-employment tax.

CORPORATIONS

Advantages:

- A corporation provides centralized management.
- Corporate shareholders have limited liability protection from the corporation's actions.
- The corporation's assets are protected from shareholders' creditors.
- Shareholders may be restricted by a shareholders' agreement from freely transferring ownership interests to outside parties.

- The corporate structure is excellent for complex financing or raising capital.
- Corporations commonly obtain both equity and debt financing.
- The issuance of stock, either to existing or new shareholders, is an easy means of raising capital for expanding the business.
- A corporation can have perpetual life; that is, the business can continue after the death, disability, or retirement of the original shareholders.
- Shareholder liability is limited to the basis in the stock.
- Easy to transfer ownership interests.

Disadvantages:

- Forming a corporation involves filing articles of incorporation, issuing stock certificates, and, generally, having the shareholders enter into an agreement governing the operation of the corporation.
- To receive limited liability protection, owners must treat the corporation as a separate entity: corporate formalities must be followed, the corporation must have its own bank account, and the corporation's funds cannot be commingled with shareholders' funds.
- Persons performing services for the corporation, including shareholders, must generally be considered employees and paid through payroll, with state and federal withholdings and deductions made.
- Shareholders generally are not allowed to "draw" from the corporate funds.
- Scrutiny by the IRS and state taxing authorities might affect the amount of compensation a shareholder or employee can receive in the form of salary, bonuses, and the like, as opposed to just taking dividends from after-tax profits.
- Corporations have a very defined and rigid management structure. Generally, shareholders have to elect a board of directors, who in turn appoint officers to run day-to-day operations. This might be cumbersome and confusing if there are only a few shareholders.
- In some states, a corporation must pay a minimum tax every year even if it shows a loss on paper.

C CORPORATIONS

IN ADDITION TO THE ITEMS LISTED ABOVE, THE FOLLOWING APPLY TO C CORPORATIONS:

Advantages:

- A C corporation can be owned by an unlimited number of any type of "persons" (corporations, partnerships, trusts, estates). A C corporation may issue different classes of stock with various rights, so it is the best ownership structure if shareholders want to go public.

- Fringe benefits for owners who are employees are usually fully deductible against the corporation's income.
- If the C corporation is a qualified small business, the owner may exclude 50 percent of the gain on the sale of his or her stock if certain requirements are met.

Disadvantages:

- C corporations are subject to double taxation. Pretax income is taxed at the corporate level. Dividends paid are taxed to the shareholders creating double tax on such distributions.
- C corporations cannot pass losses through to their shareholders. Only when the shareholders sell their stock at a loss do they have the opportunity to generate a loss for tax purposes that may offset income from other sources.
- C corporations have more administrative burdens, are more difficult to form and dissolution can trigger taxable gains.

S CORPORATION

An S corporation has the same advantages and disadvantages as corporations in general (see the first question in this section), as well as the following:

Advantages:

- The double taxation affecting most C corporations is avoided because income is passed through to the shareholders for tax purposes, increasing stock basis.
- The tax rate on S corporation earnings, when passed through to the shareholder, may be lower than the applicable corporate tax rate.
- Distributions from the S corporations are exempt from the payroll tax system, assuming the corporation issues adequate compensation to those shareholders who perform services for the corporation.

Disadvantages:

- The number of shareholders is limited to 75.
- They cannot have corporate, partnership or nonresident alien shareholders.
- They must chose a calendar year rather than a fiscal year for accounting purposes.
- An S corporation can have only one class of stock, although it can be issued with voting and nonvoting rights.
- The S election can be terminated unwittingly by not adhering to the IRS requirements.

- All corporate-level income is treated for tax purposes as if it had been distributed to the shareholders, whether it was actually distributed or not.
- Shareholders owning more then 2% of the company must pay taxes on a wide range of employee fringe benefits that would be tax free to an employee of a C corporation.
- The tax rate on S corporation earnings, when passed through to the shareholder, may be higher than the applicable corporate tax rate

PROFESSIONAL CORPORATION

Advantages:

Professional corporations offer all the advantages of either a C corporation or an S corporation, depending on which corporate form the professionals select.

Disadvantages:

In addition to having the same disadvantages as other corporations, PCs have two other drawbacks:

- Generally, stock can be sold only to persons licensed in the specific profession or back to the corporation.
- The professionals cannot use the corporate shield for actions taken as part of rendering their professional services.

CLOSE CORPORATION

Close corporations have the same advantages and disadvantages as other corporations, as well as the following:

Advantages:

- Statutes allow more flexibility in structuring close corporations (e.g., permitting management by shareholders rather than boards of directors, reducing corporate formalities, and recognizing the needs of minority shareholders).

Disadvantages:

- The number of shareholders is limited.
- There are restrictions on the transfer of shares.
- Not every state has adopted the statutory close corporation.

<u>**Limited Liability Company ("LLC")**</u>

<u>**Advantages**</u>**:**

- Forming an LLC requires only articles of organization (we recommend an operating agreement as well, although not required).
- No ongoing formalities are required (we recommend regular, documented meetings).
- Members can decide whether to have centralized management or not.
- Members can choose to equally manage the LLC, can elect a specific member or members to run the business, or can hire managers to do so.
- The managing member or operating manager can take a salary for day-to-day management of the business.
- Non-managing members may receive distributions from the LLC.
- In general, without an agreement to the contrary, members can transfer only an assignee interest in the LLC, not a full ownership interest.
- By agreement, members can be restricted from transferring any of their ownership interests without the consent of the other members.
- All members have limited liability protection from the debts, obligations, and judgments of the LLC.
- LLC assets cannot be taken to satisfy personal debts, obligations, and judgments of members.
- An LLC can have an unlimited number of members, who may be individuals or businesses.
- Funds for the business can come from capitalization from the members or from outside financing.
- An LLC does not terminate on the death or incapacity of a member; thus, LLC interests can be transferred to the member's family.
- Single-member LLCs can be taxed as a sole proprietorship or a corporation.
- Multiple-member LLCs can be taxed as a partnership or a corporation.
- Under taxation as a sole proprietorship, a partnership, or an S corporation, the LLC is not taxed since all income and losses pass through to the members.
- Distributions to managing members may be treated as ordinary income and subject to self-employment tax.
- Distributions to non-managing members are usually not treated as compensation subject to self-employment tax.
- The operating agreement for a LLC has great flexibility.

<u>Disadvantages</u>:

- An LLC cannot go public; doing so requires conversion to a C corporation.
- If an LLC reorganizes or is acquired by another organization, there may be problems in obtaining a tax-free exchange of LLC interests for stock of the acquiring organization.
- As yet, no consistent body of law exists to predict how courts will deal with LLC statutes.