Choosing a Form of Business Entity

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So, you have come up with the next great idea and you are ready to begin building your fortunes. One of the first questions you should ask is "what type of business should I be," or as we lawyer-types put it, "what choice of business entity should you make"?

Choosing the proper legal entity with which to conduct business is one of the most important decisions a business owner faces. This early decision will determine myriad other issues including responsibility for tortious acts, complexity of the entity, ability to transfer interests in the entity, ease of additional capital infusions, protection of intellectual property, and, of course, liability for the payment of taxes, to name just a few.

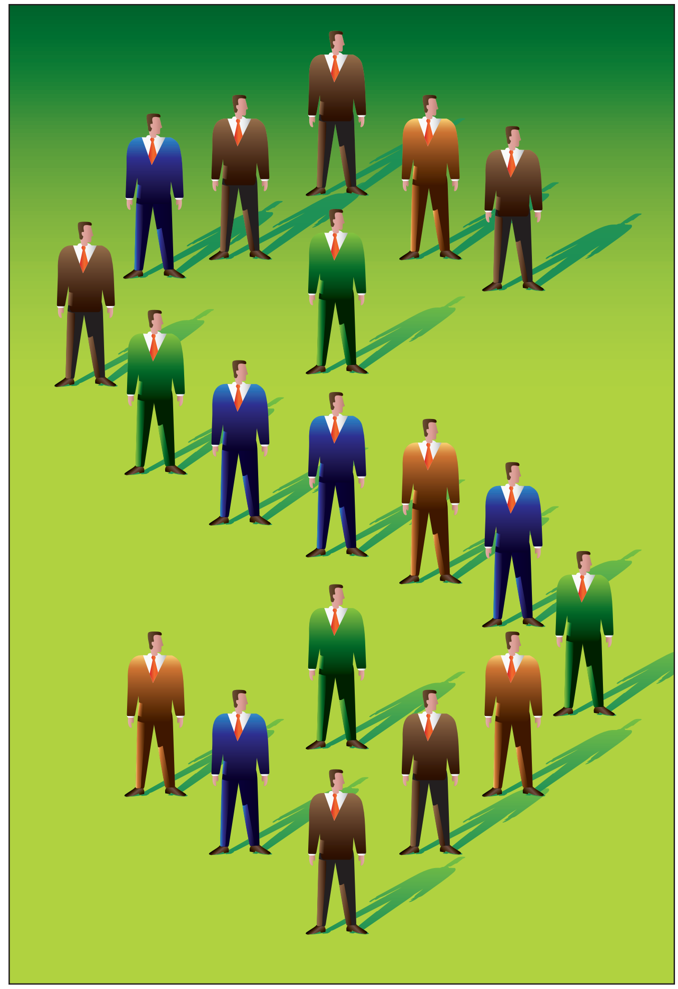
The list of available entity forms is fairly extensive. From the more traditional corporations and partnerships to the more exotic state business trusts and conduits, it seems there is a form for everyone, and in most cases, multiple forms. In some instances, it may be appropriate to forego a separate entity and conduct your business as a sole proprietorship. In a sole proprietorship, the business is conducted in the owner's individual capacity. Perhaps intuitively, a sole proprietorship offers no protection from liability, but it is the simplest way to conduct business. Generally, no separate documents or records need to be filed with any governmental authority, including the Internal Revenue Service. When a business owner wants to sell his or her sole proprietorship, it will always be a sale of the underlying business assets.

Focusing on the three most common types of entities—partnerships, limited liability companies, and corporations—important characteristics distinguish one from the others. By recognizing these differences, you will begin to highlight the factors that will influence your decision.

Partnerships

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. This means that a partnership can often arise automatically when you and one or more co-venturers start conducting business together. In most cases, you will want to spell out the rights and obligations between you and your partners in a legal document known as a partnership agreement. For example, the partnership agreement will provide that each partner is entitled to a certain percentage of the profits and/or losses from the business.

In general, as a partner, you can sell or assign your interest in the partnership, and that transfer does not cause the partnership to dissolve. However, the transferee of your interest does not



automatically become a partner. Rather, the transferee is merely entitled to a share of the profits and certain rights upon liquidation. To replace you in the partnership, that transferee must be admitted as a partner, usually by vote of the remaining partners.

Interesting partnership issues can arise in the context of intellectual property protection. For example, where one partner invents certain patentable technology, absent an agreement to the contrary, it is not entirely clear whether the partnership itself is entitled to use the technology. This could potentially result in one partner having unforeseen leverage over his co-owner(s).

Nearly all partnerships are non-taxable entities; that is, while the partnership files certain tax returns, the partnership itself does not pay any federal, Indiana, or local taxes. What is more, you can typically make contributions to and take distributions from the partnership in a tax-free manner. For this reason, many business owners will choose the simplicity of the partnership form over a corporation.

A general partnership will not provide you or your partners with liability protection. Creditors can and often do look to the assets you own individually to satisfy liabilities. However, there is a special type of partnership known as a limited partnership. In this type of partnership, there are two types of partners; the general partners, who manage the affairs of the partnership, and the limited partners, who do not participate in the management. In a limited partnership, the general partners' individual assets are subject to creditor claims, but the limited partners enjoy

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liability protection. Absent unusual circumstances, the most a limited partner stands to lose in the business enterprise is the partner's capital investment.

A limited partnership is subject to a slightly higher degree of formality in that it must file a certificate of limited partnership with the Indiana Secretary of State before it can be formed.

Limited Liability Companies

The lack of a voice in the management of a limited partnership will often be a drawback for the limited partners. Beginning in the late 1980s, various states began exploring a hybrid entity, one in which co-owners would enjoy the liability protection of limited partner status and the management participation feature of the general partners. Wyoming was the first state to enact its limited liability company statute and many states quickly followed suit. Indiana adopted its limited liability company statute, known as the Indiana Business Flexibility Act, in 1993.

Most of the characteristics of a partnership are shared by the limited liability company. The company is formed upon filing articles of organization with the Secretary of State's office; rights and responsibilities are spelled out in a written operating agreement; the interests are freely transferable (though again, the transferee does not automatically become a member in the company); and the entity itself usually does not pay any tax, although some states other than Indiana do subject limited liability companies to franchise taxes.

A major difference between a partnership and a limited liability company is that each of its members enjoys liability protection. Another major difference is that in recent years, most states have recognized limited liability companies with only one owner. This means that you can protect yourself from personal liability and yet still operate your business, in many ways, as you would a sole proprietorship (presuming you comply with the formalities of the limited liability company). These so-called "single member LLCs" offer an important tax advantage—annual information can be reported on the owner's individual tax return, and no separate tax return or identification number is required.

A limited liability company can either be managed by its members, or the members may select one or more managers (*e.g.*, a board of managers similar to a corporate board of directors) to run the business. Most states will require you to decide upfront how the company will be managed.

All things being equal, most business owners will choose the limited liability company form over the partnership form. However, things are almost never equal and nuances do exist. It is important to discuss these details with your attorney.

Corporations

A corporation is an entity created under statute that is separate and distinct from its owners. In other words, a corporation can be created only by following the requirements of the relevant statute (in Indiana, it is the Indiana Business Corporation Law) and will not automatically be created (as can be the case with some partnerships). Once formed, the corporation is recognized as being independent from you, the owner/shareholder. The corporation is managed by directors and officers; sometimes, the directors and officers are also the shareholders.

From a liability standpoint, the corporation affords you complete protection; creditors must rely on the assets of the corporation and you are not personally liable for anything beyond your investment and financial commitment to the corporation. That said, lenders frequently require shareholders of smaller corporations to personally guarantee the debt of the corporation.

Corporations are the most complex entities, both in terms of creation and operation. In addition to filing articles of incorporation, corporations need to adopt by-laws, elect directors and officers, and in many states, have regular meetings. There may also be annual reporting requirements with the Secretary of State in addition to annual fees.

The shares of a corporation are freely transferable and unlike a partnership or limited liability company, the transferee of your shares will succeed to all of your rights in those shares. In other words, the person to whom you transfer your shares will be just as much an owner of the corporation as you were. This ease of transferability can have significant impact later on as you begin to implement exit strategies (that is, you are ready to retire from the enterprise).

From a tax perspective, corporations can also be more complex than their partnership and limited liability company counterparts. Usually, a corporation is a separate taxable entity. It pays tax on its income and later, when it distributes accumulated income to the shareholders, the shareholders will pay a second layer of income tax on those dividends. This "double taxation" is a significant drawback for most corporations. There is a special type of corporation (commonly referred to as an "S" corporation) that generally is not subject to double taxation. An "S" corporation allocates income and losses on a pro-rata basis to its shareholders, although the use of losses by a shareholder is limited to that shareholder's basis in the corporation. You must strictly adhere to rigid requirements imposed on "S" corporations, and shareholders sometimes are surprised by how easy it is to terminate an existing "S" election inadvertently.

Occasionally, a business owner might intentionally choose the double taxation of a regular corporation to take advantage of certain corporate tax benefits. For instance, while partners in a partnership cannot be employees of that partnership, shareholders in a corporation can be employees; as a result, these shareholders can participate in certain fringe benefits extended to "employees" under the federal tax law, such as flexible spending accounts. Other examples include (i) the ability of a corporation to participate in tax-advantaged reorganizations unavailable to partnerships and limited liability companies and (ii) the potential for up to $50,000 ($100,000 on a Married Filing Joint Return) of losses from the sale, exchange, or worthlessness of certain small business corporation stock to qualify for ordinary loss treatment (as opposed to capital loss treatment).

As you can see, a good deal of thought and care must go into your decision of what type of legal form your new business should take. Quite often, the advantages of one form will be offset by disadvantages not present in another. As mentioned, within similar types of legal forms, nuances exist that make the decision all the more difficult. By identifying the right combination of advantages and disadvantages and with the assistance of competent advisors, the right choice of entity selection can help ensure your business success. ■