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Choosing the Right Corporate Structure for Your Small Business

One of the most important decisions faced by entrepreneurs when starting a new business is determining the best type of legal structure for the enterprise. Should you set up as a “C” corporation, a partnership, a limited liability partnership (“LLP”), a limited liability corporation (“LLC”), a “Sub-Chapter S” corporation, a sole proprietorship? The list goes on and on and can be mind boggling for even the most seasoned serial entrepreneur.

In general, the following factors should be taken into account when making such a decision:

- Your own personal assets and liabilities;
- Your existing capital and need for outside investors;
- Your ability to attract outside investors;
- State licensing, statutes, and tax requirements;
- The time commitment necessary to handle regulations and formalities;
- The size, scope, and type of business you're starting; and
- Startup costs, including licensing and other fees.

The Need For Funding. This is one of the first concerns for any new business. Unless you have the personal assets or can tap into family, friends, or your bank, you'll be seeking investors who will look at:

- Returns on their investment;

- Protection from personal liability; and
- Tax situations — their personal situation and that of your business.

While most businesses can only anticipate future returns, the business structure that protects personal assets and provides a favorable tax environment will be most attractive to investors. If, however, you don't need investors or are not seeking shareholders when starting a business, you can do what many other business owners have done — start small as a sole proprietor and incorporate.

Other Determining Factors. Determining not only the type of business you're starting, but also the type of customers you'll attract, and the manner in which you'll attract them, should be factored into your decision-making process.

The potential for liability from customer relationships or interaction impacts heavily on your liability risk. For example, someone who is opening a business that will sell goods to customers via the Internet or through mail order is less likely to garner lawsuits than someone who owns physical store locations, where customer foot traffic and potential injuries could result in a lawsuit. However, many small business owners opt for coverage from insurance policies rather than go through the time and expense of incorporating.

Accountants, brokers, or financial consultants offering advice and personal services may run a greater risk of a lawsuit from someone claiming they received "bad advice." It is also assumed that a professional business such as a brokerage house or an accounting practice will have greater assets; this makes them bigger "targets" in our overly litigious society. Therefore, such an enterprise would more likely choose a business structure that protects its personal assets. Likewise, someone who has already enjoyed previous business success — and has significant assets from this previous venture — would want to protect those assets closely.

How fast you anticipate your business growing is also of concern when selecting your corporate structure. If you expect it to take several years before you see a profit, you might select a Subchapter-S corporation, so that shareholders can offset some of their personal income with losses from the business. On the other hand, if you expect to see profits within the first three years, you may wish to incorporate as a limited liability company in order to take advantage of the “flow through” taxation benefits.

A sole proprietorship is another common choice for many people starting small businesses, some select this method primarily because it provides the easiest way in which to start and open a business quickly. The downside to this method however is that it exposes the business owner to individual liability, which simply put, means that if the business is sued, the sole proprietor can lose all of his personal assets.

Apathy can come back to haunt a successful entrepreneur. Therefore, it is wise to sit down with both an attorney and an accountant to discuss the details of the business you plan to start. Consider where you see it going in five or 10 years. Cover all the bases — including liabilities, taxes, employee benefits, and the need for investors — before making your decision. Then choose the decision that's best for your new business from all aspects.

The courts may hold a corporation's shareholders liable if they believe the corporation is not adhering to the formal regulations it must follow. This is called *alter ego liability,* and emphasizes the need for any business that has incorporated, no matter how small, to abide by the guidelines of the state in which it's incorporated.

This Newsletter was written by John J. Maalouf, ranked as one of the Top 10 Lawyers in the United States in the areas of International Trade & Finance Law by the United States Lawyer Rankings for the years 2009, 2008, 2007 & 2006. Mr. Maalouf advises entrepreneurs on all aspects of business and corporate law. If you have any questions regarding the matters discussed in this memorandum, please contact the following:

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