

Why should I incorporate my business?

*The decision as to which entity is best for your business should only be made after obtaining advice from an attorney and tax advisor. The information below is for information purposes only and is not to be construed as legal advice. Please consult your attorney and/or tax advisor prior to taking any action.*

Owning your own business is a rewarding and potentially lucrative endeavor. The freedom and sense of accomplishment of being self-employed is unmatched. However, business ownership can be a serious financial risk if you are not adequately protected. If your business is sued or if you are having financial difficulty, your personal assets such as your home, retirement, and savings may be at risk. Operating your business as a corporation or limited liability company can significantly decrease your personal exposure.

Creating a business entity is essential to the success of your business. There are legal and tax advantages to operating your business under a corporation or an LLC. The primary function of the LLC or corporation is to separate your business liabilities from your personal assets. It is essential for a business owner to protect his or her personal assets from the creditors of his or her business.

In general, there are four different ways to organize your business: sole proprietorship or d/b/a, partnership (limited or general), corporation and limited liability company. There are many advantages and disadvantages to each type of entity and the best choice depends largely on your personal, business, tax and financial situations.

Below is a brief description of the four major types of business form. There are legal and tax intricacies that extend beyond the scope of this article. The decision of which business form is best for your situation should be reached only after consultation with an attorney and an accountant.

A sole proprietorship or a d/b/a provides you with minimal legal and tax advantages. These types of business “forms” merely provide you with a business name. There is no protection for your personal assets and all income and losses are reported on your personal tax return. The LLC and corporation can be substantial financial investments. The advantage of the sole proprietorship is that the start up costs are minimal. However, by setting up a business this way, a business owner is putting his or her assets at risk of being attached by creditors.

A partnership is an agreement between two or more individuals with the common goal of operating a business (or some other type of joint venture). There are two types of partnerships: a general partnership and a limited partnership.

A general partnership does not necessarily have to be in writing. This type of partnership provides no limited liability protection for its partners and profits and losses are shared equally unless otherwise specified in a partnership agreement. We strongly recommend that you have a detailed partnership agreement and seek the advice of an attorney when entering into a partnership of any kind.

A limited partnership is a partnership that must be filed with the Secretary of State in the state(s) in which you operate your business. It is a partnership between at least one limited partner (who receives limited liability protection) and at least one general partner (who receives no liability protection).

Corporations and LLC's provide limited liability protection by separating ownership from control. Both types of entities must be filed with the Secretary of State's Office and require certain formalities (such as annual reports, votes and meetings) to be adhered to.

The major differences between the two types of entities are the method of taxation, degree of formalities and the nature of the ownership interests.

An LLC tends to be more flexible than a corporation from both a legal and tax perspective. The LLC combines the limited liability protection of the corporation with the flexibility and tax advantages of the partnership. The LLC is owned by members according to their percentage interest. Most of the corporation's guidelines are codified in state laws. The structure of the LLC allows the members more flexibility as far as the ownership structure, the division of profits and losses and the management of the business (note that owners of a corporation can have some flexibility with the corporate guidelines if the corporation is set up properly).

The corporation separates ownership from control: the corporation is owned by the shareholders via shares of stock and it is controlled by a board of directors. There are two types of corporations: the C Corporation and the S Corporation. The C Corporation is the default tax treatment/classification given to corporations filed with the Secretary of State. The earnings of this type of entity are taxed both at the corporate and shareholder level.

The S Corporation allows the shareholders of the corporation to avoid this double taxation. The earnings of the S Corporation are passed through to the shareholders. The S Corporation can be more cumbersome than the C Corporation or the LLC: there are many requirements for the S Corporation that must be met in order to achieve the pass through status. You should consult with your tax advisor or attorney before making this election to ensure that your corporation would qualify under the Tax Code.

In sum, the LLC and the corporation afford their owners with limited liability; the sole proprietorship and partnership do not. A business entity of some type is strongly recommended if you are operating any type of business even if you are doing so out of your home. Different businesses carry different types and levels of liability. Every business owner has a unique tax situation. It is extremely important that you consult with an attorney and tax advisor as to which type of entity best suits your needs prior to starting your business.