

How to Choose a Business Entity

by

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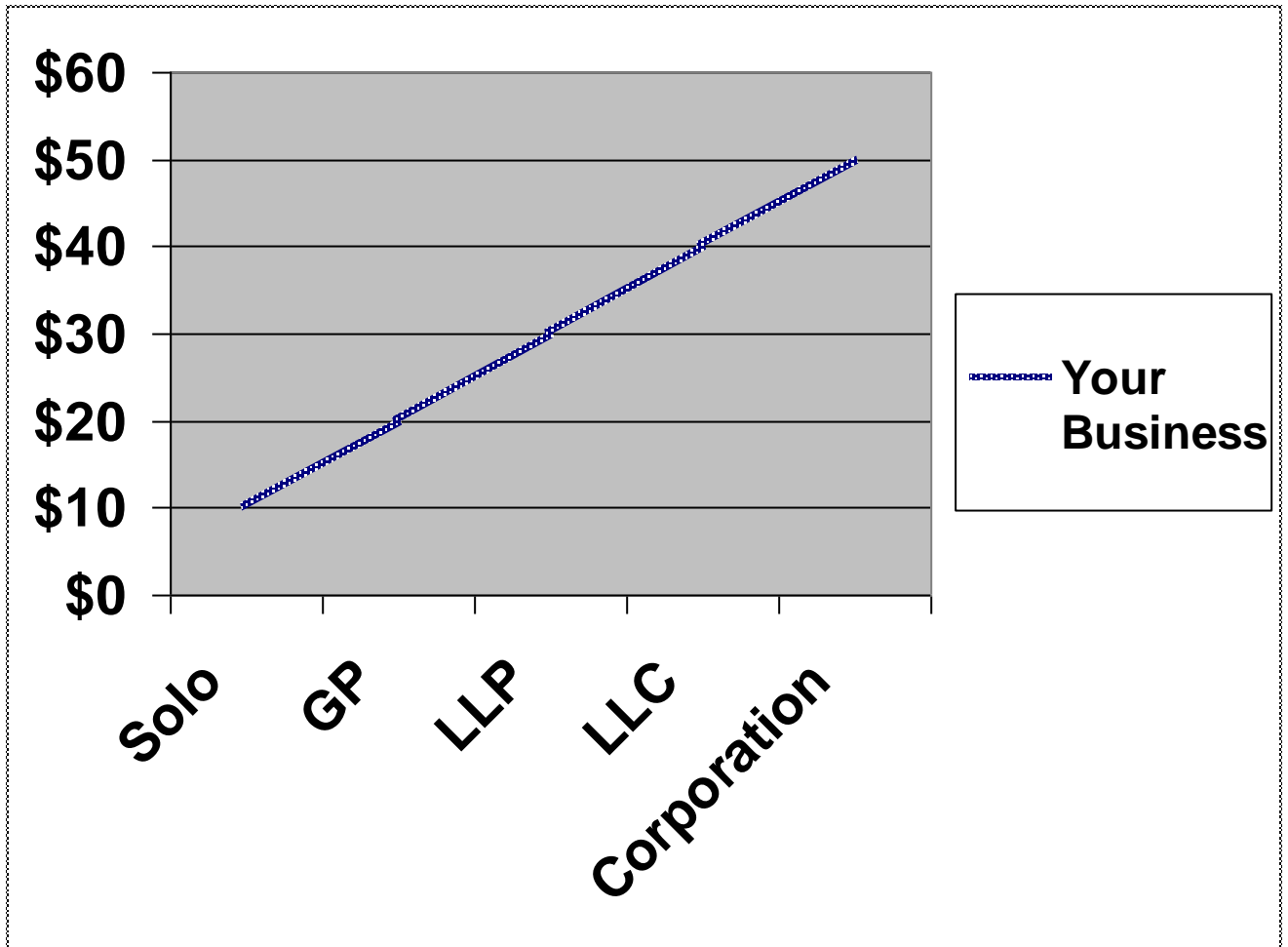
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How to Choose a Business Entity

The Key Considerations

- **Liability** (How likely are you to be sued and if so, for how much)
- **Ease of Management/Costs**
- **Taxes**



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- **Corporation**

- **Summary:** A fictitious legal entity created according to statutory requirements.
- **Examples of Typical Purpose:** any business other real estate business
- **Liability:** Assuming that the shareholders have paid the subscription price for their shares and that such subscription price is at least equal to the par value of the shares (or the stated value of no par shares), the shareholders of a corporation are generally not liable for the corporation's debts or other liabilities, including tort liabilities. Note, however, that in order to protect shareholders against personal liability it is necessary scrupulously to observe corporate formalities, including: filing articles of incorporation with the Pennsylvania Department of State, electing directors, adopting by-laws, maintaining the separate identity of the corporation by keeping its assets separate from those of the shareholders, documenting within the corporate minutes a yearly meeting of the directors and shareholders, operating by written resolution when major decisions are made, and maintaining separate books of account, records, and bank accounts.
- **Management:** There is a significant body of statutory and case law in Pennsylvania defining the manner in which a corporation may conduct its business. It is therefore relatively easy to determine how to document any particular corporate transaction and to authenticate any particular corporate action.
- **Taxes:** Corporations file tax returns and pay taxes under both federal and state income tax laws as an entity separate from the corporation's shareholders, officers and directors, who each have their own separate tax liability. While status as a separate taxpayer leads to an element of double taxation, such separate status may be desirable if the corporation expects to have a large number of shareholders, or if it is in a position to manage its income so as to reduce potential tax liability.

- **S-Corporations**

- **Summary:** A corporation that wishes to avoid double taxation by filing an "S-election" with the I.R.S. and the state.
- **Examples of Typical Purpose:** any corporation that expects to have losses or expects to make a profit but the individual shareholder's tax bracket is lower than the corporation's.
- If the business enterprise expects to have substantial earnings and can meet the requirements for a taxation as a Subchapter "S"

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corporation, consideration should be given to electing Subchapter "S" status. A Subchapter "S" corporation has the attributes of limited liability and ease of management provided by other corporate structures and, therefore, in most business situations should continue to be preferable to the general partnership form of organization. Corporate tax rates are higher than individual tax rates at certain levels.

- Important Limitations:
 - Domestic for-profit corporations, all foreign corporations and all partnerships are prohibited from being S corporation shareholders.
 - All shareholders must be citizens or residents of the United States.
 - The corporation may only issue one class of stock.
- **Restricted Professional Corporation**
 - **Summary:** A restricted professional company is a limited liability company formed by persons whose sole business is practicing medicine, accounting, psychiatry, or law
 - **Examples of Typical Purpose:** law, accountants, medicine
 - **Liability:** same as corporation
 - **Management:** same as corporation
 - **Taxes:** In comparison to a limited liability company that is not a restricted professional company, the only significant difference among the various attributes of the two types of entities is that a restricted professional company is treated as a *partnership* for Pennsylvania tax purposes as well as federal tax purposes. Thus, those professionals covered by the statute should consider a restricted professional company as the entity of choice.
- **Business Trust**
 - **Summary:** A business trust is a statutorily authorized entity whereby the beneficiaries often convey realty or personal property to trustees to operate the property at a profit as a business for the beneficiaries of the trust.
 - **Examples of Typical Purpose:** farm or other real property that generates income
 - **Liability:** Under the Statute, the beneficiaries of Pennsylvania Business Trusts have limited liability, just like the corporate shareholders. The actions of the trustees and their debts do not impose liability on the beneficiaries who are the owners of the business and its assets. However, trust assets are subject to the

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liability of the trustees. If acting properly, no liability attaches to the trustees personally as well.

- **Management:** Business trusts are created through a trust agreement in which the property owners (who can also be beneficiaries), convey the real or personal property involved under a deed of trust to the trustees for the owners' benefit. If real estate is the core, the trust agreement is often recorded as a deed. To form a business trust, a deed of trust must be written, executed, state an intention to be a business trust and be filed with the Department of State.
- **Taxes :** The enabling Pennsylvania Statute on Business Trusts does not define how they should be taxed, thus the characteristics of the trust will determine whether it is taxed as a partnership or a corporation.
- **Limited Liability Company**
 - **Summary:** A limited liability company is created by the public filing of a certificate of organization
 - **Examples of Typical Purpose:** service industries and landlords
 - **Liability:** Equity holders of a limited liability company (called "members") and managers of a limited liability company generally are not liable for "a debt, obligation or liability of the [limited liability company] of any kind or for the acts or omissions of any other member, manager, agent or employee of the company." Thus, members are shielded from both the malpractice of others *and* the general liabilities of the entity. Members are personally liable for any of their own negligent or wrongful acts or misconduct, or for any such acts committed by any person under their direct supervision and control.
 - **Management:** Limited liability companies may be managed by the members (much as a general partnership is managed) or by a manager (similar to a chief executive officer). An operating agreement, which is similar to a combination of the by-laws of a corporation and the partnership agreement of a partnership, governs the affairs of the limited liability company
 - **Taxes:** A limited liability company that is formed with proper planning will be treated as a partnership for federal income tax purposes. However, a limited liability company (other than a restricted professional company) is treated as a *corporation* for Pennsylvania income tax purposes. Thus, a limited liability company may be subject to double taxation in Pennsylvania unless a qualified election is made to be taxed like a Pennsylvania "S" corporation resulting in flow-through tax treatment, wherein the members are taxed once at the personal level.

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- **Limited Liability Partnership**

- **Summary:** Any existing general or limited partnership may create a limited liability partnership by filing a statement of registration with the Department of State. The statement of registration must be signed by any general partner.
- **Examples of Typical Purpose:** Venture capital and investor purposes
- **Liability:** The partners of a limited liability partnership are shielded from liability "for debts and obligations of, or chargeable to, the partnership that arise from any negligent or wrongful acts or misconduct committed by another partner or another representative of the partnership." Thus, partners are protected from the malpractice of others. They are not protected from general liabilities (e.g., loans, leases, etc.) of the entity. Protection from such liability is available only if the partnership maintains statutorily prescribed liability insurance.
- **Management:** The affairs of the partnership are usually managed solely by the general partner, who may create partnership obligations without the consent of the limited partners. The limited partners may not actually participate in the management of the partnership, because such activity may cause a limited partner the risk of losing his limited liability.
- **Taxes:** Limited liability partnerships are taxed in the same manner as general partnership discussed

- **Limited Partnership**

- **Summary:** A limited partnership is created by agreement and by public filing of a Certificate of Limited Partnership.
- **Examples of Typical Purpose:** Real Estate Investment Vehicles
- **Liability** The limited partners of a properly constituted limited partnership have no liability for the debts or other obligations of the partnership in excess of the amount of capital which the limited partners are obligated to contribute to the partnership, unless, in addition to the exercise of his rights as a limited partner, such a partner takes part in the control of the business. A limited partnership must, however, have a general partner who has unlimited liability for the obligations of the partnership, although he may be indemnified by the partnership against such liability to the extent of the partnership's assets.
- **Management/Costs** The affairs of the partnership are usually managed solely by the general partner, who may create partnership obligations without the consent of the limited partners. The limited partners may not actually participate in the management of the

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partnership, because such activity may cause a limited partner the risk of losing his limited liability. Very little expense or formality is required to establish a partnership. A partnership agreement, while not required, is recommended for more efficient partnership administration.

- **Taxes** A partnership prepares a separate tax return but is not a taxpaying entity. Each partner bears his pro rata share of the partnership's tax liabilities and must report his pro rata share of such liabilities on his personal tax return, paying any taxes which may be due with respect thereto. In appropriate instances, partnership losses may give rise to deductions on personal tax returns.

- **General Partnership**

- **Summary:** A voluntary associations of two or more persons for carrying on a business as co-owners for profit. General Partnerships are like solo proprietorships but with many owners.
- **Examples of Typical Purpose:** any business where a solo proprietorships would be appropriate but with many owners
- **Liability:** Each partner of a general partnership is personally liable for all of its obligations. Although each partner may be entitled to contribution from the other partners, each partner's liability to third parties is unlimited.
- **Taxes:** A partnership prepares a separate tax return but is not a taxpaying entity. Each partner bears his pro rata share of the partnership's tax liabilities and must report his pro rata share of such liabilities on his personal tax return, paying any taxes which may be due with respect thereto. In appropriate instances, partnership losses may give rise to deductions on personal tax returns.
- **Management:** Each partner may act on behalf of the partnership and may create partnership contract obligations. Thus, it is necessary for the partners to agree among themselves and be aware of partnership liabilities that each partner may create without the approval of the others. Very little expense or formality is required to establish a partnership. A partnership agreement, while not required, is recommended for more efficient partnership administration.

- **Solo Proprietorship**

- **Summary:** A form of business where the owner is actually the business; the business is not a separate entity.
- **Examples of Typical Purpose:** any

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- **Liability:** unlimited
- **Management:** simplest and requires no formal filing. Owner can make all management decisions and has the right to receive all the profits from the business.
- **Taxes:** will pay individual taxes on business profit

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### **About the Author:**

Ms. Sharmil McKee is a business attorney licensed in Pennsylvania. She focuses her practice on protecting small and mid-sized businesses from future legal problems. Visit her firm's website <http://www.mckeeoffice.com>.