



Business Practice- Choice of Business Entity

By Thomas J. Vale

Our firm represents many small business owners. One of the decisions we help clients make is choosing the right business entity for their particular business. There are advantages and disadvantages to each form. This article will highlight some of the basic and most important differences between the various possibilities.

Sole Proprietorship

The simplest form under which to operate is a sole proprietorship. This individual owns the business assets in his or her own name and any income is taxed directly to the owner. The biggest advantage of this form of ownership is its simplicity. There is no formal requirement for filing organizational documents with the State of Wisconsin and income tax returns are normally relatively simple.

Many small businesses start out as sole proprietorships and change to a different entity as the business grows. The principal disadvantage of a sole proprietorship is that the business owner is not protected from personal liability for obligations of the business. If the business fails, the business owner can potentially lose not only his or her business assets, but potentially their personal assets as well.

General Partnership

A partnership is an organization of two or more individuals joining in a business venture for their mutual benefit. The partners pool their resources to form the business. Obviously, with shared resources, a partnership can generate more money and assets to start a new business. The partnership is normally a “pass through” tax entity, meaning the profit or loss is distributed proportionately to the partners.

Normally, a partnership will have a formal written partnership agreement spelling out the rights and obligations of each individual member. This requires more paperwork than a sole proprietorship. While a partnership spreads the risk of supporting the business between the partners, it does not protect the individual partners from personal liability.

Corporation

Corporations protect the individual shareholders from personal liability for business debts. For example, you may hold a few shares of a large corporation with publicly traded stocks, such as General Motors. If General Motors is sued and ultimately goes bankrupt, you may lose the money invested in the shares, but you as an individual shareholder will not be responsible for any debt beyond that. The same concept applies to a small closely held family corporation. The corporation enables individuals to invest in a business without putting all of their personal assets at risk.

There is more paperwork involved in creating a corporation than the entities previously discussed. You must file Articles of Incorporation with the State of Wisconsin. It is also necessary to create and maintain other corporate records, including subscription agreements, minutes of meetings, bylaws, stock certificates, buy-sell agreements and the like.

The corporation is also treated differently for income tax purposes. What the IRS terms “C” corporations can be taxed at the corporate level as well as when income or dividends are received by the individual shareholders. Small, closely held corporations can elect to be taxed as “Subchapter S” corporations. This allows the profits to be passed





through the corporation directly to the shareholders, similar to the way a partnership is taxed as a “pass through” entity. There are other tax issues to be considered with corporations that are beyond the scope of this article. The important thing to note is that a business owner is going to need professional advice to make the right decisions. It is usually best to work with an attorney and accountant to carefully consider all of the issues before deciding how to organize the corporation.

Limited Liability Company

A limited liability company (LLC) is a type of hybrid business organization which combines some of the benefits of a business partnership with some of the benefits of a business corporation. In most respects, the LLC operates as a partnership. However, it gives the individual members the same protection from personal liability that they would have as shareholders in a corporation.

When organizing an LLC, it is necessary to file Articles of Organization with the State of Wisconsin and create a Member’s Agreement and Operating Agreement. While a limited liability company is a useful option for entrepreneurs, there are still some circumstances where a corporation is the preferred business entity. In some situations, persons may actually set up two business entities. Because of tax benefits, sometimes an LLC or partnership is set up to own real estate which is leased back to a business corporation.

Businesses should be careful to use the right designation when putting their names on business documents, letterhead, and checks. The State of Wisconsin requires that the business name includes the letters “Inc.” or “Corp.” when a business is incorporated, or “LLC” when a limited liability company is formed. This keeps the public informed to what type of business they are dealing with. Those designations should not be used if the business has not, in fact, filed papers with the State of Wisconsin.

There is no single right answer when deciding on a choice of business entities. It is important to understand the consequences of your decisions before you choose the appropriate business entity. We encourage clients to work with a “consulting team” which might include your business associates as well as your attorney, accountant, and lender. These individuals can discuss issues and options to help you make sound business decisions.

