



Which Legal Form Is Best for Your Business?

Choosing the right form has a lot to do with who will own your business and what its activities will be.

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When you start a business, you must decide on a legal structure for it. Usually you'll choose either a sole proprietorship, a partnership, a limited liability company (LLC), or a corporation. (Also, some businesses choose to operate as cooperatives.) There's no right or wrong choice that fits everyone. Your job is to understand how each legal structure works and then pick the one that best meets your needs. The best choice isn't always obvious. You may, after reading this section, decide to seek some guidance from a lawyer or an accountant.

For many small businesses, the best initial choice is either a sole proprietorship or, if more than one owner is involved, a partnership. Either of these structures makes good sense in a business where personal liability isn't a big worry -- for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money. Sole proprietorships and partnerships are relatively simple and inexpensive to establish and maintain.

Forming and operating a corporation is more complicated and costly, but it's worth it for some small businesses. The main feature of LLCs and corporations that attracts small businesses is the limit they provide on their owners' personal liability for business debts and court judgments against the business. Another factor might be income taxes: You can set up an LLC or a corporation in a way that lets you enjoy more favorable tax rates. In certain circumstances, your business may be able to stash away earnings at a relatively low tax rate. In addition, an LLC or corporation may be able to provide a range of fringe benefits to employees (including the owners) and deduct the cost as a business expense.

Given the choice between creating an LLC or a corporation, many small-business owners will generally be better off going the LLC route. For one thing, if your business will have several owners, the LLC can be more flexible than a corporation in the way you can parcel out profits and management duties. Also, setting up and maintaining an LLC can be a bit less complicated and expensive than a corporation. But there may be times a corporation will be more beneficial. For example, because a corporation -- unlike other types of business entities -- issues stock certificates to its owners, a corporation can be an ideal vehicle if you want to bring in outside investors or reward loyal employees with

stock options.

Keep in mind that your initial choice of a business form doesn't have to be permanent. You can start out as sole proprietorship or partnership and later, if your business grows or the risks of personal liability increase, you can convert your business to an LLC or a corporation.

Cooperatives

Some people dream of forming a business of true equals -- an organization owned and controlled democratically by its members.

These grassroots business organizers often refer to their businesses as a group, collective, or co-op -- but these are usually informal rather than legal labels. Everyone who starts a business with others needs to select a legal structure. Generally, this means picking one of the traditional formats: partnership, corporation, limited liability company (LLC), or, perhaps, a nonprofit corporation. However, some states do have specific laws allowing the formation of a cooperative corporation. For example, in some states, a consumer co-op could be formed to run a food store, a bookstore, or any other retail business. Or a workers' co-op could be created to manufacture and sell arts and crafts.

If a co-op law exists in your state, it can help make the process of democratic ownership go more smoothly. Otherwise, you'll need to make sure your partnership agreement, corporate bylaws, or LLC operating agreement contains the cooperative features that you and the other members feel are appropriate.

To learn more about cooperative-type organizations and how to start one, read *We Own It: Starting and Managing Cooperatives and Employee-Owned Ventures*, by Peter Jan Honigsberg, Bernard Kamoroff, and Jim Beatty (Bell Springs Publishing). Another fine resource is *Co-op Incorporation Sourcebook* (Center for Cooperatives, University of California at Davis). It reviews business feasibility and legal requirements for starting a nonagricultural cooperative in California.

Ways to Organize Your Business

Type of Entity	Main Advantages	Main Drawbacks
Sole Proprietorship	Simple and inexpensive to create and operate	Owner personally liable for business debts

	Owner reports profit or loss on his or her personal tax return	
General Partnership	<p>Simple and inexpensive to create and operate</p> <p>Owners (partners) report their share of profit or loss on their personal tax returns</p>	Owners (partners) personally liable for business debts
Limited Partnership	<p>Limited partners have limited personal liability for business debts as long as they don't participate in management</p> <p>General partners can raise cash without involving outside investors in management of business</p>	<p>General partners personally liable for business debts</p> <p>More expensive to create than general partnership</p> <p>Suitable mainly for companies that invest in real estate</p>
Regular Corporation	<p>Owners have limited personal liability for business debts</p> <p>Fringe benefits can be deducted as business expense</p> <p>Owners can split corporate profit among owners and corporation, paying lower overall tax rate</p>	<p>More expensive to create than partnership or sole proprietorship</p> <p>Paperwork can seem burdensome to some owners</p> <p>Separate taxable entity</p>
S Corporation	<p>Owners have limited personal liability for business debts</p> <p>Owners report their share of corporate</p>	<p>More expensive to create than partnership or sole proprietorship</p> <p>More paperwork than for a limited liability company, which offers similar advantages</p>

	<p>profit or loss on their personal tax returns</p> <p>Owners can use corporate loss to offset income from other sources</p>	<p>Income must be allocated to owners according to their ownership interests</p> <p>Fringe benefits limited for owners who own more than 2% of shares</p>
Professional Corporation	<p>Owners have no personal liability for malpractice of other owners</p>	<p>More expensive to create than partnership or sole proprietorship</p> <p>Paperwork can seem burdensome to some owners</p> <p>All owners must belong to the same profession</p>
Nonprofit Corporation	<p>Corporation doesn't pay income taxes</p> <p>Contributions to charitable corporation are tax deductible</p> <p>Fringe benefits can be deducted as business expense</p>	<p>Full tax advantages available only to groups organized for charitable, scientific, educational, literary, or religious purposes</p> <p>Property transferred to corporation stays there; if corporation ends, property must go to another nonprofit</p>
Limited Liability Company	<p>Owners have limited personal liability for business debts even if they participate in management</p> <p>Profit and loss can be allocated differently than ownership interests</p> <p>IRS rules now allow LLCs to choose between being taxed as partnership or corporation</p>	<p>More expensive to create than partnership or sole proprietorship</p> <p>State laws for creating LLCs may not reflect latest federal tax changes</p>
Professional Limited Liability	<p>Same advantages as a regular limited liability company</p>	<p>Same as for a regular limited liability company</p>

Company	Gives state-licensed professionals a way to enjoy those advantages	Members must all belong to the same profession
Limited Liability Partnership	<p>Mostly of interest to partners in old-line professions such as law, medicine, and accounting</p> <p>Owners (partners) aren't personally liable for the malpractice of other partners</p> <p>Owners report their share of profit or loss on their personal tax returns</p>	<p>Unlike a limited liability company or a professional limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders, and landlords</p> <p>Not available in all states</p> <p>Often limited to a short list of professions</p>

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