**Legal Form Chart**

Many learners have questions about what legal form their budding enterprises should

take. Here is a primer on legal form and some concerns about maintaining that form.

**Form Impact Finances**

Sole proprietorship You and the business are one Business income is the same

and the same. There is no as your income.

personal liability protection.

Partnership The business is one with you Business income flows

and your partners. There is no through the partners as

personal liability protection. Ordinary income.

Corporation The business is different from The business pays taxes as

you. There is personal liability a separate entity.

protection.

**Types of Corporations**

Traditional (C) The business is different from The business is doubly

you. You are protected from taxed – first on profit and

liability. Then on any money

distributed, such as

dividends.

Nonprofit The business cannot make Profits must be spent.

profit.

Limited liability company You are protected from The business is taxed like

(LLC) liability. A partnership. Profit and

loss flow through as

ordinary income.

Sub-chapter S You are protected from The business is taxed like a

liability. Partnership.

There are also some hybrid styles as well. Limited and general partnerships are

examples.

Sole proprietorships have the great disadvantage of leaving you open to any liability,

and they do not provide any tax benefits. In these lawsuit-happy days, it simply is not

good business not to protect yourself as strongly as possible from personal liability.

Therefore, one could surmise that almost every business organization should be a

corporation of some sort. There are some advantages to a sole proprietorship, in that

it is easy to set up and requires little record keeping or other formalities.

**Partnerships** also have the great disadvantage of not providing liability protection

(and worse, you can also be held liable for the acts of other partners). There are no

tax benefits. And in many states, when one partner dies, the partnership is

automatically dissolved. The benefits include ease of setting up (just an agreement

between the parties) and little administrative work.

A **corporation** is a legal term for a fictitious entity that is independent from its

shareholders. If the corporation is traditional (usually because it is large), it is in C

form and more likely than not also incorporated in the state of Delaware (because

corporations incorporated there have many benefits in terms of oversight, laws,

shareholder control, and things such as poison pill defenses against hostile

takeovers). Most investors providing funding will want you to be a C Corp and most

likely incorporated in Delaware.

The principle benefit is protection from liability (but there are things you have to do –

see below). The corporation can be sued, but lawsuits cannot touch the personal

assets of investors and owners. The company can provide for fringe benefits. There

are some tax benefits, and the corporation can retain earnings. It is also easy to raise

capital by selling stock. However, a corporation can be costly to form, require a lot of

administration, and may not be very flexible.

A **sub-chapter S (Sub-S) corporation** is a form of corporation that provides the

liability protection, but allows income and losses to flow through the corporation to the

owners as if it were a partnership. While it can be somewhat costly to form, it is the

best compromise for a small organization. The **limited liability company (LLC)** is

very similar to the Sub-S, except that it has more flexibility (depending on local state

laws). For example, a Sub-S Corp is limited to 35 shareholders. LLCs can have an

unlimited number of shareholders. A few states tax the LLC like a regular corporation,

but most tax it as a partnership.

As mentioned earlier, the largest benefit in being a corporation is protection from

liability, because even something like a bookkeeping service can have potential

liability issues in every business. But the corporation can be gotten around (called

piercing the corporate veil) if the managers and owners do not carefully do two things:

1. Funds of the shareholders and the business cannot be commingled. There

must be separate bank accounts and funds must be carefully kept separate

(that is, no paying personal bills with company checks).

2. The owner must 'follow the corporate form'. They must have annual meetings

(even if there is only one owner), keep corporate minutes, et cetera.

After all, a corporation is supposed to be a separate entity, and if the owners

interchange cash or do not treat it like a real company, it is clear that it is a sham. The

courts will then void the corporation, and the owners will be exposed to personal

liability.

One would argue that almost everyone should have a corporation and not a sole

proprietorship or partnership. Even though liability may seem unlikely, and given you

will have insurance, the possible problems from liability are so huge that it does not

make sense not to have the protection of incorporation. Remember, McDonald’s lost

a very large settlement to a person who opened their cup of coffee while holding the

cup in her lap. Tort lawyers always sue everyone to find the 'deep pockets'.