

# Beginner's Guide to Business Entities

by NEIL PATEL on MARCH 31, 2010

One of the most important early decisions an entrepreneur must make in connection with his or her venture is the choice of entity. There are basically six choices:

1. Sole proprietorship
2. General partnership
3. Limited partnership
4. C corporation
5. S corporation
6. Limited liability company

Below is a discussion of each entity, including a basic description, its advantages and disadvantages, the ideal candidate/business for such entity, the cost to set-up such entity and the most important take-away.

## 1. Sole proprietorship

A sole proprietorship is the simplest, most common way of organizing a business. A sole proprietorship is not a separate legal entity; it is a business owned and run by one person (hence, the term “sole”). For legal purposes, there is no distinction between the business and the sole proprietor.

### What are the advantages?

The significant advantages of utilizing a sole proprietorship include:

- **Ease of formation** – the owner does not have to file any formation documents with governmental agencies (other than perhaps a simple fictitious name or “DBA” certificate if it is doing business under a name other than the owner).
- **Very inexpensive** – since there are no organizational documents, there will be no legal fees for drafting documents and no filing fees (other than for a DBA).
- **No double taxation** – unlike a C corporation, the business and the owner do not pay income taxes separately; indeed, all income taxes are handled on the owner's personal tax returns.

### What are the disadvantages?

The significant disadvantages of utilizing a sole proprietorship include:

- **Unlimited personal liability** – this is the biggest problem with a sole proprietorship. The owner will be held personally liable for all of the business's activities, including its debts and liabilities.
- **No equity issuances** – a sole proprietorship is by definition owned by one individual; accordingly, the business cannot issue equity (e.g., stock options) to a key employee or to an investor.
- **No continuity of existence** – upon the death or incapacity of the owner, the business ceases to exist.

### **Ideal for whom?**

A sole proprietorship is ideal for someone who wants to start a one-person business quickly and inexpensively, and such business will not be seeking outside investment and has limited liability exposure; e.g., a service provider like an accountant would be an ideal candidate – particularly if he or she can buy insurance to protect against any malpractice claims.

### **How much does it cost to set-up?**

There is no cost for setting-up a sole proprietorship, other than the cost of filing/publishing a DBA certificate (approximately \$50).

### **What's the most important take-away?**

The most important take-away is that sole proprietorships have very limited utility for entrepreneurs and should generally be avoided due to the unlimited personal liability and lack of structure for equity issuances.

## **2. General partnership**

A general partnership is an association of two or more individuals (or entities) to conduct a business as co-owners.

### **What are the advantages?**

The significant advantages of utilizing a general partnership include:

- **Ease of formation** – like a sole proprietorship, there are no formalities required to form a general partnership (though a few states require a simple filing at the county level and a DBA certificate may be required); in fact, a general partnership can be formed without a written agreement between or among the partners – though it would be prudent to have one.

- **Relatively inexpensive** – since there are generally no formalities to form a general partnership, it is less expensive than other entities – both initially and on an ongoing basis; however, there will be legal fees associated with the drafting of a partnership agreement.
- **Separate legal entity** – in most states, a general partnership is a separate legal entity, with partnership interests that can be issued and transferred, and the partnership can own real estate and other property in the partnership name.

### What are the disadvantages?

The significant disadvantages of utilizing a general partnership include:

- **Unlimited liability** – every partner in a general partnership assumes unlimited liability for the partnership’s debts and liabilities, including any tortious acts committed by a co-partner during the ordinary course of partnership business; obviously, this is a huge potential problem if the partners are individuals – it’s like a sole proprietorship on steroids.
- **No outside investors** – from a practical standpoint, the business will not be able to raise capital from outside investors because investors will not want to be a general partner and subject themselves to unlimited liability.
- **Fiduciary obligations** – each partner has a fiduciary obligation to the other partners with respect to all matters affecting the business – which is an extremely high standard requiring undivided loyalty, good faith and fair dealing; this standard has led to a lot of litigation among partners and allegations of conflicts of interest and self-dealing.

### Ideal for whom?

A general partnership is ideal for two or more individuals who wants to start a business quickly and inexpensively – particularly if the business will not be seeking outside investment and has limited liability exposure; e.g., an accounting firm or a law firm would be an ideal candidate.

### How much does it cost to set-up?

As noted above, a general partnership is relatively inexpensive to set-up. There are generally no filing fees, other than a DBA certificate (approximately \$50); however, there may be legal fees associated with the drafting of a partnership agreement (approximately \$1,000 to \$2,500).

### What’s the most important take-away?

The most important take-away is that (like sole proprietorships) general partnerships have very limited utility for entrepreneurs and should generally be avoided due to the unlimited personal liability of the owners.

### 3. Limited partnership

Like a general partnership, a limited partnership is an association of two or more individuals (or entities) to conduct a business as co-owners; unlike a general partnership, however, there are two kinds of partners: general and limited. A general partner's liability is unlimited, and a limited partner's liability is limited to the amount of his or her investment in the business (hence the term "limited"). The business is managed by the general partner(s).

#### What are the advantages?

The significant advantages of utilizing a limited partnership include:

- **Limited liability** – as noted above, the number one advantage of a limited partnership is that the limited partners do not have unlimited liability (such as in a sole proprietorship or a general partnership); again, a limited partner's liability is limited to the amount of his or her investment, subject to the caveat below (i.e., if a limited partner participates in the control of the business, he or she could be deemed a general partner).
- **Facilitates outside investors** – a limited partnership is a good vehicle for raising capital because the investors become limited partners and thus have limited liability, and the limited partnership interests/units can be easily transferred.
- **Pass-through tax treatment** – assuming all of the required formalities have been complied with, a limited partnership's profits and losses flow directly to the individual limited partners (the entity itself is not taxed, as in a C corporation), which is desirable in certain ventures.

#### What are the disadvantages?

The significant disadvantages of utilizing a limited partnership include:

- **Unlimited liability for general partners** – every general partner has unlimited liability; accordingly, in most limited partnerships, the general partners are corporations or limited liability companies in order to shield against personal liability (which creates a complex and expensive structure).
- **Creature of statute** – unlike a general partnership, a limited partnership is a creature of state law; accordingly, a certificate of limited partnership must

- be filed with the applicable Secretary of State and, in some states (including California), a written limited partnership agreement must be executed.
- **Limited partners may not participate in management** – if a limited partner “participates in the control of the business,” he or she could be deemed a general partner and be subject to unlimited personal liability; in certain states, it is unclear what activities constitute “control”.

### **Ideal for whom?**

Limited partnerships are ideal for businesses that focus on a single or limited-term project (e.g., a real estate project or a film production project) or for so-called “labor-capital” partnerships, where one partner or set of partners (the general partners) do the work and the other partners (the limited partners) provide the capital (e.g., a private equity firm or hedge fund).

### **How much does it cost to set-up?**

The costs for setting-up a limited partnership are going to be more than for a partnership because a certificate of limited partnership must be filed with the applicable Secretary of State and a limited partnership agreement must be executed. Accordingly, there will be filing fees of approximately \$250 and related legal fees for drafting such certificate and the limited partnership agreement of approximately \$1,000 to \$3,000. Obviously, there will be additional costs if the general partner is an entity, not an individual.

### **What’s the most important take-away?**

The most important take-away is that limited partnerships have limited utility for most entrepreneurs due to their complexity and the unlimited liability of the general partner(s).

## **4. C corporation**

A corporation is a separate legal entity created under state law, with a legal existence distinct from its owners. A C corporation is the most common type of corporation; unlike an S corporation, it is subject to double taxation – which means that first the corporation (as a separate taxable “person”) is taxed on its profits; and second, each of the shareholders are taxed on any dividends distributed to them.

### **What are the advantages?**

The significant advantages of utilizing a C corporation include:

- **Best shield against personal liability** – a C corporation is the most widely-accepted and well-established entity for the protection against

- personal liability; accordingly, so long as all corporate formalities have been complied with, the shareholders of a C corporation will only be liable for the debts, obligations and liabilities of the corporation up to the amount of the respective investment (regardless of any management participation).
- **Best entity to attract venture capital** – VC funds generally invest only in C corporations (and indeed C corporations formed in Delaware); from a tax perspective, VC funds generally avoid (and may be prohibited under their respective fund documents from) investing in “pass-through” entities such as S corporations or limited liability companies, as discussed below; and from a corporate perspective, Delaware is the most common state of incorporation due to its well-developed case law, management protections and ease of corporate filings (and related administrative issues).
  - **Flexible capital structure** – a C corporation offers the simplest and most-flexible capital structure of any entity – e.g., unlike an S corporation, a C corporation may have different classes of stock, and unlike a limited liability company, a C corporation may easily issue stock options to employees and consultants; moreover, such flexibility facilitates capital raising due to the accessibility of a broad range of financial instruments/vehicles, including preferred stock, warrants, convertible notes, subordinated debt, etc.

### **What are the disadvantages?**

The significant disadvantages of utilizing a C corporation include:

- **Not a pass-through entity** – the biggest disadvantage of a C corporation is that it is not a pass-through entity; accordingly, as noted above, it is subject to double-taxation, which means that corporate profits are taxed twice and any losses do not pass through to its shareholders.
- **Onerous formalities and recordkeeping** – corporations are subject to onerous formalities under applicable state law, including the filing of a certificate of incorporation, the adoption of bylaws, the election of a Board of Directors, annual meetings of the Board of Directors and shareholders, the maintenance of separate books and records and bank accounts, capitalization requirements, etc.; the failure to adhere to such formalities could result in a court “piercing the corporate veil” and holding the corporation’s shareholders personally liable.
- **Costly set-up and maintenance** – as a result of the onerous corporate formalities noted above, the costs for forming and maintaining a corporation are relatively high; e.g., if a corporation is “doing business” in a state other

than state of incorporation, it must qualify to do business there (which is like a mini-incorporation) triggering additional costs and taxes.

### **Ideal for whom?**

A C corporation is ideal for any business that desires strong protection against personal liability and will be seeking venture capital funding, but does not need pass-through tax treatment prior to such funding (or does not otherwise meet the S corporation requirements below).

### **How much does it cost to set-up?**

A corporation (whether it be a C corporation or an S corporation) is the most expensive entity to set-up due to all of the required paperwork and filings. Filing fees range from approximately \$100 to \$900; and legal fees range from \$1,000 to \$4,000 depending upon the extent of the documentation (e.g., a corporation seeking venture funding should execute founders stock purchase agreements and invention assignment agreements, among other things). There may also be some accounting fees (approximately \$500 to \$1,500).

### **What's the most important take-away?**

The most important takeaway is that a C corporation is the best shield against personal liability and should be the first choice of entity for any business that will be seeking venture capital funding. If venture capital funding is not imminent and the founders will be investing a significant amount of money and would like to personally write-off anticipated losses, an S corporation should be considered as well, as discussed below.

## **5. S corporation**

An S corporation is a type of corporation; it is formed under applicable state law just like a C corporation, but an "election" is filed with the Internal Revenue Service. Accordingly, as noted above, it is a separate legal entity, with a legal existence distinct from its owners. The name "S corporation" refers to sub-chapter S of the Internal Revenue Code, under which such election is made. ("C corporations" are named and governed by sub-chapter C of the Internal Revenue Code.) Unlike a C corporation, an S corporation is a pass-through entity and thus is not subject to double taxation – i.e., profits and losses of the corporation pass through to the individual shareholders. An S corporation can be converted to a C corporation at a later date.

### **What are the advantages?**

The significant advantages of utilizing an S corporation include:

- **Effective shield against personal liability** – like a C corporation, an S corporation is an effective and well-established entity for the protection against personal liability.
- **Pass-through tax treatment** – as noted above, the profits and losses of an S corporation flow directly through the corporate entity to the individual shareholders, which is often desirable; e.g., if founders will be investing a significant amount of cash in a startup venture and VC funding is not imminent, an S corporation may be very appealing because any losses can be written-off on the founders' respective tax returns up to the amount of their investment (and the amount of certain corporate debt of the S corporation).
- **Easy to convert to C corporation** – as noted above, VC funds generally invest only in C corporations (and are not eligible to invest in S corporations in any event, as discussed below); the conversion from an S corporation to a C corporation, however, is relatively easy – unlike the conversion from an [LLC](#) to a C corporation, as discussed below.

### What are the disadvantages?

The significant disadvantages of utilizing an S corporation include:

- **Limitation on type and number of shareholders** – the biggest disadvantage of an S corporation is that the shareholders may only be (i) individuals who are U.S. citizens or residents, (ii) estates and (iii) certain eligible trusts; and the number of shareholders is capped at 100.
- **Limitation on capital structure** – another major disadvantage of utilizing an S corporation is that it may only have one class of stock (except that stock with different voting rights is permitted); accordingly, an S corporation may not issue both common stock and preferred stock – and even the issuance of certain options or convertible notes could invalidate the S corporation election.
- **Onerous formalities and recordkeeping** – like C corporations, S corporations are subject to onerous formalities under applicable state law, including the filing of a certificate of incorporation, the adoption of bylaws, the election of a Board of Directors, annual meetings of the Board of Directors and shareholders, the maintenance of separate books and records and bank accounts, capitalization requirements, etc.; the failure to adhere to such formalities could result in a court “piercing the corporate veil” and holding the corporation’s shareholders personally liable.

### Ideal for whom?

An S corporation is ideal for any business that meets the shareholder eligibility requirements and desires strong protection against personal liability and pass-through tax treatment (whether permanently or during the period prior to venture capital funding).

### **How much does it cost to set-up?**

As noted above, a corporation (whether it be a C corporation or S corporation) is the most expensive entity to set-up due to all of the required paperwork and filings. Filing fees range from approximately \$100 to \$900; and legal fees range from approximately \$1,000 to \$4,000 depending upon the extent of the documentation. There may also be some accounting fees (\$500 to \$1,500) relative to the S corporation election and other accounting issues.

### **What's the most important take-away?**

The most important takeaway is that an S corporation is an excellent shield against personal liability and should be the choice of entity for any business that will be seeking venture capital funding if such funding is not imminent and the founders would personally like to take advantage of anticipated losses of the corporation.

## **6. Limited liability company**

A limited liability company (LLC) is a relatively new entity and can best be described as a hybrid between a C corporation and a general partnership: it protects against personal liability like a C corporation (subject to the caveat discussed below) and it has a general partnership's flexibility and pass-through tax treatment. Unlike S corporations, LLC's have no limitations with respect to the eligibility of its owners (called "members"); accordingly, a corporation or another LLC may be a member of an LLC. And unlike a limited partnership, the members of an LLC may control the company and participate in its management and still be protected against personal liability.

### **What are the advantages?**

The significant advantages of utilizing a limited liability company include:

- **Extraordinary flexibility** – probably the most appealing aspect of an LLC is its extraordinary flexibility, including with respect to the distribution of cash and other assets, the allocation of income or losses, etc. (all of which is generally reflected in a written operating agreement); indeed, an LLC may be operated like (i) a corporation, with a Board of Managers and officers, (ii) a general partnership, with all members appointed "managers" or (iii) a sole proprietorship, with one member (or outside individual/entity) appointed the manager; an LLC may also elect to be taxed as a C or an S corporation if it so

chooses; and, in certain states (like Delaware), an LLC may even limit the fiduciary obligations of its manager(s).

- **Effective shield against personal liability** – like a C corporation and an S corporation, an LLC is an effective shield against personal liability, subject to one caveat: a few courts have held that a single-member LLC (i.e., an LLC with one owner) is not protected against personal liability; note: single-member LLC's are tricky and advice from counsel is strongly recommended.
- **Pass-through tax treatment** – as noted above, the other major advantage of an LLC is that profits and losses flow directly through the entity to the individual members (unless, as noted above, the LLC elects otherwise – which is quite rare); as previously discussed, this can be very appealing to avoid the double taxation of profits and to permit the members to write-off certain losses of the company.

### What are the disadvantages?

The significant disadvantages of utilizing an LLC include:

- **Complexity** – the most significant disadvantage of an LLC is its complexity, particularly from a tax and accounting perspective; LLC's are generally governed by extremely complex partnership tax rules – which trigger pages and pages of tax provisions in the operating agreement and significant ongoing compliance costs.
- **Unattractive to VC's and other investors** – as noted above, VC funds and other institutional investors generally do not invest in pass-through entities; accordingly, if a business is seeking venture capital funding, this would not be a good choice of entity; indeed, converting an LLC to a C corporation is much more difficult and expensive than converting an S corporation to a C corporation.
- **Limitation on capital structure** – the other major disadvantage of an LLC is that it is very difficult and expensive (i) to grant options to employees and consultants and/or (ii) to issue other types of securities, such as “preferred” membership interests (like preferred stock in a C corporation), convertible notes, etc.

### Ideal for whom?

An LLC is ideal for any business that desires (i) protection against personal liability, (ii) pass-through tax treatment and (iii) flexibility with respect to distributions, allocations and/or management. Consulting firms and real estate projects are ideal

candidates; also, certain private equity and investment funds that previously utilized limited partnerships are adopting the LLC structure.

### **How much does it cost to set-up?**

An LLC can be as expensive as a corporation to set-up due to the legal and tax/accounting fees relative to the drafting of an operating agreement. Filing fees generally range from approximately \$130 to \$600; possible legal fees range from approximately \$1,500 to \$4,500; and tax/accounting fees could range from approximately \$250 to \$2,500 depending upon the complexity of the operating agreement.

### **What's the most important take-away?**

The most important takeaway is that LLC's offer the attractive features of protection against personal liability, pass-through tax treatment and flexibility, and simplicity of record keeping but are not the best choice of entity for businesses that will be seeking venture capital funding.

### **Conclusion**

Picking the right corporate entity is a very important step in the entrepreneurial journey. A bad choice could mean that you'll be paying more taxes. Or even worse, a wrong mistake could mean that you are personally liable for the company's actions.

So the big question is, which corporate entity is right for you?