

Selecting the Legal Entity for Your Enterprise

Which form of organization will be best for your business? You should discuss the best business entity for your situation with an attorney or accountant. The type of business entity that you choose will be dependent on how much personal liability you choose to assume. Taxing structures for the different types of entities, management structure, and type will determine which entities you may or may not have, and what degree you need to raise capital from external source to fund expansion and growth. There are several ways to form a business including: sole proprietorship, partnerships, limited liability companies, and corporations.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual, or very often by a husband and wife. A sole proprietorship is not considered to be a separate legal entity under the law, but an extension of the individual(s) who own(s) it. The sole proprietorship is the most common form of business organization as it is the easiest to set up. Profits are taxed as income to the owner personally. This rate is usually lower than the corporate tax rates would be. However many the benefits, the owner is personally responsible for debts and liabilities assumed by the business. The income or loss of a sole proprietorship is combined with the other earnings of an individual for income tax purposes.

Partnership

A partnership is a legal entity recognized under the law and as such it has rights and responsibilities in and of itself. A partnership can sign contracts, obtain credit, and borrow money. When a partnership is small, most creditors require a personal guarantee of the general partners for credit.

Partnerships can take these legal forms: general, limited, or limited liability. In a general partnership, two or more individuals join together to run the business enterprise. A partnership must usually file a fictitious business name statement to operate a business under the partnership name. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as authority in running the business. The authority of the partners, and the way in which profit and losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but the partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debt.

A limited partnership is comprised of one or more general partners who are personally liable for partnership debts and one or more limited partners who contribute capital and share in the profits or losses of the business. The limited partners do not participate in managing the business and are liable for the debts of the partnership only to the extent of their capital contributions. The rights, responsibilities, and obligations of both the limited and general partners are typically detailed in a written partnership agreement. It is strongly recommended to have such agreement for any partnership, whether limited or general.

A relatively new type of partnership, legislatively authorized, is a Limited Liability Partnership (LLP). An LLP provides limited liability to all partners and is formed by filing a registration statement with the Wisconsin Department of Financial Institutions. It functions as a general partnership with its operation and rights of partners to participate being governed by its partnership agreement.

Limited Liability Company

A relatively new type of business entity legislatively authorized in most states is a Limited Liability Company (LLC). An LLC provides limited liability to all owners. Owners of an interest in an LLC are often referred to as members. An LLC is created by filing Articles of Organization and paying a processing fee to the Wisconsin Department of Financial Institutions. For more information about the process contact the DFI at (608) 261-7577. You may also download files and create an LLC using "QuickStart" at the DFI website: www.wdfi.org.

Offering limited liability protection to its owners makes an LLC resemble a corporation, but it typically lacks certain corporate characteristics. In most cases an LLC will be classified as a partnership for federal and state tax purposes. Members will report their share of the LLC's income, loss, deductions, or credits on their individual tax returns.

Corporation

A corporation is a separate legal entity that exists under the authority granted by state law. A corporation has substantially all of the legal rights of an individual and is responsible for its own debts. It must file income tax returns and pay taxes on the income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the liabilities of the business. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a corporation can far outweigh the additional expense of starting and administering a corporation. A corporation must adopt and file articles of incorporation and bylaws with the Wisconsin Department of Financial Institutions, which governs its rights and obligations to its shareholders, directors, and officers. You may call the DOA at (608) 261-9555.

Corporations must file annual income tax returns with the IRS and the Wisconsin Department of Revenue and possibly other states in which it does business. The elections made in a corporation's initial tax returns can have a significant impact on how the business is taxed in the future. Corporations may be taxed under subchapters "C" or "S" per IRS Codes as elected by the shareholders. In an "S" corporation income or loss is passed through to the individual shareholders tax returns. For additional information please contact your tax advisors.