Considerations and criteria for forming a business entity

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Important Considerations

One of the first and most important decisions a business owner makes is selecting the organizational form under which he or she will operate. The following are some common organizational types (also called “legal structures”):

- Sole proprietorship
- General partnership
- Franchise
- Limited partnerships and limited liability partnerships (LLP)
- Limited liability company (LLC)
- C corporation
- S corporation

Each form of ownership has advantages, disadvantages, risks, and rewards that can affect the business’s chances for long-term success. The following are some of the important factors business owners should consider when selecting a form of ownership.

Cost of Start-up

Setting up a business can involve little more than printing some business cards, or it may entail hiring a corporate attorney to draft corporate charters, agreements, and articles of incorporation. As the forms of business ownership become more complex, the cost associated with establishing the business also increases. Every business owner must decide how long he/she wants to wait before getting the business up and running and also how much of his/her own money to invest.

Control vs. Responsibility

One of the primary reasons people give for wanting to start their own business is the desire to be independent and “be your own boss.” Different legal structures provide the owner with more or less control and authority. There are trade-offs in each case, though, because with autonomy and control comes responsibility. For instance, if you’re the sole proprietor of a business with no employees, as a one-person show, you retain all the control, but you also have all the work and responsibility. Other forms of business (such as partnerships, for example,) may mean relinquishing some control, but, in return, the responsibility (and liability) may be spread among several principals. You’ll learn more about these trade-offs later in the module.

Profits—to Share or Not to Share

Many first-time business owners look to people like Bill Gates, Oprah Winfrey, or Ben & Jerry and aspire to their level of wealth and success. How a business’s profits are shared (or not shared) is determined by the legal structure. Some owners are willing to share the profits in exchange for assistance and support establishing and running the business. Other business owners make the conscious decision to limit the scope and nature of the business to avoid having to bring in others, thereby retaining all of the income themselves.

Taxation

When planning to start a new business, many people instinctively seek the advice of an attorney as the first step in the process. However, legal advice is not actually what’s needed initially. Instead, no matter how large or small your business is going to be, it’s much more important to first get the advice of a seasoned tax professional, such as a CPA. The reason for this is that each form of business ownership is treated differently by the IRS and by state and local taxing authorities. Depending on the legal structure of the business, the owner may be taxed at a lower rate than someone working for a large company, or the owner might see his or her business income taxed twice, sometimes with additional specialty taxes imposed by governmental agencies. The time for a business owner to decide how heavy a tax burden he/she is willing to bear is at the start of the business, not on April 15 when taxes are due.