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When you start any business, you must decide on a legal structure for it. Usually you'll choose either 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 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.