

Title:

Why You Need A Business Entity

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Summary:

When starting or expanding a business, many owners wonder if they should form a business entity and, if so, which one they should use. There is a wide variety of information and "pitches" being made on the Internet regarding the benefits of certain entities versus others. When you cut through the flak, however, the primary reason for forming a business entity is to create protection from personal liability arising from your business activities.

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Article Body:

When starting or expanding a business, many owners wonder if they should form a business entity and, if so, which one they should use. There is a wide variety of information and "pitches" being made on the Internet regarding the benefits of certain entities versus others. When you cut through the flak, however, the primary reason for forming a business entity is to create protection from personal liability arising from your business activities.

It is well established that up to eighty percent of businesses will fail in their first two years. Many of these businesses, and probably yours, carry a high level of personal risk for their owners. If you are not using the correct entity for your particular business, you are going to be personally liable if the business fails. Do you want to expose your home, car and other assets? How about the assets owned by your spouse or their paycheck from a regular job? Selecting the correct entity for your business prevents such nightmares from occurring. More importantly, you can sleep at night knowing that the worst thing that can happen is losing your investment in the business, not your home.

## Business Structures

There are a number of business structure options that exist in the modern corporate world. Following is a short explanation of the most common business structures.

### Corporations

Corporations come in two basic forms, a "C" corporation and an "S" corporation. There are a variety of differences, but the central one is a tax issue. Briefly put, "C" corporations are taxed on their revenues and you are then taxed separately on any money you take out of the corporation. An "S" corporation "passes through" all taxes to the shareholders with the information being reported on your personal tax returns.

Regardless of the tax classification, a corporation is considered an independent entity from a legal standpoint. This independent status acts as a shield between the activities of the business and your personal assets. As a practical example, Kmart recently filed bankruptcy. The individual shareholders were not required to file bankruptcy and lost nothing more than their investment in the stock of the company. Forming and using a corporation for your business activities will have the same effect, to wit, your personal assets will not be wiped out if the business fails.

#### Limited Liability Company

A limited liability company, or "LLC" as it is better known, was a very popular entity choice in the early 1990s. LLCs are similar to corporations, but can be taxed as a partnership. In California, the LLC can have either one owner or two. Regardless of the number, these owners carry the legal title of "member." The LLC provides a shield for your personal assets just like a corporation.

#### Partnerships

In my opinion, it is better to have died a small child than be in a partnership. Unfortunately, many business owners form partnerships and don't even know it. This occurs when they go into business with another person. If no business entity is formed, the law considers the business to be a partnership and treats it accordingly.

Partnerships are dangerous for one primary reason: a partnership does not provide any protection from liability and, in many ways, invites personal liability. Under well-established law, most partnerships are classified as "general". This simply means that all the partners are contributing to the administration and running of the partnership business. This classification can have grisly results.

In a general partnership, each partner is jointly liable for the debts of any other partner arising from the business. For instance, you and your partner go to a business dinner with a client. Your partner has a drink and then a few

more. They then get into an accident on the way home. Each of the partners is liable for the damages claimed by the injured people. That means YOU! Even if you were not in the car, did not rent the car, never saw the car and don't drink!

Partnerships are a recipe for disaster. Stay away from them whenever possible.

### Limited Partnerships

Limited Partnerships ["LP"] are perhaps the most misunderstood business entity. A limited partnership is similar to a general partnership, but allows a number of the partners to limit their liability by being limited partners. It is critical to note that these limited partners are restricted to simply making a capital [cash, content, equipment] contribution to the partnership. They cannot be involved in actively running the business. If they are, they lose any protection from partnership debts. Many limited partnerships end disastrously. If you are married to the idea of pursuing a limited partnership, you must do so in combination with corporations. That particular strategy is well beyond the scope of this article, but feel free to contact me if you wish to pursue a limited partnership.

Business owners should protect themselves by forming entities for their business activities. The real issue is identifying the structure that is best for your particular situation.