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Which Entity Should I Form For My Business Enterprise?

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Whether starting a business or operating an existing enterprise, business people should consider the legal form of their business and the need to protect their personal assets from business liabilities, while also considering the applicable tax consequences of such decision. In New Jersey, you can choose from among corporations, limited liability companies, general and limited partnerships and sole proprietorships. The following is a quick summary of key legal issues with each type of entity for you to consider:

- Sole Proprietorship. When you conduct business on your own without another owner and without forming a separate legal entity, you are doing business as a sole proprietorship. Your personal taxable income includes the profits of the business. Significantly, however, you are personally liable for all debts (including taxes and lawsuits) of your business, and creditors can reach all of your personal assets (including your house and personal bank accounts). It is for this reason that, for the most part, a business owner should not utilize this alternative.
- Partnership. Where more than one person owns a business without forming a separate legal entity, they are partners and the business is a partnership. While it is simple, similar to the sole proprietorship structure, a partnership offers no protection against liability. In addition, the law provides many rights and obligations to each partner. Many people simplify the effect of partnership law by having their own partnership agreements to deal with control of the business operations, sale of the business, allocation of profits and similar matters. A partnership has no taxpayer identification number, and each partner reports his or her portion of the income on his or her personal tax returns. Like a sole proprietorship, each partner has unlimited personal liability for the debts and lawsuits of the partnership, and creditors can reach each partner’s personal assets.
- Limited Partnership. This type of entity provides limited liability for partners who are merely investors and are not involved with the operation of the business. Limited partnerships are commonly used for real estate investments and are not appropriate for businesses in which all owners are actively involved.
- Corporation. This type of structure provides owners/investors with strong protection against personal liability. Only in special circumstances can the creditors of the corporation “pierce the corporate veil” to reach beyond a corporation’s assets to the personal assets of a shareholder. A traditional corporation (or "C-corporation") pays corporate tax on its earnings and any profits paid to shareholders are then taxed again as dividends. While appropriate for certain structures and business, this “double taxation” makes the C-corporation unattractive for most small businesses. Thus, a way around this "double taxation" is to make an “S election” with the IRS such that that profits are taxed only at the shareholder level. S-Corporations have additional limitations that must be met, such as the number and type of shareholders.
- Limited Liability Company. A business owner can form a limited liability company (“LLC”), which can be thought of as a hybrid between a partnership and a corporation. The LLC operates much like a partnership in that its income can be taxed only at the owners' level, but also has protections against liability similar to those of a corporation. The flexibility of ownership, pass through tax treatment and protection from liability make the LLC a favored choice for most small businesses.

In sum, a business owner must weigh the pros and cons of each structure. Often the decision turns on the tax considerations associated with the business and the entity.

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