A Brief Introduction to Business Entities[1]

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Starting a small business involves many issues. One of the most important is to determine which form of entity is right for *your* business. Most people think they need to form a corporation, but, in fact, there are several alternatives that may be more attractive, depending upon the type of business you are in.

When deciding the form of business ownership to use, there are two main factors to consider: **liability exposure** and **tax ramifications**.

Liability is the risk that the business will have to pay someone for a business owner's mistake or for debts that the business itself cannot pay. To whom would you be liable and what is the possible scope of that liability (how much might it cost you to cure the mistake or pay the bill) depends on multiple circumstances. Some business forms, if properly used, provide the owners with a shield from liability, so that only the business assets (and not the owner's personal assets) can be reached if there is a judgment against the business due to a mistake. Corporations, limited partnerships, and limited liability companies can each provide a shield for personal assets against business debts. There are requirements that must regularly be met to keep that shield in place, however, and the costs of forming and maintaining one of those business entities may be more than the business can afford.

As a result, some businesses prefer to operate as a sole proprietorship or general partnership. A sole proprietorship, as the name implies, is a business that has only one owner – only one person makes decisions and shares in the profits. A general partnership is a business in which several owners share management decisions, and share in the profits (according to their ownership interests).

The start-up costs for these business forms can sometimes be less than for a corporation, limited partnership, or limited liability company. You should file a fictitious name registration for your business if you will be using a name other than your given name. This is filed with the Department of State, and then the filing is advertised in the *Pittsburgh Legal Journa*l and a newspaper of general circulation, such as the *Post-Gazette*. In a sole

[1] If you have questions about what form of business entity is right for you, please contact the author at 412.338.1129

proprietorship, no management document is required, but in a general partnership, you may want to consider having an agreement among the general partners that provides: 1) how decisions will be made; 2) how profits will be shared; 3) whether interests can be transferred to outsiders; and 4) what happens if a partner dies or becomes disabled and cannot participate in the business. If you fail to have such an agreement, the state law will apply, and may impose restrictions to which you may not agree.

Taxes are payable by the owner or general partners on their individual tax returns. In corporations (unless special "S" status is sought), the corporation itself pays income tax, and then the profits distributed to shareholders in the form of dividends are taxed again.

With a sole proprietorship or general partnership, however, you can be fully liable, and your personal assets seized, to satisfy the liability or debts of the business if the assets of the business are not enough to pay those debts or satisfy the liability.

That does not necessarily mean that you should never operate a business as a sole proprietorship or general partnership. You need to evaluate how much potential liability there is, and whether you can protect against that liability, either because the business will not enter into contracts beyond its ability to pay, or because you can insure against the liability.

For example, consider where your business will operate. If you are leasing office space, and the business defaults under the lease, the sole proprietor or general partners could be fully liable for all damages under the lease. The same is true if you buy an expensive piece of equipment over time, and then can't make the payments. But, if you are operating out of your home, and your business does not involve substantial inventory or equipment, the risk for contractual liability may not be significant.

As to other liability, you can obtain general liability insurance to protect you against liability for anyone getting hurt on the business property. As to the business you do, and the mistakes that can occur, consider the worst mistake you could make, and what it would cost you to fix it. If you are an antique restorer, or jewelry repairperson, the cost of repairing your mistakes will differ from those of the operator of a catering service, or the owner of a business specializing in cleaning houses. You need to evaluate your risks, and determine if you can obtain sufficient insurance to protect you against them. There are many insurance products available to protect against various risks – some you may never have considered. The issue then becomes whether the cost of the insurance is greater than the cost of forming a business entity that will provide a liability shield.

If you are comfortable that you can make all your expenses, and insure against all potential risks at an affordable cost, then you might want to consider operating as a sole proprietorship or general partnership. Otherwise, you may need to consider a corporation, limited partnership, or limited liability company, where your personal assets can be shielded against business liability.