

## **The Sole Proprietorship**

The sole proprietorship is the most basic and simplest form of business entity. Any business operated by a single individual who has chosen not to form a specialized entity such as an LLC or a corporation operates as a sole proprietorship. The primary tax advantage to doing business as a sole proprietorship is that the entity is disregarded for tax purposes and only the business owner is subject to taxation on business profits at individual income tax rates. Furthermore, losses flow through to the owner.

The primary disadvantage to doing business as a sole proprietorship, and the reason why operating as such should be avoided if possible, is that the owner of the business has unlimited liability for obligations or debts of the business. There are no specific requirements to form a sole proprietorship such as filing with the appropriate government office.

## **Doing Business As" (DBA)**

A DBA, also called an assumed name, trade name, or fictitious name, is a business filing that allows business owners to operate a company under a name other than its real name. The owner must file a "DBA form" to register the name with the appropriate state and/or local agency, such as a county clerk.

Many business owners prefer to use a DBA rather than a personal name or company name for a variety of reasons. Some of these reasons could include the development of a business identity, the creation of a marketing campaign or the requirements imposed by banking organizations. Once the state and/or county has approved the DBA filing, the business can begin using this name as its official business name by publishing stationery and/or business cards, developing advertisements and/or directories, making transactions on behalf of the company, etc.

## **The General Partnership (AKA Partnership)**

The general partnership is an association of two or more persons (or entities) to carry on, as co-owners, a business for a profit. The business is owned and managed by the partners as they determine. Generally, this is done through a written partnership agreement, but an oral agreement between two or more persons or entities suffices for them to be deemed a general partnership. No special filings with the Secretary of State are necessary to create a general partnership, although there is an affidavit to file with the Department of Revenue. Next to the sole proprietorship, the general partnership is the simplest entity to form.

Like the sole proprietorship, partners in the general partnership are personally liable for the debts and obligations of the business. Thus, partners historically have not been afforded the protection of limited liability.

For income tax purposes, the partnership is a flow-through entity. The partnership itself is not subject to taxation, rather, the partners are taxed at their individual tax rates for profits earned by the partnership. Losses flow through to the partners and may generally be used to offset any other income of the partners subject to the passive income/loss rules. Generally, distributions to partners do not give rise to adverse tax consequences. Thus, it is usually easy to terminate a partnership. This contrasts to a C-corp or S-corp which can have adverse tax consequences in the event of a dissolution or distribution to shareholders.

## **The Registered Limited Liability Partnership (LLP)**

A registered LLP is a general partnership which files a registration statement with the Secretary of State. As a result, the partners are not personally liable for the debts and obligations of the partnership (unless they have otherwise subjected themselves to liability, for example, by guaranteeing a debt). In most other respects the LLP is formed and operated the same as a general partnership. An LLP is not a permissible entity in many states or recognized in other jurisdictions.

## **Corporation (Inc.)**

The "Corporation" is the classical structure for providing personal liability protection to the owners of the business. Although a corporation is relatively easy to organize, it may not be the best choice of entity for conducting business.

Corporations are taxed on their income at the corporate level and then, if they pay dividends to shareholders, the dividends are taxed at the shareholders' individual tax rate.

A corporation must have a board of directors (which may consist of one person), must maintain books and hold meetings of shareholders. In small, closely held corporations, the documentation of these activities may be more cumbersome than is warranted.

The following is a brief overview of the various type business corporations that exist:

Business corporations are either domestic or foreign corporations. A domestic corporation has been incorporated under the laws of the specific State. A foreign corporation has been incorporated under the laws of another state or country and, by registering with the state, may be authorized to do business within a different State. A business corporation is formed for the purpose of transacting business in the broadest sense of the word, and these transactions are conducted to return a profit.

Closed corporations are designed to make it easier for a corporation with a small number of shareholders (number of shareholders depends on jurisdiction of Incorporation) to operate as a corporation. A close corporation can choose not to have a board of directors, annual meetings or bylaws if so stated in its articles of incorporation.

Professional corporations are organized by those persons licensed to practice certain professions who are eligible to be shareholders in this corporate entity. Those professions eligible to organize vary from state to state but normally include: accountants; architects or engineers; attorneys at law; chiropracist-podiatrists; chiropractors; dentists; optometrists; physicians, surgeons, doctors of medicine or doctors of osteopathy; psychologists; veterinarians; registered nurses; any natural person licensed as a real estate salesperson; and physical therapists.

A C-Corporation is not actually a business structure, but a "tax status" of the company. All corporations are C-Corporations unless they opt to take advantage of a provision in both federal and state tax laws to become S-Corporations. Taxes on profits of a C-Corporation are paid by both the corporation itself and the shareholders when the profits are received as dividends. However, shareholders cannot deduct any losses posted by the C-corporation.

An S-Corporation is not a business structure, but is a type of "tax status" that an existing corporation may choose to elect. Closely-held corporations may elect to be taxed as federal or state S-Corporations (IRC 1361-1379), which permit shareholders to pay taxes on corporate net income personally, as if it were a partnership. S-Corporation status is limited to corporations that have a certain limited number of shareholders. The percentage of income the corporation can derive from passive investments is also restricted.

## **The Limited Liability Company (LLC)**

The LLC brings together the tax benefits of the partnership with the limited liability of the corporation.

The owners of the LLC are known as "members." The LLC may be member-managed, meaning that any or all members have a right to participate in management, or it may be manager managed, meaning that the members have decided to appoint a manager who will oversee the operations of the company. A manager does not need to be a member in the LLC and can be a person or entity. There are some subtle differences between how a member-managed and manager managed LLC operates, but in many cases it may not be an important distinction. In any event, the LLC operating agreement typically spells out the management provisions.

An LLC is created by filing Articles of Organization with the Secretary of State. Typically, the members enter into an operating agreement which sets forth operation and management terms between the members. The operating agreement is analogous to a partnership agreement. An LLC may have an unlimited number of members or as few as one member. Members can be individuals, trusts, corporations, partnerships, other LLCs or other entities.

Members and managers are not personally liable for the debts and obligations of the LLC, except to the extent they have personally obligated themselves for debts or claims against the LLC. Like a corporation, the protection of an LLC can be pierced if the LLC is formed or operated as a sham.

The LLC is taxed as a partnership so all profits and losses flow through to the members. Similar to general or limited partnerships, complex rules apply relative to the allocation of company debt and the allocation of profits and losses to the members. There is a cautionary note concerning the tax consequences of an LLC operating in states other than Colorado. Some states, for example Florida, do not tax LLCs as partnerships for state income tax purposes.

poses. In these states, LLCs are taxed as corporations. Accordingly, it is important to check on state income tax consequences when forming an LLC.

### **Conclusion and General Recommendation**

When forming a new business entity (or restructuring an old) considerations have historically focused upon the liability of owners and taxation of the entity and its owners. Because of all the entity choices, this decision is more difficult than in past years. The following are some very general recommendations, but you should consult your personal advisors concerning your particular situation.

For large businesses with many owners, complex classes of ownership and/or where tax flow-through treatment is not an important feature, the C-corp may be an appropriate entity. For some businesses, an S-corp may be appropriate because of the tax pass through and the traditional acceptance of corporations as limited liability entities. However, an S-corp is often an inappropriate choice to hold real estate, oil and gas or other appreciating assets. Also, if the owners of an S-corp are not individuals or certain trusts, an S-corp is not a viable choice.

An LLP in many ways is similar to an LLC and may be a simpler entity because it essentially is a general partnership. Thus, in some cases where an LLC is appropriate an LLP could also be used. However, because the LLP is not recognized in all states, if the business is operated outside of Colorado, an LLP may not be a good choice.

The LLC incorporates the benefits of limited liability historically afforded only to shareholders of a corporation, and the single level of taxation historically afforded only to partners in a partnership. For this reason, as has been the case in recent years, the LLC is a good choice of entity (and perhaps the best choice) for a relatively small group of owners where a single level of taxation is important. This would typically include ownership of real estate, oil and gas, other types of appreciating assets, as well as on-going businesses.