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When you Start to Outgrow Your Sole Proprietorship

Much of the wealth in the United States is created by business owners. Although many owners start out as sole proprietorships, as the business grows, they may want and need to consider a more formal approach to owning their business.

The key question is how to choose among entity options.

First, seek advice. Because of the legal and tax ramifications, you want to get it right the first time.

There are quite a few factors to consider when selecting the appropriate entity for your business. Your *goals* will help determine which factors must be considered and which are most important.

Here are some of the considerations.

Ease and Cost of Formation: If a business is going to operate as a sole proprietorship, there may be little cost to the formation and establishment of the business. However, if the business is going to be an entity formed under state law, there are filing fees and possibly minimum annual taxes required. Usually, the type of business venture and its complexity will have a greater bearing on the choice of business entity than will the cost of formation.

Management and Control: If there are multiple owners, you will have to consider whether all of the owners will have equal say in the management and control of the business. For example, in a general partnership, all of the partners have an equal vote in the management and control of the partnership. However, in a limited partnership, only the general partner is charged with the responsibility of management and control. The limited partners have no right to control the limited partnership, but also have no personal liability for the partnership's obligations.

Liability of Owners: In a general partnership or sole proprietorship, the owners have personal liability for the debts and obligations of the business. However, shareholders of a corporation, members of an LLC, and limited partners of a limited partnership do not have personal liability for the debts and obligations of the business.

Transferability of Interests: With a limited partnership, LLC or closely held or professional corporation, there are generally restrictions on the transferability of the entity's interests. In a publicly-held corporation, transferability of interests is usually a non-issue, due to the free market trading of public securities.

Ability to Raise Capital: Outside investors would prefer to invest in a business where they are insulated from the liabilities of the business. This makes a corporation or LLC a more appropriate entity if raising capital is an important consideration.

Sale of the Business: If you want to sell your business, you may wish to consider a corporation or LLC for ease of transferability of the ownership interest. Income tax considerations are always an important aspect of selling a business and the appropriate entity structure can help you achieve certain tax advantages.

Income Tax Considerations: A C corporation is subject to entity-level taxation while partnerships, LLCs and S corporations can elect to be taxed as "pass-through" entities. That is, the tax is imposed on the owners as opposed to the entity. Income tax considerations can also apply to the contribution of property or services by the owners to the entity. States may also impose minimum annual franchise taxes on certain entities. Finally, depending on the type of entity, self-employment taxes may be imposed on the share of income of the owners.

There are many types of legal entities, and the best choice for one particular business may not be the best choice for another. In deciding which entity to use, it is important to understand the characteristics of the various entity choices, considering the pros and cons of each in the context of your own business. Keep in mind that you may want to change your entity type as the business grows and changes, but each change requires the input of your professional advisors to avoid adverse tax consequences.

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