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Summer 2004

BUSINESS & EMPLOYMENT LAW

NEWSLETTER

CHOICE OF BUSINESS ENTITY

Comparison of Entity Types

A. Sole Proprietorship – An individual starts operating a business.

1. Advantages:

a. One owner.
b. No formation documents. No state involvement in formation.

c. Very simple administratively – just starting doing business. May need to obtain regulatory licenses and file for trade name/fictitious name.

d. No securities issued.
e. No separate tax return.

2. Disadvantages:

a. Full personal liability for all obligations.

b. Usually capitalized by personal funds, credit cards, personal loans.

c. Can have employees but will have to get federal IN for payroll purposes.

d. Estate planning difficult because no stock to transfer, family members may not want business assets. Executor will have to operate business.

3. Tax Considerations:

a. Not a separate entity.

b. Owner reports income on Schedule C to personal tax return.

B. General Partnership – Two or more individuals carry on a business for profit.

1. Advantages:

a. Each partner is a general partner with ability to bind the partnership (could be a disadvantage too).

b. No formation documents required, but highly recommended.

c. No securities issued.

d. No separate tax return.

2. Disadvantages:

a. Each partner is fully and personally liable for the liabilities of the partnership.

b. Unlimited liability exposure.

c. Generally undesirable for most businesses to use this entity.

3. Tax Considerations:

a. Partnership is not taxed separately.

b. Partnership income is allocated to each individual partner, pro rata in accordance with such partner's profit/loss percentage as set forth in the partnership agreement, and each partner is taxed on such amounts accordingly.

c. Partnership creates a capital account for each partner, and that capital account is increased by the amount of pro rata income allocated to such partner and decreased by the amount of any distributions and losses.

d. Partnership income is taxed as ordinary income to the partner (unless the partnership itself has a capital gain) (e.g. through sale of a capital asset).

e. Partners subject to self-employment taxes (they are not employees).

f. Partnership has to file income tax return.

g. Need to provide for distributions to partners to pay tax liability.

C. Limited Partnership – A partnership with at least one general partner and at least one limited partner.

Ohio law permits a partnership to statutorily elect to be a limited liability partnership. LLPs limit the liability of partners for negligence to such partner's own acts or omissions and those of such persons that partner is supervising. Many venture capital funds are formed as limited partnerships.

1. Advantages:

a. Limited partner's liability is limited to its capital contributions to the partnership.

b. Easy to form – file certificate of limited partnership with state.

2. Disadvantages:

a. Unlimited personal liability for the general partner.

b. Limited partners not permitted to have a role in operations or they will be treated as general partners – must be “silent partners.”

c. Limited partner interests are securities.

3. Tax Considerations:

a. Pass-through tax treatment.

b. Tax treatment is generally the same as a general partnership.

D. C-Corporation – Statutory corporate entity.

1. Advantages:

a. Shareholders have limited liability. They are at risk of only losing their investment (provided the corporate veil is not pierced).

b. Separate legal entity with perpetual existence. Does not dissolve upon owner's death.

c. Familiar to almost everyone.

d. Easy to transfer ownership.

e. Entities and foreign individuals can be owners.

f. Can have different classes of stock.

2. Disadvantages:

a. State reporting requirements.

b. Compliance with corporate formalities.

c. Double taxation – C-Corporations are taxed at corporate level on profits, and then shareholders are taxed on dividends.

d. Expense of formation and upkeep.

e. Cannot separate ownership interest from economic interest.

3. Tax Considerations:

a. Double taxation is a burden.

b. Corporation must file tax return.

E. S-Corporation – Statutory corporate entity where the corporation elects to be taxed under subchapter S of the Internal Revenue Code.

1. Advantages:

a. Shareholders have limited liability.

b. Separate legal entity with perpetual existence. Does not dissolve upon owner's death.

c. Familiar to almost everyone.

d. Easy to transfer ownership.

e. Pass-through tax treatment – eliminates double taxation.

2. Disadvantages:

a. Ownership limited to individuals and some qualifying trusts (no entities and no nonresident aliens).

b. Limited to 75 shareholders.

c. One class of stock only. Only permitted distinction between shares is voting rights.

d. Cannot separate ownership interest from economic interest.

3. Tax Considerations:

a. Eliminates double taxation.

b. Must make timely election.

c. Need to provide for distributions to shareholders to pay tax liability.

F. Limited Liability Company – Statutory entity combining the limited liability of a corporation with the pass-through tax treatment of a partnership. Owners are called “members.”

1. Advantages:

a. Members have limited liability.

b. Pass-through tax treatment – eliminates double taxation.

c. Separate legal existence with perpetual existence. Need not dissolve upon owner’s death.

d. Minimal formalities.

e. Easy to transfer ownership.

f. More flexible – can separate ownership interest from economic interest.

g. Entities can be members.

h. Can have single member LLC.

2. Disadvantages:

a. Not as familiar as corporations – have only existed since mid-1990s.

b. Membership interest is a security.

3. Tax Considerations:

a. Eliminates double taxation.

b. Single-member LLC is disregarded entity for tax purposes.

c. Need to provide for distributions to members to pay tax liability.

NEXT ISSUE:

10 Steps to Avoid Being Sued.

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