Types of Businesses - Advantages & Disadvantages

Choosing the right business entity allows an entrepreneur to reduce liability exposure, minimize taxes, and ensure that the business can be financed and run efficiently. It also provides business owners with a mechanism for ensuring that the business operations will continue, rather than being automatically terminated, upon the death of an owner. Formalizing the business also clarifies the ownership of all participants in the venture.

When choosing a business entity, you should consider:

(1) the degree to which your personal assets are at risk from liabilities arising from your business;
(2) how to best pursue tax advantages and avoid multiple layers of taxation;
(3) the ability to attract potential investors;
(4) the ability to offer ownership interests to key employees;
(5) the costs of operating and maintaining the business entity.

Sole Proprietorship

Advantages

- Relatively little time and expense required for creation. Easy start-up.
- Relatively few required formalities and regulatory requirements.
- Some states do not impose a fee for the mere privilege of existing.
- No separate income tax filing for the company - income and losses are reported on the owner's tax return.

Disadvantages

- Unlimited Liability. No Personal Liability Protection
  - The owner is personally responsible for the debts of the company, meaning the owner's personal assets may be used to satisfy business debts.
- Limited capital. Capital is limited to the amount the owner can raise on his/her own.
- Limited Life

Partnership

Advantages

- Relatively little time and expense required for creation.
- Relatively few required formalities and regulatory requirements.
- Some states do not impose a fee for the mere privilege of existing.
- No separate income tax filing for the company - income and losses are reported on the owners' tax returns.
- Flexibility in establishing the responsibilities (capital, management, etc.) of the partners.
- More capital available than in a sole proprietorship

Disadvantages

- Partners are personally liable for the debts of the partnership.
- Partners are responsible for the business-related actions of all other partners.
- Unlimited Liability
- Limited Life

Corporation

Advantages

- Limited Liability. Shareholders are not typically personally liable for the debts of the corporation.
- The ownership of the corporation is easily transferable through the sale of stock.
- Corporations have unlimited life extending beyond the illness or death of owners.
- Tax benefits such as insurance, travel and qualified retirement plans are deductible.
- Additional capital can be easily raised through the sale of stock (shares) in the corporation.

Disadvantages

- Possibility of double taxation. Double taxation occurs at (1) the corporate level and (2) at the individual level.
- Corporations are more expensive to form and operate than sole proprietorships and partnerships.
- More corporate formalities (annual paperwork) and more state and federal rules and regulations than with sole proprietorships and partnerships.

S Corporations

An S Corporation is a standard corporation that has elected a special tax status with the Internal Revenue Service. S Corporations have the same limited liability protection of standard corporations. The S Corporation's special tax status eliminates the possibility of the double taxation that occurs with a standard corporation. The standard corporation pays a federal corporation income tax on its profits. Double taxation then occurs if the corporation distributes profits in the form of dividends to the shareholders, because the shareholder must then report the dividend as personal income and pay taxes on it.

Limited Liability Company

The Limited Liability Company (LLC) is a distinct business entity that offers an alternative to partnerships and corporations by combining the corporate advantage of limited liability protection with "pass-through" taxation. The LLC is taxed like a partnership or S Corporation. The LLC's income is not taxed at the entity level; however, the LLC does complete a tax return. The income or loss of the LLC as shown on this return is "passed through" the LLC and is reported on the owners' individual tax returns.

The LLC is owned by its members and does not have any restrictions on the number of members it can have. Members are analogous to partners in a partnership or shareholders in a corporation, depending on how the LLC is structured. A member will more closely resemble shareholders if the LLC utilizes a manager or managers, because the members will not participate in the management of the LLC. If the LLC does not utilize managers, then the members will more closely resemble partners, because they will have a direct say in the decision-making of the company. A member's ownership of the LLC is represented by "membership interest", just like a partner's interest in a partnership or a shareholder's interest in a corporation.

Some advantages of LLCs include:

- Pass-through taxation where earnings are treated like those in partnerships and S Corporations.
- Members are not held personally responsible for the debts and liabilities of the company.
- No restrictions on the number of owners (members) allowed.
- Flexibility in structuring the management of the company.
- The LLC does not require as much annual paperwork and have as many formalities as corporations and S Corporations.

Some disadvantages of LLCs include:

- More paperwork required than with a general partnership.
- Ownership is harder to transfer than with a corporation.