

# **Take Time When Choosing Legal Business Structure**

**by**

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Selecting an appropriate legal structure for your business is not a multiple-choice test.

Nor is it simply a matter of scoring a simple magazine quiz to see how many As, Bs and Cs you have. It is instead more of an essay question about how you want to handle and respond to the inevitable challenges ahead.

## **LLCs v. partnerships**

The main options available seem clear enough. Businesses with only one owner can be a corporation or a limited liability company. Individuals can also operate their businesses without forming either, becoming sole proprietorships by default.

A business with multiple owners can be a general or limited partnership, a corporation or a limited liability company.. If no conscious decision is made, a two-owner business will automatically be a general partnership.

Sole proprietorships have their disadvantages. For businesses owned by an individual, remaining a sole proprietorship has a number of drawbacks. Except for very small, new businesses with neither the desire nor ability to grow significantly - and which provide goods or services of a kind very unlikely to give rise to any lawsuits - failing to separate business and personal affairs by opting for a sole proprietorship is probably not a good decision.

The legal costs of incorporating a business or forming an LLC for a single owner are not large, generally less than \$1,000. A more formal business structure can enhance a company's credibility with vendors and customers. At the same time, it can also offer protection from personal liability for company debts to vendors and other creditors if the business ever becomes unable to pay.

Transferring ownership of the company, especially for owners hoping to eventually sell out to investors, is greatly simplified with a corporation or LLC. There may also be a number of tax advantages.

The impetus for the emergence of the LLC alternative was the desire of owners to participate directly in management of a business, as in a general partnership, while retaining the protection from personal liability found in corporations. Basically, an LLC is a cross between a partnership and a corporation, allowing the best of both.

LLCs are a fairly new choice, first appearing in 1977 in Wyoming. Ohio law has only authorized formation of LLCs since 1994 and, prior to 1997, did not permit one-member LLCs.

LLCs can be structured like either a limited or general partnership with respect to the management of the business. Under the IRS check-the-box regulations adopted in 1997, LLCs can choose to be taxed as either a partnership or sole proprietorship, as applicable, or a corporation.

Because of the flexibility of LLCs, partnerships have largely been replaced by LLCs as a business form. Consequently, both limited and general partnerships are now obsolete choices except in some very specific and unusual circumstances.

## **LLCs v. corporations**

Given the disadvantages of operating a sole proprietorship and the obsolescence of the partnership alternative, the real choice for all business owners comes down to incorporating or organizing as an LLC.

Whether the corporation or the LLC alternative is better for a particular business depends on a number of factors, including the number and type of owners and under what conditions, if any, there will be other owners. Also important are subjective complexities such as whether distinctions in the owners' respective equity and management rights are necessary or appropriate.

Businesses considering the corporation form must further choose between being an S-corporation or a C-corporation. Most of the best known public companies are C-corps. However, because profits of a C-corp are taxed twice (once as corporate income and once as dividends), C-corps are generally not appropriate for small - and medium-sized privately held businesses.

In certain situations, an S-corporation is not an option. Businesses with more than 75 owners, or ones that include non-individual owners, are automatically excluded from S-Corp eligibility. In addition, if owners will have differing rights to manage or receive distributions, S-corps are off-limits.

LLCs have none of these restrictions. In addition, management and voting rights do not have to correlate directly with ownership interest. Essentially, virtually any business arrangement among owners can be easily accommodated.

Another advantage is that, unlike corporations, LLCs do not have to comply with statutory formality requirements, such as maintaining a minute book and the like.

If a business is not otherwise excluded from being an S-corporation, structuring it as an S-corporation or an LLC in many cases is just a personal preference.

If structured as an S-corp, a close corporation agreement will be needed to eliminate having to comply with several corporate formalities statutes. The overall flexibility of the LLC probably gives it an edge.

## Other questions to deal with

What really matters, regardless of the legal form chosen, is deciding more personal questions. What will be the responsibilities of each owner with respect to the business? If a decision has to come to a vote, will each owner have one vote or will votes be by the level of ownership interest or some other formula? Will different kinds of decisions be decided by different kinds of votes and, if so, what will that be?

How will profits (and losses) be allocated among owners? What happens if owners want to leave the business? How (and under what circumstances) will transfers of ownership be allowed?

The answers should be incorporated into a close corporation agreement or an operating agreement. Thinking these questions through now can help prevent nasty disputes later and help you formulate procedures now to enhance the likelihood of success in your new business venture.



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*As published in Columbus Business First, June 13, 2003.*