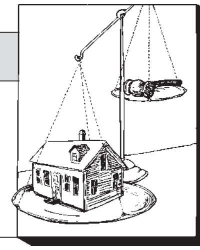

To Inc or Not: Choosing the Right Form for Your Business

by Lisa N. Davis

As a contractor, one of the most basic decisions you must make is what organizational form to use for your business. There is no one right form for a small construction company — it depends on your situation. Every form has its drawbacks and advantages. Choosing the right one requires weighing your concerns and goals against the advantages and limitations of each form.

A business may take one of several basic forms, from the simple sole proprietorship to the full-fledged C corporation. These forms provide the owners with various degrees of protection from legal and financial liabilities. In general, as protection from liability increases, the owner's direct control of running the business decreases.

Noncorporate Forms

An unincorporated business can be owned by a single person, or by a number of general or limited partners.

Sole proprietorship. In a sole proprietorship, you are the business. You pay taxes on the profits of the business in the same way an employee pays taxes on his wages. You are solely responsible for the company's actions. In return, you exercise sole control and claim all the profits (or suffer all the losses). As with your car, you purchase insurance to protect yourself against mishaps that might incur liability.

General partnership. A general partnership lets you pool the resources and talents of several people, while dividing the responsibilities and profits among yourselves in whatever way you, as partners, agree upon. Each partner pays taxes on his or her share of the profits. However, this form does not let you shift your personal legal liability: Each partner is personally and fully responsible for the company's legal and financial liabilities. If one partner does something relating to the business that creates legal or financial liability, any partner can be forced to bear the entire responsibility.

Limited partnerships. A limited partnership is one step closer to a corporation. The *limited partners* invest money in the business, but they don't run it, and they generally cannot lose any more than their original investment. Meanwhile, the *general partner* runs the business, assuming the legal responsibility for its conduct. All partners share in the profits according to the terms of the partnership agreement. Like partners of general partnerships, each partner of a limited partnership pays income tax on his or her share of the partnership profits, but the partnership itself does not pay income tax.

Drawbacks of partnerships. Partnerships can seem attractive because they let you pool talents and resources. This mingling of assets, however, makes for complications if someone gets cold feet or things go sour. Any partner who wants to leave the business is entitled to his or her share of the business and can go to court to have the business divided up.

In addition, operating a partnership, whether general or limited, can be expensive. Partnership tax returns are complicated. If you decide you want a limited partnership, you will probably have to file papers with the state and follow some formalities. Because these formalities may be almost as cumbersome as corporate formalities, most active small businesses concerned with liability — that is, businesses that do more than just invest in property — opt to incorporate instead of forming a limited partnership. Most importantly, in any partnership, whether general or limited, at least one partner is personally liable if the partnership is sued. That person can lose all his *personal* assets, not just his investment in the business.

Corporate Forms

Corporate forms do provide some protection for the owners, who own the company by means of stock. There are two main corporate forms.

C corporations. The traditional corporation, known as a C corporation, is the one most larger businesses use. The corporation is owned by its stockholders, who enjoy any profits by means of dividends the corporation may pay, and who can sell their shares or pass them on to their families when they die. The elected officers and directors, *not* the shareholders, run the corporation. You can adjust this setup to your needs: Just one person can own all or most of the stock and even be the sole director, and you can restrict who may buy a stockholder's shares.

In general, corporate stockholders enjoy some protection from financial and legal liabilities. They can lose what they have invested if the business goes under, but they cannot lose their personal assets. If the corporation loses a lawsuit, the shareholders are not personally liable — with some important exceptions — for the balance of a judgment that the corporation does not or cannot pay.

To receive this protection, however, you must run the corporation like a corporation. This can decrease your flexibility and, depending on how much stock other people own, it can mean relinquishing considerable control over the business. In addition, the corporation must file documents with the state on a regular basis, hold regular meetings, take minutes, and keep separate accounts. The company must be run as a separate entity by its elected officials; as primary owner, you cannot mix the company's finances with your own. Most of these formalities have been described in another article, "The Risky Side of Incorporation," 10/90.

All of these formalities cost money. To begin with, you must pay a lawyer to set up the corporation, fill out forms, explain your obligations, handle issuance of stock, and oversee other related matters. Most states charge fees for filing the many documents required.

Corporations also cost time, in that you must follow the formalities described earlier. If you neglect these and start running the corporation like a sole proprietorship, you risk losing the limitations on your personal liability. Courts won't take your corporation seriously if you don't.

Finally, the C corporation is subject to "double taxation": income tax must be paid on its profits, and the shareholders must, in turn, pay income tax on any dividends they receive, as well as capital gains tax if and when they sell their shares at a profit.

S corporations. The S corporation is a cross between a traditional C corporation and a partnership. Congress created the S corporation to allow small business owners to enjoy the limited personal liability provided by the corporate form, while paying federal taxes as if the business were a partnership, thus avoiding double taxation.

The main advantage of this form is that, for federal tax purposes, the business income or loss is generally "passed through" to the shareholders directly, and the corporation itself pays no income tax. Some states, like Connecticut, do not recognize S corporations, and require corporations to pay state income taxes just as if they were C corporations.

S corporations must meet certain requirements. For example, they must have fewer than 35 shareholders (husband and wife count as one), all of whom must be U.S. citizens (or the estates of deceased U.S. citizens); and they must have only one "class" of stock (although some may be non-voting). S corporations must also follow all of the corporate formalities described above.

Corporations and Liability

As someone doing business in construction, an industry not short on lawsuits, you may be very concerned about your personal liability. If you're a sole proprietor, your general liability insurance can protect you against certain types of lawsuits, such as personal injury. But it may not protect you if someone claims you did not live up to a contract, or if you have to pay a judgment that exceeds your policy limits. A partnership has the same vulnerabilities.

This liability exposure is what often sends business owners down the corporate path. The corporate form, however, is no cure-all for personal liability concerns.

First of all, if your business is small, new, or risky, banks and other lenders may ask that you guarantee loans personally. Second, if you act as a corporate officer, you may still be personally liable for certain claims brought by third parties, particularly state claims for unpaid taxes and government claims for environmental cleanup costs. No business form will protect you from these types of claims.

If you don't mind complex legal arrangements, remember that you can create a corporation in order to carry out a particular project and then dissolve it when the project has been completed. The same is true for both general and limited partnerships.

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How to Choose

When choosing one of these business forms, you need to consider the potential liability, tax, and organizational aspects of your business. Ask yourself the following questions:

- What kind of liability am I worried about — contractual liability or liability from personal injury lawsuits? How expensive is my insurance, and how broad is my coverage? How much would it cost to increase or broaden it? Am I willing to give up control and flexibility to gain increased protection from liability?
- If I incorporate, how careful will I be about all the technicalities — shareholder and board meetings, paperwork, stock certificates, corporate records?
- How do I want my business to be run? Do I want to share control with anyone else, and, if so, with whom?
- What kind of financing do I need to draw on? — Bank loans? Loans from relatives? Investments by family or friends that they don't expect back any time soon? How does my need for capital compare to my need for freedom in running the business?
- Does my state levy a corporate income tax, and, if so, does it include S corporations? Is there a state personal income tax? What is my tax bracket, and what are the tax brackets of my potential investors?

The answers to these questions should begin to point the way to the best form for your business. If you are still unsure, a good attorney can help you explore the fine points. In any event, your choice of business form should be based first and foremost on which form will best allow you to run your business the way you want to. If incorporating will require sacrificing this, be sure the benefits of personal liability protection and financing options are worth the sacrifice. You can always incorporate later.

In my next article, I will spell out some of the tax differences between S corporations, C corporations, and partnerships. ■

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