

Should I form a corporation or a limited liability company?

by Barry Dorans

Limitation of liability

One of the main benefits of a corporation or limited liability company ("LLC") is that unlike a partnership or sole proprietorship, the owners of the entity have no personal liability to any contractual creditors of the corporation, unless they have signed documents to the contrary, such as personal guarantees. While owners of a sole proprietorship or partnership may be personally liable for claims arising from the negligent acts of their employees, owners of corporations and LLCs are generally not personally liable for those claims. Since corporations and LLCs both offer limits on personal liability, the question is which of those entities is preferable for a small business.

Corporation

The main benefit of using the corporate form is that it is easy to accomplish and easy to understand. There are three basic components of stock ownership – voting at meetings, the right to share in the profits earned each year, and the right to a portion of the proceeds of the company upon the sale of the company. In general, these rights are fixed in relationship to each other. For example, absent special written agreements to the contrary, if a shareholder owns 25% of the stock, she

has 25% of the vote on any matter voted on by the stockholders, she is entitled to receive 25% of the profits of the company, and upon sale of the company she would receive 25% of the proceeds. Unless there are documents executed to the contrary, any stockholder can sell all or a portion of his stock in the company at any time he desires, or he can pass it to his heirs. Note that whether a corporation is taxed as a C corporation or it is treated as an S corporation depends on whether a timely S election is filed with the IRS. Otherwise, they are similar in formation.

Limited liability company

The main benefit of an LLC is that it is much more flexible in how it is organized and allows a variance between the components of ownership such as voting, profits and losses, and distribution upon sale. An LLC can be established such that one member is entitled to 50% of the profits, 25% of the distribution of the company upon sale, and yet has 0 percent of the vote. For example, when the parents who own the business want to give their children a share in the income but do not want their children to vote on how to run the company, they may prefer creating an LLC to a

corporation. While some of this variation in the components of ownership can be accomplished in a corporation, not all of the same structures can be achieved. The flexibility of an LLC, however, comes with the added disadvantage of all the work involved in drafting the operating agreement of an LLC because there are so many choices involved. In addition, it is more difficult for people to understand their rights.

In choosing which entity to use, business owners should consider the tax implications and the factors discussed in this article. Unless the tax issues primarily favor one choice of entity, all things being equal, a corporation is an easier entity to establish and easier for the participants to understand. An LLC gives greater flexibility in dividing up the various attributes of ownership; however, it comes at a cost of additional time and effort in structuring it at the outset and in ensuring that every owner understands his or her rights.

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Legal notes are not legal advice. Because legal problems are factually intensive, the reader must always consult their counsel before acting on any legal matter.