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STARTING A BUSINESS

Choosing the Right Business Entity

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SHOULD a new business incorporate? The key question is whether the business is likely to generate claims against the business owner. Tax issues are secondary.

But no business entity will protect the owner from liability for the owner's wrongful actions.

To decide whether to incorporate, first identify the liabilities that are reasonably likely in this business. It will help to discuss this with a liability insurance agent who is familiar with this line of business.

There are several ways that a business owner can be exposed to "strict liability," which can be imposed even if the owner does nothing wrong. Both the employer and the employee are liable for claims that are caused by the employee's actions in the course of employment. Partners in general partnerships (and general partners in limited partnerships) are liable for all claims against the partnership. Generally, everyone in the chain of distribution of a defective product shares liability for an injury caused by the defect. Also, all record owners of contaminated real property share the duty to remediate the property.

If a liability insurance policy covers a claim, the insurer will pay for attorneys to settle or litigate the claim, and will pay the covered claim, subject to deductible and coverage limits.

Is the liability exposure minimal? If so, the owners can avoid complexity. If not, can likely claims be covered by insurance? Are the premiums and deductibles manageable? Are the coverage limits high enough? If the answers are "Yes," then keep it simple. For one business owner, a "sole proprietorship" can be used and no business entity is necessary. For more than one owner, a "general partnership" is the least complex form.

A 'limited liability company' (LLC) is ideal for many businesses. It provides protection for the owners and avoids the tax problems of corporations.

If adequate liability insurance is not available or affordable, the owner should consider incorporating. A "limited liability company" ("LLC") is ideal for many businesses. It provides protection from liability for the owners (if it is organized and operated properly) and avoids the tax problems of corporations. But it is subject to a California tax (up to $11,700) on its total receipts that applies even in years in which it has a net loss.

Before there were LLCs, a "limited partnership" with a corporation as the general partner was a common structure. Now this structure is most useful in states that tax LLCs like corporations.

Businesses that are licensed under the California Business and Professions Code (which include most licensed businesses) cannot use a limited liability company. Partnerships of accountants, attorneys and architects can use registered limited liability partnerships ("LLPs") to limit the liabilities of partners.

What if the business needs to incorporate but can't use an LLC or an LLP? The last resort is a corporation. There are two kinds for tax purposes. If it will probably be sold for much more than the owners invested in it and all of the shareholders are eligible to hold shares of an "S corporation," that type of corporation will provide limited liability and avoid a double tax.

If the business will offer its shares to the public or the owners never expect to sell it for much more than they invest in it, a "C corporation" will serve the business owners' purposes.

S corporations that fail to meet eligibility rules become C corporations. This is one of several reasons why the LLC is preferred over the S corporation.

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