
The Legal Insider

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To Incorporate or Not to Incorporate

Choosing the form of legal entity for your business

Part 1 of a 2 part series

Most individuals start a business without truly determining which form of entity makes the most sense for their business. People who start businesses must consider how they envision the business at its inception and what they expect the business to offer in the future. The choice of entity can have a significant impact on the amount of money the individuals owning the business ultimately personally realize or whether the individuals lose their homes, cars and other personal assets due to their ownership of the business.

The main entities of choice in the United States, and particularly in Connecticut, are: (1) sole proprietorship; (2) general partnership; (3) limited partnership; (4) C corporation; (5) Subchapter S corporation; and (6) limited liability company. The amount of personal liability imputed to the individuals owning the business and the tax implications vary significantly depending on the entity. In addition, the choice of entity has a tremendous impact on the amount of money the owners will actually

derive from the business.

Sole proprietorship

A sole proprietorship is formed when a person owns all the assets of the business. There is neither an agreement governing operations of the entity nor is there a filing with the Secretary of State of the State of Connecticut.

In a sole proprietorship, the owner, or proprietor, has unlimited personal liability for the debts of business. Therefore, if the business has liabilities in excess of the assets of the business, the owner is personally responsible for these liabilities and may need to use his or her personal assets to extinguish those liabilities. Liabilities of the business include not only loans, but also liability for any lawsuits, including personal injury claims, accidents on the job, etc. To the extent business insurance does not provide adequate coverage against a lawsuit, the owner must compensate for the deficiency from his or her personal resources.

In terms of profits and the tax implications, a sole proprietorship is advantageous. All income remaining

after expenses are deducted goes to the owner. This profit is then declared as income on the personal income tax return of the owner and taxed. It is subject to only one level of taxation, the personal income tax rate of the owner. Therefore, all of the profits of the business pass-through to the owner.

General partnership

A general partnership is created when two or more persons agree to own commonly the assets of a business. It is what most people call a "partnership." The partnership agreement does not have to be in writing or take any particular form. An oral agreement to own the assets of the business jointly is sufficient to create a partnership. In addition, a filing with the Secretary of State is not required.

The partners in a general partnership have the same liability as an individual in a sole proprietorship - unlimited personal liability. The personal liability need not be evenly divided. To the extent one of the partners has greater personal assets than the other, he or she may have to bear personal liability at a percentage

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greater than his or her percentage interest in the partnership. This is because general partners in a partnership are jointly and severally liable to creditors for the debts of the business, which means all or either are responsible for bearing one hundred percent of the liability.

From a tax standpoint, like a sole proprietorship, net profits from the business pass-through to the partners in the business. Therefore, there is only one level of taxation.

Limited partnership

A limited partnership is a partnership comprised of one or more general partners and one or more limited partners. The general partners manage the business with the limited

partners playing no role in the operation of the business. The limited partners only contribute capital. A certificate of limited partnership must be filed with the Secretary of State.

The general partners in a limited partnership are personally liable for the debts of the partnership whereas the limited partners' liability for debts is limited solely to his or her investment in the partnership. However, limited partners can become personally liable for debts if they play any role in the management or operation of the business.

General partners and limited partners are treated similar to partners in a general partnership from a tax standpoint, i.e., there is only one

level of taxation.

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