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A PRIMER ON BUSINESS ENTITIES

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OUTLINE

• Introduction
• Concepts
• Common Types
• Conclusion and Links

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INTRODUCTION
What is a “business entity”? 

• A separate unit or “person” for most legal purposes, which can hold property and do business in its own name, enter into contracts, and sue or be sued

• Generally created and governed by state law

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INTRODUCTION
Preliminary Considerations

• Prospective planning is critical
• Potential problems may occur whether or not the business is successful
• Form should be driven by business plan, goals, and expectations

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CONCEPTS

General Advantages and Disadvantages

• Some advantages include: build name and reputation; facilitate investment, management, and transfer; limit personal liability; and possible tax consequences

• Some disadvantages include: greater formality; more paperwork; and possible tax consequences

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CONCEPTS
Limited Liability

- **Limited Liability**: Each owner is generally liable only for his or her own investment or personal negligence or guaranties

- **Unlimited Liability**: Each owner is jointly and severally liable for all debts or judgments

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CONCEPTS

Taxation

• “Pass-Through Taxation”: Annual net income or losses are “passed through” the entity and attributed to the owners

• “Double Taxation”: Annual net income or losses are taxed at the entity, and any dividends are taxed again to the owners

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CONCEPTS

Taxation (cont.)

• Example: the business earns net income of $100,000

• If the entity has pass-through taxation then the owners personally owe $40,000 in federal and state taxes, leaving $60,000 left over

• If the entity has double taxation then the entity owes and pays $40,000 in federal and state taxes, and if it distributes the rest then the owners personally owe and pay another $24,000 in federal taxes, leaving only $36,000 left over

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COMMON TYPES

• Sole Proprietorship / General Partnership (GP)
• Corporation
• Limited Liability Company (LLC)
COMMON TYPES
Sole Proprietorships

• Default rule for an individual
• An entity in name only
• Easiest and most flexible, at least initially
• Riskiest and not feasible, in the long run

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COMMON TYPES

General Partnerships (GPs)

• Default rule for more than one person

• Similar to sole proprietorships, but riskier and more complicated
COMMON TYPES
Corporations

• Owners are “shareholders” or “stockholders” (limited liability and rights)
• The shareholders elect a “board of directors” to manage the entity, which appoints and oversees “executive officers” to make day-to-day decisions, sign contracts, etc.
• The entity is created by filing Articles of Incorporation with the Secretary of State; it is also advisable to adopt bylaws and a shareholders agreement
• The most formal but also the most well-defined and recognized entity

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COMMON TYPES
Limited Liability Companies (LLCs)

- Owners are “members” (limited liability but limited or expansive rights)
- The members may appoint one or more “managers” to manage the entity
- The entity is created by filing Articles of Organization with the Secretary of State; it is also required to adopt an “Operating Agreement”
- This type of entity is relatively new and, generally speaking, the most flexible (other than transfers)

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COMMON TYPES
Taxation of Corporations vs. LLCs

• By default, corporations are “C Corporations” for tax purposes, meaning they are subject to double taxation

• By default, LLCs are “partnerships” for tax purposes, meaning they are subject to pass-through taxation

• Either entity may elect to be an “S Corporation” for tax purposes, in which case it would be subject to special rules similar to pass-through taxation
CONCLUSION

• There are many options and details with different consequences

• It is better to plan ahead and choose what is most appropriate for your business

• The first thing to do is retain a good attorney and accountant

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Some helpful links on choosing and forming a business entity:

MO SOS:  http://www.sos.mo.gov/business/sbac/


SBA: http://www.sba.gov/smallbusinessplanner/start/chooseastructure/index.html

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