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News

What a Difference 3 Little Letters Can Make

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by ANGELA B. MARTIN

Your name is your brand and your face to the world. Yet even more important is how you classify your business, as that is the determining factor in how your company is taxed and what legal protections are given to company owners. Choosing the right type of business entity is one of the first major decisions—and most important—you will make in starting your business enterprise and consequentially warrants close examination.

The choices may only differ by a few letters, such as LLC versus Inc., but the ramifications of those choices reach into all aspects of business operations, not the least of which are their financial protections. Those decisions should include consideration of your particular business operations, including limiting personal liability to the owners, protecting intellectual property, restrictions on transferability of ownership interests, hiring employees and providing them with incentives, and obtaining financing.

While NH law provides a business owner with several options to choose from, the three most popular forms are sole proprietorship, corporation and limited liability company (LLC).

Sole Proprietorship

When a business is just getting started, owners will often register a trade name under which the business operates. In doing so, there is no separate legal entity. Instead, the owner owns all of the business assets and is personally responsible for all of the business debts and liabilities.

This structure works well for certain types of businesses, such as individuals delivering professional services. Personal liability can be mitigated in these cases by purchasing general liability and professional liability insurance. As a practical matter, owners operating as sole proprietorships should always consult with an insurance professional before relying on their homeowner's policy for liability protection because the policy may not cover (and may specifically exclude) liabilities that arise in connection with the operation of a business.

Entrepreneurs running sole proprietorships may not only be personally liable for business debts, but any liability of the company, such as those created by employees. Under this business arrangement, the business enterprise terminates upon the owner's death or disability. Due to the lack of perpetuity of the business, lenders may be reluctant to provide financing if the entire business rests on the health and well-being of one individual.

Business Organizations

Unlike the sole proprietorship, the limited liability company and corporation are separate legal entities apart from their owners. They can sue and be sued, borrow money, own property, enter into contracts, hire employees, pay taxes, lease office space and generally conduct business. As a rule, business owners find that forming a separate legal entity to conduct business is the best way to shield themselves from personal liability, retain qualified employees, attract investors, and implement a successful business succession strategy.

Even with these advantages, an informed business owner also knows that he or she is always personally liable for his or her own negligence and that banks are happy to lend money to a company so long as the owners personally guarantee payment of the debt. With these caveats in mind, the

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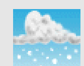

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following is a short overview of some of the characteristics of limited liability companies and corporations.

Limited Liability Company (LLC): Limited liability companies have the most flexibility in doing business. The LLC originated in Wyoming as a hybrid between a general partnership and a corporation providing much needed flexibility of management, taxation and structure. When formed correctly and properly maintained, a limited liability company can provide its owners with limited liability with respect to its debts, liabilities and obligations.

One appealing aspect of the LLC is that it can issue different classes of membership interests. As a result, it is possible for an LLC to raise capital through equity investors. In addition, there are virtually no restrictions on who can be an owner in an LLC. Owners can include other LLCs, corporations, individuals, partnerships and trusts, to name a few. Also, owners of an LLC can provide unique employee incentive programs such as profit interests, membership unit appreciation rights and other equity-based compensation. These programs require careful consideration and drafting so as not to run afoul of employee or benefits laws, but can serve as useful tools in incentivizing key personnel.

The operating agreement is the governing document of the LLC and a negotiated contract among the members. Like the LLC, it too is a hybrid combining provisions found analogously in corporate bylaws and shareholder or buy/sell agreements. New Hampshire law dictates many of the provisions that are required in the operating agreement and, in addition, many terms are customized to the particular business enterprise and owner requirements.

Corporations: Shareholders of corporations enjoy the same liability shield as members of an LLC. In NH, most small business corporations elect to be taxed as “S” corporations, which means the entity itself does not pay a tax, but the profits are passed through to the owners, who pay a tax at the shareholder level. Without this special election, the corporation is by default a “C” corporation and pays a tax on profits at the entity level and, in addition, at the shareholder level when the profits are distributed to the owners—resulting in double taxation.

A key difference between LLCs and S corporations is that S corporations are less flexible than LLCs in that they only allow a limited number of shareholders (100), one class of stock (except that the one class may have voting and non-voting stock), and have much stricter and more burdensome statutory compliance requirements. On the other hand, only corporations can offer their employees incentive stock options, which are a special type of stock option that receive beneficial tax treatment. And venture capitalists prefer the familiar and more predictable corporate form and are more likely to insist upon that traditional structure rather than deal with an LLC.

There are many details to consider when choosing your business entity form, which can be a challenge when starting out. New business owners also need to know that there are numerous other factors to be considered, such as NH’s unique tax structure and the importance of having an exit strategy for business owners. Ultimately, the choice on business structure must be carefully made and a business owner is well advised to choose knowledgeable tax and legal professionals who can assist with this important decision.

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