Overview of In Business? Incorporate!

If you go into business, you can operate as a sole proprietorship, corporation, or limited liability company (LLC). If your business has multiple owners, your choice is between a general partnership, limited partnership, corporation or LLC. (You can always operate through a limited liability company, but let's consider the LLC the same as a corporation as a liability insulator.)

Before we make the case for the corporation, let's make the case against a sole proprietorship or general partnership. Begin with definitions. A sole proprietorship is when you operate your business without creating a formal legal entity – such as a corporation or LLC. Operate your business as a sole proprietorship and there is no legal separation between yourself and your business. You become personally liable for every business debt.

In these litigious times, why do so many small businesses still function as sole proprietorships? Four out of five small businesses fail within their first several years. The owners of these unincorporated businesses needlessly gamble their family's financial security on the success of their venture. When their business fails – as most do – their owners end in financial ruin, because their business creditors can claim their personal assets. That could have been easily avoided.

General partnerships are a more dangerous form of business organization. General partners are jointly and individually liable for every partnership liability. Partners in a general partnership can even more easily lose their personal wealth to business creditors if their business or their other partners have too few personal assets to satisfy the partnership obligations. You can lose your wealth – even if your partner created the liability! Our advice – never operate as a general partnership.

The major disadvantage with both the sole proprietorship and general partnership then is that they create 'inside-out' liability. Proprietorship or partnership creditors can go outside the business to satisfy their claims from the owners' personal assets.

There is also 'outside-in' exposure. An owner's personal creditors can seize business assets to satisfy the owner's personal debts. With the general partnership, a partner's personal creditors can force the liquidation of the partnership to claim that partner's equity in the business.

A corporation is a separate legal entity distinct from its shareholders. That's why a corporation (or LLC) can protect your personal assets from the inevitable debts and lawsuits that may arise against your business. Your corporation is its own legal entity. As its shareholder, director or officer you are not liable for its debts or lawsuits. If your corporation is sued or becomes insolvent, you'll lose only your investment in the business. Your other assets remain safe.

Business owners frequently start as sole proprietorships or general partnerships and become concerned about losing their personal assets only when their business is sued or suffers financial reversal. If you are sued while operating as a sole proprietor or general partnership, it's too late to convert your company to an LLC or corporation to protect your personal assets. However, you do have the opportunity to avoid personal liability from future company lawsuits or debts. Incorporate your business. Transfer the assets of your proprietorship or partnership to the corporation. Your new corporation might eventually pay the debts for which you have personal liability.

No business is too small to protect, because no business is lawsuit-proof. The larger enterprise has more need for corporate protection because it is a bigger target. But no business – no matter how small or seemingly safe – is immune from legal and financial disaster.