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Why You Should Form a Business Entity

Forming a business entity can have several benefits for you and your business, and in certain circumstances, you may be required to form an entity (e.g. businesses that want to have multiple owners or co-owners). Even if you do not intentionally form a business entity, a sole proprietorship is automatically formed if you engage in business activity without forming another type of entity. However, sole proprietorships may be high-risk and do not have the benefits that other entity types do. Personal liability protections, tax benefits, and greater ability to raise capital or receive outside funding are the primary reasons to form a business entity.

Personal liability protections

Forming an entity can create a shield for the owners of a business. Depending on the type of entity, the owners may get the benefit of limited personal liability. This means that the owners will not be liable for some or all of the entity's liabilities, debts, and obligations because the assets of the entity are separate from the personal assets of the owners. It could be potentially devastating to an owner to have unlimited personal liability if their business faces financial hardship or incurs debts it cannot repay. Creditors may come for the owners' personal property if the owner does not have personal liability protections. However, personal liability protections may not protect owners who engage in fraud or certain types of negligence.

Tax benefits

Entities have different tax advantages that are not available to non-entities. Depending on the type of entity, some of the tax benefits available are pass-through taxation, allowing the owners to avoid double taxation, and lower or no self-employment taxes. Corporations may additionally benefit from tax deductions on certain business expenses, which lowers its taxable income, and other forms of tax savings. However, a corporation's shareholders may be subject to double taxation on the corporation's profits if they receive dividends. Limited liability companies have an additional benefit of flexible tax benefits, which means a limited liability company may choose if it wants to be taxed as a sole proprietorship, partnership, or corporation, depending on which tax structure would best suit the needs of the business.

Availability of capital & funding

Banks and investors may be hesitant to lend money to or invest in businesses that have unlimited personal liability, as they are generally higher risk. Additionally, corporations have even greater access to capital though the issuing of shares of stock or issuing bonds. With greater access to capital, corporations are able to increase liquidity, invest back into the corporation, and grow their business.