CHOOSING THE BUSINESS LEGAL STRUCTURE
Mostly from "The Small Business Start-Up Guide" by Robert Sullivan

Okay, you've chosen your business. What next? No doubt, one of the most asked questions by the prospective business owner is "Should I incorporate?" To answer this question, we need to examine what the options are and their respective advantages and disadvantages. So as not to keep you in suspense, it should be noted that most new small businesses will not incorporate - but will operate as a sole proprietorship.

Actually, you have three basic business structures from which to choose:
1.Sole proprietorship
2.Partnership (limited or general)
3.Corporation (S, C or LLC)

The legal structure you choose depends on a number of things, including your type of business, individual situation, goals for the business, and a number of other personal and financial factors. Before deciding what's best for you, discuss your plans with your accountant and attorney. Make sure you are prepared to describe your business plans in some detail. It will be money and time well spent. Making the right choice can help you avoid a mistake that can cost you big in terms of possible future liability.

Before you have any discussions with your professional advisors, it is useful to understand the basics of the various legal structures available to you ... sole proprietorship, partnership, and various forms of corporations.

SOLE PROPRIETORSHIP

This is the most popular form of small business and, as the name implies, ownership is totally vested with one person. It is the easiest to establish since no legal formalities are necessary. The only business requirement may be a license from your local jurisdiction to allow you to conduct the type of business you are planning. For example, you may need a license to sell food to the public.

Sole Proprietorship Advantages:
•Easy and quick and usually the least expensive to establish.
•You have total ownership and control of the business.
•All the profits of the business belong to you, the owner.
•No additional Federal taxation on business profits (No double taxation).
•No periodic business reporting to the IRS or other government agency is required.
•Income tax filing is simply part of your annual personal tax return (Schedule C).

Sole Proprietorship Disadvantages:
•The owner is personally liable for all business debts and the liability is not limited to the value of the business. You are personally liable for any and all business debt you incur.
•It is generally more difficult to borrow money or obtain outside investment than with other types of legal structures.
•If the owner is incapacitated for any reason, the business is likely to fail.
•All management responsibility is with the owner which can be a heavy burden.

IMPORTANT NOTE

A "home business" is frequently a sole proprietorship and offers a number of unique advantages. However, just because you are conducting business from your home does not exempt you from possible legal or other liabilities.

PARTNERSHIP

This type of business is just what the name implies: Business ownership is divided between two (or more) partners. The general partnership is the most common and is formed to conduct a business with two or more partners being fully involved in the operation of the business. All the partners share both profits and liabilities. A limited partnership, as the name implies, provides for limited liability of the partners. (This liability can be no greater than the partner's investment in the partnership). In a limited partnership there must be a least one general partner who remains liable for all the debts of the partnership. Forming a partnership is complex and legal advice is very important. The kind of partnership and the type of partner you will be determines your potential personal liability.

Partnership Advantages:
•Synergy as a result of pooling partners' different areas of expertise.
•The partnership does not pay Federal in-come taxes. An informational tax return (IRS Form 1065) must be filed which shows the pass-through of income/loss to each partner.
•Liability may be spread among the partners.
•Investment can come from the partners in the form of a loan which creates interest income for the partners and a business deduction for the partnership.

Partnership Disadvantages:
•Formation and subsequent changes in structure are complex.
•Problems with partner(s) as the result of misunderstandings, different goals, etc., can weaken or destroy the partnership.
•Limited partners are liable for debt if they are active managers in the business. General partners have unlimited liability. You may also be liable for the commitments of your partners.

CORPORATION

There are three major types of corporations, the C-corporation ("regular corporation"), the S-corporation (or "S-Corp"), and the Limited Liability Corporation (or "LLC"). All of these forms of the corporation are complex legal entities. Their detailed structure may vary from state to state (incorporating a business in a given state allows you to conduct business only in that state). It is essential for you to obtain legal advice if you are thinking about forming a corporation. Since each state has its own set of corporation laws, you should contact the appropriate state office in your state (usually the office of the Secretary of State) for additional material and procedures. Most offices can provide a guide for new businesses to follow for incorporation and doing business in their state. Call or write for a copy.

Most people immediately think of incorporating in order to minimize their personal liability. Indeed, the liability of stockholders (owners) in a corporation is limited under certain and complex conditions. Today, with the Tax Reform Act of 1986 and other legislation, there are really few good tax reasons to incorporate (with the exception of dividing corporate profits as noted below). The best reason for incorporating is, in fact, the limited liability. However, there is no such thing as total insulation from liability resulting from doing business as a corporation.

Record keeping and tax matters with a corporation are difficult and time-consuming tasks usually requiring the services of an accountant. You need to keep this in mind when considering operating costs for your business.

Avoid the "do it yourself" incorporation guides. Incorporating is a complex process and you should not take on the task yourself. You cannot afford any mistakes at this point in your new business, so if you decide incorporation is for you, do it right and spend the money required to have it done professionally. Legal fees for setting up a corporation can run between $350 and $1,500 (assuming it is relatively straightforward).

REGULAR CORPORATION

The corporation is a taxable entity and, as such, pays taxes. This results in the "double taxation" you may have heard about. The corporation pays corporate taxes on its profits, and then, you the owner (shareholder), pay personal taxes on the dividends your corporation pays you. (The dividends are not deductible by the corporation). This is one of the biggest disadvantages of a corporation.

On the other hand, incorporating your business usually makes it easier to establish credit with suppliers and borrow from banks. If you expect to use outside investors for business capital, a corporation is a must.

Regular Corporation Advantages:
•Shareholders (the owners) enjoy personal limited liability.
•It is generally easier to obtain business capital than with other legal structures.
•Profits may be divided among owners and the corporation in order to reduce taxes by taking advantage of lower tax rates.
•The corporation does not dissolve upon the death of a stockholder (owner) or if ownership changes.
•Favorable tax treatment for employee fringe benefits including medical, disability, and life insurance plans.
•70% of any dividends received by the corporation from stock investments are deductible (unless you purchased the stock with borrowed money).

Regular Corporation Disadvantages:
•More expensive and complex to set up than other legal structures.
•Completing tax returns usually requires the help of an accountant.
•Double taxation on profits paid to owners (corporation pays corporate taxes on profits and owner pays personal taxes on dividends from the corporation).
•Recurring annual corporate fees.
•Tax rates are higher than individual rates for profits greater than approximately $75,000.
•28% accumulated earnings tax on profits in excess of $250,000.
•Business losses are not deductible by the corporation.

S-CORPORATION

The S-corporation offers the limited liability advantages of a corporation but does NOT pay Federal taxes. All the earnings and losses of an S-corporation are passed through to the share-holders. It is a popular form of incorporation in the startup years of a business but there are some subtle disadvantages that need to be taken into account as you grow. Again, because of the complexities involved, talk with your attorney and accountant.

S-corporation Advantages:
•Owners enjoy personal limited liability as in a regular corporation.
•No Federal income tax liability, and in most cases, no state income tax.
•3. Profit/losses are passed to owners ... no double taxation.
•The S-corporation does not dissolve if one of the owners dies or otherwise leaves (like a regular corporation).
•Wholly owned subsidiaries are permitted.

S-corporation Disadvantages:
•Legal assistance is required to set up.
•Maximum of 75 shareholders.
•Only one class of common stock is permitted (no preferred stock).

LIMITED LIABILITY CORPORATION (LLC)

This type of corporation blends the tax advantages of a partnership and the limited liability advantages of a corporation. Owners of an LLC are referred to as "members." As you might expect, it also has some limitations but is definitely worth considering. Ask about the LLC when you contact your appropriate state office for incorporation information as suggested earlier in the chapter.

LLC Advantages:
•Limited personal liability for the owners (like a corporation and unlike a partnership).
•No Federal taxes (like a partnership).
•No limit on the number of stockholders (unlike an S-corporation).
•More than one class of stock is permitted (unlike an S-corporation).
•Business losses may be deducted on your personal tax return (like a S-corporation).

LLC Disadvantages:
•Legal assistance is required to set up. The paperwork is complex.
•No "continuity of life" as in a regular corporation. The LLC dissolves if one of the owners dies or otherwise leaves. However, other formal agreements between the owners can overcome this.
•Some states require that an LLC have more than one member.

NOTE:
Depending on the charter and underlying documents etc. the IRS can determine that the organization should be taxed as a regular corporation. Be certain to get really good legal advice on this form of organization.

PROFESSIONAL CORPORATION

Groups of certain professionals can form corporations knows as professional corporations or professional service corporations. The list of professionals covered by professional corporation status differs from state to state, it typically covers accountants, engineers, physicians and other health care professionals, lawyers, psychologists, social workers, and veterinarians. Typically, these professionals must be organized for the sole purpose of providing a professional service - for example, a law corporation must be made up of licensed attorneys.

In certain states, this is the only incorporation option available for certain professionals, whereas in others, they are given the choice of being either a professional corporation or S or C corporation. Contact your states filing office to see what options are available in your state.

According to tax and legal experts, there is no longer a significant tax benefit to professional corporation status over sole proprietorship or partnership. The IRS treats most professional corporations as "personal service corporations," taxing corporate income at a flat rate of 35%. Professional corporations can shield owners from liability. While it can't protect a professional from his/her own malpractice liability, it can protect against liability from negligence of an associate. Malpractice insurance is still the way to go for most professionals, however. Still, you might want to consider this corporate status as a back-up against rising rates or inadequate coverage.

BENEFITS
Owners not liable for negligence of other owners

Disadvantages
Higher cost and more paperwork than a sole proprietorship or partnership Ownership restricted to members of a certain profession.

ESTABLISHING PARTNER RESPONSIBILITIES IN A NEW BUSINESS

To Be Done Once It Has Been Decided More Than One Person Will Be Active In Managing The Business

Often a new business is made up of friends or family who will be active in the business and/or asked to invest in it. At other times people come together to form a new business. Whenever some type or partnership or co-ownership occurs, it is vital for the survival of the business that an agreement is reached between all parties concerning who will be responsible for what. A lack of such an agreement can result in a breakup of friendships or family, wasted time and energy, larger than necessary legal and accounting fees, and possibly the business's failure. To help establish responsibilities, each person involved should independently make the following lists.

1. What do I believe my responsibilities are/will be?

2. What do I believe the other person(s) responsibilities are/will be?

3. What do I believe the other person(s) believe my responsibilities are/will be?

If the members of the firm are also investing money, add the following lists to the exercise:

A. Who puts in how much?

B. If one person is putting in the concept and/or equipment, does that constitute a share in the business?

C. How does the amount of investment relate to the percentage of ownership of the business?

D. Who gets what salary and is this in relationship to the ownership and/or title/job function(s)?

E. When the business shows a profit, how and when will the profit be divided or dividend paid?

F. If additional money is needed, who puts in how much and does this change the percentage of ownership of the business?

G. If the business fails, who will be responsible for what part(s) of any debt?

H. If the business fails how will the dispersement of any assets be handled?

I. If one of the partners wishes to withdraw or one partner wants the other to withdraw, who will establish the value of the business and how will the settlement be made?

When everyone has completed their lists, the lists should be compared and differences worked out before proceeding with the business's plans. This exercise applies whether the business format will be a partnership, LLC or C or S Corporation.

MAKING YOUR CHOICE

It is difficult to give specific advice as to the choice of legal business structure since every situation will be unique. The advantages and disadvantages noted above should be assessed based on your particular situation. In any case, it is important to discuss your plans with advisors including both an attorney and an accountant prior to making your final decision. The various tax consequences for corporations and partnerships are complex and must be carefully considered for each specific situation.

LIMITED LIABILITY COMPANIES: THE 11 MOST FREQUENTLY ASKED QUESTIONS

1. What is the advantage of an LLC over a general corporation?

One of the primary reasons individuals form corporations is to protect their personal assets in case of a legal judgment against the company. Unfortunately, owners are taxed twice on their income: once at the corporate level and again at the personal level when dividends are paid. The LLC, on the other hand, offers both personal asset protection and the elimination of corporate-level taxes. In addition, the record-keeping requirements of a corporation are far greater than those of the limited liability company.

2. What is the advantage of the LLC over an S Corporation?

While the S corporation's special tax status eliminates double taxation, it lacks the flexibility of an LLC in allocating income to the owners. For example, the owner of 25% of an S corporation normally pays 25% of the taxes on reported income. On the other hand, LLC owners are free to divide income and tax liability among themselves within the constraints of IRS regulations for distribution of partnership income. Equal partners may change the allocations of profit or loss from year to year to benefit their individual tax needs. In addition, LLCs have no ownership restrictions. An S corporation limits the number of owners to just 35 and prohibits corporate and foreign ownership.

3. Why is the LLC Superior to a Joint Venture or General Partnership?

The personal assets of owners of joint ventures and other forms of general partnerships are totally exposed to lawsuits stemming from the actions of any one partner. All personal assets of the LLC partners are legally protected. Partnerships of every form and LLCs enjoy a great deal of flexibility compared to corporations when allocating their tax attributes.

4. Why is the LLC Superior to a Limited Partnership?

Limited partners are protected from business-related lawsuits that may place their personal assets at risk. However, this structure prevents them from actively participating in the management of the business. The non-limited partners' personal assets are exposed. LLCs are designed to protect all partners' personal assets while imposing no limit on their management activity.

5. Why are Foreign Entrepreneurs Attracted to LLCs Versus Other Business Structures?

Business entities similar to the limited liability company have been popular in European and Latin American countries for more than 100 years. LLCs often prove to be the most familiar and least imposing business structure for foreign entrepreneurs who wish to enter the American market. There is another clear attraction for foreign owners. If their LLC does not earn income within the U.S., and receives no income from U.S. business enterprises, these foreign owners are normally not subject to U.S. federal income tax.

6. How do I Form a Limited Liability Company?

You can form a limited liability company yourself by reading a book or articles available from www.nolo.com and obtaining the necessary forms from the Secretary of State of the state in which you want to form the LLC. You may also choose to employ the services of an attorney or a professional service company to aid you. Professional service companies are low-cost alternatives that completely eliminate all the uncertainty and paperwork involved. One of the nation's largest service companies is:

Corporate Agents, Inc.
2711 Centerville Road, Suite 420
Wilmington, DE 19808
(800) 499-9519
www.instacorp.com/about.cfm

In addition to helping LLC startups at very low cost, CAI can assist in the formation of LLC’s or corporations in most foreign jurisdictions. However, LLC’s are a new form of legal organization and vary from state to state. So you may want to use a local lawyer who promises that he KNOWS LLC’s for the state and EXACTLY what is required.