



## Retire On Time & Parker Fin. Svcs., LLC

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"Helping Business Owners and Professionals Retire on Time"

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### LEGAL ENTITIES FOR BUSINESS

When setting up your business, one of the most important decisions you will have to make is under which type of legal entity you will operate. This decision affects everything in your business, from the ease of formation, to organizational structure, the amount of legal liability, the amount of taxes you will have to pay, and even the ability to change ownership or dissolve the business. There are four basic forms to consider: Sole Proprietor, Partnership, C-Corporation and S-Corporation. Each has its own set of advantages and disadvantages. Let us take a look at each one in detail.

#### SOLE PROPRIETORSHIP

A Sole Proprietorship is the easiest and least expensive type of business to start. As the title states, the owner is a single proprietor with total ownership of all assets and responsible for all liabilities.

To start your business under this form, you may simply need to buy a license (or a retail vendors license) for doing business in your city or county.

If you are operating your business under a name other than your name (fictitious name: dba = doing business as), you will need to register it with the Secretary of State. After you have done a name search and after you have registered this name with the Secretary of State, it must be published in a newspaper or periodical authorized by the office of the Secretary of State. Now you can open a bank account under your company name.

#### ADVANTAGES OF SOLE PROPRIETORSHIP

- It is the easiest and cheapest form of business to start
- The owner receives 100% of the profit or 100% of losses that offset other earned income
- It requires the minimum processing of legal documentation
- The Sole Proprietor maintains complete ownership and control of the operation
- You are the ultimate decision-maker and you have the flexibility to make decisions quickly in order to take advantage of a market opportunity

- Tax filing for the Sole Proprietor is very simple. There is no double taxation. All income and expenses from the business are reported through the owner on Schedule C of the 1040 tax form

## DISADVANTAGES OF SOLE PROPRIETORSHIP

- The Sole Proprietor, while maintaining complete ownership and control of the operation, has complete responsibility for the liabilities of the firm. The Sole Proprietor has no protection from personal liability for all debts. Everything he or she owns, both business and personal assets, can be used as payment for business debts
- As the sole decision-maker, you have the burden of being accountable to yourself. You may not have a management team to share the responsibilities of day-to-day tasks and decisions, successes and failures. It is strongly recommended that you have at your disposal an independent board of advisors and consultants to give you guidance and symbolically hold you accountable for good solid decisions
- If the owner dies, there may be legal complications
- The possibility of the owner's death may cause suppliers to terminate their relationship and cause creditors to call their loans
- When the owner dies the business is terminated
- The Sole Proprietor is limited in fund raising capacity equal to his or her net worth
- The Sole Proprietor cannot transfer the business to a partner or to others
- Sole proprietors are not employees, therefore, they cannot deduct certain expenses that may be a deduction for a corporation
- The Sole Proprietor is limited to his/her skills, capabilities and talents unless subcontractors or employees are used

## PARTNERSHIP

A partnership is a group of two or more people sharing ownership and responsibilities in a company. The partnership arrangement can be either formal or informal, written or a handshake. There are two types of partnerships—general and limited.

A general partner shares the liabilities as well as the assets of the firm as does the sole proprietor. Each of the partner's personal assets can also be held as payment for debt of the partnership.

A limited partner makes an investment into the business, but cannot take an active management role in the day-to-day operations. Unlike the general partner, the limited partner's liabilities are only attached to the amount of money invested and not too personal assets. If you are a limited partner, you must be careful not to change your status to an active management role. If your limited partner status changes so does your limited liability. You would then be subject to debts being settled against your personal assets.

As in any relationship or marriage, there are many human relation variables that need to be addressed in order to determine the compatibility of the partnership. This can be very difficult. Just as in any marriage, there may also be ups and downs in the business relationship. If you choose to form a partnership for your business, you must be very careful with whom you join hands and wallets. You must also be careful to establish the proper legal contracts to protect all parties and to state very clearly, what each partner's role is and how it is to be carried out.

## RIGHTS AND OBLIGATIONS OF PARTNERS

In their book, *Starting and Managing the Small Business*, Arthur Kuriloff and John Hemphill, Jr. have neatly outlined the Uniform Partnership Act as developed by the National Commissioners on Uniform State Laws.

The relationship of partners in the conducting of business has been spelled out in the Uniform Partnership Act. This model partnership law was developed by the National Commissioners on Uniform State Laws. Many states have adopted the Uniform Partnership Act in its entirety while others have enacted variations of it. You should follow the legislation in force in your state if you enter into a partnership. In any event, the Uniform Partnership Act gives useful guidelines for a partnership, by outlining both rights and obligations of partners.

**RIGHTS:** Under the Uniform Partnership Act, each partner has the right to:

- Share in the management and conduct of the business
- Share in the profits of the firm
- Receive repayment of contributions
- Receive indemnification for, or return of, payments made on behalf of the partnership
- Receive interest on additional advances made to the business
- Have access to the books and records of the partnership
- Have formal accounting of partnership affairs

**OBLIGATIONS:** Under the act, each partner has the obligation to:

- Contribute toward losses sustained by the partnership
- Work for the partnership without pay in the customary sense, but rather for a share of the profits
- Submit to majority vote, or arbitration, when differences arise about the conduct of affairs of the business
- Give other partners any information known personally about partnership affairs
- Account to the partnership for all profits coming from any partnership transaction, or from partnership property

## ADVANTAGES OF PARTNERSHIPS

- Partnerships are fairly easy to form
- The owners share the risk between themselves
- There is access to diverse management skills and a larger pool of talent
- There is no double taxation, income is taxed through each individual partner and not the partnership
- Division of profits based on partnership agreement
- Larger pool of capital than Sole Proprietorship
- Ability to attract other partners
- Little governmental regulation

## DISADVANTAGES OF PARTNERSHIPS

- In a general partnership, each partner is responsible for 100% of all debts, holding their personal as well as business assets liable, regardless of which partner made the commitment
- In a limited partnership, the limited partner is liable for only the total investment made
- As each partner shares in the liabilities, they also share in the profits
- Upon the death of any partner, the partnership is dissolved
- Dissolution of an existing partnership requires legal procedures
- Either you or your partners' values may change over time, causing disunity and conflict in making decisions
- Partners are bound by law of agency
- Limited capability for capital accumulation

## C-CORPORATION

A C-Corporation is a legal entity. Its ownership is offered to the public. It is a separate entity formed by the state that pays taxes and is itself liable for all debts. It is in essence a third party individual that in the eyes of the law is a living and breathing person and as such can accept the responsibility for assuming liabilities.

A corporation is more difficult to form than a sole proprietor or partnership and can be formed only by complying with the state laws governing such formation and by fulfilling certain statutory requirements.

Although forming your company as a corporation puts the liability of debts in the hands of the corporation itself, this does not always hold true for small start-up companies. Many entrepreneurs find that in order to get financing, they must personally guarantee the loan before it can be approved. In this case, if the debts are not paid, the personal assets can be seized from the owner. Therefore, you can see that there may still be some limited liability as a C-Corporation when starting your enterprise.

## ADVANTAGES OF C-CORPORATIONS

- The company continues to exist despite any ownership changes
- You have an increased ability to raise capital as a result of the sale of stock
- Each corporation must establish a board of directors that may provide valuable management assistance
- You can have limited or no personal liability
- Ease of transfer of ownership
- Larger pool of skill talent and knowledge
- Potential for economies of scales in operations

## DISADVANTAGES OF C-CORPORATIONS

- It is much more complicated and expensive to start-up
- There are many more legal requirements, reports and tax returns. It is expensive to support the reporting requirements for C-Corporations
- You must adhere to government regulations regarding meetings of the board of directors (usually a meeting once every quarter is required). You must maintain Board Meeting Minutes and document all major actions
- Earnings are double taxed, once on the corporation and once on the personal salary or dividends you receive from the corporation
- Potential loss of control by founder(s) of the corporation

## S-CORPORATION

An ordinary corporation may elect to be taxed as a S-Corporation, provided several criteria are met. For example, there cannot be more than thirty-five stockholders (a husband and a wife are counted as one shareholder); no shareholder may be a non-resident alien, etc.

Under this election, corporate incomes flow through to the stockholder's income tax return.

The corporation does not pay income taxes; the stockholders' record the income on their individual tax returns. The stockholders are taxed on the total corporate income, although not all of it may have been

distributed. No double taxation is encountered under the S-Corporation form. A S-Corporation formed after 1983 must have the same tax year as its owners (generally, a calendar year).

Before electing this form of corporation for tax purposes, the electors should be thoroughly aware of all aspects of the S-Corporation requirements as well as the impact that such an election will have on after-tax cash flows. Such an election may or may not be an advantage depending upon the particular situation.

As with other legal forms of business, an attorney should be consulted prior to the enterprise creation. This is especially true because some of the aspects of this law that might affect your business and your decision as to type of legal form of business may have changed.

#### **ADVANTAGES OF S-CORPORATIONS**

- If the corporation expects to lose money in the early years of operation, and the shareholders will have income from other sources. The corporate losses will shelter the income from other sources
- Because of the tax bracket the shareholders are in, there can be tax savings if the expected profits of the S-corporation are split among the shareholders
- The business is such that the corporation does not need to retain a significant portion of its profits

#### **DISADVANTAGES OF S-CORPORATIONS**

- You may have only up to 35 shareholders limiting your level of financing
- A non-resident alien may not take a part ownership in the corporation
- No shareholder can be a partnership or a corporation
- The corporation can have only one class of common stock and no preferred stock
- The tax laws regarding the S-corporation are very complex
- When an S-corporation begins to produce very high levels of taxable income, it would be a good time to change to a C-Corporation and begin collecting profits in the corporation. The IRS will allow you to change to a C-Corporation status

#### **THE SELECTION PROCESS**

From the above legal entities, you should select the one that is most advantageous to you. Generally with a new venture, the sole proprietorship is preferable, unless you need large financing for your project. The description of your business will take on the characteristics of the legal form you choose.