

STRUCTURING YOUR BUSINESS

The legal structure of your business can take four basic forms:

- Sole Proprietorship.
- Partnership ("Limited" or "General").
- Corporation, S or C class.
- Limited Liability Company (LLC).

Before selecting the legal structure of the business, the following questions should be asked:

- How much money do I need?
- Who will be the source of any needed funds?
- What skills are needed that I cannot provide?
- Are there other people available to round out the necessary skills in starting and continuing a business?
- How much control do I have over the operation?
- How will the business be taxed and how will applicable laws influence it?
- To what extent will I be personally responsible for debts or claims against the business?
- What will happen to the business if I am not able to work for any length of time?

There are many legal and tax considerations that will enter into this decision, so make sure you consult your attorney and your accountant.

Sole Proprietorship

The sole proprietorship is the most common form of business organization. You own and operate the business and have sole responsibility and control. Essentially you, the owner, are the business. The profits of the business are considered personal income and therefore are taxed at your personal rate.

Advantages

- Ease of formation: Fewer legal restrictions, usually less expensive than a partnership or corporation.
- Flexibility: Quick response to business needs.
- Profits: You have sole ownership of profits.
- Exclusive control and decision making: You are in charge.
- Tax deductions: Losses are tax deductible.

Disadvantages

- Unlimited liability: You are responsible for the full amount of debts, and this liability extends to your personal assets.
- Unstable business life: Business could be crippled or terminated by your illness

- or death.
- Limited investment: Investment in the business is limited to the resources that you can raise.

Partnership

A partnership is the association of two or more people as co-owners of a business. It is a legal mechanism that allows for profits and losses to be divided among a group of investors. Partnerships are typically used by groups of professionals such as lawyers and accountants, or for groups of real estate investors.

When forming a partnership, you should have a written partnership agreement that specifies the legal obligations of each partner. A partnership agreement will:

- Stipulate the initial amount of funding each partner will contribute to the business.
- Determine how management decisions will be made and authority will be divided.
- Establish methods for settling disputes among partners.
- Set up a procedure for selling out: specify how each partner's interest will be valued; establish restrictions on partner's interest to a third party.
- Specify what would happen to your business if one of your partners dies or becomes physically or mentally incapacitated.
- Specify the rights of the partner's spouse.

The most common types of partnerships are "general" and "limited."

General Partnership

General partners participate in the management of the business and are personally responsible for all debts.

Advantages

- Ease of formation.
- More skills and capital available to boost performance and growth.
- Flexibility and decision making with relative freedom from government control and special taxation.
- Losses are tax deductible.

Disadvantages

- Unlimited liability.
- Personal liability of a solvent partner for the actions of unscrupulous partners.
- Unstable life of business: partnership is dissolved if a partner dies or withdraws, unless specifically prescribed in the written agreement.
- Buying out a partner may be difficult unless specifically prescribed in the written agreement.
- Potential for disagreements between partners could lead to costly dissolution.

The above disadvantages may be minimized in an agreement reached by the partners at the formation of the business.

Limited Partnership

Limited partners are liable only to the extent of their investment and do not share in the management of the business.

Advantages

- A person can invest capital in a partnership business and reap a share of the profits without becoming liable for all debts of the partnership, or risking more than the amount of capital contributed.

Disadvantages

- Must have at least one partner who is liable for all debts of the partnership and other (limited) partners whose liability is limited to their investment in the partnership.
- No voice in the management of the partnership.
- There are other legal and tax considerations involved and legal advice is necessary in choosing this form of organization.

Corporation

The most complex form of business organization is the corporation. A corporation is made up of three groups of people: shareholders, directors and officers. The corporation can borrow money, own assets and perform business functions without directly involving you or the other corporate owners.

Advantages

- Limitation of the stockholders' liability to a fixed amount, usually the amount invested.
- Business looks more credible than a sole proprietorship to potential suppliers, employees and bankers.
- Ownership is readily transferable.
- Separate legal existence.
- Relative ease of securing capital in large amounts and from many investors.

Disadvantages

- Activity is limited by the corporation's charter and various laws.
- Extensive government regulation and federal, state, and local reports.
- Considerable expense in formation of corporation.
- Greater administrative expense on an annual basis.
- Double taxation may occur if dividends are distributed.

"Tax Option" Corporation (Sub-Chapter "S")

This form of business organization permits a small business corporation to have its income taxed to the shareholders as if the corporation were a partnership. The double tax feature of the system of corporation income taxation can therefore be avoided. Shareholders can offset business losses incurred by the corporation against their income.

Advantages

- Losses are tax deductible.
- Share the same operational advantages of a corporation.
- The double tax feature of corporate income taxation can be avoided.
- No limit is placed on the size of the corporation's total income and assets.

Disadvantages

- Limited to a maximum of seventy-five shareholders.
- Limited to one class of stock.
- Limited as to sources of income.

Limited Liability Company

The limited liability company (LLC), now available in California, is a form of business organization that has both corporate and partnership characteristics. An LLC provides its owners with corporate-type limited liability protection and partnership tax treatment.

Advantages

- Limited liability for all owners.
- Treated as a partnership for income tax purposes.
- More flexible and less formal than other entities.

Disadvantages

- Complex Formation: need Operating Agreement, higher organizational costs, new to more professionals.
- The Operating Agreement must be drawn carefully to avoid taxation as a corporation.
- LLC interests will not likely be freely transferable.
- Practical inconveniences in business transactions.
- Legal aspects of LLCs are in transition and not uniform in each state.

Comparison of Forms of Business

Characteristic	General Partnership	Limited Partnership	Corporation	Limited Liability Company
Formation	Statement of partnership may be filed with Secretary of State	Certificate of Limited Partnership must be filed with Secretary of State	Articles of Incorporation must be filed with Secretary of State	Articles of Organization must be filed with Secretary of State
Filing Fee	\$70	\$70	\$100	\$70
Minimum Franchise Tax Prepayment	None	\$800	\$800	\$800
Management and Control	Control is by numerical majority of all partners, unless an agreement provides otherwise.	Day-to-day control is by partners only; limited partners typically participate only in major decisions.	Control can be centralized. May separate management rights from ownership (e.g. <i>nonvoting stock</i>).	Control may be exercised by members or manager
Liability of Owners	All partners are jointly and severally liable without limitation.	General partners have unlimited liability. Limited partners risk only the loss of their capital contribution.	Shareholders risk only their investment, not their personal assets, unless court "pierces the corporate veil."	Same as corporation.
Continuity of Business	No perpetual existence. Dissolved by death or withdrawal of a partner.	No perpetual existence. Dissolved by death of any general partner, but not by the death of the limited partner.	Perpetual existence is possible. Dissolution is independent of the lives of the shareholders.	Subject to agreement, but could affect whether entity qualifies for partnership tax treatment.
Transfers of Interests	Difficult. Partner can assign right to receive distributions, but assignee cannot be substituted as a partner, except by consent of the remaining partners.	Same as general partnership, but partnership agreement can provide otherwise for limited partners.	Shares are more readily transferable, but articles, by-laws, or shareholders' agreement can impose restrictions on sale.	Assignable, but usually subject to members' approval of restrictions contained in operating agreement.
Taxation	Partnerships do not pay income tax, but file information returns. Partners are taxed on their share of the profits, whether distributed or not.	Same as general partnerships, but partnership is subject to annual franchise tax (now \$800 minimum).	Double taxation (corporation is taxed on pre-dividend profits and shareholders are taxed on dividends), unless Subchapter S status can be elected. Also subject to annual franchise tax.	Generally, same as partnerships, but LLC is subject to \$800 annual franchise tax, plus fees assessed on a graduated scale, up to \$4000 on income exceeding \$5 million.