

# **CHOOSING THE RIGHT BUSINESS STRUCTURE**

**S**tarting your own business is one of the greatest events of your life! It deserves careful planning but don't get bogged down in excessive worrisome detail, just necessary detail.

Two necessary details would be:

1. How do I get the best tax breaks to insure the life of my business; and,
2. How do I protect myself from the greatest amount of risks and what are they?

One of the best sayings of the 70's was, "If you have it in writing, you have a prayer. If you don't have it in writing you just have air!"

An understanding of the term "Contract" is a must. According to "Black's Law Dictionary," a Contract is simply a meeting, that is, agreement of the minds of two or more people. "Cavendish Law Publishing" defines a contract as, (and based on case law): "A valid offer and a valid acceptance of that offer must be identified...however case law weighs that acceptance connotes following through with the acceptance as in 'I'll pay you \$5.00'" (and then the giving the physical \$5.00 to complete the contract when called for.) Merriam-Webster Unabridged Dictionary defines contract simply as: "an agreement between two or more persons or parties to do or not to do something."

In any case nothing is said about "writing" or "noting" or any other form of physical memorabilia. The ancient form is currently referred to a "meme" or "an idea, behavior, style, or usage that spreads from person to person within a culture." Ever played the game where everyone sits in a large circle? The first person whispers a sentence to the person on the left. That person whispers the heard phrase to the next one, and so on until it is finally repeated to the original person that thought up the phrase. The only rules are that you cannot ask for someone to repeat the phrase and you have to state it to the next person exactly as you heard it. Remember the outcome? Of course you do! That is why we have WRITTEN CONTRACTS . That's why we have courts!!! That is why we **WRITE it down.**

Before you launch your business, make sure that you have the right contracts in place so that everyone is clear from the start about your expectations. If you are not concerned about too many taxes or problems with liability, don't worry about a "business structure." Just start a business as yourself:

## Sole Proprietorship\*

Sole ("only") Proprietor ("owner, grantee, one who controls"). This is your business. You take on full exposure for everything. One aspect is that you may be exposed to liability arising from a faulty product or poor service and a legal judgment arising from either could wipe out everything you've got. If that is fully understood and acceptable to you and your attorney feels the same, you're on solid ground.

There's no cost to set up a sole proprietorship, no legal forms to fill out and no government hoops to jump through. You will need, however, the appropriate licenses that would apply to your business: e.g. business

license, trade name registration, proper permits, State, County, City, Sales Tax, Use Tax, Franchise Tax (usually synonymous with Sales Tax), and any other specialty licenses.

You are responsible for all IRS filings as a Sole Proprietorship, employee's withholding, etc. Be sure to check with an accountant before issuing the first employee paycheck, (or your own). Any profits that you earn will simply appear on your personal tax return as Schedule C income.

You can open or close the business at any time, and you'll retain full control of the company's operations. Raising capital and transferring ownership will be difficult as a sole proprietor because you're the only owner.

\*You can always start as a Sole Proprietor and change your legal structure at a later date.

Before you decide, consider your options and take a closer look at the pros and cons of each structure.

## Partnership (aka The General Partnership)

Like the sole proprietorship, starting up the general partnership could be a relatively easy process. No costs or formalities are required. Wise counsel, however, will give you about a dozen or more reasons, (maybe 1,000), why you should have a detailed partnership agreement drafted whenever you put yourself on the line with any other individual. Reasons abound for that last statement and experience is a teacher of vicious sagacity.

A few items that you would be best advised to spell out in writing are:

- Ownership percentage of each partner;
- The rights and duties of the partners;
- The amount of capital each partner is expected to contribute up front;
- The method for sharing profits and losses;
- The authorization for cash withdrawals and salaries,
- The methods for resolving disputes or taking in new partners;
- The method for dissolving the partnership should dissolution become necessary.

In the case of a "Partnership" it is always wonderful to have a wonderful relationship and keep it that way. Experience has shown that the best way to insure a wonderful relationship is to have everything above board, "spelled out" as clearly as possible, including any possible negative outcomes. Of course this would never happen, but in the even it does freeze over then this writing serves as a road map to help the partners navigate a reasonable way out of the entanglement. A firm agreement that addresses every issue is an absolute. A partnership is either great synergy or doomed to failure.

You and your partner(s) need the same licenses as the Sole Proprietor above. One serious caveat to seek legal

opinion on is personal liability for your partner(s)'s actions within the partnership and without (i.e. arm's length from) the partnership. In some states a partner is fully responsible for his partner's entire personal liability! It is worth scrutiny. In most all states all partners are responsible for any other partner's actions within the partnership.

A partnership shares the same problem in raising capital as a Sole Proprietorship in that it has fixed owners. That is, unless you wish to sell a piece of the "partnership," in agreement with all partners.

Partnerships are "pass-through" entities for tax purposes; the general partnership itself does not pay taxes. Each general partner takes into account his or her share of general partnership income, losses, deductions and credits in determining his or her personal tax liability. A partnership agreement may provide for the allocation of these tax benefits and burdens.

## Limited Liability Partnership (LLP)

So far in this discussion this is the first point at which a limitation of personal liability is discussed since the first paragraph.

A limited partnership is composed of general partners and limited partners. The defining characteristic of a limited partnership is that limited partners can invest capital in a business of the limited partnership and take a share in the profits without becoming personally liable for partnership debts and obligations.

The liability of the Limited Partner is limited to the amount of their investment. The General Partner in the LLP accepts full liability. For this reason many LLPs elect to have a corporation (see "C Corporation" below) act as 'General Partner' to limit personal liability.

The LLP Agreement calls for the General Partner(s) to manage the LLP, and thus the limitation of liability and management on the part of the limited partners. Generally speaking, this protection exists as long as the limited partner does not play an active role in the partnership operation. In some states, limited partners may participate in managing and controlling the business without becoming personally liable for the limited partnership's obligations.

The limited partnership agreement may govern which partners or classes of partners control the entity. Most all LLP agreements require the close scrutiny of qualified counsel, if not all! As with general partnerships State Law will govern the handling of matters not addressed in the partnership agreement. General Partners have equal rights to participate in the management of the partnership and have the power to bind the limited partnership in transactions with third parties. A limited partner can assign his or her interest in the profits of the partnership and the assignee may become a limited partner if the limited partnership agreement provides or if all other partners consent.

Regarding tax, the limited partnership pays no entity-level income tax or "net worth" tax. Each partner is taxed directly upon his/her respective distributive share of the limited partnership's profits as the LLP

agreement calls for. It is possible that the LLP agreement may elect for the LLP to be taxed as a corporation, (see “C Corporation” below).

A Limited Liability Partnership, generally, is registered by the respective Secretary of State and governed by the Limited Partnership Agreement among the parties. There are generally no burdensome requirements for filings, publications, or record maintenance. However, if one is not very careful, bureaucracy will seep in and paperwork will abound. If so, efficiency will decrease inversely proportionate to the amount of the paperwork which in turn is inversely proportionate to personal responsibility/accountability of management.

## Corporation

### C Corporation (Regular Corporation)

Generally speaking, the purpose of setting up any kind of corporation is to shield the Entrepreneur from liability and protect personal/corporate assets from creditors.

Concept: A corporation is a person, a “corpus” (body). It is a legal entity artificially created and has nearly every right of existence (or more) than you and I except for the right to vote. An additional advantage it has as an independent body is potential perpetual existence by transferring or selling ownership shares to another entity.

A corporation consists of three critical “Players:”

1. **Shareholders:** The owners of the corporation. They hold “shares” of paper that say they own X (percent) of the company. They hire a Board of Directors to oversee the management of the Company.
2. **Board of Directors:** The Board serves at the pleasure of the shareholders. They are the “oversight” committee that filters, so to speak, the minutiae of management and general corporate course of action into formal decisions. They hire specified (by the shareholders) Officers of the Corporation to manage the day to day affairs of the company.
3. **Officers:** The Officers that are specified to be hired by the Board of Directors, e.g. normally the Chief Executive Officer, Chief Accounting Officer, etc., serve at the pleasure of the Board of Directors. These officers, in turn, hire other officers under them and create a hierarchy of command and management efficiency.

It is not uncommon for a start up business to have a single shareholder, director and officer as the same person. A corporation requires only one “person” to incorporate, (an “incorporator”). That incorporator files Articles of Incorporation and By Laws with the respective Secretary of State. The Incorporator (if different than shareholder(s)) signs over paperwork from State to Shareholders. Shareholders hold “First Organizational Meeting of the Shareholders of X Corporation, a X (state) Corporation, ...etc.” In that meeting a Board of Directors is elected.

The above may appear bureaucratic if you are the incorporator, shareholder, director and sole officer. But it is absolutely crucial to your corporation's life, as are additional meetings and filings\*\*.

If you're planning to give your clients advice, publish articles written by others, manufacture products or engage in any other kind of business that might get you entangled in a lawsuit, you should definitely consider incorporating your business.

Other advantages to incorporation include:

- Ability to raise capital by selling stock;
- The ability to transfer ownership to heirs or investors quickly and easily;
- Greater flexibility in setting up retirement funds and qualified retirement plans, like a 401(k).

The downside is that you'll need to lay out money to set up your corporation, keep careful records\*\* of shareholders' meetings and file a separate tax return. You will also be taxed on your corporation's profits and again on any dividends you receive as an individual. This separate taxation is commonly known as "double taxation."

It is generally recommended that if it is your first time setting up a regular corporation (or "S" corporation – see below), it is highly recommended that you seek the services of a corporate attorney and/or filing service.

Today, the Internet is an excellent service for information on corporations. Most every Secretary of State will have an entire "business portal" dedicated to helping you. In California, for example, go to: <http://www.ss.ca.gov/business/business.htm> and you will see a wealth of information. The following are examples of links you may find on the California government site:

- *California Codes*
- *Legislation*
- *Private Service Companies*
- *Technical Assistance Business Portal*
- *California Business Portal*
- *Online Services*
- *California Business*
- *Business Entities (Forms, Samples & Fees) – Filing requirements, name availability, status requests, copies/certificates*
  - *Corporations*
  - *Limited Liability Companies*
  - *Limited Partnerships*
  - *General Partnerships*
  - *Limited Liability Partnerships*
  - *Trademarks and Service Marks*
  - *Miscellaneous Filings*

- *Business Entities Mail Processing Times*
- *California Business Search*
- *E-File*
- *Publicly Traded*
- *Disclosure Search*
- *Corporations Main Page*
- *Corporate Records*
- *Certificates*
- *Copies*
- *Status Reports*
- *Name Availability*
- *Annual/Biennial Statements*
- *Filing Tips*
- *Preclear/Expedite Filing Service*
- *Frequently Asked Questions*
- *Regional Offices*
- *Business Resources*
- *Contact Us*
- *Site Search*

If you decide to incorporate your company, Federal and State securities laws may apply to the sale of classes of stock in a corporation. “Classes” of stock are simply a means of distinguishing between what the stock means to its holder, i.e. owner. For example: Common Stock would normally be a share ownership interest in the corporation with a right to vote that share as an owner. If there were five owners there would be five votes at a meeting unless otherwise decided upon by the five shareholders.

Preferred Shared Stock: Preferred Shares can be shares that are the same as “common” in every respect but can be “preferred” in the respect that if dividends are declared the Preferred Shares are declared first, OR the Preferred Shares are required to receive a dividend. Preferred Shareholders may or MAY NOT have voting power. In all reality, “Preferred Shares,” by definition, need only to have one form of preferential treatment approved by the voting shareholders and acceptable by the State.

“Series A” (any name): Any name of stock of any design that is approved by the majority of shareholders that carry voting power (the approval of the stock is by the shareholders holding the voting power) and approved by the resident State for the purposes intended.

An example of stock issuance for the purposes of financing and concomitant control could be: Issuance of Common Stock in XYX Corp. for \$X.00/share.

For each share of Common Stock that is issued in XYZ Corp. one share of Series L Stock is issued to Ford Family Voting Trust. In this case, the Ford Family Voting Trust would most likely have owned at least one common share prior to the shareholders electing the issuance of the “Series L Share Program” to guarantee the Ford Family Voting Trust control of the corporation. Variations of this methodology have been used in many successful public companies that are considered “family companies” and are among some of the best known in history.

This explanation of stock, its meaning and issuance is by no means meant to be construed as legal definition nor opinion. For a decision on the issuance of stock, the type, purposes and requirements, competent legal counsel is always required.

## S Corporation

**If personal tax savings is a major issue, it is highly recommended that you compare “S Corporation” with LLC before making any decisions.**

An “S Corporation” is identical to a regular “C Corporation” for all intents and purposes except for two facts:

1. Pass through-profits (losses) to shareholders; and,
2. Limit of 75 shareholders.

An “S Corporation” is one of the most common types of small-business corporations (with the possible advent of the “LLC” - see below) as it protects its shareholders from the debts of the corporation and is managed by a board of directors elected by the shareholders (who are often the company’s owners and officers).

The big advantage of an S corporation over a regular corporation (C corporation – see above) is that the profits (or losses) pass through to the shareholders directly instead of being taxed twice as corporate dividends and then as personal income. Like a C corporation, shareholders of an S corporation can raise money and sell shares without a problem; however, the total number of shareholders is limited to 75. If that number is exceeded the IRS will invalidate the “S” qualification and treat the corporation as a regular “C” corporation.

To become an S corporation, you must first file with your resident state incorporating your business, then complete IRS Form 2553 and elect S corporation status.

All of the caveats in meetings, recordings, filings and licenses apply to the “S” corporation as they do the “C” corporation in order to maintain the integrity of the “corporate shell.”

## Limited Liability Company (“LLC”)

The LLC is formed by filing an “Articles of Organization” with the respective Secretary of State and drafting an “Operating Agreement” if there is more than one owner. Tax advice should be sought prior to forming an LLC and legal advice is highly recommended.

The “LLC” is often mistakenly called, “Limited Liability Corporation” because it is “like” a corporation and yet does not have the formal meeting and reporting requirements of a corporation, e.g. no regular meeting of owners, managers and timely filings, etc., in order to preserve the impermeability of the company shell.

LLC offers the two basic advantages of a startup:

1. Pass through taxes; and,
2. Limited Liability to the Entrepreneur (and other owners)

The Limited Liability Company (LLC) is a business entity organized under state law that offers limited liability like a corporation along with the possibility of “pass-through” taxation, unless it elects corporate treatment for federal tax purposes. The owners’ risk is limited to the investment in the LLC. Therefore, an LLC is an actual cross between a Partnership and a Corporation.

As a corporate filing, an LLC filing will cost money for legal and accounting advice and to file the LLC documents with the Secretary of State. Like a corporation, an LLC has potential perpetuation as its ownership interests can be transferred or sold according to agreement of its owners.

Under new IRS regulations, an LLC with more than one member will be taxed as a partnership unless it elects to be taxed as a corporation and the LLC with only one member will be disregarded for tax purposes. If it is treated as a partnership, the LLC’s earnings will be apportioned to its owners and taxed at their personal tax rates, similar to the tax treatment of a limited partnership.

An LLC is owned by one or more interest holders called “Members.” Any Member can exercise management rights as designated in an “Operating Agreement, which, like the agreement of a partnership or LP, determines the conduct of the business, including the rights and powers of its members, managers, and employees and which generally allow the members to structure the company’s affairs as they see fit, rather than as a statute requires.

## WHICH BUSINESS ENTITY IS RIGHT FOR ME?

### In Summary:

Depending on your personal experience, knowledge, support, needed assistance from legal/accounting, which can be just a few dollars for permits and licensing to a few thousand, including all the bells and whistles that you can dream up, The following may help guide you to your decision:

If you’re alone and don’t want outside capital:

#### **Sole Proprietorship**

**Advantage:** Total control, personal tax

**Disadvantage:** Total liability.

**Growth Potential In Owners:** Virtually Zero

If you have a partner and are NOT worried about partner problems nor personal liability: **A Partnership.**

Generally more expensive than a Sole Proprietorship and more liability but may be offset by the additional resources of partners.

**Have partners but don't want liability:  
Limited Partnership, (LLP).**

Much more expensive than partnership and paperwork intensive.

**Need to raise capital, need shelter from liability:  
C Corporation.**

Small business not as expensive as expected, (as opposed to LLP), more structure, paperwork and with the raising of capital there will be additional legal and accounting fees.

**Want all the trappings of a Corporation but want the personal tax benefits: Subchapter S Corporation.**

This will have all of the costs of a regular C corporation plus the cost of the subchapter S filing. (minor).

**Disadvantage:** Limit of 75 shareholders

**Protection of a corporation, less formality and pass-through tax benefits: Limited Liability Company, (LLC)**

Minimal costs equal to or less than minimal costs of filing of C corporation. Paperwork equivalent to Partnership.

Depending on which attorney you choose, you can spend anywhere from a few hundred to a few thousand dollars in legal fees to set up your Business Entity.

While Doppelit strongly recommends consulting an attorney before setting up your business, many entrepreneurs prefer to save money by doing it themselves.

The Internet is a great resource. Sites like Xtreme Business Solutions, Business Filings and MyCorporation.com let you create your own corporation by filling out an online form. The cost to use these services is \$99 to \$310, plus the applicable state filing fees. (Buyer Beware!! You will get the “kit” and you MUST understand your obligations).

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