THE LEGAL ASPECTS OF GOING INTO BUSINESS

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Small Business Development Center

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SOLE PROPRIETORSHIP

The sole proprietorship is the most common form of small business legal structures where one person owns and operates the business. Obtaining the required license or permit, and filing the business name with the county courthouse, establishes the business.

Advantages of a Sole Proprietorship

- A sole proprietorship requires **minimal government** approval; it is less expensive to set up than the other legal business structures.
- The sole proprietor has total control over the business and can respond quickly on a day-to-day basis to needs that arise.
- For tax purposes, the individual and the sole proprietorship business can be applied against income earned from another job and is especially useful when the venture begins on a part-time basis, or (if filing jointly) a spouse has earned income which can be offset by the loss. This may be done even if the business runs in the red for several years.

Disadvantages of a Sole Proprietorship

- The major disadvantage of the sole proprietorship is unlimited personal liability. Business debts could exceed the total investment in the business. If the business fails while owing creditors, all personal assets are at risk, including home, car, and savings. Liability in the event of physical loss, product failure, or personal injury, could be substantial, but depending on the business, may not pose a great risk. Insurance may or may not be appropriate.
- A sole proprietorship is limited by the individual. The enterprise could be put in serious jeopardy, or even terminated, by a serious illness or event that takes the owner away from the business for an extended period of time.
- Organizing as a sole proprietorship can make it more difficult to obtain capital than would another type of business structure; there is only one person that will be liable for the debt. Collateral will probably be required. The lender has fewer means of securing the debt than with a partnership, limited liability company, or corporation.

PARTNERSHIP

The partnership, like the sole proprietorship, has limited life, is easy to set up, but there is still unlimited liability, for at least one of the partners. Nearly all states have adopted the Uniform Partnership Act which defines partnership as an association **of two or more persons to carry on as co-owners of a business for profit. A partnership agreement** is the contract which contains articles which define the obligations of each partner. The articles may be very simple or quite complex, depending on the nature of the business, and the relationship of the partners. The groundwork for the partnership agreement can, and perhaps ***should*****,** be done by the individuals involved, by exploring all imaginable potential eventualities. There are many books that provide guidelines for writing a partnership agreement. We strongly recommend that a competent legal advisor review the contract before it is finalized; a partnership agreement is a binding legal document.

Topics that need to be addressed in the partnership agreement include:

- ***Arbitration***
- ***Separate debts***
- ***Release of debts***
- ***Settlement of disputes***
- ***Employee management***
- ***Performance by partners***
- ***Absence and disability***
- ***Duration of agreement***
- ***Draws and/or salaries***
- ***Handling expenses***
- ***Sale of partnership interest***
- ***Dissolution and winding up***
- ***Division of profits and losses***
- ***Authority of each partner to conduct business***
- ***Type of partners -- general, limited, active or silent***
- ***Contributions by partners -- financial or service***
- ***Name, purpose, and domicile of partnership***
- ***Records and method of accounting***
- ***Required acts and prohibited acts***
- ***Rights of the continuing partner***

Before entering into a partnership, also consider:

- Compared to a sole proprietorship, partnerships can be less flexible when responding to changing business conditions. This is offset by the additional abilities and financial resources the partner, or partners, bring to the business.
- Legal expenses associated with forming a partnership are greater than those of a sole proprietorship but are less than for incorporation. A business license can be obtained from the county clerk’s office and the cost is the same as a proprietorship license.
- Tax report preparation for a partnership is more complex than a sole proprietors but is minimal, when compared to a corporation. The monies received by the partners is taxed as ordinary income, just as in a sole proprietorship. In like manner, losses in a partnership are deductible against other income earned.

Types of Partners

Limited partners risk only their agreed upon investment in the business and usually are not liable to the same extent as are ***general*** partners who manage the day-to-day activities of the firm, because limited partners do not participate in management.

Nominal partners are not parties to the partnership agreement; however, nominal partners represent themselves as partners, or permit others to make such representation, by the use of their name. Under the law, nominal partners are liable as if they were partners, if another party acts in the belief that the nominal partner was a true partner.

Ostensible partners are active and are known to be partners. ***Secret*** partners are inactive but may be known to be partners. ***Subpartners*** are not members of the partnership but they contract with one of the partners and participate in the interest of that partner regarding the firm’s business and profits.

Type of Partnerships

In the state of Wisconsin, there are three types of partnerships. They are ***General Partnership*****,** ***Registered Limited Liability Partnership (LLP),*** and ***Limited Partnership****.* The Registered Limited Liability Partnership (LLP) is new to Wisconsin in 1996. It provides some liability protection for partners and continues to be taxed as a partnership. New or existing general partnerships can become Registered Limited Partnerships. Both the Limited Partnership and the Registered Limited Liability Partnership (LLP) must file with the Wisconsin Department of Financial Institutions. It is advisable to seek legal council concerning the liability and tax status of each agreement.

Of interest to some, is the **Family Limited Partnership**. One obstacle in succession planning is a business owner’s desire to retain control of a closely held business when considering a stock transfer to children. The family limited partnership is one solution. A typical partnership is formed with both parents as general partners and the children as limited partners. The parents transfer assets such as stock in the family business, real estate, over-the-counter stocks and other investments into the partnership, which would hold and manage them.

For income tax consequences, consult a professional advisor, but generally there would be no income tax consequences upon contribution of the assets to the partnership. The transfers are a gift from the parents to the children. Ownership has effectively been transferred from the parents to a pooled ownership by the parents and children based on their ownership interests in the partnership. These gifts are subject to gift tax, although the IRS has ruled that transfers of limited partnership interests qualify for the $10,000 annual gift exclusion.

One of the most significant advantages of the family partnership is the ability to use the valuation discounts when determining the value of the gifts to the limited partners. The interests can be discounted to reflect their lack of marketability and minority ownership. These discounts can range from 10 percent to as much as 40 percent. In general, the income arising from the activities of the family limited partnership can be allocated to the partners according to the partnership agreement. This might allow income to be allocated to the children who might be in a lower income tax bracket. However, allocations must be consistent with their actual ownership interests.

From an operational standpoint, the general partner controls the family partnership by making management and investment decisions, including the amount of cash distributions to the partners. The limited partners cannot make management, investment or distribution decisions, and cannot force the liquidation of the partnership. Therefore, the general partner can maintain control of the business while receiving the benefits of the valuation discounts, among others.

To discuss how your estate plan could use the advantages of a family limited partnership, contact a business-finance consultant, such as a certified public accountant, or an attorney who specializes in family businesses.

(Information on the Family Limited Partnership was taken from the February, 1998 issue of Wisconsin Small Business Counselor)

The main **disadvantage** of a partnership is that in some cases, partners are liable for the actions and commitments of the other partners. In order to reduce the potential for disagreement, the partnership agreement **must** contain articles which address the decision making process. Contingencies *are* likely to arise.

Note: The Tax Reform Act of 1986 caused limited partnership interests to be treated as passive activities; losses from passive activities are not deductible when computing the alternative minimum tax, and are *being phased out for regular tax purposes. We advise you to consult with your tax specialist on this matter.*

CORPORATIONS

Corporate legal structure is more complex than other forms and usually requires the help of an attorney. There are several advantages to structuring a business as a corporation:

- **Liability is limited** to the amount a person has invested in the business. Creditors cannot take personal holdings or assets should the corporation fail or be sued for more than the corporation is worth. (An exception might be for a new corporation where the lender or supplier may ask the owner for a personal guarantee.)
- **Capital may be obtained by issuing stock or bonds.**
- **A corporation is a legal entity in itself and exists wholly separate from the individuals that created it.** Death or illness of a principal officer has no affect on the existence of the business.

However, **government regulation** at the federal, state, and local levels, the time and effort required to comply with the numerous report requirements, may make the advantages of incorporation less distinct. Additionally,

- The state maintains close watch over corporations, and requires a board of directors, and that the corporation hold stockholders' meetings. These characteristics may diminish the amount of personal control an individual would have over the business.
- Losses sustained as a corporation cannot be applied against other earned income unless you sell your stock in the corporation. (There is an exception to this if the corporation is set up as a ***subchapter S*** corporation which is discussed below.)
- Corporate profits are taxed twice; once at the corporate level, because the corporation is a taxable entity in itself; and a second time when a salary is paid, or profits are distributed to the stockholders. (Subchapter S corporations are not taxed at the corporate level. Shareholder profits are taxed as personal income only.)

Regulation of corporations varies from state to state; those that do business in more than one state must comply with federal regulations regarding interstate commerce. In general, to form a corporation, subscriptions to capital stock are taken and a tentative organization created. Approval is then obtained from the secretary of state in which the corporation is formed, and a charter, stating the powers and limitations of the corporation, is granted. In Wisconsin, address requests for incorporation papers to:

Wisconsin Department of Financial Institutions 608-266-3590

Secretary of State

PO Box 7846

Madison, WI 53707-7846

<u>‘S’ CORPORATIONS</u>

Subchapter S corporations were created by Congress to give tax relief to small companies. This type of legal organization retains the liability protection of a corporation but permits a shareholder to apply business losses against ordinary income -- just as is allowed in a sole proprietorship or partnership -- thus avoiding the double taxation of the C corporation. In order to qualify as an S corporation, you must meet the following requirements:

1. ***The number of shareholders are limited to 75, including individuals or estates.***
2. ***There can be only one class of outstanding stock.***
3. ***All shareholders must consent to the election of S corporation status.***
4. ***A specified portion of corporate income must be derived from actual business activity, <u>not</u> passive investments.***

In addition to filing articles of incorporation with the State Department of Financial Institutions, to elect S Corporation status, Form 2553 must be properly filed with the IRS. It is necessary to seek competent legal advice in establishing an S Corporation.

<u>LIMITED LIABILITY COMPANIES</u>

The Limited Liability Company is a legal classification that combines the "pass-through" taxation that partnerships and S corporations enjoy, and also provides for personal limits on liability, as does a limited partnership or a corporation. LLC’s lack the complex restrictions of an S corporation, are easy to set up, and unlike a limited partnership where limited partners have liability protection because they are not involved in management decisions, all investors in the LLC (there is no limit to the number of members allowed) can be involved in management and still enjoy the liability protection of a corporation. They are especially useful in small, family, and entrepreneurial businesses that have a limited number of investors, or where estate planning, asset management, and control is desired while gifting the business to heirs.

The LLC may be taxed as a corporation or partnership but most will elect to be taxed as a partnership. New laws took effect January, 1997 governing the classification of entities as partnerships or corporations. Under the prior regulations, whether an entity was classified as a partnership or corporation was based on four factors: continuity of life, centralization of management, limited liability and free transferability of interests. Under the new regulations, a domestic entity that is not organized under a corporation law will **not** be treated as a corporation **unless** it affirmatively elects such status by filing IRS form 8832. Unless such an election is made, such an entity will be either treated as a partnership only if it has more than one member, or disregarded as a partnership for tax purposes if it has only one member. If such an election is made, a business can be an LLC and taxed as a partnership with only one owner.

Prior law required more than one owner. The effect of the new law will be to make clearer the tax status of limited partnerships and limited liability companies. LLC's must file Articles of Organization with the Department of Financial Institutions. At this printing, the fee was $130.00. It is important to retain a legal advisor before entering into the contract known as the operating agreement.

Limited Liability Company legal structure is recognized in Wisconsin. If business will be conducted outside of the state, it is important to know that being organized as an LLC here does not license the company to do business in a state that does not recognize the LLC form of organization. The forms necessary to file as a Limited Liability Company are available from the Wisconsin Department of Financial Institutions.

A GUIDE TO DECISION MAKING

1. ***Cost, in time and money -- not only in set up -- but in maintenance.***
2. ***The value of partners, for capital or personal resources, in a partnership or corporation.***
3. ***Flexibility in decision making, personal control, and provision for illness or vacations.***
4. ***Risks associated with each form of structure.***
5. ***Influence of federal, state, and local laws.***
6. ***Taxation. Corporate tax rates are different than personal tax rates, capital gains are taxed different than ordinary income. Consult with an accountant or tax attorney for advice.***

Much of this handout has been adapted from: Cohen, William A. The Entrepreneur and Small Business Problem Solver. (New York: John Wiley & Sons, 1990): 1-7, 10.

It is not the intent of the Small Business Development Center that this brief overview of legal business structures substitute for sound legal advice.