

Starting Your Own Business

Part II -- Choosing the Form of Organization for a New Business

Doing It on Your Own

This is the second in a series of articles that will look at the legal and business issues that arise when a new business is started. The first article, published last month, dealt with developing a business plan. This article will focus on the issues that need to be considered in choosing the right form of organization for a new business.

Starting a new business is, essentially, a decision about taking a risk. Everyone knows that there is no guarantee of success, and that a high proportion of new businesses fail. It is not surprising, given the risks involved, that most people starting a new business want to minimize the investment that will be required to get that business off the ground. On the other hand, most business-savvy people recognize that the form of the business organization may have a significant impact on the personal risk that the founders will take in operating the business, and on the taxes that they will have to pay if the business earns income.

I Have No Money -- What Form of Business Organization Should I Choose?

Although it seems strange to contemplate people commencing business operations without any capital to run a business, I frequently hear words quite close to the title of this section from new or prospective clients.

In most cases, "no money" really means very little money, or that what money is available is already committed to other necessities to get the business going.

The most costly forms of organization, at least at the starting gate, are entities that enjoy limited liability (*i.e.*, creditors usually cannot sue you individually to collect business debts, unless you have signed personally for such debts or guaranteed payment). Entities that enjoy limited liability are corporations, limited partnerships and limited liability companies. The cost of making necessary filings, advertising the formation and drafting the underlying documents (articles of incorporation, by-laws, resolutions and shareholder agreement for a corporation; limited partnership certificate and agreement for a limited partnership; and certificate of organization and operating agreement for a limited liability company) can equal or exceed several thousand dollars. These entities also cost more to keep up over time, with additional fees necessary to change or amend underlying documents, and employ lawyers and accountants to do the housekeeping activities of writing minutes of meetings and preparing more complicated tax returns.

It is cheaper to form a proprietorship (single individual in business) or general partnership (two or more people conducting a business as partners), because there are no required agreements or filing requirements (except for fictitious name filings, where the individual or partners do not use their own names as the name of the business). A general partnership can have a partnership agreement, but many do not. Obviously, if nothing has to be filed, and lawyers are not needed to draft specialized legal agreements and other documents, the cost is minimal to set up the business organization.

Unfortunately, proprietorships and general partnerships do not offer the owners limited liability -- in other words, when the business agrees to pay for something, the owner is personally liable for that obligation and exposes his or her personal assets to being attached or sold in order to pay the debts of the business.

"I Don't Get No Respect" -- Business Perceptions and Reality

If you form a proprietorship -- that means that you individually are in business -- the rest of the world may not take you seriously. Alternatively, if you form a corporation as your business entity, and name it "Widget Corporation of America", it is likely that some people will be fooled into thinking that you are really a big successful company instead of a one person corporation with minimal assets. Also, you get to be called "President" or "Chief Executive Officer".

Limited liability companies are the hot new form of business entity because they combine the attribute of being taxed like a partnership (there is a federal income tax on amounts distributed to members or partners, but not a separate tax on the entity's income) with the attribute of limited liability. There is a sense among some entrepreneurs that use of a limited liability company (named, for example, "Widgets R Us, L.L.C."), evidences a sophistication about business and legal form that is valuable for marketing purposes.

While this may seem silly, if you intend to market a product or service to large corporations or to mid-sized successful businesses, their perception of your business's size and level of sophistication may make a difference when they choose a supplier or vendor.

Limited partnerships frequently were used as tax shelter vehicles before 1986 for real estate investments, book investments, movie investments, coal investments, and other forms of investment that were challenged as abusive tax shelters in the mid-1980's and after the 1986 tax reform law. Because many of these investments were unsuccessful, and in some cases resulted in severe adverse tax consequences for the limited partners, the form of entity has a stigma attached to it today. Most people trying to raise money for new ventures shy away from using limited partnerships as the business entities to own the investments.

Here Comes the Tax Man

The choice of organization has a direct impact on how taxes will be computed and paid.

Proprietors, and partners in a general partnership, are taxed directly on the income derived from the operation of the business, after deduction of all ordinary and necessary business expenses. Although partnership taxation is somewhat complicated, the basic principle is pretty straightforward -- the partnership earns income and the income is reported for tax purposes by each of the general partners, usually based on the share that each owns of the partnership. Income taxes will be paid to federal and state, and sometimes local, taxing authorities.

Corporations are taxed on their income by federal and state, and sometimes local, taxing authorities. When corporations distribute income in the form of dividends to shareholders, that income gets taxed again at the shareholder level. In effect, the income of corporations is subject to double taxation, unless the corporation involved can eliminate its income by paying out all revenues in the form

of expenses and salaries. Not surprisingly, the taxing authorities have developed policies that will challenge the salaries paid out to corporate employees who are shareholders if such salaries can be characterized as "unreasonable".

For most small corporations, double taxation is not really a problem, because salaries to shareholders can effectively avoid the corporation actually earning taxable income. But if the corporation should become very successful, or have significant amounts of non-cash income (or if it must pay out amounts, such as principal repayment on debt, that are not deductible as expenses), or if at some point the shareholders want to cash out by having the corporation sell its assets, then the double taxation risk can suddenly become very real and very costly.

There is an election available to many small corporations where they can elect to be treated much like a partnership for tax purposes. This is the S corporation. The taxation of S corporations is significantly more complicated than partnership taxation, and S corporations require sophisticated accountants and lawyers to maintain their S status and properly compute the tax treatment arising from their income and operation. S corporations are very popular because the owners can avoid double taxation on corporate income, but the restrictions on use of S corporations have prevented many small businesses from using this type of entity. The IRS has eased up on the rules applicable to the use of S corporations in recent years, but they are still subject to many restrictions.

Limited partnerships avoid double taxation, and provide limited partners with the benefit of limited liability, but they must have a general partner that will be personally liable for all debts and creditor claims. This is cumbersome, and being the general partner, with fiduciary duties to all partners and personal liability for the limited partnership's debts, is not exactly a desirable position. Although the partners may form a corporation to be the general partner, this itself presents certain tax problems, and greatly increases the expense and complexity of forming and running a limited partnership. Another common problem with limited partnerships is that the limited partners generally cannot participate in management of the business, further restricting the limited partnership's usefulness as an operating vehicle.

Limited liability companies have the unique attribute of being taxed like partnerships, but are viewed under state law as corporations for liability purposes. The owners or members of LLC's cannot be sued (except in rare cases) for the debts of the LLC entity, unless the owners or members personally assume or guarantee such debts.

In some states, including Pennsylvania until the beginning of 1998, the state taxing authorities have refused to recognize LLC's as being other than corporations for tax purposes. The effect of this, in those states, is that LLC's may be subject to double taxation at the state level, but not at the federal level. In early 1997 the owners of a new LLC entity in Pennsylvania decided to move the business out of Pennsylvania for the sole purpose of avoiding state income tax on LLC income. Pennsylvania is has now passed legislation to correct this situation.

OK, Now I am Thoroughly Confused -- What Do I Do?

The above considerations are by necessity only a brief review of the issues that may be important in choosing the proper entity. Selection of the form of business entity involves many factors, and should not be done without prior consultation with a business attorney and accountant.

The next installment in this series will discuss the management, control and division of money issues that are important in entering into a partnership, corporate shareholder agreement or LLC operating agreement with other equity owners in the business.