HOME-BASED AND MICRO BUSINESSES

CASHING IN ON BUSINESS OPPORTUNITIES

CHOOSING THE BEST BUSINESS STRUCTURE

PREFACE

The following outline of the presentation, "Choosing the Legal Structure of Your Business," assumes that the presenter has detailed knowledge of the issues discussed. This information is not intended to educate the presenter. It is important to note that this lesson on this one legal issue, selection of a business structure, was developed for a national audience and must be, by necessity, a broad general outline. **Each state may have different laws on these issues.** The presenter must know the laws in his or her state or have a co-presenter that does to make an effective presentation.

An attorney is the most appropriate person to present this information, preferably an attorney who practices or teaches business law. A lay person who presents legal information, even in an educational setting, runs the risk of giving legal advice in response to questions from the audience. Giving legal advice is considered to be the practice of law. The practice of law is a highly regulated profession. Only someone licensed to practice law may do so. If an unlicensed person gives legal advice or performs legal services, he or she may be subject to criminal penalties, including fines and imprisonment. The only exception to this rule is when the person represents himself or herself in a legal matter. For example, it is legal for a lay person to incorporate his or her business, but it is illegal to help others incorporate their businesses. Whether the person charged a fee for his or her advice or services is irrelevant.

Goal: Entrepreneurs will make informed decisions about the choice of a legal structure for their businesses.

Objectives: This program is intended to do the following:

- Raise the consciousness of home-based business owners about the importance of choosing the legal structure of their businesses.
- Provide information and comparisons about the four basic forms of business structures available to most business owners.
- Motivate home-based business owners to discuss this topic with professional advisers to help them make informed choices.

HANDOUTS

Handout 1 — Choosing the Legal Structure for Your Business

ADDITIONAL RESOURCES

NOLO: Law for All www.nolo.com – Check for legal topics and forms
Internal Revenue Service www.irs.gov – Check for various small business topics

INSTRUCTIONAL MATERIALS

SLIDE 3

CHOOSING THE LEGAL STRUCTURE OF YOUR BUSINESS

There are four basic forms of doing business.

- Sole Proprietorship
- Partnership
- Limited Liability Company
- Corporation

There is a common misunderstanding that a franchise is a type of business structure. It is actually not a structure but a way to acquire, manage and operate a business that you may wish to operate. Franchise owners also select a legal structure under which they wish to acquire and hold the business.

SLIDE 4

QUESTIONS YOU SHOULD ASK

Understanding the differences among the different business forms is important. This is a good time to use professional help, commonly lawyers and accountants, as they will understand some of the unique differences of each time and be able to provide you with the structure that best meets your goals. When thinking about this area, most owners have one to five thoughts in mind. The slide shows those common ideas. Prospective owners want a form that is easy to set up, minimizes taxes, limits liability, and make the business transferable to others.

How easy is it to set up and operate? Some forms of business are easier to set up and operate than others. This may be an important factor if start-up funds are limited.
What are the tax advantages and disadvantages? Different forms of business are taxed differently, and it is important for you to understand how your business will be taxed. In 1997, the IRS simplified classification of business entities for tax purposes by adopting "check-the-box" regulations. Under these regulations, a business entity with two or more members is classified either as a partnership or as a corporation. A business entity with one member is classified either as a corporation or as a sole proprietorship. An entity can elect its classification for federal tax purposes by checking the appropriate box. However, some entities, such as corporations, do not have the option of electing their tax classification.

To what extent are you able and willing to be responsible personally for business debts and losses? If your business poses a risk of personal injury or property damage, this is an important consideration. Insulating your personal assets from claims against your business may be an overriding factor in your choice of legal structure. Of course, you cannot eliminate the risk, so good insurance planning is critical.

What happens to the business if you should die? Some forms of business exist only so long as the owner lives. Proper estate planning should take this into account.
How easy will it be to liquidate the business? If you decide to quit doing business, for

whatever reason, how difficult will it be to liquidate? Some forms of business may be costly to liquidate. Keep in mind that a high percentage of small businesses do not make it beyond the first year or two of doing business. In choosing the legal structure of your business, consider the cost of liquidating if your business should fail.

LESS COMMONLY CONSIDERED CONCERNS

SLIDE 5

There are a number of other important issues related to legal structure that business owners should understand.

Raising money. Lenders are more familiar with certain business structures more than others. These structures may make it easier to borrow money. Certain structures also are more likely to limit the amount of personal information that must be provided when raising finances once the business is established

Regulations. Although certain businesses are easy to set up, the more important question is which will be easiest to operate in the long term. If more time will be spent on certain regulations over the long term, it may make sense to use a business structure that may seem more complicated in the beginning but offers less red tape as the business develops.

Continuity. Often the owner thinks about what form best allows for the transfer a business or is most clear about who acquires the business upon the owner's death. Owners also need to consider business succession and transferring the business to other family members.

Flexibility. It is important the that the structure chosen allows the owner to have the greatest number of options as the business reaches points where critical decisions need to be made.

SOLE PROPRIETORSHIP

SLIDE 6

A sole proprietorship is a business owned and operated by one person for profit. There are two key elements:

One person. Owned and operated by one person. If you are in business with another person, including your spouse, you do not have a sole proprietorship, but you may have a partnership. A sole proprietorship has one owner. Of course, you may hire employees. You must look at all of the circumstances to determine if your spouse (or other potential partner) is an employee or a partner.

For profit. Your business must be for profit. If you have no intent to make a profit or if the IRS considers your business a hobby, you may be limited in deducting your business expenses, and you may lose some important tax advantages. This is true no matter what legal structure you choose for your business.

SLIDE 7

SOLE PROPRIETORSHIP CHARACTERISTICS

Formation. A sole proprietorship is the easiest form of business to set up and operate. There are very few steps to take in starting your business. We'll discuss the formation of a sole proprietorship in a few minutes.

Taxes. A sole proprietor is self-employed and pays self-employment and estimated taxes. Profit and loss are reported on the sole proprietor's individual income tax return. The business itself does not pay tax. Profits are taxed once, and losses can be used to offset other income. This is a tax advantage.

Liability. A major disadvantage of a sole proprietorship is unlimited legal liability. If your business is sued, your personal assets may be at risk. Good insurance planning is necessary to minimize this risk.

Death of Owner. In a sole proprietorship, the business and the owner are considered to be one and the same. Thus, if the owner dies, the business terminates. Sole proprietors need a good estate plan to ensure that the business is carried on after their death by their executors and eventually their heirs.

Liquidation. A sole proprietorship is easy to form, and it is also easy to liquidate. You simply wind up the business after paying all taxes, debts, and claims against the business.

SLIDE 8

FORMATION OF A SOLE PROPRIETORSHIP

A sole proprietorship is the easiest form of business to set up and operate. While there is often no formal process, you must obtain all necessary federal, state, and local licenses and permits. Often this requires payment of fees. Also, if the name of your business is different from your own name, you may have to register the assumed or fictitious name. Check with your state's law to determine when and where you register an assumed name. Finally, you may need to potential acquire a Federal Tax Identification number. Your Social Security number is what you will use if you have no employees. However, if you:

- Pay wages to employees
- Have a Keogh retirement plan
- Pay excise taxes

you are required to obtain a Federal ID number. There are also some additional times when you may have to obtain such a number but these are not as common as the three listed above.

SLIDE 9

TYPES OF PARTNERSHIPS

There are basically two forms of partnerships:

- General Partnerships
- Limited Partnerships

Note: Some states may have limited liability partnerships, which were statutorily created

with limited liability companies. Discussion of this form of business is beyond the scope of this presentation.

GENERAL PARTNERSHIP

SLIDE 10

A partnership is any two or more individuals who contribute money, labor, or skill to a business and who share in its profits, losses, and management. A partnership can exist even if the parties do not intend to have a partnership. For example, a husband and wife who jointly own and operate a business may call their business a sole proprietorship, but in fact, they may have a partnership.

Although a partnership is easy to set up and operate, it is one of the most difficult forms of doing business because the personalities of the partners will have a tremendous impact on the success of carrying out the business. A partnership is often compared to a marriage — it is easy to get into but difficult and sometimes very painful to get out of. The formula for a successful partnership is MUTUAL effort, values, and goals and a well-written partnership agreement. Choose your partners carefully. A partnership can offer advantages if the each partner brings different resources and skills to the business. Recognize, however, that you also become responsible for the activities of the partner.

LIMITED PARTNERSHIP

SLIDE 11

A limited partnership has one or more partners who have limited liability and no rights of management. Basically, limited partners are investors. Their liability is limited to their investment in the business. Their personal assets are not at risk. A limited partnership must have at least one general partner who manages the business and who has unlimited legal liability. A sole proprietor who needs additional capital but who does not want to borrow or give up any control might consider a limited partnership arrangement. A limited partnership arrangement is, for most home-based and micro businesses, not commonly used.

CHARACTERISTICS OF PARTNERSHIPS

SLIDE 12

Formation. Partnerships are easy to set up and operate. However, limited partnerships require some formalities, which we will discuss later.

Taxes. Partners are self-employed and must pay self-employment and estimated taxes (certain payments made to limited partners are excluded from net earnings for self-employment tax purposes). Profit and loss are reported on each partner's individual income tax return. The partnership itself does not pay tax. Profits are taxed once. The partnership files an annual information return with the IRS to report each partner's share of profit and loss.

Liability. Each partner is personally liable for claims against the partnership (except for limited partners). The liability is joint and several, which means that any one partner is liable for the entire claim. Choose your partners carefully and have a well-written partnership agreement reviewed by an attorney. Good insurance planning can help minimize this risk.

Death of Partner. A partnership is an unstable form of business because it terminates upon the death or withdrawal of a partner, unless there is a partnership agreement to the contrary. Partnership agreements are important to prevent sudden and unexpected termination of the partnership.

Liquidation. A partnership is fairly easy to liquidate. You wind up the business; pay debts, taxes, and claims against the partnership; and settle partnership accounts.

SLIDE 13

FORMATION OF GENERAL PARTNERSHIP

A general partnership is easy to set up and operate. No formal process is required.

You must obtain an employer identification number (EIN) from the IRS and from your state's department of revenue.

You must obtain all necessary federal, state, and local licenses and permits.

If the name of the partnership does not contain all of the names of the partners, you must register an Assumed Name Certificate. Check with your state's law to determine what, when, and where you register.

Although a partnership agreement is not required, it is highly recommended. A partnership agreement should address the following issues:

- Profit sharing
- Participation rights
- Continuation after death or withdrawal of partner
- Buy-out agreement
- Expulsion or addition of partners
- Distribution of assets
- Appraisal of assets

SLIDE 14

FORMATION OF LIMITED PARTNERSHIP

You must file a Certificate of Limited Partnership with the Secretary of State or other appropriate agency. Check the law in your state to find out what and where to register. The name of the partnership must contain the words "Limited Partnership." Abbreviations may be used. A written partnership agreement is required.

You must maintain certain records according to the laws in your state.

Note: Limited partnerships are a rarely used form by home-based and micro business owners.

LIMITED LIABILITY COMPANY

SLIDE 15

A limited liability company is created by state law. It is a relatively new form of business that is now available in all 50 states and the District of Columbia. A limited liability company is a cross between a partnership and a corporation with mostly partnership characteristics. The owners of the business are called "members." It has the tax advantages of a partnership and the limited liability of a corporation. Some states allow for one member limited liability companies.

CHARACTERISTICS OF A LIMITED LIABILITY COMPANY

SLIDE 16

Taxes. A limited liability company has the tax advantages of a partnership (unless the members elected to be taxed as a corporation). Members report profit and loss on their individual income tax returns. Profits are taxed only once. The limited liability company itself does not pay tax. Members are self-employed, and they pay self-employment and estimated taxes (under proposed regulations, some members may be treated as limited partners for purposes of calculating net earnings from self-employment).

Liability. A limited liability company has the limited liability of a corporation. Generally, a member's legal liability is limited to his or her investment in the business. A member's personal assets are not at risk, but there are some exceptions to this rule, depending upon your state's law.

Death of Member. A limited liability company has an unstable business life because the business may be terminated upon the death or withdrawal of a member, unless all the remaining members agree to carry on, or unless the operating agreement states otherwise.

Liquidation. LLC's are relatively easy to liquidate. To do so, you must follow state law but the following are the general steps.

- File articles of liquidation with the Secretary of State.
- Wind up the business.
- Pay all debts, taxes, and claims against the business.
- Distribute the remaining assets to members.

FORMATION OF LLC

SLIDE 17

A limited liability company is more complex to set up and operate than a general partnership, but not as complex as a corporation. Some elements of forming a limited liability company include the following:

- The formation of a limited liability company requires some formalities, depending upon state law. You must obtain all necessary local, state, and federal licenses and permits.
- You must file articles of organization with the Secretary of State.
- You must file certain applications with the Secretary of State and pay filing fees, depending upon state law.

- You must prepare and adopt an operating agreement.
- You must file all necessary reports with the Secretary of State, depending upon state law.

SLIDE 18

CORPORATIONS

A corporation is formed under state or federal law. Legally it is treated as an artificial person, distinct from the individuals who own it.

SLIDE 19

ORGANIZATION OF A CORPORATION – THE CORPORATE STRUCTURE

Shareholders own the corporation. The percentage of stock owned by a shareholder determines how much control that shareholder has in the corporation. If a shareholder owns 51 percent of the voting stock, that shareholder holds controlling interest. Only one shareholder is required to incorporate a business.

The shareholders elect the Board of Directors, who, in turn, elect corporate officers, control overall corporate policies and procedures, and run the day-to-day business affairs of the corporation. In small corporations it is not unusual for the shareholders, Board of Directors, and officers to be the same people.

SLIDE 20

TYPES OF CORPORATIONS

C Corporation. This is a corporation that has not elected to be an S corporation. A C corporation may be subject to double taxation, first at the corporate level and again at the shareholder level.

S Corporation. An S corporation is a product of federal tax law. It is a corporation that is taxed like a partnership. Shareholders are self-employed, and they pay self-employment and estimated taxes. Profit and loss are reported on shareholders' individual income tax returns. With some exceptions, the S corporation itself does not pay income tax. Profits are taxed only once. This is a major advantage over a C corporation.

Professional Corporation. A professional corporation allows members of certain professions to incorporate their business. The IRS defines a professional corporation (or a personal service corporation) as one in which 95 percent of the stock is owned by employees, and the employees spend at least 95 percent of their time performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. Check your state's law to see how it defines a professional corporation.

SLIDE 21

CHARACTERISTICS OF A CORPORATION

Formation. A corporation is the most complex form of business to set up and operate.

Taxes. A corporation is a separate legal entity, so it pays corporate income tax. Thus, profits

may be subject to double taxation if the corporation pays a dividend to its shareholders with after-tax dollars. The dividend is taxed to shareholders as ordinary income. Profits are taxed at the corporate level and again at the shareholder level. To avoid this problem, pay reasonable salaries to shareholder/employees rather than dividends; or elect to be an S corporation.

Liability. A corporation has limited legal liability. Shareholders are liable for the debts and liabilities of the corporation to the extent of their investment. Personal assets are not usually at risk. There are some exceptions: (1) If the shareholder personally guarantees a business debt; (2) If the court finds that the corporate form is a sham; or (3) If the shareholder is personally at fault. Good insurance planning can minimize this risk.

Death of Shareholder. The death of a shareholder does not affect the continuation of the business. Although a corporation is a stable form of doing business, good estate planning is important for small corporations.

Liquidation. A corporation is the most expensive form of business to liquidate. You must obtain shareholder approval to dissolve it and file an intent to dissolve with the Secretary of State. You must pay all taxes, debts, and claims against the corporation. Assets must be distributed among corporate shareholders. As gains on the distribution of assets may be subject to double taxation (except for S corporations), this makes liquidating a corporation expensive and is a major disadvantage to incorporating a business.

SLIDE 22

FORMATION OF A CORPORATION

A corporation is the most complex form of business to set up and operate. You must:

- File articles of incorporation with the Secretary of State
- Pay license, filing, and franchise fees, depending upon state law
- Prepare and adopt corporate bylaws
- Obtain certain supplies such as a record book and seal depending upon your state's law
- Check to see what is required in your state.
- File annual reports with the Secretary of State
- Maintain certain records that are required by state law
- Check your state's law to see what reports or records are required
- Follow corporate formalities, such as:
    - Hold an annual meeting of shareholders after giving appropriate notice of the meeting
    - Keep corporate finances, records, and assets separate from personal finances, records, and assets.

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GLOSSARY

Estimated taxes. Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes, and awards. Estimated tax is used to pay both income and self-employment tax. You must make estimated tax payments for the current tax year if your estimated tax will be $1,000 or more, and the total amount being withheld from your salary or other income will be less than the lesser of: (1) 90 percent of the tax you owe for the current year; or (2) 100 percent of the tax you owed in the previous year. Note: For high income taxpayers, substitute 105 percent for 100 percent. A high income taxpayer is one who had an adjusted gross income for the previous tax year in excess of $150,000 ($75,000 for married individuals filing separately). There are additional exceptions to the general rule for farmers and fishermen. Estimated tax payments are due on April 15, June 15, September 15, and January 15.

Excise taxes. Excise taxes are special taxes on the manufacture, sale, or use of selected items or transactions, such as diesel fuel, highway use, alcohol, and tobacco.

Hobby expenses and losses. Losses incurred by individuals, S corporations, partnerships, and estates and trusts that are attributable to an activity not engaged in for profit (hobby losses) are generally deductible only to the extent of income produced by the activity. An activity is presumed not to be a hobby if profits result in any three of five consecutive tax years ending with the tax year in question. An activity involving the breeding, training, showing, or racing of horses is presumed not to be a hobby if profits result in two out of seven consecutive years.

Keogh retirement plan. A Keogh retirement plan is a qualified retirement plan maintained by a self-employed business.

Self-employment taxes. Self-employment tax is the method used to pay Social Security and Medicare taxes by self-employed persons. You owe self-employment tax if you have more than $400 of net earnings from self-employment in your taxable year.

HANDOUT 1

CHOOSING THE LEGAL STRUCTURE FOR YOUR BUSINESS

1. If the customer successfully sues you, your personal assets may be at risk if:
    a. You are a sole proprietor.
    b. You are a general partner in a partnership.
    c. You are a shareholder of the corporation.
    d. You are a member of a limited liability company.
    e. None of the above.
    f. A and B.

2. The simplest legal structure for a business is:
    a. A sole proprietorship.
    b. A partnership.
    c. A corporation.
    d. A limited liability company.

3. Profits of a corporation may be taxed twice.
    a. True.
    b. False.

4. An S Corporation is taxed like a partnership, but has limited liability like a corporation.
    a. True.
    b. False.

5. A limited partner is personally liable for business debts and liabilities.
    a. True.
    b. False.