

Choosing the Legal Structure of Your Business

- Sole Proprietorship
- "C" Corporation
- Limited Liability Partnership
- Partnership
- "S" Corporation
- Limited Liability Company

(This information is provided for guidance only. Competent legal accounting advice should be obtained to assist you in making a decision on form of organization)

I. INTRODUCTION

One of the most important decisions you will make as a business owner involves the selection of the legal structure or form of your business. The form of business enterprise you choose will have important consequences in terms of how your business will be managed, the personal liability of the owners, how taxes are paid, and how ownership is held. Planning ahead is the key. Each business form has its advantages and disadvantages and should be evaluated in the context of your particular situation.

II. SUMMARY OF THE MOST COMMON FORMS

A. SOLE PROPRIETORSHIP

1. *Definition and Characteristics.* A sole proprietorship can be defined as a business where one individual owns and manages the entire business in his or her own name.
2. *Legal Prerequisites to Begin Operation.* With the exception of obtaining a separate employer tax identification number, using Form SS-4 if you have employees, and the usual business licenses that are applicable to all forms of business (such as vendor license, workers compensation and unemployment taxes, special industry licenses, etc.), no form of report is required before you begin operation as a sole proprietorship. If you plan to use a name for the business other than your full legal name, application for a fictitious name or trade name will have to be made with the office of the Secretary of State Use form 53A the cost is \$50.00.

See

<http://www.sos.state.oh.us/sos/upload/business/filingformsfeeschedule.aspx?page=251#Name>

1. *Liabilities.* The owner has unlimited liability for the liabilities of the business.
2. *Taxes.* The profits of the business are taxed as personal income to the owner. Income is reported on Schedule C or C-EZ.

B. PARTNERSHIPS

General Partnerships

1. *Definition and Characteristics.* Although there are different types of partnerships, the most common is called the general partnership where two or more persons carry on as co-owners of a business. Even if the parties do not call their association a partnership, the law will treat it as a partnership if they share the profits. Unless otherwise agreed to by the partners, each general partner has equal management authority and a percentage share of the profits of the business. For example, in a four-person partnership, each general partner will share 25% of the profits and losses and be responsible for 25% of the expenses. To commence operations, each partner contributes a proportionate share of cash and other property to the partnership to establish relative capital contribution shares.
2. *Legal Prerequisites to Begin Operations.* In addition to the usual permits and licenses discussed above for proprietorships, a certificate listing all of the partners' names and addresses will have to be filed with the County Recorder where the partnership has its principal office, and in each county in which it owns real estate. With the exception of those matters, there are no prerequisites to start business as a partnership.

Although there is no requirement under Ohio law that a partnership have a written agreement, such an agreement is generally considered necessary as a record of the terms of the partnership. A written partnership agreement can provide for such matters as the rights of partners regarding profits and management when there are differing capital contributions, admitting new partners, and what happens upon the death, retirement, or disability of a partner. In the absence of an agreement, provisions in state law govern resolution of these matters.

3. *Liabilities.* All the Partners have unlimited liability for the liabilities of the enterprise.
4. *Taxes.* A partnership must report income on Form 1065, but does not pay income taxes directly. The partners are, however, taxed on their respective shares of the partnership profits, reported to them on a Form K-1 by the partnership as personal income.

Limited Partnerships (Excluding Banking and Insurance)

A Limited Partnership is one in which there are one or more General Partners, who manage the business and bear unlimited liability personally for the liabilities of the partnership, and Limited Partners, whose name(s) does not appear in the name of the partnership, who do not participate in management and primarily contribute only funding. The Limited Partners are not personally liable for the liabilities of the partnership, risk only their investment. A Certificate of Limited Partnership must be filed with the Secretary of State. See Form #531.

C. CORPORATIONS

1. *Definition and Characteristics.* The corporation is an artificial entity that is created when certain documents are filed with the Secretary of State for the state in which the owners decide to incorporate. Once formed, the law treats the corporation as being separate from its owners in several respects.
2. *How the Corporation Works.* The person who owns part of the corporation is called a shareholder. A shareholder contributes cash, property or services to the corporation and in return receives share(s) of stock that, in effect, are certificates of ownership. A shareholder is entitled to receive the profits from the business and to vote on various matters, including electing the persons who are the managers of the business. The managers of the business are called directors. A shareholder, although he or she owns a part of the corporation, does not have the responsibility and power by law to manage the business. The directors of the corporation are responsible for making policy decisions such as whether to acquire a building, enter into agreements, borrow money, decide what kinds of business activities to be involved in, and other matters. The directors elect the officers of the corporation (i.e., president, vice-president, treasurer, and secretary) who are charged with the responsibility of the day-to-day operation of the business.
3. *Legal Prerequisites to Begin Operation.* Like the sole proprietorship and the partnership, the corporation has to have the usual permits and licenses. In addition, a document known as the "Articles of Incorporation", must be filed with the Secretary of State. There are other formal documents executed at the beginning of the corporation that your attorney will prepare.
4. *Liabilities.* The shareholders are not personally liable for the liabilities of the corporation.
5. *Taxes.* The income of the corporation is taxed directly at the corporate level. In addition, after tax profits distributed by the corporation as dividends to its shareholders are taxed to the shareholder as personal income.

"S" CORPORATION ELECTION.

Shareholders of a corporation can elect to have the corporation taxed like a partnership instead of a corporation by filing an "S" corporation election (Form 2553) with the IRS within 75 days of the beginning of the corporation taxable year. Instead of the taxation of both corporate profits and shareholder dividends, profits and losses flow to the owners for tax purposes.

The main requirements for an "S" corporation election are to have less than 75 shareholders and only one class of stock. The decision to elect "S" corporation status should be reviewed carefully with the professional advisers to the business.

CLOSE CORPORATIONS. *The following applies to both 'C' and 'S' corporations.*

A typical Close Corporation is one with few shareholders whose corporate shares are not traded on a securities market and whose owners take an active role in management. Ohio provides for qualifying as a Close corporation under Section 1701.591 of the Ohio General Corporation Law permitting many simplifications in form of management structure, including elimination of the board of directors.

Election of a close corporation requires stipulation thereto in the corporation agreement between shareholders which must include, as a minimum, the items listed in section C of that agreement. It is noted that if the Close Corporation agreement provides that there shall be no board of directors, the shareholders are deemed to be directors and have all of the liabilities, immunities, defenses and indemnifications of directors with respect to any action or inaction of the corporation. Such may severely limit their limited liability protection. Most corporations provide liability insurance protection for their directors.

D. LIMITED LIABILITY PARTNERSHIP

In 1994 the State of Ohio passed legislation to recognize the legality of the Limited Liability Partnership, with a minimum of two participants, called "Associates" rather than "Partners."

To become a Limited Liability Partnership, LLP, a partnership files a registration application with the Secretary of State. The partnership name must contain the words "limited liability partnership" or "LLP" so that others doing business with them are on notice as to the specifically codified limited liability provisions. The partnership must also file an annual report (during the month of July) with the Secretary of State. The statutory revision provides that the certification automatically eliminates "joint and several liability" and specifically lists and authorizes twelve activities (previously prohibited) that the limited partners may engage in without losing their limited liability

E. LIMITED LIABILITY COMPANY*I. Definition and Characteristics.*

In a Limited Liability Company the owners are not shareholders or partners but members who desire to affiliate. Articles of Organization are filed with the Secretary of State and must cover duration (which may be unlimited) and purpose. These may also cover membership, management, and other issues. An Operating Agreement must also be filed. The enabling legislation is so general and unrestrictive that legal advice and great care in preparing the agreement are essential to obtain the desired benefits. The name of the company must include the words "limited liability company," "LLC," or "Ltd" in its name. The "pass-through income tax" feature will be dependent upon the filing of a form with the IRS and checking the box that calls for flow-through treatment.

Legal Prerequisites to Begin Operation.

One or more persons may form an LLC by signing and filing Articles of Organization with the Ohio Secretary of State and paying the specified fee. A person means any natural person, partnership, limited partnership, trust, estate, association, limited liability company, or corporation; any custodian, nominee, trustee, executor, administrator or other fiduciary; or any other individual or entity in its own or any representative capacity. The Articles of Organization must be on a form prescribed by the Secretary of State.

See <http://www.sos.state.oh.us/SOS/Upload/business/forms/533a.pdf>

If a limited liability company is formed for the purpose of rendering professional services, each member, employee, manager or other agent of the company who renders a professional service in the state must be licensed or otherwise legally authorized to render the same kind of professional service (or if applicable, the kinds of professional services).

3. *Statutory Agent.* At the time the Articles of Organization are filed, a written appointment of statutory agent and acceptance of the appointment signed by the designated agent must be filed in order that there is a responsible representative of the company upon whom legal documents may be served.
4. *Purposes and authority of an LLC.* An LLC may be formed for any purpose or purposes for which individuals lawfully may associate themselves.
5. *Operations.* An Operating Agreement should set forth the particular rules to govern operations. While in general an operating agreement can be oral, it is highly recommended that the Agreement be put in writing.
6. *Management.* The LLC is managed by the Members or a Manager(s) can be appointed to take any and all actions that the Members can legally take. The Operating Agreement should specify who can manage the Company.
7. *Personal Liability of Members or Managers.* In general, the debts, obligations, and liabilities of an LLC, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the LLC. Neither the members nor the managers are personally liable to satisfy any claim or liability of the company solely by reason of being a member or manager. Nothing in this statute, however, affects any personal liability of a member or manager for the member's or manager's own actions or omissions. Finally, this statute does not affect any statutory or common-law rights against those that render professional services. As with corporations, care must be exercised to observe the legal requirements and formalities so as not to jeopardize liability limitations; obtain competent legal review.
8. *Self-Employment Taxes.* Similar to a proprietorship, all member earnings from the LLC are subject to self-employment taxes. If a member is also an employee of the LLC, the LLC will have to withhold social security and Medicare taxes from the members salary, and pay the corresponding employer's share. In addition, the member will have to pay self-employment taxes on any distribution profits from the LLC; this is not the case with a corporation, including an "S" corporation

III. RELATIVE DIFFERENCES BETWEEN THE FORMS OF ORGANIZATION

Generally the state fees for each form of organization are \$125. An S-Corp is an election available to C-Corps. Legal fees related to the setup of an organizational form can vary widely (See attachments for more information).

IV. RISK OF LOSING LIABILITY LIMITATION

The liability limitation for shareholders of corporations is dependent on the parties properly following all of the legal requirements and formalities regarding organization, records, filings, decision making and the like, which will require definition and review by competent legal counsel. Many small corporations act like proprietorships or partnerships; operating in this manner may obviate the limited liability of the owners with respect to claims for damages or legal action that may be taken against the corporation. The courts, in practically all such cases, look behind the corporate name to the actual operation and, if it is essentially operating as a proprietorship or partnership, may consider the owners liable for corporate debts.

The same generally applies to liability limitations of Members of LLCs. Care must be taken to follow legal requirements and formalities, though these may be less than for corporations. In general keep business finances separate from personal, only sign documents over your title in the organization to assure that it may not be interpreted as a personal guarantee, establish and maintain a registered agent, follow the provisions of the operating agreement and follow reasonable business practices. Again, competent legal counsel should be obtained. Generally, owners can not get insurance protection from such liabilities; such is limited to directors and officers.

IV. SUMMARY

It is believed that the best form of organization for a new small business is a Limited Liability Company or an "S" Corporation, unless the business poses such small potential for liabilities that a Sole Proprietorship would suffice. Be sure to consult your attorney in making such decisions.

V. OTHER FORMS

Several other corporate types exist, but are generally not applicable to small businesses; these include **Nonprofit Corporations**, **Professional Associations** and **Business Trusts**. **Foreign corporations** are corporations incorporated under the laws of another state or foreign country; they must be licensed to do business in the state.

| Sole Proprietor | Partnership | C Corporation | S Corporation | Ltd. Liability Partnership | Ltd. Liability Company |
|---|---|---|---|--------------------------------------|---|
| Simple to Organize | More complex to organize. | Very complex to organize. | Complex to organize. | Most complex to organize. | Complex to organize. |
| Owner has maximum freedom in decisions. | Authority divided among partners. | Authority is with the Board of Directors. | Authority is with the Board of Directors. | Authority is divided among partners. | Authority is divided among members or managers. |
| Minimum of legal restrictions. | Moderate legal restrictions. | Many state and federal controls. | Many state and federal controls. | Some state controls. | Some state controls. |
| Owner receives all profits. | Partners divide profits. | Shareholders divide profits | Shareholders divide profits. | Partners divide profits. | Members divide profits. |
| Easy to discontinue. | Somewhat easy to discontinue. | Costly to discontinue. | Costly to discontinue | Somewhat easy to discontinue. | Somewhat easy to discontinue. |
| Owner has unlimited personal liability. | Each general partner has unlimited liability. | Shareholders generally not liable. | Shareholders generally not liable. | Partners not liable.* | Members not liable.* |
| Profits taxed as personal income. | Partners are taxed on partnership profit. | Both corp. and shareholders taxed. | Shareholders taxed on corporate profits. | Partners taxed as personal income. | Members are taxed on company profits. |
| Limited ability to raise capital. | Expanded ability to raise capital. | Best ability to raise capital. | Expanded ability to raise capital. | Expanded ability to raise capital. | Expanded ability to raise capital. |

Forms of Organization - Relative Differences

Note: * Extent of liability varies from state to state.

Relative advantages and disadvantages of S-corporations and limited liability companies

S-Corporations

Advantages: 1) protects shareholders against liability. 2) profits taxed as personal income. 3) can sell stock to raise money. 4) one shareholder cannot bind others. 5) no self-employment tax on corporate profit. 6) legal agreement relatively inexpensive. 7) one person can form an s-corp.

Disadvantages: 1) many state regulations. 2) only one class of stock. 3) limited to 75 shareholders. 4) must dissolve to change to an llc 5) no non-us citizens as shareholders. 6) no corporations as shareholders.(unless the corporation owns 100%) 7) minimum of 1 employee.

Limited Liability Companies (LLCs)

Advantages: 1) protects members against liability. 2) profits taxed as personal income. 3) can add members to raise money. 4) one member could not bind others if legal agreement spells it out. 5) more informal-less regulations. 6) unlimited members, including foreigners. 7) relatively easy to change to an S-corp. 8) one person can form an LLC.

Disadvantages: 1) members must pay self-employment taxes on profit. 2) legal agreement relatively expensive. 3) this is a new type organization; new rules could evolve.

Neither provides liability protection if operated as a sole proprietorship.