



Choosing the Legal Structure of Your Business

(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 is 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. 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.
3. *Liabilities.* The owner has unlimited liability for the liabilities of the business.
4. *Taxes.* The profits of the business are taxed, at ordinary income tax rates, as personal income to the owner. All income that the owner receives is also subject to self-employment (FICA and Medicare) taxes. Income is reported on Schedule C or C-EZ of Schedule 1040, Personal Income Tax Return.

B. LIMITED LIABILITY COMPANIES (LLCs)

1. *Definition and Characteristics.* A Limited Liability Company is a concept that was initially adopted in the 1990s. All 50 states and the District of Columbia now recognize this popular business type. Because of its simplicity, flexibility and pass through tax characteristics, it is

becoming the preferred form of business entity for many small and some large businesses. In a Limited Liability Company, the owners are not shareholders or partners but members who desire to affiliate.

An LLC is an entity, governed by a state LLC statute, which offers its owner(s) the ability to limit his or her responsibility for debts to the amount of equity committed to the entity. As with a corporation, limited liability may depend upon observing all formalities in treating the LLC as a separate entity.

This business structure has many *advantages*, including:

- Independent legal structure separate from its owners > separate owners' personal assets from their business debt
- Help separate owners' personal assets from their business debts
- Owners do not share management power with a Board of Directors.
- Much less administrative paperwork and record keeping.
- Owners have *limited liability* for business debts and obligations
- Pass-through (Sole Proprietorship and Partnership) taxation (i.e. no double taxation)
- No limit to the number of owners. One owner may form a single member LLC
- Owners do not need to be U.S. citizens or permanent residents
- Owners can be individuals or other companies or mixtures thereof
- LLCs do not need to hold annual meetings or record meeting minutes as do corporations
- Governed by operating agreements.

The main *disadvantages* are:

- LLCs may not issue stock to attract investors.
- Similar to a sole proprietorship, all income that members receive, both from guaranteed distributions and operating income, is taxed at ordinary income rates and subject to self-employment (FICA and Medicare) taxes. This can be alleviated by selecting on IRS form 2553 to be taxed as an S corporation where earnings, after paying a reasonable salary to the owners, are not subject to self-employment taxes.

2. Legal Prerequisites to Begin Operation. One or more persons may form an LLC by signing and filing Articles of Organization with the 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. The name of the company must include the words 'limited liability company,' "LLC," or 'Ltd' in its name.

If a limited liability company is formed for the purpose of rendering professional services (e.g. lawyers, doctors, dentists, accountants, financial advisors), 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. An LLC must obtain a Federal EIN by filing a form SS-4, Application for Employer

Identification Number, to establish a business checking account and to pay employees; if there are two or more members, this number will be used on the LLC's business tax returns.

3. *Statutory Agent.* At the time the Articles of Organization are filed, a written appointment of statutory agent must be filed so there is a responsible representative of the company upon whom legal documents may be served.
4. *Operations.* An LLC is governed by the operating agreement which establishes the business and legal relationships among the members of the LLC. This agreement similar to corporate by-laws, helps ensure that courts will respect the members' limited personal liability.

The operating agreement sets forth the particular rules to govern operations and can provide for a successor to the member in the event of death of the member. The operating agreement defines those services to be rendered by the member(s) and the reasonable compensation to be paid for those services; this may provide protection against creditors seeking to attack such distributions. The operating agreement structures the financial and working relationships of the co-owners and establishes each partner's:

- current capital contribution, right to make additional contributions
- capital account to track contributions; withdrawals; share of net income, loss
- management duties; powers of managing partner and tax matters partner
- hours of work, paid time off for vacation, personal use, illness
- guaranteed payments = compensation for performing management duties
- percentage of ownership units = share of net income, loss, capital gain, tax deductions and credits
- **important: guaranteed payments and ownership unit share %s can vary**
- income tax distribution = partner's income taxes due on company earnings
- buy-sell rights/triggering events; process for valuing fair market value of ownership units; provision for company-funded buy-sell life insurance

5. *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. The limitation does not apply to personal commitments or guarantees provided directly by any member, such as guaranteeing payment of a loan. Finally, this statute does not affect any statutory or common-law rights against those that render professional services.

The liability limitation for Members is dependent on their 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

companies, particularly single member LLCs, 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 company. The courts will 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 company debts.

Care must be taken to follow legal requirements and formalities:

- ✓ keep business finances separate from personal
- ✓ only sign documents over the 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
- ✓ manage business risk, including maintaining sufficient business insurance.

6. The Operational and Financial Use of Multiple LLCs by A Single Operating Business

An LLC can be used to compartmentalize different economic activities, locations or projects of a Parent (holding company) LLC into separate LLC "Children" (operating units) in order to limit the exposure each activity has to liabilities from the other activities.

The company can structure the business with a parent LLC and then create a number of custom-made, single member LLC subsidiaries for each activity. Modern accounting software has facilitated the performance of accounting functions for multiple, related LLC's.

Each subsidiary can incur separate debt, either from an outside lending source or through a private line of credit from the parent, secured by a security interest in assets of the subsidiary. If the lines of credit from the parent company are extended on reasonable terms, the parent company's security interest in the subsidiary's assets can afford protection against the claims of general creditors. In some cases, the parent company can isolate activities involving potential exposure to various kinds of business risks.

For example, a construction company might own all construction equipment, form separate LLCs for each of its construction projects and lease equipment to each as needed; in the event of failure of one of the projects, the construction equipments may be protected from attachment.

C. CORPORATION

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.

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.
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 shareholders 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 taxing both corporate profits and shareholder dividends, profits and losses flow to the owners for tax purposes.

An "S" corporation is limited to 75 shareholders and one class of stock (for example, an "S" corporation cannot issue convertible or preferred stock).

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