Choosing Your Legal Structure

Your choice of whether your business should be a proprietorship, a partnership or a corporation can be important for many reasons. Each has advantages and disadvantages depending on the type of activity you are engaged in.

Part of keeping your home-based business legal involves choosing the legal structure for it: sole proprietorship, partnership, or corporation. Aside from being necessary for government reporting and tax purposes, this can enable your business to operate more efficiently. Since each legal form has its own unique characteristics, your goal is to choose the form that works best for you.

Once the entrepreneur has determined the goods or services the company will offer and whether there is a market for the product, a decision must be made on the type of business formation. Usually you will choose either a sole proprietorship, a partnership or a corporation. There's no right or wrong choice that fits everyone. Your job is to understand the advantages and disadvantages of each legal structure and pick the one that best meets your needs.

Sole Proprietorship

A business owned by one person, who is entitled to all of its profits and responsible for all of its debts, is considered a sole proprietorship. These firms are owned by one person, usually the individual who has day-to-day responsibility for running the business. Sole proprietors own all the assets of the business and the profits generated by it. They also assume complete responsibility for any of its liabilities or debts. This legal form is the simplest, providing maximum control and minimum government interference. Currently used by more than 75 percent of all businesses, it is often the suggested way for a new business that does not carry great personal liability threats. The owner simply needs to secure the necessary licenses, tax identification numbers, and certifications in his or her name, and you are now in business!

The main advantages that differentiate the sole proprietorship from the other legal forms are (1) the ease with which it can be started, (2) the owner's freedom to make decisions, and (3) the distribution of profits (owner takes all).

Still, the sole proprietorship is not without disadvantages, the most serious of which is its unlimited liability. As a sole proprietor, you are responsible for all business debts. Should these exceed the assets of your business, your creditors can claim your personal assets--home, automobile, savings account, and investments. In other words, the law basically treats the business and the owner as one and the same. This uniform treatment also has important tax implications. Partnerships and corporations may lessen their tax liability through a myriad of business expenses and other tax avoidance techniques. These tax deductions may not be applicable to a sole proprietorship. Also, the potential growth and reach of a sole proprietorship pale in comparison with that of a corporation. Sole proprietorships also tend to have more difficulty obtaining capital and holding on to key employees. This stems from the fact that sole proprietorships generally have fewer resources and offer less opportunity for job advancement. Thus, anyone who chooses the sole proprietorship should be prepared to be a generalist, performing a variety of functions, from accounting to advertising.

Advantages

- You're the boss.
- It's easy to get started.
- You keep all profits.
- Income from business is taxed as personal income.
- You can discontinue your business at will.

Disadvantages

- You assume unlimited liability.
- The amount of investment capital you can raise is limited.
- You need to be a generalist. Retaining high-caliber employees is difficult.
- The life of the business is dependent on the owner's.

Partnership

A business owned by two or more people, who agree to share in its profits, is considered a partnership. Like sole proprietorships, the laws do not distinguish between the business and its owners. The Partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out, or what steps will be taken to dissolve the partnership when needed. Its difficult to think about a "break-up" when the business is just getting started, but many partnerships split up at crisis times and unless there is a defined process, there will be problems. They also must decide up front how much time and capital each will contribute. Like the sole proprietorship, it is easy to start and the red tape involved is usually minimal. The tax structure is the same as proprietorship except in the profits and losses of the partnership are divided by an agreed percentage by the partners.

The main advantages of the partnership form are that the business can (1) draw on the skills and abilities of each partner, (2) offer employees the opportunity to become partners, and (3) utilize the partners' combined financial resources.

However, for your own protection, it is advisable to have a written partnership agreement that will spell out the specifics of the agreement. This should state (1) each partner's rights and responsibilities, (2) the amount of capital each partner is investing in the business, (3) the distribution of profits, (4) what happens if a partner joins or leaves the business, and (5) how the assets are to be divided if the business is discontinued. Things have a way of changing and people forgetting over time, so it is essential that there be a signed document that all abide by.

Partnerships also have their share of disadvantages. The unlimited liability that applies to sole proprietorships is even worse for partnerships. As a partner, you are responsible not only for your own business debts, but for those of your partners as well. Should they incur debts or legal judgments against the business, you could be held legally responsible for them. Disputes among partners can be a problem, too. Unless you and your partners see eye to eye on how the business should be run and what it should accomplish, you are in for trouble.

However, a partnership is generally the least advisable way to go. It requires filing a separate partnership tax return, does not carry liability protection for general partners, and can lead into legal and personal disputes. A corporate form of ownership is generally recognized as preferable over partnership, because it can serve the same purpose while offering a cleaner and better protected structure for the owners.

Advantages

- Two heads are better than one.
- It's easy to get started.
- More investment capital is available.
- Partners pay only personal income tax.
- High-caliber employees can be made partners.

Disadvantages

- Partners have unlimited liability.
- Partners must share all profits.
- The partners may disagree.
- The life of the business is limited.

You can create a partnership based on an oral agreement, but it's much smarter to put it in writing. A partnership is a business form created automatically when two or more persons engage in a business enterprise for profit. Consider the following language from the Uniform Partnership Act: "*The association of two or more persons to carry on as co-owners of a business for profit forms a partnership, whether or not the persons intend to form a partnership.*" A partnership – in its various forms – offers its multiple owners flexibility and relative simplicity of organization and operation. In limited partnerships and limited liability partnerships, a partnership can even offer a degree of liability protection.

Partnerships can be formed with a handshake – and often they are. In fact, partnerships are the only business entities that can be formed by oral agreement. Of course, as with any important legal relationship, oral agreements often lead to misunderstandings, which often lead to disputes. Thus, you should only form a partnership that is memorialized with a written partnership agreement. Preferably, you should prepare this document with the assistance of an attorney. The cost to have an attorney draft a partnership agreement can vary between $500 and $2,000 depending on the complexity of the partnership arrangement and the experience and location of the attorney.

How Partnerships Are Managed

Partnerships have very simple management structures. In the case of general partnerships, partnerships are managed by the partners themselves, with decisions ultimately resting with a majority of the percentage owners of the partnership. Partnership-style management is often called *owner management*. Corporations, on the other hand, are typically managed by appointed or elected officers, which is called *representative management*. Keep in mind that a majority of the percentage interest in a partnership can be very different from a majority of the partners. This is because one partner may own 60 percent of a partnership, with four other partners owning only 10 percent each. Partnerships (and corporations) universally vest ultimate voting power with a majority of the percentage ownership interest.

Of course, partners and shareholders don't call votes every time they need to make some small business decision such as signing a contract or ordering office supplies. Small tasks are managed informally, as they should be. Voting becomes important, however, when a dispute arises among the partners. If the dispute cannot be resolved informally, the partners call a meeting and take a vote on the matter. Those partners representing the minority in such a vote must go along with the decision of the partners representing the majority.

Partnerships do not require formal meetings like corporations do. Of course, some partnerships elect to have periodic meetings anyway. Overall, the management and administrative operation of a partnership is relatively simple, and this can be an important advantage. Like sole proprietorships, partnerships often grow and graduate to LLC or corporate status.

Varieties of Partnerships

There are several varieties of partnerships. They range from the simple general partnership to the limited liability partnership.

The general partnership. By default, a standard partnership is referred to as a *general partnership*. General partnerships are the simplest of all partnerships. An oral partnership will almost always be a general partnership. In a general partnership, all partners share in the management of the entity and share in the entity's profits. Matters relating to the ordinary business operations of the partnership are decided by a majority of the partners. Of course, some partners can own a greater share of the entity than other partners, in which case their vote counts according to their percentage ownership--much like voting of shares in a corporation. All partners are responsible for the liabilities of a general partnership.

The limited partnership. The limited partnership is more complex than the general partnership. It is a partnership owned by two classes of partners: *general partners* manage the enterprise and are personally liable for its debts; *limited* partners contribute capital and share in the profits but normally do not participate in the management of the enterprise. Another notable distinction between the two classes of partners is that limited partners incur no liability for partnership debts beyond their capital contributions. Limited partners enjoy liability protection much like the shareholders of a corporation. The limited partnership is commonly used in the restaurant business, with the founders serving as general partners and the investors as limited partners.

A limited partnership usually requires a state filing establishing the limited partnership. Some states, most notably California, allow the oral creation of a limited partnership. Of course, establishing a limited partnership with nothing more than an oral agreement is unwise. Oral limited partnership agreements will very likely lead to disputes and may not offer liability protection to limited partners. Because of the complexity of limited partnerships, the formation of one is not something you should undertake on your own. The formation of a limited partnership is best left to a qualified attorney.

Partnership Agreements

Your partnership agreement should detail how business decisions are made, how disputes are resolved, and how to handle a buyout. You'll be glad you have this agreement if for some reason you run into difficulties with one of the partners or if someone wants out of the arrangement.

The agreement should address the purpose of the business and the authority and responsibility of each partner. It's a good idea to consult an attorney experienced with small businesses for help in drafting the agreement. Here are some other issues you'll want the agreement to address:

1. How will the ownership interest be shared? It's not necessary, for example, for two owners to equally share ownership and authority. However you decide to do it, make sure the proportion is stated clearly in the agreement.

2. How will decisions be made? It's a good idea to establish voting rights in case a major disagreement arises. When just two partners own the business 50-50, there's the possibility of a deadlock. To avoid a deadlock, some businesses provide in advance for a third partner, a trusted associate who may own only 1 percent of the business but whose vote can break a tie.

3. When one partner withdraws, how will the purchase price be determined? One possibility is to agree on a neutral third party, such as your banker or accountant, to find an appraiser to determine the price of the partnership interest.

4. If a partner withdraws from the partnership, when will money be paid? Depending on the partnership agreement, you can agree that the money be paid over three, five or ten years, with interest. You don't want to be hit with a cash flow crisis if the entire price has to be paid on the spot in one lump sum.

How Partnerships Are Governed

Partnerships are governed by the law of the state in which they are organized and by the rules set out by the partners themselves. Typically, partners set forth the governing rules in a partnership agreement.

Often the governance rules determined by the partners differ from the governance rules set by state law. In most cases, the rules of the partners override state law. For example, state law typically dictates that a partnership's profits are to be divided among partners in proportion to their ownership interests. However, the partners are free to divide profits by a formula separate from their ownership interests, and the decision of the partners will override state law. Thus, the governance rules in state law are default provisions that apply in the absence of any rules set by the partners in a partnership agreement.

This fact underscores the need for a partnership agreement. Otherwise, the partnership will by default be governed by state law. The laws set forth by state law may not be appropriate for every partnership. For the most part, however, the default state rules are fair and well-balanced.

Corporation

A corporation differs from the other legal forms of business in that the law regards it as an artificial being possessing the same rights and responsibilities as a person. This means that, unlike sole proprietorships or partnerships, it has an existence separate from its owners. It has all the legal rights of an individual in regards to conducting commercial activity -- it can sue, be sued, own property, sell property, and sell the rights of ownership in the form of exchanging stock for money. A corporation can be taxed; it can be sued; it can enter into contractual agreements. The owners of a corporation are its shareholders. The shareholders elect a board of directors to oversee the major policies and decisions. The corporation has a life of its own and does not dissolve when ownership changes.

A corporation is a juridical entity. It must be created by or composed of at least 2 natural persons, technically called "incorporators." Juridical persons, like other corporations or partnerships, cannot be incorporators, although they may subsequently purchase shares and become corporate shareholders/stockholders. The liability of the shareholders of a corporation is limited to the amount of their capital contribution. In other words, personal assets of stockholders cannot generally be attached to satisfy the corporation's liabilities, although the responsible members may be held personally liable in certain cases. For instance, the incorporators may be held liable when the doctrine of piercing the corporate veil is applied. The responsible officers may also be held solitarily liable with the corporation in certain labor cases, particularly in cases of illegal dismissal.

As a result, the corporation offers some unique advantages. These include (1) limited liability: owners are not personally responsible for the debts of the business, (2) the ability to raise capital by selling shares of stock, and (3) easy transfer of ownership from one individual to another. Plus, unlike the sole proprietorship and partnership, the corporation has "unlimited life" and thus the potential to outlive its original owners.

Advantages

- Stockholders have limited liability.
- Corporations can raise the most investment capital.
- Corporations have unlimited life.
- Ownership is easily transferable.
- Corporations utilize specialists.

Disadvantages

- Corporations are taxed twice.
- Corporations must pay capital stock tax.
- Starting a corporation is expensive.
- Corporations are closely regulated by government agencies.

The main disadvantage of the corporate form can be summed up in two words: **taxation and complexity**. In what amounts to double taxation, you must pay taxes on both the income the corporation earns and the income you earn as an individual. Along with this, corporations are required to pay an annual tax on all outstanding shares of stock. Given its complexity, a corporation is both more difficult and more expensive to start than are the sole proprietorship and the partnership. In order to form a corporation, you must be granted a charter by the state in which your home-based business is located. For a small business the cost of incorporating usually ranges from $500 to $1,500. This includes the costs for legal assistance in drawing up your charter, state incorporation fees, and the purchase of record books and stock certificates. And, since corporations are subject to closer regulation by the government, the owners must bear the ongoing cost of preparing and filing state and federal reports.

The biggest businesses take the form of corporations, a testament to the effectiveness of this business organization. A corporation, however, is relatively more difficult to create, organize and manage. There are more reportorial requirements with the stock-exchange. Unless you own sufficient number of shares to control the corporation, you'll most likely be left with no participation in the management. The impact of these concerns, however, is minimized by the army of lawyers, accountants and consultants that assist the corporation's management.