Structuring Your Business

Overview of Guide
This guide is designed to provide basic information on some of the legal and practical issues to consider when setting up a business and applies only to New York law. **THIS GUIDE DOES NOT CONSTITUTE LEGAL ADVISE AND IS NOT A SUBSTITUTE FOR LEGAL OR PROFESSIONAL ADVICE. PERSONS CONTEMPLATING STARTING A BUSINESS ARE STRONGLY ENCOURAGED TO CONSULT PROFESSIONAL LEGAL, FINANCIAL AND TAX ADVISORS.**

This guide provides information on the following legal structures:

Unincorporated Business Entities
- Sole Proprietorship
- General Partnership

Incorporated Business Entities
- Limited Partnership
- Corporations
    - C Corporation
    - S Corporation
- Limited Liability Company

Business Entities for Professionals

Basic Legal and Practical Issues to Consider
One of the first decisions that you will have to make as a business owner is how your company should be structured. No one legal structure is best for all small businesses. Whether you are better off starting as a sole proprietor or choosing one of the more complicated organizational structures such as a partnership, corporation or limited liability company depends on several factors including those listed below.

In making an entity choice, you should take into account the following:

- Your vision regarding the size and nature of your business
- Number of co-owners of the business
- Relationship between owners and management
- Extent to which you will seek outside investors
- Level of "structure" and formality you are prepared to manage
- Expense, in time and money, of forming and maintaining the business entity
- Business's vulnerability to lawsuits and other liabilities or obligations
- Tax implications of the different ownership structures
- Expected profit (or loss) of the business
- Whether you will need to re-invest earnings into the business
- Your need for access to cash from the business for personal use

UNINCORPORATED BUSINESS ENTITIES

You may create certain business entities without going through the process of drafting and filing formal paperwork. The benefits of this approach are simplicity, low cost and flexibility. The disadvantages are that you will not be able to take advantage of many of the protective features that more formal business entity structures offer. The two types of unincorporated business structures are sole proprietorship and general partnership.

Sole Proprietorship

The vast majority of small businesses start out as sole proprietorships because this entity is the simplest type of business organization to establish for an individual starting a business. Under this structure, your business is an extension of you. There are no formal steps you need to take or public filings to make to form a sole proprietorship. Many people, though, choose to operate their sole proprietorship under a "doing business as" name or assumed name (e.g., Candy's Treats), which requires filing a Certificate of Assumed Name with your local county clerk's office.

PROS

- Easiest and least expensive form of business entity to organize.
- Continuing maintenance costs of the business are minimal.
- Sole proprietors are in complete control, and within the parameters of the law, may make decisions solely as they see fit.
- Profits from the business flow through directly to the owner's personal tax return without taxation at the business level.
- Sole proprietorship can easily be converted into another type of entity as the business grows.

CONS

- Sole proprietors have unlimited and direct liability and are legally responsible for all debts against the business – not only are the business assets at risk but your personal assets may be at risk as well (creating a "doing business as" name and marketing your business under a trade name will not create a separate legal entity or shield you from direct liability).
- May be at a disadvantage in raising funds and are often limited to using funds from personal savings or consumer loans.
- May have a hard time attracting high-caliber employees with experience in larger organizations, or those that are motivated by the opportunity to own a part of the business.
- As the sole owner, the demands of running a business are high and fall solely on your shoulders without the benefit of other owners or partners.
- The business entity dissolves automatically upon retirement or death of owner.

General Partnership

In a general partnership, two or more owners share ownership of a single business. Owners of general partnerships may be individuals, other partnerships, corporations or associations. As is the case for sole proprietorships, in a partnership, the law does not distinguish between the business and its owners. Each owner has both unlimited personal liability and full authority to conduct business for the partnership. This means that one partner will be liable for the business decisions of the other partner. No formal paperwork needs to be filed to form a general partnership, and a written partnership agreement is not required either; however, co-owners should clearly set out in advance each partner's upfront and potential future contributions, level of involvement in the business and precisely what will happen in the event of a liquidation. It may be difficult to think about a "break-up" when the business is just getting started, but many partnerships split up in times of crisis and a legal partnership agreement can prevent problems from escalating.

PROS

- Partnerships are relatively easy to establish; however, time should be invested in developing a partnership agreement.
- A general partnership has pass-through tax treatment, meaning no taxes are paid at the business entity level. Instead, the individual partners are taxed on the income they receive from the partnership. Each partner will pay taxes on their share of the business income on their personal tax returns.
- Having multiple owners creates options and flexibility for the financing and management of the business.

CONS

- Each partner is jointly liable for the entire amount of any business debt or obligation, including court judgments, even if the obligation was incurred by the other partner, meaning that partners will be held personally liable as with a sole proprietorship.
- Because no formalities are needed to form a general partnership, it could potentially be difficult to prove in court that a general partnership exists if one of the parties later denies forming the partnership. Similarly, a court could deem two or more people partners based on implication and the conduct of the parties, even when one or more of the parties never intended to create a partnership.
- A general partnership will have a limited life and will end upon the bankruptcy, withdrawal or death of any of the partners.

INCORPORATED BUSINESS ENTITIES

All of the following entities are either "incorporated" or "formed" by filing specific documentation with state or local officials. Formal filing requirements create additional burdens to small business owners, but formalizing a business in this manner can provide valuable protections and benefits to business owners.

Limited Partnership

A Limited Partnership (LP) is a entity where most of the partners have limited liability (to the extent of their investment) as well as limited input regarding management decisions, which generally attracts silent investors interested in making capital investments for short-term projects. This form of ownership is not often used for operating retail or service businesses. An LP must have one or more general partners and one or more limited partners. The general partners are in charge of the business and retain unlimited personal liability for the debts and obligations of the partnership (similar to the general partners of a general partnership). The limited partners in an LP are not bound by the obligations of the partnership and do not have unlimited personal liability. Rather, limited partners are liable to the LP only up to the amount of money or property they contributed to the business. The trade-off to limited partners for having limited liability is that they must take no role in the management of the LP. If a limited partner takes part in the management or control of the business, then that partner may lose his or her limited liability.

Forming an LP is more complex and formal than a general partnership. The general partners must draft and sign a written partnership agreement, file with the state a certificate of limited partnership laying out the terms of the LP and comply with various publication requirements.

PROS

- Formal structure may provide added credibility to the business.
- All partners in limited partnerships benefit from pass-through taxation.
- Partners may customize how profits are distributed in the partnership agreement.
- Limited Partnerships allow businesses to have silent investors.
- Increased flexibility and structuring options for financing and management of the business.

CONS

- General partners retain unlimited personal liability for business debts.
- Increased cost and time to draft the formation documents.
- Limited partners always have the risk of losing their limited liability if they become involving in managing or taking control of the business.

Corporations

C Corporation

The C Corporation is the standard type of corporation with which people are most familiar. A corporation is considered by law to be a unique legal entity, separate and apart from its owners. 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 and may appoint officers or hire employees to carry out these decisions and direct day-to-day management and operations. Overall, though, the board of directors is responsible for the organization and there are circumstances where directors could have personal liability. The corporation has a life of its own and does not dissolve when ownership changes.

A corporation, when properly formed and operated, assumes a separate legal and tax life distinct from its shareholders. The separation between the shareholders and corporation leads to several important differences between corporations and all other entities. Because corporations have separate legal identity, they are responsible for their own liability and business debts, and therefore shareholders' liability is normally always limited to the amount of money they paid for their shares. A corporation also pays its own taxes at the corporate income tax rate and files its own corporate tax forms each year. This process, however, can subject a corporation to "double taxation," meaning that the corporation pays corporate tax on all of the corporation's income, and, in addition, any profits paid out to its shareholders in the form of dividends are taxed again as dividend income at the individual shareholders' tax rate. Corporations cannot deduct dividends from business income.

PROS

- Having a corporate entity may be seen as a sign of seriousness and maturity to potential investors and may aid in attracting investment in the business.
- All shareholders have limited liability and that liability is capped at the amount shareholders invested, i.e., the amount they paid for their shares of stock in the corporation.
- As a separate legal entity, a corporation is capable of continuing indefinitely. Its existence is not affected by death or incapacity of its shareholders, officers, or directors or by transfer of its shares from one person to another.
- Owners, i.e. the shareholders, have the option to elect directors to oversee the business for them or to do it themselves, potentially, by personally sitting on the corporation's board.

CONS

- The process of incorporation requires more time and money than other forms of organization.
- Corporations must continually observe corporate formalities that can be time consuming and costly, e.g., holding periodic board meetings and annual shareholder meetings and abiding by various record-keeping requirements.
- Corporations are monitored by federal, state and some local agencies, and as a result may have more paperwork to comply with regulations.
- Corporation profits are subject to double taxation.

S Corporation

Owners who want the limited liability of a corporation and the "pass-through" tax treatment of a partnership or a sole-proprietorship can form an S Corporation. The IRS created the S Corporation entity specifically to aid small businesses. A corporation may be newly incorporated as an S Corporation, or existing C

Corporation may elect to become S Corporation for any given tax year by applying for S Corporation status anytime in the preceding tax year or on or before the fifteenth day of the third month of the current tax year.

Small business corporations seeking to be S Corporations must meet the following four criteria:

1) The corporation can have no more than 100 shareholders;
2) All shareholders must be individuals (with limited exceptions for certain types of trusts and estates);
3) No shareholder can be a nonresident alien (a non-US citizen who does not have a Green Card and who does not pass the "Substantial Presence Test"); and
4) The corporation does not have more than one class of stock, though straight debt will not constitute an additional class of stock.

To become an S Corporation, a corporation must make the federal S corporation election by filing a Form 2553 with the IRS and file a Form CT-6 with the New York Department of Taxation and Finance. All S Corporations are required to have a calendar year end to their fiscal year (to coincide with when individuals file their tax returns). You can petition for a date other than December 31 by applying to the IRS for permission under the provisions of IRS code section 444. Further, no more than 25 percent of the S Corporation's gross receipts can be derived from passive investment activities such as interest or real estate income.

Forming an S Corporation is most beneficial when the business's owner can take advantage of differing income tax rates by taking only a small but reasonable salary and distributing the bulk of the profits to the shareholder(s) (even if the owner is the only shareholder). The Internal Revenue Service, however, requires that salaries paid be "reasonable" (assuming there is enough profit to do so). A reasonable salary is equivalent to what it would cost to pay someone to do that job (subject to geographic differences and level of company profits). If you do not do this, the IRS can reclassify all of the earnings and profit of the corporation as wages, and you will be liable for payroll taxes on the total amount.

PROS

- Shareholders benefit from pass-through taxation of a partnership and limited liability of a corporation.
- Owner/managers can benefit from advantageous income tax rates.
- Shareholders can also receive stepped-up basis in stock annually.

CONS

- Limitation on who may be and the number of shareholders.
- Limitation on capital structure of the corporation.
- IRS "reasonable" salary requirements for owner/managers.

- Must follow all corporate formalities and ongoing regulations just like C Corporations.

Limited Liability Company

The limited liability company (LLC) is a relatively new type of hybrid business structure that is permissible in most states, including New York. This entity structure provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. The owners of the company are called members, and the lifespan of the LLC is usually determined when members file the entity's formation paperwork. However, the time limit can be continued if desired by a vote of the members at the time of expiration. LLCs are the most flexible of all incorporated business entities. The entity structure allows members to divide and delineate management responsibility, profit sharing, funding obligations, continuity of existence, dissolution, etc. as they see fit. An LLC can be easier to form than a corporation, but is more complex to form than a general partnership. A formal, written operating agreement is not required, but it is strongly advised to set out clearly in advance each member's upfront and potential future contributions, involvement in the business, management structure and what will happen in the event of a liquidation.

PROS

- LLCs have great organizational and managerial flexibility. Members can structure the organization in almost any way they deem advisable.
- LLCs may be managed by the members (in any manner they see fit to arrange) or may be managed by a manager. The manager is not required to be a member of the LLC.
- The liability of a member of an LLC is limited to the member's personal investment in the company.
- LLCs can choose how they are taxed, including having pass-through taxation for their members, like partnerships.
- LLCs do not have to follow the same stringent corporate formalities that apply to corporations.
- There are no limitations on who may be a member of an LLC or how many or how few members an LLC can have.

CONS

- LLCs tend to have a much more complex tax filing system than other entities (please consult a tax advisor for details).
- Tax and liability treatment of LLCs is not uniform across state lines.
- LLCs may have some restrictions placed on the transfer of ownership.
- LLCs must use an accrual basis accounting method and are not allowed to use the cash or modified-cash basis accounting systems.

Business Entities for Professionals

In New York, there are special varieties of corporations, partnerships and LLCs that are available only to groups of professionals all practicing the same profession and authorized or licensed by the state to practice their professional service, e.g., attorneys, dentists, doctors, architects. The principal benefit of these business entities for professionals is that the members are not liable for one another's negligent or wrongful acts or misconduct, but rather only their own and those people they directly supervise. You should consult professional legal, financial and tax advisors if you are considering taking advantage of any of these entity structures.

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NYC BUSINESS SOLUTIONS

Business Entity Legal Structure Comparison

	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	Limited Liability Company
Formation Requirements and Costs	None, unless you file an Assumed Name Certificate	None, unless you file an Assumed Name Certificate	State filing and publication requirement; filing fee	State filing; filing fee	Same as a C Corporation, plus additional federal filing	State filing; filing fee
Management	By the sole proprietor	Each general partner has full authority to manage and control the partnership	Only general partners have authority to manage the entity. Limited partners cannot have a management role	Management overseen by board of directors, which is elected by shareholders (directors may be shareholders)	Same as a C Corporation	Members choose preferred management structure; may be member managed or manager managed
Operational Formalities	Very Few	Very Few	Few	Must observe corporate formalities	Same as a C Corporation	Few
Life Span	Dissolved upon sole proprietor's death or retirement	Dissolved by death or bankruptcy of any partner or other statutory events	May continue indefinitely, but will be dissolved upon agreed, or withdrawal of the general partner(s) without a replacment	Perpetual existance	Same as a C Corporation	Perpetual existance unless otherwise specified by the members
Personal Liability	Sole proprietors have unlimited personal liability	All general partners have joint and personal liability	Limited liability only for limited partners. The general partners have joint and personal liability	All shareholders have limited liability	Same as a C Corporation	All members have limited liabilty
Tax Structure	Sole proprietor pays taxes at individual level	Partners pay taxes at inidividual level	Partners pay taxes at inidividual level	Corporation pays taxes on income; dividends to shareholders	Shareholders pay taxes on all income at the individual level	Members pay taxes at the inidivdual level (could choose to

	Sole Proprietorship	General Partnership	Limited Partnership	C Corporation	S Corporation	Limited Liability Company
				are also taxed at the individual level		adopt corporation tax structure instead)
Double Taxation	No	No	No	Yes	No	No
Pass-Through Tax Treatment	Yes	Yes	Yes	No	Yes	Yes
Restrictions on Owners	None	None	None	None	Must be individuals (certain trusts and estates allowed) who are not nonresident aliens	None
Number of Owners	1, the sole proprietor	At least two, no maximum	At least two, no maximum	No restriction	Maximum of 100 shareholders	No restriction

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Glossary of Legal Terms

Capital Structure
Capital is a word used to describe the money a company has to finance its business. The capital structure of a company refers to the mix of debt and equity the company has used to raise money for operations, i.e. its capital.

- Debt is any kind of loan or obligation that the copmany must repay.
- Equity is the stock (for coprorations) or membership interests (for limited liability companies) that the company has sold to investors that gives those investors an ownership stake in the business.

For example, if a corporation had sold shares of stock to various investors for a total of $50,000 and had also taken out a $150,000 loan from a bank, then the corporation's captial structure would be 75% debit financed and 25% equity financed, and it would have a 3:1 debt-to-equity ratio. The choice to raise money through the sale or equity or the issuance of debt is a complicated decision that could depend on many factors, including the type of company, the currents assets and profit or losses of the company, and the goals of the owners.

Class of Stock
Corporations may divide their stock into multiple classes. The standard types of classes of stock are "common stock" and "preferred stock", though a corporation may have multiple classes of each, i.e. "Series A Preferred Stock," "Series B Preferred Stock" etc. Stockholders of any one class of stock must have all identifcal rights, but corporations are allowed to give different rights and preferences to holders of different classes, and shares of a corporation's classes of stock may be worth different amounts based on the varying rights and preferences attached to each class.

Dividend
A portion of the profits of a corporation that is paid shareholders for each share they own based on the type of stock and number of shares owned. Dividend payments are not automatic and may be dependant on a minimum level of profits or assets of the business. All dividends are approved by the board of directors of the corporation. Dividends are usually be paid in cash but can be in the form of additional shares of stock.

Double Taxation
Taxation by the government of the same asset or piece of property for the same purpose more than once. Double taxation can arise in various circumstances but most commonly occurs when profits of a C Corporation are taxed first at the corporate income tax rate and then a second time, when the corporation pays dividends to shareholders, at the personal income tax rate.

Gross Receipts
The total revenue received in one year from all sources of income. This amount is not reduced by any costs or expenses.

Liquidation
Where a business closes down, folds or terminates its existence voluntarily or involuntarily and all the business's assets are sold and any proceeds from those sales are first used to pay the business's creditors and then, if any money is left, to the business's owners.

Pass-Through Taxation
The type of taxation where a business's income is not taxed by the government at the entity level but rather is "passed through" to the business's owners and taxes are paid only at the owner's personal income tax rate.

Perpetual Existence
The concept that an entity may continue to exist forever without any specific end date.

Shareholder
An owner of a corporation, also called a stockholder, whose ownership is reflected in one or more shares of stock of the corporation.

The benefits of being a shareholder include receiving dividends for each share as determined by the board of directors, the right to vote (except for certain preferred shares) in the election of the board of directors and other matters, to bring a derivative action (lawsuit) if the corporation is poorly managed, and to participate in the division of value of assets upon dissolution and winding up of the corporation, if there is any value. A shareholder should have his or her name registered with the corporation, but may hold a stock certificate issued by the corporation. Before registration the new shareholder may not be able to cast votes represented by the shares.

Stepped-up Basis
The adjustment of the value of a piece of property for tax purposes, typically applicablly upon the death of the owner of the property and subsequent inheritance of the property by the owner's heirs. Under Internal Revenue Code §1014(a), the value of the property is determined to be the higher market value of the property at the time of inheritance, not the value at which the original owner purchased the asset.

Substantial Presence Test
The test used by the IRS to determine whether an individual may be considered a

U.S. resident for tax purposes. To pass the test, in a single calendar year, an individual must be physically presented in the United States on at least 31 days during the current year and 183 days during the 3-year period that includes the current year and the two years immediately preceding it, counting only: (i) all the days you were present in the current year, (ii) 1/3 of the days you were present in the first year before the current year, and (iii) 1/6 of the days you were present in the second year before the current year.