CHAPTER 1

SELECTING A LEGAL ENTITY

One of the first major decisions you will have to make as you start your new business is the form of legal entity it will take. To a large degree this decision may be dictated by the way you have organized your operations and whether you intend to work on your own or in conjunction with others.

The form of entity you choose can have a significant impact on the way you are protected under the law and the way you are affected by income tax rules and regulations. There are five basic forms of business organizations. Each has its own benefits and drawbacks and is treated differently for legal and tax purposes.

Sole Proprietorship

A sole proprietorship is typically a business owned and operated by one individual. A sole proprietorship is not considered to be a legal entity under the law, but rather is an extension of the individual who owns it. The owner has possession of the business assets and is directly responsible for the debts and other liabilities incurred by the business. The income or loss of a sole proprietorship is combined with the other earnings of an individual for income tax purposes.

A sole proprietorship is perhaps the easiest form of business to own and operate because it does not require any specific legal organization, except of course, the normal requirements such as licenses or permits. A sole proprietorship typically does not have any rules or operating regulations under which it must function. The business decisions are solely the result of the owner's abilities.

Partnerships

Partnerships can take two legal forms, general or limited. In a general partnership, two or more individuals join together to run the business enterprise. A partnership must usually file a fictitious business name statement to operate a business under the partnership name when it is different from the names of the partners. Each of the individual partners has ownership of company assets and responsibility for liabilities, as well as authority in running the business. The authority of the partners, and the way in which profits or losses are to be shared, can be modified by the partnership agreement. The responsibility for liabilities can also be modified by agreement among the partners, but partnership creditors typically have recourse to the personal assets of each of the partners for settlement of partnership debts.

A limited partnership is comprised of one or more general partners who are personally liable for partnership debts and one or more limited partners who contribute capital and share in the profits or losses of the business. The limited partners do not take a part in running the business and are not liable for the debts of the partnership.

The rights, responsibilities, and obligations of both the limited and general partners are typically detailed in a partnership agreement. It is a good idea to have such an agreement for any partnership, whether limited or general.

A partnership is a legal entity recognized under the law and as such it has rights and responsibilities in and of itself. A partnership can enter into contracts, obtain trade credit, and borrow money. When a partnership is small most creditors require a personal guarantee of the general partners for credit.

A partnership is also required to file Federal income tax returns and some states also require a state income tax return. Effective for taxable years beginning on or after January 1, 2004, Virginia requires the filing of a separate partnership state income tax return. A partnership typically does not pay income tax; the information from the tax return is combined with the personal income of the partners to determine the overall tax liability.

Corporation

A corporation (also known as a "C corporation") is a separate legal entity which exists under the authority granted by state law. A corporation has substantially all of the legal rights of an individual and is responsible for its own debts. It must also file income tax returns and pay taxes on income it derives from its operations. Typically, the owners or shareholders of a corporation are protected from the liabilities of the business. However, when a corporation is small, creditors often require personal guarantees of the principal owners before extending credit. The legal protection afforded the owners of a small corporation can far outweigh the additional expense of starting and administering a corporation.

A corporation must obtain permission from the State to use the name it chooses or to do business under a fictitious name. A corporation must also adopt and file **Articles of Incorporation** and by-laws which govern its rights and obligations to its shareholders, directors, and officers.

Corporations must file annual income tax returns with the IRS and the Virginia Department of Taxation and possibly other states in which it does business. The elections made in a corporation's initial tax returns can have a significant impact on how the business is taxed in the future.

Incorporating a business allows a number of other advantages such as the possibility of bringing in additional capital through the sale of equity, or allowing an individual to sell or transfer his or her interest in the business. It also provides for business continuity when the original owners choose to retire or sell their interest.

Should you decide to incorporate your business venture, you should seek the advice of competent legal counsel and business-oriented accountants.

S Corporations

An S corporation is treated like a regular corporation (a "C corporation") with one exception. For income tax purposes, an S corporation will pay no income tax. The net income or net loss from the S corporation's tax return is combined with the other income of the stockholder on his or her personal tax return. There are special rules governing the deductibility of S corporation losses.

S corporation status is attained by timely filing Form 2553. The decision to elect S status is not always an easy one. Careful consideration should be given to electing S corporation status prior to incorporation for new businesses or before filing the election for existing corporations.

Limited Liability Company

A limited liability company (LLC) is a relatively new form of business organization that combines the liability protection of a corporation with the favorable tax treatment of a partnership.

An LLC is a business organization that generally protects all owners against individual liability for the organization's liabilities and obligations, and against vicarious liability for the negligence and malfeasance of others involved in the business. Management may be flexibly structured to allow members to apportion management authority in the manner they determine the most appropriate. Partnership classification is assured under some state statues, and may be attained through proper structuring in others.

Most LLCs will have limitations on the transferability of the interest of its members and the ability of members to carry on the business after any member ceases to be involved in the LLC through death, retirement, withdrawal or expulsion. Under the more flexible state statutes, these limitations may be reduced or eliminated through careful drafting of the articles of organization.

Creating an LLC is as simple as forming a corporation. The organization must file **Articles of Organization** with the State. These are similar to the articles of incorporation used to form corporations. The filing fees are much the same.

An operating agreement defines the rights and obligations of the members, including how profits, losses, and distributions will be shared among the members. If you form an LLC, be sure that you understand its attributes.

Members are not personally liable for the debts and obligations of the LLC. The only individual liabilities the members have are for (1) the amounts the members have agreed to contribute to the LLC, (2) under some statutes, amounts distributed to the members, and (3) any negligence or malfeasance the member individually commits or that the member supervises. This generally means that members are not liable for the contracts and general liabilities of the LLC or for any mistakes or improper actions of others in the name of the LLC.

One of the greatest advantages of forming an LLC is its tax structure. If properly structured, LLCs provide the benefit of one level of taxation; therefore, as with partnerships, any income generated by the company is passed through to the tax return of the owner. Owners do not avoid personal taxes; but corporate taxes are avoided.