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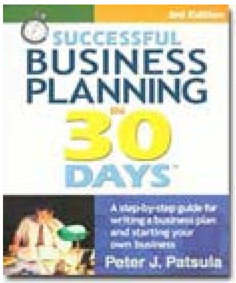

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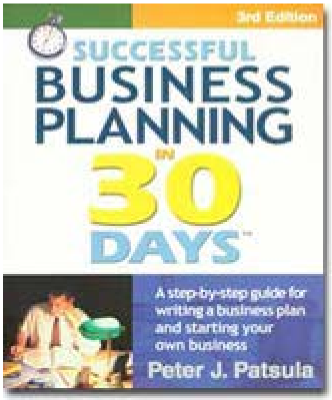

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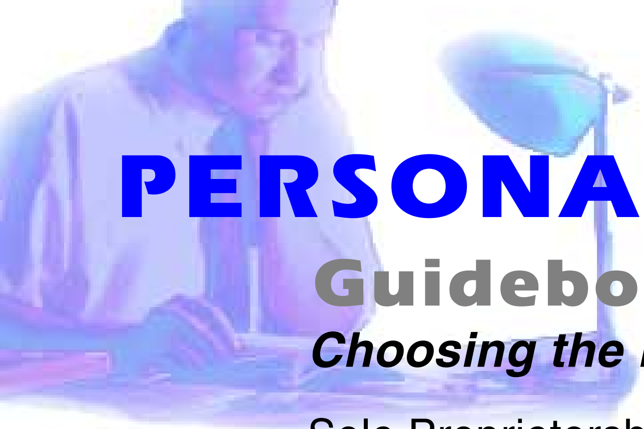

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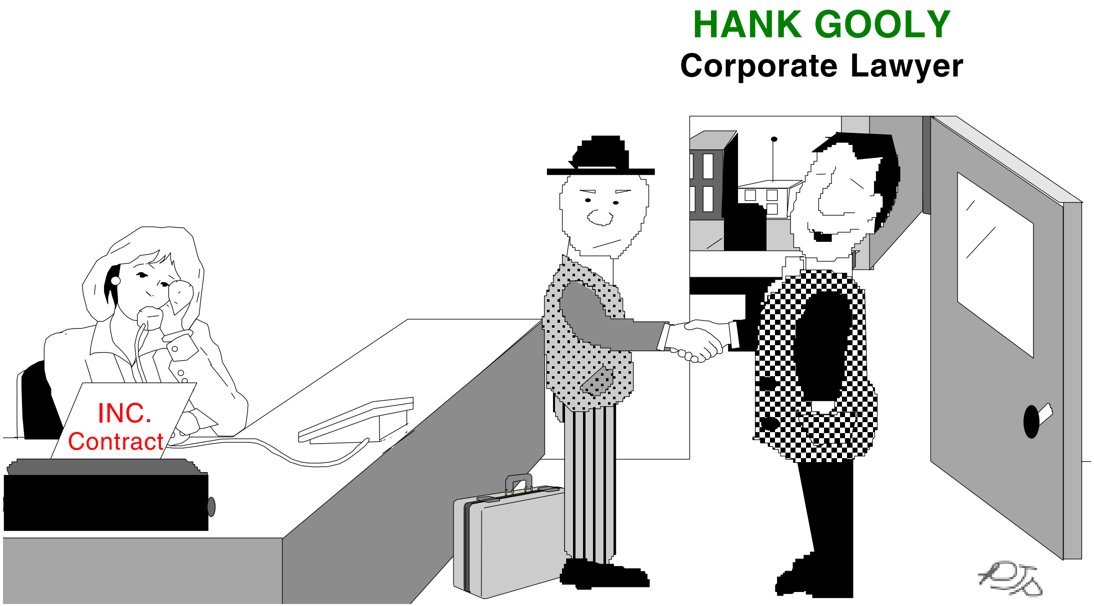

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CHOOSING THE RIGHT LEGAL FORMATION

ESSENTIALLY, there are three types of legal formations: *Sole Proprietorships*, *Partnerships* and *Corporations*. For most entrepreneurs, unless definite financial goals and expectations make incorporation a must, starting out as a sole proprietorship – with plans to expand into a corporation once substantial assets are generated and liability protection required – is generally the best course of action.

Partnerships however, should be treated more cautiously, as they are fraught with problems. In fact, for the most part, partnerships should be avoided, unless more start-up capital is needed (and you have exhausted other sources), the workload is too much and too complex for you to handle alone, or you need moral and technical support because you lack the experience, skills and confidence to go it alone.

NOTE In this section the pros and cons of the three major legal structures are described. Registering and licensing these three types of businesses are dealt with more specifically, in Guidebook #34 "Licensing Your Operations."

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SOLE PROPRIETORSHIPS

A SOLE PROPRIETORSHIP is a form of business where one person assumes complete liability for all actions of the business. About seventy percent of the thirteen million businesses in the United States are in this category.

Sole proprietorships create only 6 percent of all revenue but report 25 percent of all profits. ***FUNFACT***

PROS

Absolute Control Over Decision Making – A sole proprietorship offers you maximum authority, flexibility, freedom of action, and the greatest psychological rewards because no one else runs the business but you. There are no bosses to issue orders, supervise your coming and goings, challenge your decisions, or gawk over your shoulder.

Ease of Formation – Barring the need for special licenses or permits, all you have to do to get a proprietorship off the ground is to start working at it. It is by far the easiest type of business formation to set-up.

NOTE You should open a separate bank account to keep track of your business's finances and keep records of all of the expenses and revenues connected with running the business.

Easy to Get Out of – Terminating your proprietorship is easy. To close down operations, all you need to do is liquidate

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your assets, pay off your debts, lock the door, and walk away.

Flexibility of Management – Management can quickly respond to the needs of the business and can make day-to-day decision faster than other types of formations.

Low Startup Costs – Setting up a proprietorship usually doesn't require legal consul. Unlike partnerships and corporations, you have no special contracts or agreements that need to be drawn up. In fact, if you plan to do business under your own name, your set-up costs can be almost next to nothing. However, if you decide (as many people do) to operate under a trade name, you will encounter a few more expenses and red-tape.

Starting a company is a little like getting married, accept their ain't no honey moon. ***POWERPOINT***

NOTE The fee for registering a proprietorship is typically no more than $30.

Possible Tax Advantages – Tax-wise you and your sole proprietorship are treated as inseparable companions. Considering most new ventures end up in the red, after their first six months and often longer, it is nice to know, you're entitled to deduct those lost dollars on your tax return against any other income you may have earned that year. Moreover, this holds true for succeeding years.

NOTE A sole-proprietorship has no double taxation on profits as in a corporation.

Relative Freedom from Government Control – If you run your operation hon-

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orably and above the board (not under the table), and you keep accurate bookkeeping records, no one will likely interfere with how you conduct your business. Of the three legal forms, proprietorships get the least attention from the IRS, the Better Business Bureau, consumers groups, and other government agencies (the corporate form receives the most).

Sole Ownership of Profits – In a proprietorship, all the profits go straight to you the owner. Profits become your personal income and are taxed as such.

CONS

Difficulty in Obtaining Long-term Financing – As a proprietorship, banks consider you a higher risk than a corporation or partnership and will less likely be willing to loan you start-up capital. You'll also find it more difficult to attract capital into your enterprise for growth or expansion, because no one wants to invest in a company that could fall apart overnight if something happens to you.

As a proprietorship, banks consider you a higher risk than a corporation or partnership and will less likely be willing to loan you start-up capital.

Highly Subjective Decision Making – Your business is limited by your own skills, experience and management capabilities.

Less Available Capital – Capital is limited to the owner's personal assets and the funds he or she can borrow.

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Limited Business Deductions – Certain types of business deductions may not available to the sole proprietor. These include worker's compensation insurance and a portion of personal health and injury insurance.

Personal Affairs Often Get Mixed up with Businesses Affairs – Taking a few dollars out of the till to buy your buddies some drinks after a hard days work, as often happens with proprietorships, may be convenient, but can quickly get out of hand leading to serious cash flow problems and tax nightmares.

The most serious drawback to forming a proprietorship is the problem of unlimited personal liability for business liabilities

Unlimited Liability – The most serious drawback to forming a proprietorship is the problem of unlimited personal liability for business liabilities. If your business fails and the remaining business assets aren't sufficient to cover your obligations, your creditors can move in and take away your home, your automobile, your bank accounts, and any other personal assets you hold until all the debts are fully satisfied. Consequently, if your personal holdings are considerable, you might be better of opting for the corporate mode.

NOTE The types of items that can be taken from you depend on your state's bankruptcy rules as well as civil procedure laws.

Unstable Business Life – Since the success of your proprietorship will likely be heavily dependent on your presence, many problems can arise during unforeseen or

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occasional absences. What happens to your business if you become seriously ill for an extended period? When you need a vacation, who will be qualified enough to keep things running smoothly?

NOTE Sole proprietorships are usually crippled or terminated upon the illness or death of the owner.

Sole proprietorships are usually crippled or terminated upon the illness or death of the owner.

Tax Liability

A sole proprietor is taxed on all income from the business at applicable individual tax rates. The business income and allowable business expenses are reflected on individual tax returns. No separate federal income tax return is required of the sole proprietor. Ordinarily, sole proprietors will have to make quarterly estimated tax payments.

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PARTNERSHIPS

A GENERAL PARTNERSHIP is created when two or more individuals, other partnerships or corporations, decide to combine their financial and intellectual resources to create and run a new company. There is no limit to the type of partners or number of partners. The primary advantage of this type of business formation is the pooling of talent, experience and capital. However, dual and multiple ownership, can lead to serious complications if the relationships between individuals begin to break down. Quite often, the *pool* becomes a *drain*.

Before you run in double harness, look well to the other horse.
OVID
Remedia Amoris

PROS

Avoids Double Taxation – Unlike corporations, the profits from partnerships are not taxed twice.

Broader Array of Skills and Talents – Most people starting a company have never run a business before and likely do not possess all the skills and experience required to make a new enterprise a success. Thus a partner or two can provide the missing elements and bring a broader array of experience to bear on your operations.

For example, if you were an engineer type hoping to start a high-tech business, you might look for a marketer type. As the inside person you would be responsible for

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conceiving, designing and manufacturing the product. As the outside person, the promoter type would be responsible for raising money and selling the product.

On the other hand, in a service business, such as an investment planning firm, as the inside person you might carry out the necessary research to make sound investments for your clients while the outside person would concentrate on finding new clients, managing relations and customers, and generally promoting the business.

Partnerships make up about ten percent of the U.S.'s 13 million small businesses, create 4 percent of all business revenue, but reports a slight loss in profits. ***FUNFACT***

Combining your talents with the talents of others can work to yours and theirs mutual benefit, but of course, you must be astute enough to select only those partners whose skills really do complement your shortcomings.

Direct Ownership of Profits – The rewards or profits from the business go directly to the partners.

Easier to Obtain Investment Capital – Individuals investors or formal venture capital organizations, are more comfortable with teams, rather than individual entrepreneurs. Teams also seem to command more respect when seeking trade credit or bank loans.

Emotional Support – Starting a new company can be very lonely. It can be similar to walking down a

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road covered with banana peels. Every once in a while when you slip, you may need a shoulder to cry on.

Flexibility – A partnership is more flexible than a corporation, but less flexible than a proprietorship.

Greater Capital Resources – By pooling your financial resources with those of others, you can count on more initial capital than if you go it alone.

Limited Government Regulation – Like the sole proprietorship, the partnership form is relatively free of bureaucratic red tape. The are also no special taxes on a partnership.

Reduced Risk and Improved Likelihood of Success – Companies formed by teams of three of four people have lower risk than companies formed by one person. If the founder should be unable to perform his or her duties for any reason, one of the other team members can step in and save the day. Statistically, partnerships are more likely to endure their first few years than sole proprietorships, especially if the team includes a strong marketing person.

For a partnership to be a success roles and responsibilities of all potential team members must be easy to define. ***FUNFACT***

Relative Ease of Formation and Low Startup Costs – While hardly as easy to form as a proprietorship, a partnership is easier and less costly of form than a corporation. Other than drawing up a partnership agreement with or without a lawyer, you have not much more to set-up and pay for than you would with a sole proprietorship.

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NOTE The fee for registering a partnership is typically no more than $30. However, to register a limited partnership (as is the case in Canada) may cost upwards to $150.

CONS

Complex Partnership Agreement Required – A general partnership is deceptively easy to start because it can be formed by an oral agreement. However, this can lead to numerous conflicts. It is therefore advisable to have a written contract drawn up by an attorney and signed by all partners. This agreement should address major issues relating to the business and attempt to anticipate potential problems. The agreement should specify:

One of the most fruitful sources of ruin to men of the world is the recklessness or want of principle of partners, and it is one of the perils to which every man exposes himself who enters into partnership with another.
SIR. R. MALINS V.C.

Objectives of the Partnership – A partnership agreement should outline the purpose of the partnership including its long-term goals.

Date of Commencement – A partnership agreement should outline the exact date the partnership agreement will come into effect.

Amount of Investment to be Contributed by Each Partner – A partnership agreement should specify how much time and/or money each partner will contribute to the business and their resulting percentage of ownership.

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NOTE In the absence of an agreement, each partner will own an equal portion of the business and profits as well as its liabilities.

How Profits and Losses are to be Shared – A partnership agreement should clarify items like remuneration and profit sharing as well as how and when payments of income earned will be passed on to its partners based on their share of ownership. It should also clarify when and how business losses will be distributed.

Provisions in the Event of Death – Often partners purchase insurance on each other's lives so that the surviving partner can purchase the firm from the estate of the deceased.

In the absence of an agreement, all general partners have equal control and equal management rights over the business, meaning that all partners must consent and agree to partnership decisions.

Duties and Responsibilities of Each Partner – A partnership agreement should clarify the role of each partner within the partnership as well as outline special duties or responsibilities.

How Decisions will be Made – A partnership agreement should specify what percentage of influence each partner will have on the decision making process.

NOTE In the absence of an agreement, all general partners have equal control and equal management rights over the business, meaning that all partners must consent and agree to partnership decisions.

Transfer of Ownership Clause – A partnership agreement should contain a

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transfer of ownership clause and a buy-out agreement. This is to help keep the business viable in case of extreme internal conflict.

NOTE If a partner does transfer his or her share of a partnership to an interested third party, that partner is still liable for any business losses incurred prior to the sale of that interest.

A friendship founded on business is better than a business founded on friendship.
JOHN D. ROCKEFELLER

Duration of the Agreement – A partnership agreement should clarify how long the partnership will exist.

Special Conditions – More specifically, a partnership agreement may clarify participation of family members, choice of employees, determination of resources, provisions for emergencies, borrowing and credit policies, expansion policies, as well as advertising and public relations methods.

Dissolution of the Partnership – A partnership agreement should clarify what happens to the business and to a partner's shares of the business if that partner dies. It should also specify what happens if a partner becomes disabled or stops contributing/working to the business.

Difficulty in Finding a Suitable Partner – Finding a good business partner is as difficult or more difficult than finding a good marriage partner. Obviously there are situations in which the strengths and weaknesses of each partner are well balanced and the business benefits, but the odds are a lot greater that the partnership itself will become the busi-

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ness's worst enemy. It is not an accident that most of the greatest entrepreneurial successes have been solo acts.

Difficulty in Obtaining Long-term Financing – Partnerships cannot obtain long-term, or for that matter, short-term financing as readily as can a corporation.

Divided Authority – The need to cooperate can provide a continuing assault on your entrepreneurial spirit. Be prepared to give up a great deal of freedom. There's nothing worse than three guys or gals driving the same car.

General Partnership Interest Can Not Be Sold Without Consent of the Other Partners – In many states, the sale or transference of a partnership share cannot take place without the consent of all the other partners. In other words, once you agree to a partnership you cannot get out of it whenever you want as easily as you can a proprietorship. In fact, it is often quite difficult to dispose of a partner's interest in a business.

Not enough people examine their motives for taking on partners as carefully as they should. Often they do it simply because they believe in safety in numbers. ***POWERPOINT***

Inequalities in Responsibility – In most companies formed by a team of entrepreneurs, one is usually selected as president. The others may hold lesser key positions such as vice president of research or vice president of marketing. This not only leads to conflicts over important business decisions but also over such insignificant trivialities as who will open up (or close) on Wednesday or Sat-

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urdays; when to take vacations; who will run the machines, do the buying, supervise office staff; and so on.

Possible Development of Serious Conflict Between Partners – A partnership theoretically offers access to more personal and financial resources, greater stability, and increased assets. However, for some reason, especially where money is concerned, partners have a tendency to generate more conflicts than profits. Conflicts can be caused by the emotional strain of running a new business, a feeling that one partner is not carrying his or her weight, personal incompatibility, or by a spouse who feels their marital relationship has been hurt by the demands of the business. To make matters worse, North Americans are people of the melting pot tradition and are fierce individualists who tend to not like working with others. Imagine the tension inherent in a situation where two or more individuals, often unrelated, must act, work, plan, and operate in tandem for years and years. Usually it is not a question of whether there will be a conflict but how bad it will be.

When you do run into a problem there are only three alternatives, buy the partner out, sell the business to the partner, or put up with it.

NOTE When you do run into a problem there are only three alternatives, buy the partner out, sell the business to the partner, or put up with it.

Reduced Profitability to Founder – According to figures released by Dun & Bradstreet, partnerships have lower average profit margins than proprietorships or

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corporations. This problem is further compounded by the tendency for many founders to be unnecessarily generous in sharing ownership in their new venture. Don't even think about giving away ownership unless the recipient can contribute in a meaningful way.

Unlimited Liability Including Liability From Business Actions of Partners – Not only are you liable for your own actions and debts, but you are also liable for those of your partner or partners. In other words, you are personally liable for any business decisions, contracts signed, legal obligations or actions taken by your partner(s), even in a case where you knew nothing about his or her actions or perhaps even advised against it. This obligation is something to think about.

Not only are you liable for your own actions and debts, but you are also liable for those of your partner or partners.

NOTE If you are the only partner with any assets or money, the creditors of the partnership can require you to pay them all. It is then your problem to get your partner(s) to reimburse you.

Unstable Business Life – A partnership exists as long as the partners agree it will and as long as all of the general partners remain in the partnership. However, if a partner dies or leaves the partnership, the partnership dissolves and the assets of the partnership must be sold or distributed to pay first the creditors of the partnership and then the partners. To avoid this, the partnership agreement must include a clause that provides for the continuation of the business by the remaining partners.

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Tax Liability

A partnership itself is not responsible for paying state/provincial or federal taxes on the income generated by the business. Although a partnership tax return is filed, this is only for information purposes. Instead, each partner pays taxes individually on his or her personal share of the business income.

NOTE Recent changes in the tax law may restrict the use of partnership losses to offset income of the partner generated by activities outside of the partnership.

In the United States, twenty percent of all businesses are incorporated, but they create 90 percent of all business revenue and 75 percent of the reported profits. ***FUNFACT***

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CORPORATIONS

A CORPORATION – sometimes called a "C-Corporation," "incorporated company," or "limited company" – is a legal entity that is chartered by and subject to the laws of the state or province in which incorporated in and is separate and distinct from the person or persons who own it. Because of this, the owners of the corporation, (known as its shareholder or stockholder) are not personally responsible for the losses of the business. A corporation may own property, borrow money, incur debts, enter into contracts, sue or be sued. Generally speaking, the more money you invest and the larger the scope of your business, the more you should consider forming a corporation.

If you are starting a business in which there is a high risk of being sued or incurring a debt and not being able to pay it, you should incorporate from Day 1 because the risk starts at Day 1. This advice holds true even if you plan to start a home-based business.
SUPERTIP

NOTE Although a corporation usually has more than one owner, it is possible for one individual to create and own 100 percent of a corporation.

PROS

Delegated Authority of Management – A board of directors and officers gives structure to the decision-making process.

Ease of Securing Funds – Corporations have a significantly easier time attracting investors or securing capital in large amounts and from many investors

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including banks and individuals, than do individuals or partnerships or sole-proprietorships. This is especially true if the corporation has been operating successfully for some time or if new, has sufficient equity and promise. However, it should be noted that lenders will sometimes insist on collateral or require personal guarantees from stockholders as a precautionary measure against loans given.

Flexible Staffing – Regardless of who runs the corporation or holds stock in it, people can be changed as needed.

Founders Can Semi-Retire – Management structures and the

Setting up a Nonprofit Organizations

A NONPROFIT ORGANIZATION is an economic entity providing, without profit to any owners, a service beneficial to society and financed by equity interests that cannot be sold or traded by individuals or profit-seeking entities. Although, a nonprofit organization may plan for and actually make a profit, this profit must be used to implement or expand its services. Nonprofit organizations are characteristically exempt from federal income tax. Classifications of organizations that may qualify for such exemption include governmental entities, colleges and universities, most hospitals, health and welfare agencies, churches, and foundations. Special forms must be filed with tax authorities in order to claim this tax-exempt status.

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delegation of authority can permit large share holders to separate themselves from everyday activities.

Larger Management Base – Corporations can draw on the expertise and skills of many individuals creating an objectivity often lacking in proprietorships. Boards of directors usually are made up of members with a variety of perspectives.

Corporations can draw on the expertise and skills of many individuals creating an objectivity often lacking in proprietorships.

Limited Liability – Shareholders are generally protected from liability and can lose only the money they have invested in the corporation. Your personal holding will not come up for grabs if your corporation becomes insolvent and its assets are insufficient to satisfy the creditors. In fact, considering that personal liability insurance is becoming more difficult and expensive to obtain, you might be opt to choose the corporate mode right away, especially if your personal holdings are considerable.

NOTE There are certain cases in which shareholders do incur some legal liability for the corporation. These cases include if the shareholders: do not observe the statutory requirements for running the corporation; do not keep the corporation's money, accounts and assets separate from their personal accounts; or "guarantee" the obligations of the corporation to borrow money or lease space. It should also be noted that if shareholders make loans to the corporation and the business fails, their loans may be paid off only after the other loans of the corporation are paid.

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Ownership is Readily Transfer-able – Ownership of a corporation can be transferred by sale of all or a portion of its stock (with various re-strictions). Additional owners can be added by selling stock directly from the corporation or by having current owners sell some of their stock.

NOTE Before selling key shares of stock to outsiders, you will have to whether federal or state securities laws permit the sale.

Possible Tax Advantages – In-corporation becomes increasingly desirable particularly at higher in-come levels, where there is a grow-ing discrepancy between corporate tax rates, which cap out at 35%, and individual income tax rates, which

Canadian Co-operative Corporations

A CO-OPERATIVE is a special form of business organization (allowed in Canada), different from an ordinary corporation, but is still able to enter into contracts under its own corporate name. Li-ability for the individual members of a co-operative is limited to the extent of the value of shares held. Each member of a co-operative has only one vote, no matter how many shares he or she possesses. Dividends are paid according to patronage and not by the number of shares held. Co-operatives must be incorporated and contain the word “co-operative” in their name. Applica-tions for co-operatives are approved by the Co-operative Program and then forwarded to the Corporate Registry for incorporation.

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have increased to almost 40% (this is for the U.S.). In fact, if you have the kind of business that generates a lot of cash flow, you can save by keeping the money in the business and taxing it at the corporate rate. However, if your personal tax rate is 28 percent and you don't typically spend much money in your business, you will likely not save much in taxes by incorporating (this is a question worth hiring an expert to crunch numbers for you).

Stability – A corporation is recognized as a separate legal entity distinct from the individuals who own it. It has a continuous existence despite management or ownership changes, or even the death of key shareholders or founding members. Its corporate existence last as long as its shareholders decide it should.

A corporation is recognized as a separate legal entity distinct from the individuals who own it.

CONS

Complex Management Structure Required– Managing a Corporation is far more complex than setting up a sole-proprietorship or partnership. In most states, it is mandatory that you elect a board of directors and officers of the corporation as well as develop a charter, articles and bylaws.

Board of Directors – At least once a year, corporation's shareholders must elect a group of individuals to act as their board of directors. Usually, the directors must be elected by a majority of the shareholders. Thus, those who hold a majority of the shares have ultimate control over the corporation. The board of directors is responsible for the major decisions of the corporation.

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Each director on the board is given one vote. Terms of directors are staggered to provide continuity and are often for more than one year. Directors may be paid for their services.

NOTE Shareholders can elect themselves to be on the board of directors. It should also be noted that in some states, small businesses are permitted to incorporate without a board of directors.

Charter, Articles and Bylaws – Every corporation must outline rules as to how it will be operated and managed. These rules are contained in its Charter, Articles and Bylaws (see Guidebook #34 "Licensing Your Operations for more details).

Officers of the Corporation – The officers of a corporation usually consist of a president, vice-president, secretary and treasurer. They are elected by the board of directors and are responsible for running the day-to-day business of the corporation. In many states, one person may hold any or all of these offices.

Corporation. An ingenious device for obtaining individual profit without individual responsibility.
AMBROSE BIERCE
The Devil's Dictionary

NOTE Certain major decisions must be approved by the shareholders, such as amendments to the articles of incorporation, merger with another company and dissolving the corporation. In some states, some of these decisions require more than a majority of shareholders to agree.

Corporate Activities Limited by Various Laws – The activities of the corpora-

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tion are limited by their charter and by various state and federal laws.

Difficult to Form – To set up a corporation, one or more individuals must apply within the state where they wish to do business and where their principal office of their business is located (the number of persons involved depends on state regulations). The application is accomplished by preparing a detailed “Certificate of Incorporation” which includes names and addresses of both the proposed corporation and of the incorporators, areas and type of business activities contemplated, amount of stock authorized, and so on, and then filing the certificate with the Secretary of State, and paying the required fee.

Special incorporation service firms, which can be found in the back of magazines like The Economist, *will help you establish your corporation with headquarters anywhere in the U.S. or other country. Some Charge as little as $99 plus state fees. Many major corporations are incorporated in Delaware.* ***SUPERTIP***

NOTE Most states require only one director in order to create a corporate entity.

Double Taxation – A major problem with the corporate form is the problem of double taxation. The corporation must pay taxes on its profits, since it is considered a separate entity, and the shareholder must pay taxes on the dividends paid to them from the profits. In addition, if you serve as the corporate president and chairman of the board, you’re also legally an employee of the business. Hence, you’re liable for income tax not only

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on your share of the distributed profits, but also on your salary. The total tax bite can really hurt.

Expensive to Form – Forming a corporation is not only cumbersome and subject to numerous restrictions, but also costly. Forming a corporation usually requires professional help to draft "Articles of Incorporation" and other documents. Costs can range from as little as a few hundred dollars for do-it-yourself kits to well over a thousand or more, if you hire a good lawyer. And although it isn't absolutely necessary to retain a lawyer during the formation of your company, most experts strongly recommend it. A good lawyer will not only easily handle all the details that normally boggle the typical layman – corporate law is complicated – but will also save you needless headaches in the future by spelling out responsibilities to shareholders, planning corporate activities for future years, and generally pointing out things you haven't even thought of.

Not only is a corporation more expensive to set-up but it is also more expensive to operate.

Expensive to Maintain – Not only is a corporation more expensive to set-up but it is also more expensive to operate. There are significant overhead costs (a good reason why you shouldn't incorporate too soon). Your accounting, legal, tax return preparation and insurance fees will be much higher. In fact, everything you do will become more complex and expensive. It will even cost you money to terminate your corporation.

Extensive Government Regulation – Along with increased record keeping re-

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quirements and burdensome local, state, and federal reports; corporations are closely regulated by the state or province in which they are franchised, are legally required to hold regular stockholders meetings, and must announce and follow their own bylaws. Furthermore, they aren't supposed to conduct business in a second or third state or province without making formal applications to the respective authorities and obtain permission to conduct operations there.

Many companies incorporate in the state of Delaware because its business law is considered more friendly to corporations. ***SUPERTIP***

Incentives for Management Needed – Incentive and indirect rewards are often needed to motivate management who otherwise might not be overly excited about increasing company profits.

Paying Yourself is More Complex than in a Sole Proprietorship or Partnership – If you own stock in a small business corporation and also work as an employee or officer of the corporation, you can be paid two ways: either a salary for the work you perform, or if the corporation makes a profit, you can be given a share of the dividends according to how much stock you own.

However, to complicate matters further, it is the board of directors that decides whether dividends shall be paid and how much – not you (unless you have the controlling share). In fact, if dividends are not allowed in any given period, you have no right to any money the corporation has made other than your salary. This is because the cor-

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poration is a separate legal entity, and the money it makes belongs to the corporation – not you.

Tax Losses Can't be Written Off Against Personal Income – Losses sustained by a corporation are not available to owners or stockholders as deductions from other earned income. If you anticipate initial business losses, incorporation is to your disadvantage.

Taxes are More Complex – Corporate taxation is more complex than individual taxation. Extra taxes are imposed on corporations by all levels of government that are not imposed on solely owned businesses or partnerships. These special taxation's are often quite confusing to the average person even with legal consul.

Over 600,000 businesses are incorporated every year. ***FUNFACT***

Tax Liability

A corporation must file is own income tax return and pay taxes on its profits. The individual shareholders must also pay taxes on any dividends or salaries received. In figuring its taxable income, a corporation generally takes the same deductions as a sole proprietorship. However, corporations are also entitled to special dividend deductions to help avoid double taxation. In the U.S., this deduction is called the *dividends-received deduction* (see Guidebook #86). In Canada, this deduction is called the *dividend tax credit*.

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SUBCHAPTER S-CORPORATIONS

AN S-CORPORATION enjoys the advantages of a conventional corporation except that profits and losses are taxed to the individual shareholders in proportion to their ownership rather than the corporation itself. The income or losses are divided among the shareholder based upon the percentage of stock of the corporation that they own. Essentially, this means that the company files a tax return but pays no taxes.

An S-Corporation enjoys the advantages of a conventional corporation except that profits and losses are taxed to the individual shareholders in proportion to their ownership rather than the corporation itself.

Sometimes companies start as an S-Corporation when they expect to lose money and then convert to a standard C-Corporation when they get into the black. This can be especially important in the first year of operation when new companies frequently lose money. Any loss suffered can be applied against other personal income of the individual shareholders (however, losses that exceed a shareholder's basis in stocks and loans cannot be currently deducted).

NOTE A regular C-Corporation can be converted to an S-Corporation with some judicious planning, however this transition can only be done once. If you are thinking about doing this, seek out the services of a good lawyer and an accountant.

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PROS

Helps Avoid the Double Taxation that Regular Corporations Face – Using this structure, a company can overcome the double taxation feature of the regular C-corporations.

Most states recognize non-stock corporations, which are commonly used for nonprofit organizations, community association, etc. There are no owners in a non-stock corporation, although there may be members.
FUNFACT

Permits Business Losses to be Passed on to Share-holders – These losses can then be written off the share-holder's personal income.

Retains Most of a C-Corporations Benefits – An S-corporation retains the corporate characteristics of limited liability and transferability of interest or ownership; allows additional owners or investors to be added easily; allows the owners to deduct the costs of benefits such as group, life, accident, or health insurance; and allows the owner to sell or liquidate the company.

CONS

Expensive to Maintain – Like a regular corporation, a Subchapter S-corporation is more costly to set up and maintain.

Qualifying for Subchapter S-Corp-oration Status Can be a Difficult – A corporation can elect to be an S-Corporation if it meets the following requirements:

1. It is a domestic corporation.

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2. It has only one class of stock.
3. There are no more than 35 shareholders.
4. Its revenues are under the present $35 million restriction.
5. All shareholders are U.S. residents, either citizens or resident aliens.
6. All shareholders are individuals – i.e., no corporations, partnerships or other entities own the stock.
7. All shareholders consent to the firm's choice of S-Corporation status.
8. It operates on a calendar year financial basis.
9. It files form 2553 "Election by a Small Business Corporation" and, in some states, a separate state election form.

For further details see IRS publication 589 Tax Information on S-Corporations.

Even if a Subchapter S-corporation shareholder isn't paid any money (i.e., dividends or distributions), they may still be required to pay tax on company profits. ***POWERPOINT***

Tax Liability

A Subchapter S-corporation is required to file two separate tax returns, one for the company (for information purposes only) and one for each of the individual owners. Individual owners must then pay taxes on their share of the profits levied according to how many shares they own.

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LIMITED PARTNERSHIPS

A LIMITED PARTNERSHIP is a special kind of arrangement, recognized in most states in the U.S. and provinces in Canada, which permits a quasi-corporate entity to exist. It consists of one or more general partners (i.e., those who are generally liable for the business, as discussed earlier) and one or more limited partners (i.e., those who have limited liability).

Like the Sub-Chapter S-Corporations, the popularity of a limited partnership is influenced by prevailing tax laws. ***SUPERTIP***

Limited liability partners earn their share of company profits but avoid the danger of being held personally liable for business debts. They risk only an agreed-upon investment in the business. However, a limited partner cannot participate in the operation or management of the business – the management and control of the business is handled by the general partners. If they do, they jeopardize their limited partnership status.

NOTE A limited partnership may be created only by following certain steps set out in each particular state's statutes. If the statutory requirements are not followed, a limited partnership will be treated as a general partnership; therefore it is important that you consult with an attorney in creating a limited partnership. The services of an attorney who specializes in drawing up articles of partnership is essential to start this form of business (in Canada, a declaration for a limited partner must be filed with the Corporate Registry).

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JOINT VENTURES

A JOINT VENTURE is another special business form where two or more individuals or corporations associate with each other for the purpose of performing a single specific task or business activity. A contract specifies how profits will be divided and under what circumstances the venture will terminate. A joint venture usually ends when the task or activity has been performed.

Comparison of Legal Entities

Legal Entity	Difficulty and cost to form	Difficulty and cost to maintain	Risk of owner liability	Difficulty of tax preparation	Flexibility of ownership	Cost of terminating business
Sole Proprietorship	**low**	**low**	**high**	**low**	**low**	**low**
Partnership	**low to moderate**	**low**	**high**	**moderate**	**moderate**	**high**
Corporation	**high**	**high**	**low**	**high**	**high**	**high**
Subchapter S-Corporation	**high**	**high**	**low**	**high**	**low**	**high**

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