

# LEGAL PLANNING FOR START-UPS

## CHOICE OF BUSINESS ENTITY

### SOLE PROPRIETORSHIPS AND PARTNERSHIP

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# Please Note

**At the end of our three presentations, we will take general questions. For specific questions to a particular situation, consult an attorney, accountant, or other business consultant for the correct answers based on your particular circumstances.**



# Business Entity Options

## What choices are available?

- **Sole Proprietorship**

  - A Fancy Name for One Owner

- **General Partnership**

- **Limited Liability Entity**

  - General Partnership with Limited Liability (“LLP”)

  - Corporation

  - Limited Liability Company (“LLC”)

# Factors to consider when deciding what type of business organization to form

- ❑ **Who owns (or will own) the business?** – one individual, a few individuals, lots of owners, etc.,
- ❑ **What is the nature of each owner's interests?**
- ❑ **Who manages (or will manage) the business?**
- ❑ **How and when will the money flow?** – taking a loan, putting up your house?
- ❑ **What happens on April 15?** – Tax Consequences – firm (or entity) level taxation or flow through taxation?

# Factors to consider when deciding what type of business organization to form (cont.)

- ❑ **Liability** – who will be responsible for the business debts/claims?
- ❑ **Transferability** – how easily can ownership interests be transferred to someone else?
- ❑ **Continuity of existence** – how long will this business last?
- ❑ **Capitalization** - how easily can this entity raise additional money/capital?

# Factors to consider when deciding what type of business organization to form (cont.)

- ❑ Who gets what percentage of the business?
- ❑ What role and responsibility would each founder have.
- ❑ How are major decisions and day-to-day decisions of the business to be made?-majority or unanimous vote.
- ❑ What salaries are founders entitled to and how can it be changed? Expectations of time commitment to the business?

# Factors to consider when deciding what type of business organization to form (cont.)

- ❑ What happens when one founder fails to live up to expectation under their agreement? Resolution mechanism?
- ❑ What happens if the founders can no longer work together, say due to a withdrawal of a member? Is there a buy-out formula in place? What happens on dissolution?
- ❑ Can one take a sabbatical from the business, but still retain an interest in the business?
- ❑ For the lawyer, how would potential ethical issues be handled? For example, when a co-founder's interest conflicts with that of the business?

## Factors to consider when deciding what type of business organization to form-the lawyer's issue (cont.)

- ❑ It crucial that as a lawyer, you know exactly who you're representing, given your duties as a lawyer runs to them.
- ❑ In that vein, if there are other persons or entities involved who are **not** your clients but who may think you are their lawyer because of the circumstances, you must make it clear that you are not representing them, and that they are free to retain their own independent counsel.



# Factors to consider when deciding what type of business organization to form-the lawyer's issue (cont.)

- ❑ Perhaps your engagement letter should make it clear that you're representing the company and not the individuals.
- ❑ This situation is common where you have multiple prospective founders before the company is founded-one could represent co-founders in their individual capacities so long as their interests are aligned.
- ❑ Thus, making clear as to what would likely happen when there is a conflict of interests becomes paramount .

# SOLE PROPRIETORSHIP

A business individually owned by a single person  
(a fancy name for one owner)



# Operating a Sole Proprietorship

**The simplest and most common way to conduct a business is as a sole proprietor.**

***Do you want to call ALL the “shots”?***

- ❑ As a sole (one person) owner, you get to because the owner is in direct control.
- ❑ The owner is the business, and the business is the owner.
- ❑ No legal forms to file with the state government.
- ❑ Only requirement is that the owner be a single (one) individual and depending on the type of business or profession, obtain any special licenses as required.

# Advantages of doing business as a Sole Proprietorship

- ❑ **Easy to form / low start-up costs**
  - ❑ Generally, no special forms or formalities required.
  - ❑ Minimal legal costs to form.
- ❑ **Business is owned, managed, and operated by one person.**
  - ❑ You may operate/manage your business as you choose, and your business can be as flexible and informal as you desire.
- ❑ **Ease of transfer of ownership**
  - ❑ Can sell or transfer business to someone else by selling all the assets used in the business.
- ❑ **Can terminate at owner's discretion**
  - ❑ Sole proprietorship dies when the owner dies
  - ❑ Owner can sell the business or file for personal bankruptcy.
- ❑ **Avoidance of double taxation.**
  - ❑ No corporate tax payments.
    - ❑ The sole proprietor does not pay taxes as a separate entity.
  - ❑ Business income is part of the **proprietor's taxable income** for federal and state personal income.

# Disadvantages of doing business as a Sole Proprietorship

- **Unlimited liability**
  - A sole proprietor is **personally liable** for all business assets, debts and actions of the business.
  - There is NO distinction between personal and business assets- assets are at risk.
  - Liability will extend to the personal assets of the proprietor.
  - Owner should consider obtaining adequate insurance to shield you from personal liability in the event of a lawsuit.
- **Limited business capital / Financing on your own can be difficult**
  - Sole proprietor contributes whatever capital is needed.
  - No shares/stock certificates can be sold to outside investors.
  - A sole proprietor cannot bring in other investors because then it becomes a partnership.
- **Any income to the business is treated and taxed as income to the business owner**

# Taxation of a Sole Proprietorship

## Taxes are paid by the sole proprietor and not by the business itself

- ❑ **All** business income or loss is treated as individual income or loss and must be reported as business income on the individual's personal tax return.
- ❑ You must file a "Schedule C" on your personal tax return to report business income.
- ❑ If the sole proprietor will hire employees, he /she must obtain an **employer tax identification number** in order to contribute to social security and unemployment compensation on behalf of the employees.
- ❑ The form is called an SS-4 and can be found at the link below
- ❑ <http://www.irs.gov/pub/irs-pdf/SS4.pdf>
- ❑ Employer Identification Number is the IRS Form SS-4, "Application for Employer Identification Number."

# Federal Tax Employer Identification Number (FEIN)

Form <b>SS-4</b> (Rev. January 2009) Department of the Treasury Internal Revenue Service	<b>Application for Employer Identification Number</b> (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ See separate instructions for each line. ▶ Keep a copy for your records.	OMB No. 1545-0003 EIN
1 Legal name of entity (or individual) for whom the EIN is being requested		
2 Trade name of business (if different from name on line 1)		
3 Executor, administrator, trustee, "care of" name		
4a Mailing address (room, apt., suite no. and street, or P.O. box)		
5a Street address (if different) (Do not enter a P.O. box.)		
4b City, state, and ZIP code (if foreign, see instructions)		
5b City, state, and ZIP code (if foreign, see instructions)		
6 County and state where principal business is located		
7a Name of principal officer, general partner, grantor, owner, or trustee		
7b SSN, ITIN, or EIN		
8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? <input type="checkbox"/> Yes <input type="checkbox"/> No		
8b If 8a is "Yes," enter the number of LLC members		
8c If 8a is "Yes," was the LLC organized in the United States? <input type="checkbox"/> Yes <input type="checkbox"/> No		
9a Type of entity (check only one box). Caution: If 8a is "Yes," see the instructions for the correct box to check.		
<input type="checkbox"/> Sole proprietor (SSN) <input type="checkbox"/> Estate (SSN of decedent) <input type="checkbox"/> Partnership <input type="checkbox"/> Plan administrator (TIN) <input type="checkbox"/> Corporation (enter form number to be filed) ▶ <input type="checkbox"/> Trust (TIN of grantor) <input type="checkbox"/> Personal service corporation <input type="checkbox"/> National Guard <input type="checkbox"/> State/local government <input type="checkbox"/> Church or church-controlled organization <input type="checkbox"/> Farmers' cooperative <input type="checkbox"/> Federal government/military <input type="checkbox"/> Other nonprofit organization (specify) ▶ <input type="checkbox"/> REMIC <input type="checkbox"/> Indian tribal governments/enterprises <input type="checkbox"/> Other (specify) ▶ <input type="checkbox"/> Group Exemption Number (GEN) if any ▶		
9b If a corporation, name the state or foreign country (if applicable) where incorporated		
10 Reason for applying (check only one box)		
<input type="checkbox"/> Started new business (specify type) ▶ <input type="checkbox"/> Banking purpose (specify purpose) ▶ <input type="checkbox"/> Hired employees (Check the box and see line 13.) <input type="checkbox"/> Changed type of organization (specify new type) ▶ <input type="checkbox"/> Compliance with IRS withholding regulations <input type="checkbox"/> Purchased going business <input type="checkbox"/> Other (specify) ▶ <input type="checkbox"/> Created a trust (specify type) ▶ <input type="checkbox"/> Created a pension plan (specify type) ▶		
11 Date business started or acquired (month, day, year). See instructions.		
12 Closing month of accounting year		
13 Highest number of employees expected in the next 12 months (enter -0- if none).		
14 Do you expect your employment tax liability to be \$1,000 or less in a full calendar year? <input type="checkbox"/> Yes <input type="checkbox"/> No (If you expect to pay \$4,000 or less in total wages in a full calendar year, you can mark "Yes.")		
15 First date wages or annuities were paid (month, day, year). Note: If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year)		
16 Check one box that best describes the principal activity of your business.		
<input type="checkbox"/> Construction <input type="checkbox"/> Rental & leasing <input type="checkbox"/> Transportation & warehousing <input type="checkbox"/> Health care & social assistance <input type="checkbox"/> Wholesale-agent/broker <input type="checkbox"/> Real estate <input type="checkbox"/> Manufacturing <input type="checkbox"/> Finance & insurance <input type="checkbox"/> Accommodation & food service <input type="checkbox"/> Wholesale-other <input type="checkbox"/> Retail <input type="checkbox"/> Other (specify)		
17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.		
18 Has the applicant entity shown on line 1 ever applied for and received an EIN? <input type="checkbox"/> Yes <input type="checkbox"/> No		
If "Yes," write previous EIN here ▶		
Complete this section only if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.		
Third Party Designee	Designee's name	Designee's telephone number (include area code)
	Address and ZIP code	Designee's fax number (include area code)
Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.		Applicant's telephone number (include area code)
Name and title (type or print clearly) ▶		Applicant's fax number (include area code)
Signature ▶		Date ▶

# Termination of a Sole Proprietorship

A sole proprietorship could terminate in any of the following ways:

- ❑ he/she sells the business;
- ❑ brings in a partner;
- ❑ files the necessary paperwork with the state to create and replace with a different business entity;
- ❑ files for personal bankruptcy; or
- ❑ when the sole proprietor passes away.



# Business Name Registration (“Doing Business As”)

- ❑ **The legal name of a sole proprietorship is the name of the person or entity that owns the business.**
- ❑ **If you use any name other than your own name, you will need to file a “doing business as” or fictitious business name.**
  - ❑ **As long as no other valid business name is already in use or similar to another registered name, a sole proprietor may choose to conduct business under another name other than his or her own name .**
  - ❑ **If you are doing business under another name, you must register with the Division of Corporations of the Florida Department of State.**
  - ❑ **This enables the public to know who’s actually operating a**

# GENERAL PARTNERSHIP

Two or more persons to carry on as co-owners of a business for profit.



# Formation of a General Partnership

- ❑ A partnership is similar to a sole proprietorship except that in a partnership **two or more individuals have joint ownership including joint rights to carry on as co-owners of a business, trade, or profession for profit.**
- ❑ EACH person may contribute money, property, labor, or skill and EACH expects to share in the profits and losses of the business.
- ❑ Requires no formal legal steps—no filing; partnership law does not even require that there be an agreement.
- ❑ **If 2 or more persons are operating a business as “co-owners,” that business will be a partnership**—even if the partners do not realize that they have a partnership.
- ❑ Although not legally required, to avoid any misunderstandings/confusion, partners should have a written partnership agreement.

# General Partnership Agreement

## □ Why should you have a written partnership agreement?

- A partnership agreement is a contract and is binding and legally enforceable.
- NOT having a partnership agreement can cause severe problems in the future.
- With an agreement, you and your partner tailor the specific desires of the partners and set the guidelines that are to be imposed upon the business.
- Without a written, ratified agreement, your partnership is at the mercy of state laws and their default provisions will govern and control many aspects regarding your business.
- Having a written agreement will make it easier to identify the intentions of each party as well as any assets or property contributed to the partnership.

# General Partnership Agreement (cont.)

- ❑ **What should a written partnership agreement contain?**
- ❑ The agreement should contain all of the important rules and guidelines for the operation of the partnership including:
  - ❑ The names and identities of the partners,
  - ❑ the partner's percentage of ownership,
  - ❑ the partner's powers and the limitations on its powers,
  - ❑ the conditions for admission, if permissible of new partners,
  - ❑ the term of the agreement,

# General Partnership Agreement (cont.)

- ❑ The rules regulating the amendment of the agreement, and just about anything else that the partners feel is necessary or desirable for the operation of the partnership.
- ❑ Absent a partnership agreement, all partners generally have **equal** rights in the management and conduct of the partnership.

# Advantages of doing business as a General Partnership

- ❑ **Easy to form / low start-up costs / More start-up money**
  - ❑ Generally, no special forms or formalities required.
  - ❑ Minimal legal costs to form.
- ❑ **Flexible management / Shared responsibility / More skills**
  - ❑ Unlimited number of general partners allowed.
  - ❑ A partnership agreement may be amended with consent of all of the partners.

# Advantages of doing business as a General Partnership

- ❑ The general partners have equal management rights, unless they agree otherwise.
- ❑ An equal right to manage the affairs of the partnership means that the partners share equal management authority.
- ❑ The general partners typically contribute money or services to the partnership and receive an interest in profits or losses.
- ❑ The partners may decide how to distribute earnings.



# Disadvantages of doing business as a General Partnership

- ❑ **Unlimited liability:**
  - ❑ Partners are **jointly and severally liable** for all business debts and obligations including court judgments.
  - ❑ Each partner in the partnership has the **power to bind the** other partners to contracts or debts:
    - ❑ The actions and mistakes of one of the partners may become the responsibility of the rest of the partners.
- ❑ **Difficulty in finding a suitable partner.**
- ❑ **Dissolution of partnership can carry consequences.**
- ❑ **Lack of continuity.**
- ❑ **General partnerships are limited in their ability to raise money.**

# Taxation of a General Partnership

- ❑ **Single Layer of Federal and State income tax**
  - ❑ Partnership itself not subject to tax
  - ❑ Net Income taxed to partners (whether or not distributed)
  - ❑ This is “pass through” taxation, that is:
    - ❑ Each partner's proportionate share of income or loss is passed through from the partnership to the individual and each partner files their own personal income tax return .
      - So, the partnership isn't taxed, but the partners are (although there is a federal tax informational filing by the partnership).
      - Form SS-4 Employer Identification Number must also be filed.
- ❑ Unless there is a written partnership agreement, the IRS considers all partners as owners of equal shares of the partnership.

# Termination of a General Partnership

- ❑ Termination of a partnership (also known as dissolution of a partnership) happens when:
  - ❑ A partner dies, retires, or withdraws;
  - ❑ A partner goes bankrupt;
  - ❑ The partnership is ordered to dissolve by the court.
  - ❑ The partnership has completed a business project (joint venture) or come to the termination date as set forth in the partnership agreement.

# Termination of a General Partnership

- ❑ After dissolution, each partner is entitled to a settlement of all partnership accounts upon winding up of the business.
- ❑ Typically, most partnership agreements will provide that if one partner dies, retires, or withdraws, the remaining partners can vote to continue on or choose not to continue and head to winding up and then termination of the partnership.

# Checklist for All New Businesses

- ✓ Select your business structure.
- ✓ Select and register your business name and entity.
- ✓ Create or register your business.
- ✓ Obtain federal, state, county, and local tax information.
- ✓ Determine if you need any special licenses for your business.
- ✓ Obtain State Tax Id number and FEIN.

***GOOD LUCK!***

