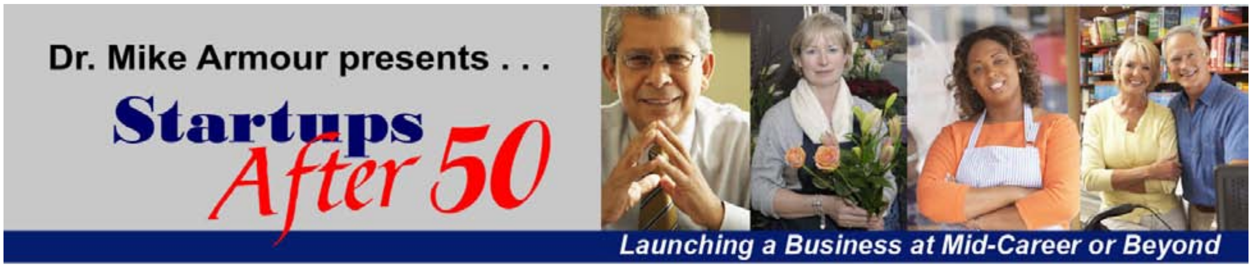


Business Startups – Choosing the Best Legal Structure

Developed by

Dr. Mike Armour
StartupsAfter50.com

This tutorial provides basic information for men and women who are starting a small business. Even though the tutorial examines legal and tax issues faced by small business owners, it should not be construed as legal, accounting, or tax advice. Always seek competent professional counsel in addressing issues and questions raised in this article.

Contents

Business Startups – Choosing the Best Legal Structure

Introduction

As the owner of a startup, one of your earliest decisions is how you will structure your business. Will you operate it as a sole proprietorship, with no legal umbrella? Or will you give it a formal legal structure? And if so, what structure will you choose?

You can elect any of several options for a legal structure. You can form a corporation, a limited liability company, or a partnership. And under the corporate option you have the further choice of two alternatives, one called a C-Corp, the other an S-Corp. They derive their names from the section of the IRS code which governs them.

Whether you opt for a sole proprietorship or one of these legal structures, your choice has significant implications. It will determine

- how your business is taxed
- how the profits of the company pass to you as an owner
- how your personal income from the business is taxed
- and the degree to which your personal assets are protected in the event that your business has a court settlement made against it.

Most of these business structures are known as "flow-through" or "pass-through" entities, because their net profits flow directly to the owner before they are taxed by the IRS. In other words, the entity itself does not pay income tax.

The sole exception is the C-Corp. All of its profits are taxed before the owners and investors receive any distribution of profits. Once its tax obligation is satisfied, the corporation can then distribute any remaining profit to its shareholders — i.e., its owners and investors — in the form of dividends. These dividends are then taxed as income for the shareholders.

The result is "double taxation" on the share of profits that pass to shareholders. Because of this double taxation, most small startups are not well-served by choosing to be a C-Corp. But as we shall see, under some conditions a C-Corp brings unique advantages to a startup that make the double taxation an acceptable trade-off. Moreover, for very small businesses, the double taxation can be avoided by paying end-of-year bonuses to the owner-manager which effectively eliminate the company's profits and any dividend distribution.

On the following pages we provide a brief, non-technical introduction to the pros and cons of sole proprietorships, LLCs, C-Corps, S-Corps, and partnerships. No one structure is right for all small businesses. So take a few minutes to familiarize yourself with your various options and make an informed decision about the best legal structure for your business startup.

Part 1: Sole Proprietorship

The simplest way to structure your business is to function as a sole proprietor. In effect, you and the business are one and the same. Laws in your area may or may not require you to register the business with your local or county government. But this normally consists merely of filing a brief form and perhaps paying a modest fee. Once you have taken these steps, you are free to start doing business.

Even filing for a Federal Employer Identification Number (EIN) may be optional. Unless your business has employees or must file excise, firearms, tobacco, or alcohol returns, you are not required to have an EIN. You file your taxes using your personal social security number.

Assumed Names

Even though you are acting as a sole proprietor, you can appear to the public as though you are a company. You do this by registering an assumed name for your business. This allows you to issue invoices, accept payments, advertise, enter contracts, and pay taxes under this assumed name, not your personal name. Most jurisdictions allow you to register multiple assumed names. (Elsewhere on our web site we have provided a fuller explanation of assumed names and how to obtain them.)

Using an assumed name is often referred to as "having a dba," which stands for "doing business as." In the eye of vendors, clients, customers, and the community you are no longer doing business as John Doe, but as XYZ Company.

Assumed names are typically registered at the county and/or state level. From one state to the next, there will be differing rules as to the terms which may be part of your dba.

One rather universal rule is that your assumed name cannot include words like "Incorporated" or "Corporation" or abbreviations like "Inc" or "Corp." These terms imply that your business is legally recognized as a corporation, which it is not. But apart from a few limitations along these lines, you are free to name your sole proprietorship whatever you wish so long as no one else locally is using that name.

Federal Taxes

When you operate as a sole proprietorship, you pay business income taxes as part of your personal income tax. For Federal filings, this means that you attach a Schedule C to your Form 1040. You will also have to pay self-employment tax for both Social Security and Medicare by attaching IRS Form SE to your 1040.

As a sole proprietor, you pay your business income' tax as part of your personal income tax.

But what happens if a sole proprietor's spouse is materially involved in running the business? Is the business still technically a sole proprietorship (from a tax standpoint), so that it reports its income on Schedule C? Historically the IRS has said "no." It treated the couple as partners in a joint business venture.

Consequently, to conform with annual reporting requirements for a partnership, the business had to issue a K-1 to both the husband and wife, stating their respective share of the profits or losses. To report this income, the two parties individually filed a Schedule E with their Form 1040. The business also filed a partnership information report with the IRS.

Of course, these filing requirements violate one of the primary reasons for having a sole proprietorship in the first place, namely, minimizing the amount of government-related paperwork. Today the rules have slightly changed for husbands and wives who jointly run an unincorporated business. Congressional legislation passed in 2007 allows husbands and wives *in community property states* to opt out of the partnership filing. Instead, they can be treated as a single entity and report income from the business on Schedule C.

However, since Schedule C's are filed in the name of a single tax-payer, each party should file a separate Schedule C, showing his or her portion of the income and expenses for the business. If only one of them files a Schedule C, the other gets no credit for social security and Medicare contributions for income from the business. (For more details governing eligibility for this option and how to exercise it, see the article on unincorporated joint ventures between spouses elsewhere on our web site.)

Pros and Cons of a Sole Proprietorship

The advantages of a sole proprietorship are the following.

- You can start it or terminate it immediately at no cost or very minimal cost.
- Since you are not answerable to most reporting regulations that govern corporations and partnerships, record-keeping requirements are minimal. Fundamentally you simply need to maintain sufficient financial records to complete Schedule C annually and to defend your income and expenses in the event of an audit.
- You have absolute control of your business, since you do not have to answer to partners or to a board of directors.

In effect, you and your business are one and the same. And therein lies a wholesale problem. **Because you and your business are one and the same, any legal action against your business is in fact a legal action against you personally.** In legal parlance, you have no limited liability.

If some disgruntled party takes you to court, your personal bank accounts and most of your family assets are not protected from a court settlement that goes against you or a lien that is created against your business.

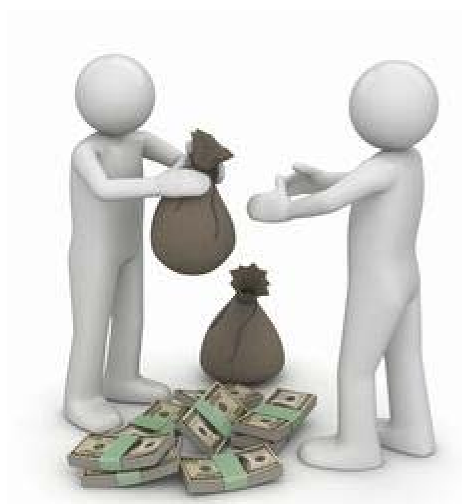
Now, you may be saying to yourself, "I'm not worried about being sued. I'm starting a business that has little risk of causing harm to anyone or doing damage to someone's property." But your business can be drawn into a lawsuit in dozens of ways that have nothing directly to do with your products or services.

- What if you have an automobile accident while running errands for your business?
- What if you get behind on your bills and a creditor sues you in small claims court?
- What if you fire a worker, who then takes you to court for a wrongful termination?
- What if an independent contractor, while working for you, takes actions that trigger some legal action? In such a case you may be named as a co-defendant, or even the primary defendant.

Should something like this occur, you can't protect your personal assets by quickly going out and incorporating your business. Liability will be determined by the structure of your business at the time of the incident around which the legal action centers.

So a word to the prudent — don't risk everything you own to chance by operating any business as a sole proprietor. Is it legal to do so? Yes! Is it wise to do so? Absolutely not. Build limited liability for yourself as quickly as possible.

Part 2: Limited Liability Companies



The most common way for small business startups to separate the liability of the business from the liability of the owner is to form an LLC. These initials stand for "limited liability company." LLCs blend many freedoms enjoyed by sole proprietorships with the greater liability protection enjoyed by corporations.

LLCs versus Corporations

LLCs can embark on any kind of investment that is open to corporations. LLCs can have ownership positions in other LLCs or enter into partnerships with them. They can also partner with individuals, corporations, or non-profits. And they can hold stock — even controlling interest — in a corporation, with but one exception. Like corporations, LLCs are precluded from being shareholders in an S-Corp.

Owners of LLCs have tremendous freedom in terms of operating their LLC. **When compared to the rules governing corporations, record-keeping requirements for LLCs are rather minimal.** In this regard LLCs have much in common with sole proprietorships.

But in contrast to a sole proprietorship, an LLC is an entirely separate legal entity from its owner. This separation is what cloaks the owner with limited liability. When your company is an LLC, any court or legal action against the company can only lay claim to the assets of the LLC itself, not to your own personal assets.

Indeed, LLCs provide the same liability protection as a corporation. Yet they differ from corporations in some fundamental ways. In contrast to corporations, LLCs do not sell stock and do not have shareholders. Instead, owners are known as "members."

Most jurisdictions allow you to form an LLC with only a single member. But theoretically you can have any number of members. Quite often a family business which operates as an LLC will have two members, the husband and wife.

Operating Agreements

Once established, the LLC creates an Operating Agreement. This agreement is roughly equivalent to the by-laws of a corporation. It lays out the policies and guidelines that will govern the way that the LLC conducts its affairs. Even if you organize an LLC in a state that has no statutory requirement for an Operating Agreement, it is sound practice to create one.

- A written Operating Agreement strengthens your claim of limited liability by demonstrating that the LLC is indeed a legal identity separate from the identity of its owners.
- In multi-member LLCs the Operating Agreement sets the ground rules for what members may and may not do in their capacity as members.
- It also spells out when distributions of profits will be made, how they will be made, and how the distributions will be prorated.

- Banks, creditors, institutions, and others with whom you may partner will often request a copy of your Operating Agreement as a condition of doing business with you.

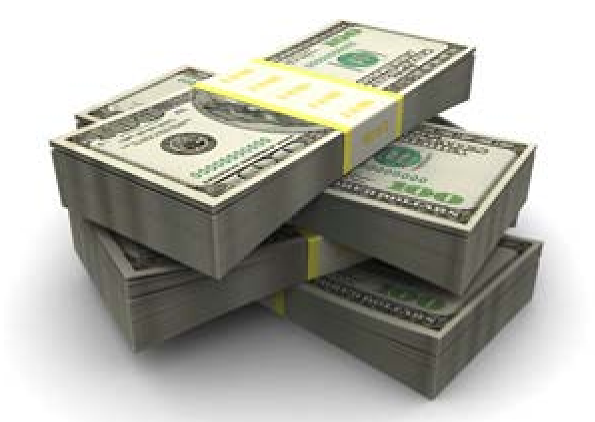
This Operating Agreement is no mere formality. In any challenge before a court or in a tax audit your Operating Agreement is open to review. If your actions have been substantially inconsistent with it, you may be denied the limited liability that you would have otherwise enjoyed. So you not only want to have an Operating Agreement in place. You also want to modify and amend it should any of its provisions become outdated or outmoded.

Even if you organize an LLC in a state which does not require an Operating Agreement, it is sound practice to create one.

Beyond this Operating Agreement, the primary record-keeping requirement for an LLC is to maintain adequate financial records to properly report local, state, and Federal taxes. You can normally do this adequately with inexpensive bookkeeping software and a good filing system for receipts.

Taxes and the Many Faces of an LLC

Because they were designed to provide maximum flexibility to their owners, LLCs have a certain chameleon-like quality about them, particularly with regard to taxes. The IRS treats single-member LLCs as though they were sole proprietorships. The income (or loss) from the LLC is reported on Schedule C of the member's 1040 tax return.



If the sole member of a single-member LLC is a corporation, the income or loss from the LLC is reported as part of the corporation's income tax.

Multi-member LLCs receive a different tax treatment. Even though they are not partnerships from a legal standpoint, they are generally taxed under the same rules that govern partnerships. Accordingly, the members report their income from the LLC on their respective 1040s, but on Schedule E rather than Schedule C.

There are two situations in which this partnership treatment may not apply. The first is when a husband and wife are the only two members of an LLC and they live in a community property state. In this instance the husband and wife can elect to report their LLC income on Schedule C, the same as single-member LLCs. But they are not required to do so.

Second, LLCs have the option of being taxed as corporations. They can choose be taxed under the rules for C-Corps or for S-Corps. They do not become a corporation by making this choice. But they file their taxes as though they were indeed a corporate entity.

This means that an LLC which chooses to be taxed as a C-Corp must pay corporate income tax on its profits. Then, at its own discretion, the LLC can pass after-tax profits to its members in the form of disbursements. From a tax standpoint these disbursements are treated the same way as dividends from a C-Corp. That is, the members of the LLC report the disbursements on their personal 1040 using Schedule E. And the disbursements are taxed at the dividend rate.

In some situations it may make financial sense for an LLC to be taxed as an S-Corp. Since an S-Corp is a "pass-through" entity like an LLC, this gives the LLC access to certain tax advantages enjoyed only by corporations, but without subjecting itself to the double-taxation of a C-Corp. On the other hand, **it is rarely financially wise for an LLC to be taxed as a C-Corp, again because of the double-taxation issue.**

Unless it does choose to be taxed as a C-Corp, an LLC never files Federal income taxes. Income from the LLC flows directly to the members and is apportioned among them in keeping with the Operating Agreement. Profits from the LLC are therefore taxed at personal income tax rates.

Incidentally, IRS regulations allow even single-member LLCs to be taxed as corporations. The considerations for making this choice are the same for both single-member and multi-member LLCs. But you should never elect to have any LLC treated as a corporation without first obtaining professional counsel from a CPA or tax attorney. You want to understand all of the long-term consequences of this election, because for the most part they are irreversible.

LLCs and Partnerships

While a multi-member LLC is usually treated as a partnership for tax purposes, it is legally quite distinct from a partnership. For one thing, there is no partnership agreement governing the LLC. The Operating Agreement sets the ground rules for the LLC.

For another, the LLC is free to apportion profits among its members in a way that is precluded to partnerships.

In a partnership, profits can only be divided among the partners based on their percentage of ownership. LLCs are not bound by this rule. The Operating Agreement can set a formula for disbursing profits that disregards how much the respective members have invested in the company.

To cite an example, consider two people who start an LLC with one putting up 60% of the investment capital, the other putting up 40%. However, because the 40% party will play a larger role in the day-to-day management of the company, they agree to split the profits 50-50. This is perfectly allowable in an LLC so long as there is a defensible reason for a disproportionate division of profits. Only an LLC allows this kind of flexibility.

Pros and Cons of LLCs

Here, then, are some of the distinct advantages to an LLC structure for your business.

- LLCs are easy to set up and have rather minimal record-keeping requirements.
- The owners maintain exceptional freedom over how they manage the affairs of the company.
- Profits from the company can be distributed in an arbitrary manner among the members.
- Income from the LLC is taxed at the personal income rate, not the (usually) higher corporate rate.

- LLCs can easily spin off other companies which they control, whether LLCs or corporations.

On the other hand, there are some disadvantages to LLCs, especially those which need to accumulate working capital in their early years of existence. **Members of an LLC are taxed on the income that the company earns, not the income actually disbursed to them as members.** Thus, if an LLC needs to reinvest some of its earnings for future operations, the members pay income tax on these reinvested earnings, even though the member never received the money that is reinvested.

All "pass-through" entities have this same disadvantage. Shareholders in C-Corps, on the other hand, are not personally taxed on earnings which are retained in the company. For that reason, one of the few cases in which an LLC might wisely choose to be taxed as a C-Corp (or even organize itself as a C-Corp from the outset) is when it needs to build up sizable retained earnings over several years to underwrite growth and expansion.

There is also another case in which a corporate structure may be preferable to an LLC, namely, if the company envisions overseas expansion. LLCs are a rather recent type of legal structure in the U.S, and corporate laws in other parts of the world do not always provide convenient avenues for American LLCs to conduct business.

We have experienced this within our own family of companies. A few years ago one of our LLCs decided to open a subsidiary in an emerging nation in Africa. But that country's laws anticipated that foreign-owned subsidiaries would be owned by a traditional corporation. They had no provision for a subsidiary owned by an American LLC. Nor did they have a provision for assumed names, which our LLC used extensively.

After weeks of frustration with the registration process, we ended up forming a corporation in the U.S., transferring the LLCs assets to the corporation, and then using the corporation as the parent company of the subsidiary.

Overall, however, most small startups — and even larger ones — opt for an LLC as the best way to organize their business and provide limited liability for the owner. Later, if circumstances dictate, the LLC can be converted to a corporation with the unique advantages (and disadvantages) of a corporate business structure.

Part 3: Corporations

What sets corporations apart from other business structures is that they issue stock and have shareholders. Technically it's the shareholders en masse, not the founders, who are the owners of a corporation. For the purposes of this discussion, however, we will use the term "owner" to refer to founders who retain enough shares to have controlling interest in the company.

There are two types of corporations in the U.S., and they take their name from the section of the IRS Code which governs them. The most common corporate form is the C-Corp. But smaller businesses often prefer being an S-Corp.

These designations — C-Corp and S-Corp — are merely tax classifications. They have no other legal meaning. When a new corporation files documents of formation with a state, the state neither cares nor asks whether the corporation will function as an C-Corp or an S-Corp. In the eyes of state the matter is inconsequential. Under the state's corporate code, all corporations are treated alike.

With the IRS, however, it's a different matter. The moment a corporation comes into existence it is answerable to the IRS as a C-Corp. The company can then notify the IRS that it wants to be taxed as an S-Corp. But until the company declares itself an S-Corp, it is treated as a C-Corp by default.

Taxes

This declaration is significant in terms of how the corporation pays its taxes. C-Corps pay corporate income tax. S-Corps do not.

S-Corps are "pass-through" entities, much like sole proprietorships, LLCs, and partnerships. An S-Corp's net profit passes directly to the shareholders, who shoulder the tax burden for the company's earnings. They report their tax liability by using Schedule E when filing their personal tax return.

A C-Corp, by contrast, is a standalone taxable entity, separate from its owner and any other investors. Its earnings are subject to a corporate tax rate that is different from the rate paid by individuals.

In any given year the owner of a C-Corp may or may not have a tax liability based on the company's operations. The determination of the owner's tax liability depends on two factors. First, is the owner salaried as an employee of the company? And second, did the company distribute dividends after paying its corporate taxes?

Any wages paid to the owner as an employee are tax-deductible expenses for the company. The owner receives a W-2 for these wages, reports them when filing his or her 1040, and pays taxes on them as ordinary income.

The owner may also have non-ordinary income from the company in the form of dividends. There is no mandate for C-Corps to issue dividends. They may instead choose to retain their after-tax earnings to fund growth, expansion, new capital equipment, or acquisitions.

If a C-Corp decides to forego dividends in a given year, its owners and investors incur no tax liability for these retained earnings. This distinguishes C-Corps from S-Corps, whose owners and investors do pay taxes on retained earnings.

In the years when a C-Corp does distribute dividends, owners report their portion of the dividends in the same way as any other shareholder. On the owner's 1040 tax return the dividends are declared on Schedule B and taxed at a rate which is normally lower than the rate for regular income.

By contrast, the operations of an S-Corp create tax liabilities for its owners every year, even when the owner is not a salaried employee. By law the S-Corp's profits must be apportioned each year to every shareholder and the shareholders must pay tax on that apportionment. Even if the S-Corp did not actually distribute its profits, opting instead to retain them, the shareholder still must pay tax on his or her share of the profits.

Which Should You Choose? A C-Corp? Or an S-Corp?

Your business does not have to be huge in order to be a corporation. A small home-based business can be organized as a corporation. Even if you are your company's only employee, your business can structure itself as a corporation.

In general, startups which choose a corporate structure opt to be treated as an S-Corp. This gives them all of the advantages of a corporation without the level of record-keeping and administrative complexity of a C-Corp. S-Corps do not pay dividends, since all of the company's profits are passed through to the shareholders as taxable income. And as we have noted, the corporation does not have the responsibility for filing an income tax report.

There are some unique limitations on S-Corps, however. As we shall see below, tax-free benefits that can be paid to owner-employees in a C-Corp are treated as taxable income to an owner-employee who holds more than 2% of the stock in an S-Corp. Also, unlike any of the other legal structures that are available to you, all shareholders in an S-Corp must be natural persons. That is, you cannot sell shares in an S-Corp to an LLC or to another corporation.

Pros and Cons of Incorporating

So, what considerations might lead you to form a corporation instead of an LLC? One reason is to have shares in the company which you can sell to raise capital. In general, corporations find it easier to raise capital than do sole proprietorships, LLCs, and partnerships, in part because the corporation can offer stock to investors.

Both S-Corps and C-Corps can sell shares. But the tax consequences for the purchaser are significantly different. With an S-Corp, as we noted earlier, the shareholder must pay taxes on company profits, whether those profits are actually distributed or not.

This can prove costly during the early years of a small startup when the company is retaining its profits to build up operating capital or in tough economic times when the company may choose to build up a cash cushion. (When S-Corps opt not to distribute their profits completely, they will commonly distribute enough profit to allow the shareholders to pay the tax liability that their shares have incurred.)

Corporations can generally raise capital more easily than small businesses with some other type of legal structure.

Shares in a C-Corp, by comparison, give the investor the promise of on-going dividend distributions, taxed at low dividend rates, along with participation economically in the growth and profitability of the company. But the shareholder has no tax liability unless a dividend is actually paid. For the business itself, selling shares may be preferable to taking out investment loans, because interest on investment loans must be paid whether the business is making money or not. Dividends, on the other hand, are paid only when the company is profitable.

A second reason to choose a corporate structure — particularly a C-Corp — is to amass working capital at a lower tax rate. If your household income is significantly higher than your company's income, your C-Corp income tax rate may actually be lower than your household income tax rate. Therefore, within a C-Corp you can build up your working reserves with a smaller tax bite than would be the case with an LLC, a partnership, or an S-Corp.

A third reason to select the corporate structure is enhanced employee benefits. There are a variety of benefits which you can pay yourself tax free inside a C-corp that are are taxed as additional income for sole proprietors, members of LLCs, or shareholders with more than 2% of the stock in an S-Corp. In a C-Corp, for instance, you can have a medical reimbursement plan that is a tax-deduction for the business and is tax-free to the employee, in this case, you.

Because the rules on fringe benefits for owners differ so markedly from one legal structure to another, you need to consult a CPA or a tax attorney to identify the potential employee benefits within your own business and how to institute these benefits to maximum tax advantage. But you can also learn about many of these benefits by doing a little research on the web. You will quickly discover that you must follow precise formalities in setting up fringe benefits within your corporation.

This is one arena, therefore, in which you do not want to try a "do-it-yourself" approach. Get the detailed counsel of a tax professional.

For small business owners, the major disadvantage of a corporation, whether a C-Corp or an S-Corp, is the compliance burden with corporate regulations. While there

are compliance burdens with any business, they are notably more complex with a corporation, especially a C-Corp.

You must have annual meetings of the shareholders. Directors, too, must hold annual meetings, along with intervening meetings whenever the company is undertaking an initiative that in a large corporation would require board approval. And minutes and records of all of these meetings must be maintained.

For small business owners, the major disadvantage of a corporation is the compliance burden with corporate regulations.

Now, in point of fact, these requirements may appear more onerous on the surface than they are in reality. In most states a C-Corp can have a single director and a single shareholder. State law will also require the corporation to have certain officers, namely a president, a secretary, and perhaps a treasurer. One person can usually fill all of these positions.

Therefore, you could theoretically be the only shareholder, the only director, the president, secretary, and treasurer. So "meetings" are hardly a laborious affair. Still, you do have to make a record of what transpired at these "meetings" and date and sign them properly.

One convenient way to do this is to use a written document called a Unanimous Consent in Lieu of a Meeting. The document simply lays out a decision that the company is making and is signed by the directors. This document of record then substitutes for the formal minutes of a meeting.

The important thing is to create such records of decisions and keep them up to date. Otherwise in a legal action the courts could conclude that the company was not indeed functioning as a corporation, but was merely an extension of your persona and therefore not entitled to the liability protection that a corporation normally provides.

For a handful of professions there is another pitfall with a C-Corp. It's commonly referred to as the "personal services corporation trap." The IRS treats certain types of C-Corps as Personal Services Corporations (PSCs) and taxes them at a flat 35% tax rate. That's a particularly punitive rate, especially when you consider that a corporation must otherwise show $75,000 in profits before it would be taxed at nearly that percentage.

Professions which are susceptible to being treated as PSCs are those in health, law, engineering, accounting, actuarial science, consulting, and performing arts.

The IRS applies two tests to determine if a C-Corp is indeed a Personal Services Corporation. First, does at least 95% of the corporation's activity fall within one of the categories just listed. (Note that the test is not 95% of the company's profits, but 95% of its activity.)

The second test is whether substantially all of the corporation's outstanding stock is directly or indirectly held by the individual who delivers the corporation's services. "Indirect" ownership refers to shares held by a spouse, lineal ancestors or descendents, or legal entities (such as an LLC) that are controlled by any of the people above.

There are common workarounds to escape the PSC classification. The simplest is to add enough diversification to your income stream that you fail the 95% activity rule.

The other is to pay out all of the company's earnings in salaries, bonuses, and fringe benefits to the owner-employees, so that there are no profits to be taxed.

Part 4: Partnerships

Of all the legal structures available to a startup, the easiest to establish is a partnership. It is also easy and inexpensive for partnerships to stay in compliance with regulatory statutes.

Technically the formation of a partnership requires nothing more than an oral agreement between two or more other parties to go into business together. Unlike an LLC or a corporation, **a partnership does not file paperwork with the state to become a legal entity.** States and the courts consider any business a partnership if it has multiple owners and has not been legally recognized as an LLC or a corporation.

Types of Partnerships

Partnerships come in two basic varieties: general partnerships (GPs) and limited partnerships (LPs). Some states also recognize a third type called limited liability partnerships, or LLPs, and a special variant of it called professional limited liability partnerships (PLLPs).

A general partnership is the simplest to form. Its partners jointly manage the decision-making of the partnership and are equally empowered to act as agents on its behalf. That is, any partner can obligate the partnership as a whole by entering into contracts, authorizing purchases, or even disposing of assets.

A limited partnership has two tiers of partners. One is the general partner, who alone can act as an agent on the partnership's behalf. The other partners (known as "limited partners") play a more passive role, which may be nothing more than providing investment capital.

Limited liability partnerships are a special form of a general partnership. They provide each partner a measure of limited liability that is unavailable in general partnerships. We will examine this issue more fully in a moment.

Limited liability partnerships (or LLPs) are of relatively recent origin. Texas, the first state to recognize LLPs, gave them statutory approval in 1991. Since then a number of other states have followed suit. But these states have not settled on a uniform set of rules to govern LLPs. As a result, the levels of limited liability within an LLP differ significantly from state to state.

Professional limited liability partnerships (PLLPs) are a special type of LLP designed specifically for certain qualifying professions. Among these are doctors, dentists, attorneys, engineers, architects, and accountants.

Few startups will likely be interested in forming an LLP or PLLP. For those who do pursue these options, a special degree of due diligence is in order early on. Because statutory provisions for these types of businesses are so new and still evolving, seek thorough professional counsel before proceeding with one.

Partnerships and Liability

A notable drawback to partnerships is their reduced level of liability protection for the owners. This is one reason that LLCs have surpassed partnerships as the legal structure of choice for small businesses.

General partnerships, in particular, offer no liability protection whatsoever. Each partner is fully responsible for any legal or financial claims that are made against the company.

A notable drawback to partnerships is their reduced level of liability protection for the owners.

This means that if one partner creates an obligation or enters into an agreement on behalf of the partnership, all of the other partners are personally and individually responsible for the partner's action, including any financial exposure that it may have created. It also means that each partner is fully responsible for any debt that the partnership incurs or for any court or tax assessment imposed on the company.

Since a general partnership has no limited liability, a partner's own personal assets are exposed to risk should the partnership fail or be unable to satisfy a claim against it. Contrast this to a multi-owner LLC, where the owners' personal assets are protected from claims and levies on the LLC.

In limited partnerships there is a reduced level of liability for at least some of the partners, the so-called "limited partners." An LP has a general partner who assumes full liability for any financial encumberance, claims, or levies resulting from activities of the business. The limited partners, on the other hand, are usually protected from any liability that exceeds the amount of their investment in the partnership.

LPs are especially common in small businesses with a number of silent partners whose only contribution is their capital investment. Someone opening a franchise, for example, might serve as the general partner in an LP, with several limited partners providing the money to purchase the franchise.

Because the general partner in an LP assumes full liability for the partnership, the general partner is also the only partner who can act as an agent to obligate the partnership to contracts, purchase agreements, court settlements, and the like. The limited partners play a passive role.

The reason that limited liability partnerships (LLPs) have gained statutory status (at least in some states) is to insulate partners in a general partnership from liability for grossly inappropriate actions on the part of another partner. Such actions might include perpetrating a wholesale fraud or knowingly undertaking an illegal transaction.

Professional limited liability partnerships (PLLPs) extend this liability protection to a professional partnership, such as a dental practice. Within a PLLP other members of a practice are shielded from liability for the gross negligence of another dentist in the group.

The thing to notice is that **no form of partnership grants full liability protection to every owner.** Even in a limited partnership, full liability rests on shoulders of the general partner. And in LLPs and PLLPs the partners are only protected from liability for gross misconduct on the part of another partner.

Therefore, where limiting liability is a primary concern, an LLC or a corporation may be a preferable structure for your startup.

Partnership Agreements

Even though a simple oral agreement is sufficient to form a partnership, it's imperative that you transform your oral agreement into a written agreement at the very outset. Otherwise your partnership experience is not likely to be a happy one.

Most states have default rules which they apply to partnerships with no written Partnership Agreement.

In a partnership the written agreement plays the same role as the By-Laws of a corporation or the Operating Agreement in an LLC. Among other things it spells out the way that the partnership will be structured and carry on its affairs.

State laws do not require you to have a written Partnership Agreement, which is why startups easily ignore this step. But most states do have default rules which they will apply to a partnership that has no written Agreement.

These rules may or may not be to your liking, as they entail such things as the formula by which the partnership distributes its earnings to the partners. You protect yourself from state-imposed rules, therefore, by having your own Partnership Agreement that you have thought through and put together carefully.

In addition, the Partnership Agreement addresses issues that are unique to partnerships themselves.

- How will the value of the business be established if one partner asks to be bought out?
- What happens to the partnership if one partner dies?

- Under what conditions can partners be expected to make additional capital contributions to the partnership?

As much as anything, **a well-framed Partnership Agreement spells out in advance the remedy for things that might go wrong in the partnership.** Partnerships start off with high hopes and exuberant optimism. In the midst of these emotions, it's counter-intuitive to pause and talk through a litany of things that could disrupt the partnership or relationships within it.

But those of us who consult widely in businesses can tell you that partnerships do go bad. And they do so far more often than you might imagine — often in some highly unexpected ways. Moreover, when partnerships do go bad, the situation usually devolves quickly into a very thorny mess that gets uglier by the minute. It's at moments like this that Operating Agreements are worth their weight in gold.

So what should your Partnership Agreement include? There is no all-encompassing list. But the following items should certainly be included.

- What name will the partnership operate under? Partnerships, like any other entity can do business under a properly registered assumed name. Many partnerships, of course, are merely known by the names of the principal partners. But even here the exact styling of the name should be set out in the Partnership Agreement.
- What specific contributions is each partner making to the partnership? These may not be financial contributions alone. They may include such things as property, equipment, furniture, office or storage space, vehicles, services, or even a key network of contacts.
- What percentage of ownership will be allocated to each partner? Partners are free to divide the ownership of their company however they wish. But it's vital that these percentages be established early to accommodate any buyout of a partner at a later time.
- How will profits be apportioned? Will profits be distributed solely on the basis of one's ownership percentage? Or will some other formula be used? Nothing

prevents the Operating Agreement from setting whatever profit-sharing plan the partners desire.

- When can a partner withdraw his or her share of profits from the company? Can these draws be made incrementally through the year? Or will profits be distributed only at the end of the year? And if drawn incrementally, at what intervals?
- How much authority will each partner have? Can partners enter into agreements or contracts for the partnership without the consent of the other partners? If not, what are the circumstances under which the consent of other partners must be sought?
- How will decisions be made? Which ones will require the unanimous support of the partners? Which ones require only a majority vote? Or a super majority?
- How will votes be counted in partnership decisions? Will each partner have an equal vote? Or will votes be weighted according to percentage of ownership?
- Under what terms or conditions can new partners be added? How will percentages of ownership be reallocated to accommodate additional partners?

- How will the death, disablement, or withdrawal of a partner be managed? In circumstances like these, what buyout options will the partnership have? Over what length of time can the buyout occur?
- In the event of a buyout, how will the value of the partner's interest be determined? Who will be charged with making this determination?
- Will particular partners have general responsibility for a specific aspect of operations? For example, will one partner be largely responsible for marketing and business development? Will another partner be primarily responsible for administration and finance? Clarification of these issues can be helpful in knowing who is expected to take the initiative when certain events transpire in the course of business.
- What will be the procedure for resolving disputes within the partnership? Are partners precluded from taking court action against one another before

submitting their dispute to mediation or arbitration? If so, how will a partner go about initiating mediation or arbitration?

Federal Taxes

The Partnership Agreement should spell out how and when profits will be apportioned and distributed. The partnership must annually file Form 1065 with the IRS summarizing the partnership's income and expenses for the year. This is an information return, not a tax return. Attached to Form 1065 is a Schedule K-1 for each partner, showing that partner's portion of the profits or losses for the year.

The partners themselves receive a copy of the K-1 and report that income or loss on Schedule E of their personal income tax. Partners are responsible for taxes on their percentage of the profits, whether all of these profits were actually disbursed or not.

Of course, if a partner is also employed by the partnership, the employee receives a W-2 and pays personal income tax on these wages. Partners are not subject to the restriction for S-Corps, in which benefits are considered taxable income to a shareholder-employee who holds at least 2% of the company's stock.

Other Considerations

Because of the collegial management structure of partnerships, the interplay of personalities and values among the partners is a life-and-death issue. Hundreds of partnerships go aground weekly because of personality conflicts, disagreements about ethics, or differences over work styles.

Therefore, **it behooves you to be well-acquainted with anyone with whom you enter a partnership.** This means much more than having known your potential partners for a long time. How well do you know their values? Their priorities? How industrious they are? How they respond under pressure? How they react when held accountable? How well they manage employees? How easily they delegate? How carefully they maintain records? How well they handle upset customers or vendors?

In a day-to-day work environment, differences over issues like these can quickly lead to resentment, frustration, or outright distrust. Before formalizing an agreement to be partners, consider working together less formally on some time-limited projects to see if the members of your proposed partnership are truly compatible.

Use the negotiation of the Partnership Agreement as a further opportunity to learn more about one another. Pay particular attention to how people react as the group works through thornier issues in the agreement. It's not uncommon, indeed, for this negotiation to become so prickly that one or more parties recognize that going forward with the partnership is ill-advised.

And if you should be cautious about going into any partnership, be doubly cautious about going into a partnership with family members. Any of us who consult with troubled businesses will tell you that nothing is more unpleasant than a family business in which the principals are at war with one another. More than once I've seen conflict among partners wreck not only a business, but marriages and long-term family relationships, as well.