Deciding How to Structure Your Business

When entrepreneurs, whether they are farmers, retailers, service providers, high-tech inventors, or others, determine to start or reorganize a business, they should investigate common options for structuring a business and choose one as the way to organize their enterprise. In general, they should pick the simplest form of organization possible, but one that meets their needs.

Choosing a form of business organization will depend on the goals and objectives of the owners. Many factors must be evaluated, including tax consequences, costs of formation, complexity, limitations on liability, needs of outside investors, estate planning and transition issues, and other goals of the owners.

In many situations the form of business organization may be dictated by the investors who are financing the business. Investors and lenders generally require use of a form of ownership that they believe will best protect their investment or security. Tax considerations must be taken into account but should not necessarily override other aspects. Estate planning issues and intra-family issues also will be important. If passive investors are involved, choosing a business form that limits their liability may be very important. Startup costs, ongoing maintenance costs, and costs associated with taxes are further considerations. Lastly, the willingness and ability of the owners to meet the formal requirements of whichever model is chosen are critical factors. It is futile to adopt a form of business organization if a court is going to set it aside because the owners failed to observe formalities.

Here is an overview of the most commonly used business-organization models—sole proprietorship, partnership, limited liability company, and corporation. Some other business models, such as trusts and estates, are not described here. Statutory limitations on the time that an estate may remain open prevent the use of an estate as a realistic choice for long-term operation of a business. Trusts, except for living trusts, usually function as passive owners in the business models described here. Revocable living trusts, when used to operate businesses directly, usually do not operate much differently than a sole proprietorship.

Sole Proprietorship

A sole proprietorship is the simplest form of business organization: One person owns all of the assets and is responsible for all of the debts. The business income is reported on the owner's federal tax return, Form 1040, Schedule C, C-EZ, or F. Many farms and independent businesses, such as restaurants, are operated as sole proprietorships.

Partnership

A partnership is an association of two or more persons established to conduct a business for profit. The relationship is consensual and usually bound by a legal contract that defines the partnership agreement. A partnership is treated as an entity for litigation and bankruptcy proceedings and may hold title to property. North Carolina has adopted the Uniform Partnership Act (UPA). Under the UPA, partners have equal management authority and share equally in profits and losses. The partners also have an equal obligation to contribute time, energy, and skill to the partnership business without compensation. Each partner has unlimited personal liability to the partnership's creditors, and all partners are liable for wrongful acts and breaches of trust by any partner. The UPA provides these default provisions in the absence of a partnership agreement to the contrary. Most provisions of the UPA can be

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modified in a written partnership agreement that specifies the details of capital contributions, management, sharing of profits and losses, rights and obligations, terms of property ownership, termination and dissolution, and buy/sell agreements.

A partnership files a federal information tax return (Form 1065) annually. Each partner receives a Schedule K-1, which provides information about his or her share of partnership income, credits, deductions, and other information. All income flows through and is taxed to the individual partners. A partnership interest is personal to the partner. The partnership is dissolved by the death of a partner or by the sale of a partnership share. While the spouse of a deceased partner is usually entitled to payment for the deceased partner's equity in the enterprise, the spouse is not entitled to participate in the partnership. Law firms and accounting practices were once operated almost exclusively as partnerships, although other models have become more prevalent in the past few decades.

A limited partnership has the characteristics of both a partnership and a corporation. It is used when some partners want neither management responsibilities nor unlimited liability for the business venture. Limited partnerships are sometimes used for investments sold to the public.

North Carolina has adopted the Revised Uniform Limited Partnership Act (RULPA). Under this statute, a limited partnership is formed by at least one general partner and one or more limited partners. The general partner manages the partnership and has full personal liability for any debts incurred by the partnership. Limited partners contribute cash or other property, and their liability for partnership debts is limited to the amount of their investment in the venture. Limited partners do not participate in the management of the partnership. A limited partnership also files an information tax return, but income is taxed to all the individual partners according to the distribution of profits specified in the partnership agreement.

Also governed by RULPA are family limited partnerships. These partnerships are generally restricted, by written agreement, to a defined range of family members. Family limited partnerships may be used to keep business assets in the family; protect the business from the consequences of divorce, death, and disability; provide for better organization and management of the business; and reduce estate taxes through valuation discounts and other means.

Limited Liability Company

A limited liability company (LLC) is a distinct entity that is a hybrid of a partnership and a corporation. North Carolina law authorized this type of business entity effective October 1, 1993. It may be treated as a partnership for tax purposes. The IRS allows an LLC to choose ("check the box") whether to be taxed as a corporation or as a partnership. As with a corporation, the members have limited liability for debts of the LLC.

This business entity offers more flexibility because of its hybrid nature. The LLC is not allowed to have an unlimited life, as a corporation is, but it may have orderly transfer provisions. Membership interests are not freely transferable without the consent of all other members, but a member may assign his or her economic rights, but not voting rights. The statute has been amended to allow for a one-member LLC.

This business entity is often used in estate planning because it can be an efficient way to transfer assets over time to the next generation. It may also generate valuation discounts that can reduce the value of the business in the gross estate and therefore reduce estate taxes. Valuation discounts typically result from restrictions on sales placed upon owners of interests in the business and the minority owner status of some or all owners.

The LLC has the same limitations on liability as a corporation. The owners, like shareholders of a corporation, are not liable for the debts, torts, or other civil liabilities of the LLC. However, the limitations on liability, for owners in family-owned LLCs and shareholders in closely held corporations, are largely illusory. Because the business owners are also generally its operators, they are likely to incur personal liability in tort because it will be argued that their personal actions as a business operator or manager gave rise to the liability. Few lenders are willing to lend to LLCs and closely held corporations without the personal guarantees of their owners or shareholders.

Corporation

Corporations are formed under state statutes. A corporation is a separate legal entity that has rights and liabilities separate from its shareholders. Shareholders of a corporation are liable for the debts of the corporation only to the extent of their investments in the corporation. Shareholders elect a board of directors, which sets policy and appoints officers to manage the company on a daily basis. Shareholders do not participate directly in management decisions (unless they are also directors or officers). A corporation has a potentially unlimited life, and it is not dissolved by the death of a shareholder, director, or officer. As noted in the discussion of LLCs, the limitations on liability from civil actions and debts for closely held family corporations, however taxed, are largely illusory.

A corporation formed under Subchapter C of the federal Internal Revenue Code is the type of corporation whose shares may be publicly traded, if exchange and SEC requirements are met, and it is an ordinary corporation subject to double taxation: Profits are taxed as they are earned by the corporation; then, when those profits are distributed to the shareholders as dividends, they are taxed again to the individual. The Internal Revenue Code places some limitations upon the ability of the corporation to avoid double taxation by not paying dividends and accumulating earnings within the corporation.

A corporation formed under Subchapter S is a "close corporation" that has elected to be taxed like a partnership. Shares of such a corporation are not publicly traded. Instead of being taxed at the corporate level, the income flows through to the shareholders and is taxed only once, at the individual level (whether the profits are distributed or not). The shareholders are responsible for payment of all taxes. As with a partnership and an LLC, the failure to distribute sufficient funds to the shareholders to allow them to pay taxes on their prorated share of profits may place hardships on those shareholders who lack other funds with which to pay the taxes. Such shareholders may have to borrow money to pay their taxes.

Generally, shares of stock in a corporation are freely transferable by any stockholder. However, North Carolina law permits restrictions on stock transfers by the articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation. The restriction must be authorized by statute and must not be excessively one-sided (unconscionable) under the circumstances. There must be a conspicuous printed notice of the restriction on the stock certificate or in the stock information statement required by the statute. One type of restriction would be a buy-sell agreement between a stockholder and the corporation or other stockholders in which the selling stockholder must first offer his or her stock to the other party to the agreement. The agreement would set a price to be paid for the shares. The restriction is useful where the shares are not publicly traded and a share price would otherwise be difficult to establish.

Shares in a corporation are defined as either common or preferred (Subchapter C only), based on the rights and privileges that belong to the owner. Common stock represents a fractional proprietary interest in a corporation's property and assets. Therefore, the common shareholder participates on a pro rata basis in the distribution of corporate assets upon dissolution and participates in corporate profits (dividends) and management of corporate activities (right to vote). Traditionally, preferred stockholders are not creditors of the corporation and do not share in corporate assets upon dissolution. Instead, they have a right to a fixed dividend, due and payable before any dividends to common shareholders. However, the articles of incorporation may grant preferred shareholders the right to receive preference over common shareholders with regard to dividend distributions and corporate dissolution proceeds.

The shareholders are the actual owners of the corporation, and ultimately they choose the people who will manage the company. Under North Carolina law, the shareholders must elect a board of directors to whom they delegate the power of management. The board is responsible for all of the corporation's business affairs, such as issuing shares of stock and defining the rights that those shares accord, selling corporate assets, mortgaging corporate assets, declaring dividends, and managing the election of corporate officers. The senior management of the company, represented by the chief executive officer (CEO) and the senior management team, are responsible for the day-to-day operations of the corporation. Their authority and duties are prescribed by the bylaws and the directors. Officers and directors owe a fiduciary duty to the corporation and the shareholders and must not engage in self-dealing. An officer or director must not engage in a competing business without full disclosure and permission from the corporation.

A corporation's articles of incorporation must be filed with the North Carolina Secretary of State, and they must contain the following information: (1) a corporate name, (2) the number of shares that may be issued, (3) the street address and mailing address, including county, of the initial registered office and the name of the initial registered agent, and (4) the name and address of each incorporator. This document may also provide (1) the names and addresses of the initial board of directors, (2) provisions regarding the business purpose and par value of shares, and (3) limitations on the personal liability of directors.

At the organizational meeting of the corporation, bylaws should be adopted and formalized in a document. This document may contain any provisions for managing the company and regulating the affairs of the company that are legal and consistent with the articles of incorporation.

The bylaws are the continuing set of governing rules under which the corporation, its officers, directors, and shareholders exercise management powers, transfer shares, hold meetings, and carry on all other activities related to the corporate objective.

A corporation may be dissolved and terminated in one of two ways—voluntary dissolution or involuntary dissolution. The directors and shareholders may voluntarily dissolve a corporation by passing a resolution of dissolution and filing articles of dissolution with the Secretary of State. In addition, a corporation may be dissolved without its consent by court action or administrative action of the Secretary of State. If the directors are believed to be not acting in the best interest of the company, any shareholder may obtain judicial dissolution. If the corporation fails to file annual reports or pay franchise tax, for example, the Secretary of State may dissolve the corporation administratively.

Formalities are very important if the corporate model is to be used effectively. These formalities include holding regular shareholder and director meetings; keeping accurate records, including minutes of shareholder and director meetings; and maintaining separation between the property and accounts of the corporation and its shareholders. Failure to observe these formalities may result in a court's setting aside the corporate structure. This will defeat any effort to use the corporate form to limit liability or protect the business from disruptions caused by the death or divorce of a shareholder. It may also result in dire and unforeseen tax consequences.

Choosing a Form of Business Organization

The goals and objectives of the owners are key elements in choosing the structure a business will take. Selecting a business model to defeat existing creditors, to disinherit a spouse, or to defeat a spouse's interests in an impending divorce are generally not valid reasons for selecting a particular business structure. However, selecting a model to protect a business from disruptions associated with the death or divorce of an owner are valid reasons for selection, so long as the choice is made well before either a death or divorce is imminent. It may also be necessary to employ other tools, such as life insurance to provide an estate for a surviving spouse or a premarital agreement to limit each spouse's rights in the other's property. In the end, those planning to establish a business need more than a business plan; they need a form—or model—for their business.

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