

WHAT TYPE OF COMPANY SHOULD YOU FORM?

There are several basic entity choices for small businesses. Each of these entities is subject to the laws of the state in which they are formed. Most state laws are pretty similar but there can be important differences. The discussion below pertains to the laws of the state of Colorado.

Sole Proprietorship

This is an unincorporated business entity that is owned by a single person. The business has no existence apart from the individual owner. You become a sole proprietorship simply by operating a business by yourself. The positive aspect is that there are no required corporate filings or records to maintain. The negative aspect (and it's a big one) is that there is nothing shielding personal assets and liabilities from corporate assets and liabilities. Therefore the liabilities of the business become your personal liabilities.

Partnership

A partnership is any relationship existing between 2 or more persons who carry on a trade or business. Each person contributes money, property, labor or skill and expects to share in the profits and losses of the business. There are limited partnerships and general partnerships. In a general partnership, all partners remain personally liable for the obligations of the partnership. In a limited partnership, the individual limited partners are not personally liable for the obligations of the partnership (much like stockholders in a corporation) but there must be at least one general partner who remains personally liable.

There is no filing required to form a partnership as it occurs automatically by operation of law (much like a sole proprietorship discussed above). However, much like the sole proprietorship, a simple partnership does not protect your personal assets.

Colorado allows the registration of Limited Liability Partnerships (LLP) and Limited Liability Limited Partnerships (LLLL). A LLP has general partners who are jointly and severally liable for the debts and obligations of the LLP; limited partners are not liable for the company debts and obligations beyond the amount of their respective capital contributions. In an LLLP, by having the partnership make an election under Colorado law, the general partners are afforded more personal protection. Therefore, by registering your LLLP with the Colorado Secretary of State, you can achieve the goals of reducing partner liability.

Corporation

A corporation is an entity where the owners (shareholders) transfer money, property and/or labor in exchange for shares in the corporation. The primary advantage that a corporation has over other entities for a small business is the potential savings on self-employment taxes. For example, let's assume an accountant has started his own business. In his first year he earns \$42,000 in profits and he pays himself \$20,000 in salary. If the business is formed as a sole proprietorship or an LLC, then the entire \$42,000 is taxed at 15.3% for self-employment tax purposes. If the business is formed as a corporation, then only \$20,000 (the salary) is subject to self-employment tax. The rest of the profits can be withdrawn from the corporation at any time and will be classified as a dividend or other distribution not subject to self-employment tax. Depending on your situation, other tax advantages may exist with regard to employee benefits. There are 2 basic types of corporations: C corporations and S corporations.

C Corporation: Although this is the chosen entity formation for most Fortune 500 companies, it is generally not a good idea for small businesses. The primary problem with the C corporation is that it generates double taxation on the profits it earns. Profits are taxed first at the corporate level on the corporate tax return. Then, an additional tax (personal income tax) is assessed on any salaries or dividends paid to the shareholders. In addition to the double taxation issue, the C corporation presents other difficulties with respect to restructuring and asset distribution. Because of the difficulty of getting out of a C corporation after it is formed, it is a good idea to consult with a qualified attorney prior to forming this type of entity. There are a couple of good alternatives in the S corporation and the LLC discussed below.

S Corporation: Much like the C corporation, this entity is formed by filing Articles of Incorporation with the Colorado Secretary of State. In fact, an S corporation and a C corporation are formed in exactly the same manner. The only difference is that the S corporation must file an additional form with the IRS electing S corporation status. S corporation status means that the corporation is electing to be taxed as a partnership, thus avoiding double taxation. All profits and losses will flow through to the individual shareholders in proportion to their ownership interests in the corporation. The S corporation does have certain restrictions on the number and type of shareholders and the class of shares that can be issued, which can limit flexibility somewhat, especially in a situation where one party wants to provide money while the other party provides the work or "sweat" equity.

Limited Liability Company (LLC)

This is a very popular form for new companies. It involves filing Articles of Organization with the Colorado Secretary of State. An LLC can be taxed as a sole proprietorship, a partnership or as a corporation. A single member LLC will be taxed as a sole proprietorship (i.e. everything flows through to the owner's personal tax return). A multiple member LLC will be taxed as a partnership (i.e. the owners are taxed on their share of the profits and losses in proportion to their respective ownership interests in the LLC) unless the LLC notifies the IRS that it elects to be taxed as a corporation. However, the owners may, by written agreement agree to divide the profits and losses in any way they choose.

Dealing with Partners/ Co-Owners

If you are in a business that you do not solely own, it is very important to have an agreement with the co-owners. In particular you should have a Shareholder, Partnership or Operating Agreement (for an LLC) that addresses issues such as:

- i) share of profits and losses
- ii) stock transfer restrictions
- iii) initial capital requirements
- iv) future investments or capital contributions
- v) management control
- vi) stock transfer on the event of death, disability, voluntary withdrawal, or involuntary withdrawal of a shareholder/member

Having a comprehensive agreement in place is a great insurance policy that allows you to protect business and personal relationships. The issues mentioned above are always easier to discuss at the beginning of operations than down the road once a serious problem has arisen.

SUMMARY

For liability reasons, it is not a good idea to operate as a sole proprietorship or an unregistered partnership. Any entity formed with the Secretary of State (corporation, LLC, LLP or LLLP) will provide you with far greater liability protection than operating as an unregistered company. Most small businesses would be best served by forming an LLC or an S corporation, depending on the potential for self-employment tax savings versus the need for ownership flexibility. There are some fairly limited situations in which a C corporation or a partnership would make sense for a new business and you may want to discuss these alternatives with a qualified attorney or accountant. Regardless of the entity formed, it is critically important to keep adequate corporate records and observe corporate formalities or you could be risking your personal assets. Simply filing your articles of incorporation or articles of organization with the Secretary of State will not protect you. (See "Piercing The Corporate Veil", an article accessible from the Intellectual Property and Business Law page of this site).