DOING BUSINESS? PROTECT YOURSELF!

By Joseph A. Bollhofer, Esq.

Every now and then a new client comes in who has started a business, but has not incorporated or formed a limited liability company. Sometimes he or she has been operating the business for a while without any such structure. Doing so is foolish.

Almost everyone obtains liability insurance. However, that insurance does not cover all perils. Some business owners also obtain insurance against business interruptions due to perils such as fire, water damage or utility failures. In some businesses errors and omissions ("E&O") coverage and fidelity insurance (against employee theft or other wrongdoing) is useful. It is important to know what the insurance covers – and doesn't cover. That is a subject between you and your insurance agent.

This article concerns common forms of doing business, their differences, and what is usually the wisest route.

The simplest form is a sole proprietorship – someone doing business in his or her own name. Although it has the advantages of no formalities and lower fees, the disadvantage outweighs them: unlimited individual liability for all obligations of the business. Even if the sole proprietor is well-insured, he or she can not escape liability for debts of the business that are not covered by insurance, such as debts to creditors.

Often a sole proprietor will file with the county clerk a certificate of assumed name, also known as a "DBA (doing business as) certificate". However, such a filing does not protect against liability.

A general partnership is an association of two or more persons to conduct a business as co-owners. Each partner has unlimited personal liability, just like with a sole proprietorship. To make matters worse, each partner is an agent for the others and for the partnership business. A partner may find himself or herself liable for something another partner did. A partnership is legally dissolved upon the death, bankruptcy or withdrawal of any partner. This type of arrangement rarely should be used. If it is, a detailed written agreement is essential.

For the vast majority of small businesses, the preferred form is either an S corporation or a limited liability company. In both cases, owners typically are not personally liable for debts of the entity. There are certain important exceptions, such as for employee wage claims and withholding, social security and sales taxes, which are considered to be obligations held in trust.

As in a sole proprietorship and a partnership, income to members of a limited liability company is taxed directly to them. No separate income tax is paid by the entity. Likewise, if certain tax elections are filed on behalf of a corporation shortly after it is formed choosing to be treated as an S corporation, the income of the corporation will not be separately taxed; only the compensation paid to employees and owners will be taxed.

Both a corporation and a limited liability company can have as little as one owner. An S corporation can not have more than 75 owners, and they each must be an individual, a decedent's estate or a certain type of trust. There also must only be one class of stock, which means that profit must be divided in accordance with the percentage of ownership.

A limited liability company does not have such restrictions. However, in most cases these restrictions are not a concern, and the S corporation usually is chosen. The cost of creating the entity is not expensive. A limited liability company costs several hundred dollars more, mostly because of the requirement of publication of "the birth" in newspapers.

This is not meant to be a thorough explanation of business forms. For example, two or more persons or entities also may form a limited partnership. In this entity, there are one or more general partners, with unlimited liability for the debts of the business and general powers of management, and one or more limited partners, with no personal liability for debts of the business and no management power. Professionals may incorporate as a professional corporation or a limited liability partnership, with similar results, except each professional still is personally liable for his or her own negligence or misconduct and that of any person under his or her direct supervision and control.

Tax consequences of each form of ownership must be discussed with a tax expert. In all cases, a written agreement among the owners is important. It should cover items such as duties of each person involved, their compensation and their rights regarding sale or other transfer of their ownership interests. It also should provide rules in the event of death or disability of an owner, and in the event that one decides to sell or cease doing business. Although the cost of creating such an agreement is additional to the cost of legally forming the entity, it is money well spent. If a dispute arises between co-owners who have no such agreement, invariably, resolution of the dispute is more expensive. The result also might not be what they expected. With thanks to Ben Franklin, "An ounce of prevention is worth a pound of cure."

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Editor's Note:
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