BUSINESS ORGANIZATIONAL FORM:
FUNCTION & FORMALITIES

Architect Louis H. Sullivan had said that the form of a building must follow its function, and in many ways this maxim applies to business organizational form as well.

A common question asked of the advisors at Niagara County Community College Small Business Development Center ("SBDC") is: "What structure is right for my business?" At the SBDC we advise a range of clients across sectors and industries and at various stages – from the would-be entrepreneur in the pre-start-up phase to established corporate entities generating millions of dollars per year in revenue.

As such, the SBDC endeavors to stay abreast of recent trends and developments on matters important to providing entrepreneurial and small business services. Our services and advice, like this article, are not legal or tax counsel or a substitute for retained qualified professionals in law, accounting and other fields, but a guide to steer our clients through the maze of considerations they must address in launching or expanding a business.

Small businesses may not have the sophisticated infrastructure and resources of Fortune 500 companies but can nevertheless lay the proper foundation for initial and ongoing success by assembling and engaging the right multi-disciplinary team of advisors. In addition to the SBDC resources, legal, financial, risk-management and other professionals are vital contributors to the strategic and organizational planning phases of a new business.

Established enterprises should also re-examine the issue of organizational form, particularly as part of any planning strategy for expansions of operations, acquisitions of assets such as real estate, or a questionable tax liability at the personal or business levels. Additionally, businesses with departing owners or principals as well as those taking on new investors or seeking new capital infusions need to carefully review organizational form. Finally, business form considerations should be integrated with any succession, retirement and estate planning sessions.

Here are some factors to consider in any analysis of business formation:

- What is the nature of the business and how does it operate – what is the business and revenue model?
- What is the growth potential?
- How large of an enterprise is it?
- How far flung is it geographically – especially if it is doing any e-commerce?
- How well is it capitalized?
- What are the taxation implications?
- How many owners are there?
- What is their personal situation like?
- Are there plans to bring in other investors?
- Are there unique business assets involved such as licenses to market a product or service?

The answers to these questions can help determine the organizational form and also eliminate some possibilities. Because there are unlimited sets of circumstances, combinations and scenarios related to business organizational forms, a mere listing would be incomplete, but a more comprehensive matrix would look at these factors:

- What is the cost and complexity of formation?
- What are the continuing costs associated with administrative and regulatory maintenance – the cost of tending to the form on an annual or other periodic basis?
- What are the taxation issues – on both the business and personal level?
- What is the personal liability or exposure to owners/officers/principals and other key persons – and on what levels?
- What is the best organizational and personal posture given the best-case scenario -- exponential growth and rapid expansion?
- What is the best organizational and personal posture given the worst-case scenario – bankruptcy and insolvency?
- What does the future of the business look like through the lens of any succession, retirement and estate planning of its principals and key leaders?
- What are the implications or contingencies in the event of a personal crisis or tragedy – divorce or unexpected death of a principal?

With this in mind, here is a basic overview of the common organizational business forms in New York and some of their main attributes and weaknesses:

- Sole Proprietorships
  - Formation is inexpensive and operationally low maintenance. A business certificate ("DBA" or assumed name certificate) is filed with the clerk of the county where business is transacted, and the papers are given a basic review by the clerk to ensure the name is not already in use in the county and that the papers otherwise conform to Section 130 of the General Business Law.
  - Personal liability attaches to the owner for debts, lawsuits and other obligations.
  - Taxes are reported on Schedule "C" of the owner's Form 1040, and the owner pays self-employment taxes (for FICA and Medicare) on profits.
  - Advantages are simplicity and economy.
  - Disadvantages are unlimited liability to owner and potentially onerous self-employment taxes.

- General Partnership
  - Formation procedures are similar to a sole proprietorship with respect to the assumed name and initial filing.
  - Personal liability attaches to the partners for debts, lawsuits and other obligations.
  - Taxes are reported on a partnership information-only return, and partnership profits flow through to the individual partner's tax returns – also subject to self-employment taxes.
  - In the absence of a partnership agreement, NY Partnership Law generally controls the rights and responsibilities of the partners vis-à-vis their relationship between/among themselves – and it isn't always fair. Partners should always be advised to consider a written partnership agreement.

- Also note that partnerships formed to practice a profession licensed by the state may require that each partner be licensed in that particular profession.
- Advantages are the economy of a sole proprietorship with the advantages of the synergies of the talents, resources and energies of each partner.
- A major consideration is "Agency Risk" -- the risk the partnership and each partner carries for the acts and omissions of any partner, for contracts and debts as well as for conduct injuring others.

- Corporations
  - Formation is administered through the New York Secretary of State, is more complicated than a DBA and should be handled by an attorney. Generally, corporate filings are given more scrutiny than DBA's at the local level with respect to name and other formalities. Continuing costs to maintain the corporation will also be incurred at least annually.
  - Corporations (and LLC's) enjoy a certain image in the eyes of some that conveys at least the appearance of some substance behind the business.
  - Liability to the owners (shareholders) is generally limited and absent a gross abuse of this form, personal assets of the shareholders are shielded from debts and lawsuits. In practice, however, note that when lending to smaller corporations banks routinely require a personal guarantee executed by the main shareholders of the corporation.
  - Taxes are reported and paid as a separate entity and subjects the business to potential "double taxation" – earnings from the corporation at the corporate rate plus dividends paid and income earned at the personal rate by the shareholder/officer/manager.
  - "S" corporation election with the Internal Revenue Service can avoid the foregoing scenario, and the corporate profits pass through in the form of salaries and distributions to the shareholders/officers/managers, thus avoiding double or triple taxation. New York recognizes "S" corporations for purposes of taxation.
  - "S" corporation eligibility restrictions include: The number of shareholders is limited to 100 with one class of stock; non-resident aliens cannot be shareholders (an issue relevant given our region's proximity to Canada); and other "artificial entities" (i.e., corporations and LLC's) cannot be shareholders with the exception of certain trusts.
  - It is not always tax-advantaged to elect "S" status in lieu of "C" corporation treatment. For example, certain scenarios where earnings are being retained to fuel growth need to be examined closely to determine the best corporate structure.

- Limited Liability Companies
  - Formation is created through articles of organization filed with the Secretary of State. Additionally, LLC's must publish with two local newspapers a notice of formation with some additional disclosures. This adds cost to the process and because of this as many as 40% of the LLC's in this state did not publish -- with little or no sanction for ignoring the step. However, recent legislation in New York now mandates that new LLC's publish or face "suspension of authority" to operate with potentially serious risk to its members. The legislation does give an "amnesty" period for existing LLC's to cure the defect by publishing before the end of this year.
  - Personal liability is shielded like a corporation with the pass-through tax advantages of a partnership.

- LLC's have three taxation options: Single member LLC's can be treated as a sole proprietorship, a "C" corporation or an "S" corporation. Multiple-member LLC's can choose to be taxed as a partnership or a "C" or "S" corporation. The "S" eligibility test, as above, must still be met by LLC's electing this option.
- Taxation strategies must be carefully analyzed and closely compared to "S" corporations. For example, aggregate employment taxes are generally higher with an LLC than with an "S" corporation, and LLC's cannot distinguish between active and passive income for taxation purposes.
- However, where a business has appreciable assets (e.g., land or un-commercialized intellectual property such as patents) an LLC may be the better holding entity.
- Other major advantages of an LLC include its flexibility to allow for different classes and levels of members, nimbleness of operation and usually lower maintenance than a corporation.

- Limited Liability Partnerships
  - An entity similar to an LLC in structure, formation and tax treatment except restricted to professional practices such as law, accounting, medicine and architecture.

- Limited Partnerships
  - An entity which in practice acts more like an investment fund or vehicle to capitalize a single project such as a real estate development or movie production. An LP is a partnership but quite different from the other entities enumerated here, and should be kept separate from any discussions about the typical small-business, general partnership or LLP business forms.

More complex operations and structuring can involve a combination of entities, and more business owners are creating multiple entities to protect business assets, minimize taxes and insulate personal assets from creditors or lawsuits. It is common now, for example, for even moderate-sized companies to form both an operating entity and a holding entity. Additionally, a "non-entity" structure to hold certain assets such as business real estate can be beneficial under some circumstances with smaller companies and professional practices: the individual or the non-working spouse owns the property and leases it to the business.

One of our biggest strengths here at the SBDC is to identify issues and spot potential problems and direct the client to seek independent and specific advice from a CPA, attorney, insurance agent or other technical advisor. We also encourage our clients to have their professional consultants team with their SBDC advisor to develop a comprehensive business plan and leverage the analytical tools and resources available. At the logical stage in this process the best choice of business organizational form emerges for each client's individual situation.

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