

Legal Forms of Business

Rob Holland

Assistant Extension Specialist - Agricultural Development Center

The type of business may not be the first question a new or potential business owner contemplates. It is, however, a question that must be carefully addressed because of the tax, managerial, legal and liability impacts that the business formation has. There are a number of legal forms that a business can take. The most common are:

Sole Proprietorship
General Partnership
Limited Partnership
Limited Liability Company (LLC)
C-Corporation
S-Corporation

Sole Proprietorships are probably the simplest and cheapest forms of business organization. They do not require registration with local, state or federal governments (other than taxes and special regulatory agencies). They are businesses which have one owner and they do not have stock. The sole proprietor owns all assets and is responsible for all debts. If the business cannot pay its bills, creditors can sue the owner to collect. The company does not conduct legal or contractual transactions, rather the owner does. Advantages of the sole proprietorship include:

- Ease of formation - no legal registrations
- Low overhead - income reported as ordinary income to the owners. Taxes tend to be straight-forward
- Easy control and direction established by the owner - no boards or advisors.
- Suitable business form for many types of products, services & enterprises.

General Partnerships are businesses having two or more owners who both bear personal responsibility for the operations and liabilities of the business. Similar to the sole proprietorship, the general partnership is not required to be registered with the Secretary of State. General partnerships may be considered when neither individual can operate the business on his own. Each partner should bring specific advantages to the business like capital, industry knowledge, labor or physical assets.

Limited Partnerships can be formed by entrepreneurs to raise capital. Limited partnerships can consist of general partners with full liability for the organization and limited partners whose liability for the organization are limited to a set amount (usually the amount of their investment). Only the general partners have any decision-making authority or any input in the operation of the business. The limited partner contributes capital only and cannot participate in the running of the business. Limited partnerships are governed by the Uniform Limited Partnership Act. Limited partnerships must be registered with the Tennessee Department of Commerce and Insurance, Securities division as well as the Tennessee Secretary of State's Division of Corporation. Entrepreneurs interested in this form of business should consult an attorney experienced in forming limited partnerships.

Limited Liability Company (LLC) is a relatively new form of business structure created by the Tennessee General Assembly in 1994 under the Tennessee Limited Liability Company Act. The LLC offers entrepreneurs limited protection from the actions of the company as well as from the actions of other company partners. LLCs provide tax benefits equivalent to a Limited Partnership and must be privately held companies. Income taxes are paid only on income distributed to members as ordinary income. This form of organization is most frequently used

by professionals and general partnerships, however, it can be cumbersome and expensive. A membership fee of \$50.00 per partner (\$300.00 minimum, \$3000.00 maximum) is due annually. An annual report must be filed with the Secretary of State; financial statements must be prepared for any partner requesting them; board minutes must be recorded. Memberships can be sold only when all members agree to the transaction. This form of organization is of most interest to general partnerships. The LLC is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. Formation is more complex and formal than that of a general partnership.

The LLC's owners are members and the duration of the organization is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration. LLC's must not have more than two of the four characteristics that define a corporation; limited liability to extent of assets, continuity of life, centralization of management, and free transferability of ownership interests. Owners are not referred to as stockholders or partners, they are members.

An LLC is a blend of some of the best characteristics of corporations, partnerships and sole proprietorships. It is a separate legal entity like a corporation but it is entitled to be treated as a partnership for tax purposes and therefore carries with it the "flow through" or "transparent" tax benefits that corporations do not have.

C-Corporations are organized with ownership of shares of stock which are assignable and transferable. In theory, corporations are separate legal entities from the owners. They can open bank accounts, borrow money and operate just as a person in the business world. Corporations provide limited liability for the owners as well. This means that the owners cannot be sued for the debts of the corporation unless they personally guaranteed the debts. The potential loss for the business owner is limited to the capital they invested. The control and operation of a corporation are in the hands of the shareholders who tend to operate with a board of directors. Because a corporation is a legal entity, it must file an IRS tax return and pay taxes on profits. To incorporate, Articles of Incorporation must be filed with the Secretary of State.

S-Corporations differ from C-Corporations with regard to a few tax considerations. Income tax reporting for the S-Corporation is for information purposes only. The corporation's profits or losses are passed through to the owners. The share holders then must report profits as supplemental income. S-Corporations do not pay taxes on profits and double taxation is avoided. Unlike the proprietorship, and like the C-Corporation, the S-Corporation can carry losses forward or backwards to offset previous or future profits. S-Corporations must:

- be domestic businesses
- have only voting or non-voting stock
- only have stock owned by individuals
- not have any nonresident stock holders
- not own any subsidiaries which are a part of any affiliated group of companies
- not have more than 35 stock holders
- file Form 2553 with the IRS when voted/elected to be S-Corporation by share holders
- use Form 1120-S to file tax returns



A State Partner in the Cooperative Extension System

The Agricultural Extension Service offers its programs to all eligible persons regardless of race, color, age, national origin, sex or disability and is an Equal Opportunity Employer.

COOPERATIVE EXTENSION WORK IN AGRICULTURE AND HOME ECONOMICS

The University of Tennessee Institute of Agriculture, U.S. Department of Agriculture,
and county governments cooperating in furtherance of Acts of May 8 and June 30, 1914.

Agricultural Extension Service

Billy G. Hicks, Dean