

# Entrepreneurial Requirements for Legal Forms of Business

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## Introduction

When forming a business, there are many start up decisions that an entrepreneur must consider. Some of the issues include properly naming the business; creating a business plan, start up capital, and the concern of failure, as well as many other aspects. Another major issue that an entrepreneur will have to face is the type of legal entity to choose upon start up and the pros and cons surrounding the legal form once it has been chosen.

Choosing the name of the company is very important. It is important to have the business name portray the proper image for the company. It should tell the consumer what type of business it is and what the principle line of business is. It is also important to know whether the state requires restricted words in the business name. For example, the state may require the business to have the word Corporation (Corp.), Incorporated (Inc.) or Limited Liability Company (LLC), behind the business name. Instead of having just Smith Construction, they may require them to use Smith Construction, LLC or Smith Construction, Inc. depending on their entity. It needs to be unique from any other business name and must be recorded with the state (Business Filings Incorporated).

A comprehensive business plan is the foundation of a good business. Without it, the entrepreneur has no direction or idea of where he is going or how he is going to get there. When making a business plan, the entrepreneur must consider what it takes to be successful by addressing the risks and opportunities that are involved. They should also consider the industry and if there is a need for that type of business in the community or if that community

is already saturated in that type of business. Another consideration with industry is whether there will be a future need for the business and if the industry has opportunity for growth. They will want to know the information that is included in the business plan and it will show them how serious the entrepreneur is in forming the business and being successful at it (Tucker, Tax and Financial Considerations).

There are many choices as to which entity to choose for a business. To name a few, there are sole-proprietorships, partnerships, C corporations, S corporations and limited liability companies. This is a very important decision when it comes to starting a business. It decides how the business is viewed for taxation, ownership requirements, liability issues and many other issues (Tucker, Tax and Financial Considerations).

Another important concern that the entrepreneur must consider is start up capital. They must have enough working capital to start up the business and enough to support the business until it takes off and is able to be self-supportive. Entrepreneurs usually do not anticipate the actual cash that is needed to start a business. They must have enough money to begin operations, account for unexpected slowdowns, carry inventory and receivables and if needed to expand. Many times entrepreneurs cannot obtain bank loans to start a business and they must have the initial capital for start up. Many times when banks do provide loans they will want collateral and personal guarantees (Tucker, Tax and Financial Considerations).

Using personal money for the start up can be a huge financial risk, as well as a big personal sacrifice. A potential entrepreneur needs to have the support and enthusiasm of

family and friends to be successful. When the business is first formed, the entrepreneur is usually the only employee and even when there are other employees they must usually be there during all hours of operation. This is a huge personal sacrifice for them, as well as for their families (Tucker, Tax and Financial Considerations).

The business entity that is chosen is also important in instances where the business fails. There are different rules and regulations for losses and for bankruptcy filings depending on the entity of the business. Even though the entrepreneur does not want to consider losses and bankruptcy at the start up of the business, it should be an important concern because it could be a possibility. They must consider how it will affect them later, for example, they should know if they will be personally liable for the loans and debts of the business or if they can be sued personally for the business's relations.

With S corporations and limited liability companies, the entrepreneur can have the same taxation considerations as the sole proprietorships and partnerships but can also have the advantage of limited liability. This will allow them to be separate from the business if the threat of bankruptcy or being sued happens. Although they have limited liability this is not totally free liability coverage. If they are personally negligent, they can still be sued for certain things. With or without having limited liability, the entrepreneur should still get a liability policy to help in situations of negligence.

## **Industry**

The business and accounting industries are growing rapidly. Everyday there is an increase in the number of new businesses being formed. There are currently more than 7,200 local and regional accounting firms in the U.S. that are generally organized as partnerships or sole proprietorships (University of North Carolina Website).

The largest accounting firms today make up the "Big 5." They include Arthur Andersen LLP, Deloitte & Toche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP. They were founded over 100 years ago and have become highly regarded as the established leaders in the auditing and accounting profession. The Big 5 are international consulting and accounting firms and they are limited liability partnerships. The typical size of their U.S. firms is 90 offices, 1,500 partners and 15,500 employees and globally they average about 100,000 employees serving clients across 130 countries. They are focusing primarily on globalization efforts towards branding, marketing, providing consistent service delivery, a common infrastructure and gaining access to additional capital resources. They are establishing international presence through international affiliations. One of the main problems they must always continue working on is to be an integrated global firm that can act as one unified firm and deliver uniform worldwide services while implementing consistent business policies (University of North Carolina Website).

The next three largest firms are BDO Seidman, LLP, Grant Thornton LLP and McGladrey & Pullen, LLP. The average size of their U.S. firms include 47 offices, 330 partners and 2,200 employees and globally they average 480 offices across 80 countries. They are also international accounting and consulting firms and limited liability partnerships. The primary clients they serve include the middle market or entrepreneurial clients. With increasing

competition, these firms have started adopting some of the same growth strategies and focuses as the Big 5 firms (University of North Carolina Website).

## **Trends**

When talking about the accounting industry, there are many trends to consider. With more and more businesses being formed, there is more competition and a need for companies to present their “sizzle” to make them stand out to consumers. Just a few of the accounting trends that businesses need to be aware of are globalization, skill and education, accountant’s image, technology, and new laws and regulations.

The increase in competition has led many companies to expand internationally and gain access to new markets and consumers. Globalization is providing firms with a source of growth while allowing them to increase their competitiveness, increase their expertise and satisfy demand. They are able to provide products to markets where there is more demand than supply or where there is no supply. This also allows the company to try and sell products to different markets that they were unable to sell in other markets (PricewaterhouseCoopers).

Not only is there more competition for businesses but there is also more competition for accountants and Certified Public Accountants (CPAs). Beginning in 2000, more than 30 states passed laws to require a fifth year of education to be eligible to sit for the CPA exam. This was passed due to a more competitive business environment and the needed increase in skill level. With more globalization and businesses becoming more complex, there is a need for people to be more knowledgeable. There is a high demand for people with technical skills, foreign language skills, and people with industry and international experience. With the need for experience, there is less demand for the college graduate. The companies are more interested in

the graduates that have also received their MBA or who are CPAs (Careers in Accounting).

With the current issues surrounding Enron and WorldCom, the accounting industry is trying to change their image. The AICPA has launched a \$3 million campaign to spread the word about how CPA’s add value. They are also trying to recreate a positive image of accountants. Mitchell Klein, a partner of Fasman, Klein & Feldstein, an accounting firm in New York, said, “Too many people associate accountants with death, tax and bad news and question our integrity because of the big audit failures that major accounting firms have failed to catch.” With many people associating accountants to death, tax and bad news, the AICPA has a lot of work to do to change the image of accountants (Careers in Accounting).

The accounting industry relies heavily on computer information systems. There is a growth towards more technology and easy to use systems. An example of the use of accounting information systems is the software that provides the ability to file taxes electronically over the Internet. There are many systems to help in the areas of accounting, auditing, and controls (Cardiff Business School).

Tax laws are changing all the time to incorporate new areas of concern. There is new legislation cracking down on business and corporate leaders for wrongdoing and fraud. The Sarbanes-Oxley Act is a regulation that includes a wide range of topics discussing corporate responsibility. It was placed into legislation to increase investor confidence due to the recent corporate scandals (Crimmins). It makes executives sign off on their books and to establish and maintain strict internal controls to ensure proper financial reporting. Many of the accounting firms are raising their fees to help account for the increase in time, risk, and accountability for their audits. According to a survey by Financial Executive International, many companies expect to pay 35 percent more on average for additional audit work and

25 percent of them expect the fee to increase at least 50 percent (Nelson). The legislation also covers the role of attorneys who represent public companies by requiring them to step forward and report any evidence of material violations to the company's CEO. If the CEO fails to respond to the violation, the attorney then must report it to the audit committee and continue until the issue is resolved (Crimmins).

The Job Creation and Worker Assistance Act of 2002 has provided many incentives to increase corporate spending. The main incentive is "the 30% first-year special-depreciation allowance." This act increases the amount of depreciation that businesses are allowed to claim for the year that they acquired the eligible property. The eligible property includes computers, office equipment and furniture; vehicles used 50% or more for business, as well as other items. The eligible property must have been acquired after September 10, 2001 to qualify for the allowance.

With the Jobs and Growth Tax Relief Reconciliation Act of 2003, the special depreciation is increasing from the 30 percent to 50 percent for property acquired after May 5, 2003 and before January 1, 2005. Just like the 30 percent special depreciation, the 50 percent special depreciation is in addition to the regular depreciation and the current Section 179 deduction (CCH Tax Group).

## **Objectives**

The objectives of this paper target operational procedures and considerations that an entrepreneur must evaluate when buying or starting a business. There will be a discussion of the different types of entities that an entrepreneur must compare to see what legal form best fits the business. The discussion will include a definition of the entity, its advantages and disadvantages, which include the allowable number of members or shareholders, taxation, and liability issues.

After discussing the types of entities, another issue of relevance to a business owner is the risk of failure and bankruptcy. The three types of bankruptcy that will be discussed include Chapter 7, Chapter 11, and Chapter 13. After touching on bankruptcy, including some alternatives and costs associated with it, an executive summary from the small business perspective will be analyzed.

## **Sole Proprietorship**

The simplest form of business is the sole proprietorship. A sole proprietorship is a single business owner. A major advantage of a sole proprietorship is that administration, organization, legal and accounting costs, as well as federal and state income taxes, are usually lower. Some of the disadvantages are paying self-employment tax, personal liability and limited fringe benefits (Gear Up Tax Seminar). The sole proprietor is taxed at the personal level for the business income and is personally liable for the business debts (Koelbl). They are limited on fringe benefits because of the cost associated with having life insurance, retirement accounts, and medical premiums. The sole proprietor separates a portion of their personal assets and uses them in business. There are no legal filings required to be a sole proprietorship (Gear Up Tax Seminar).

## **General Partnerships**

After 1996 to be classified as a partnership for federal tax purposes, there had to be two or more members and they could not be any of the following. They could not be an insurance company, tax-exempt organization, real estate investment trust, any organization that is filing as a corporation, and there are many more requirements (IRS).

Two or more individuals or legal entities may form a partnership. There are no legal filings required to be classified as a partnership (Gear Up Tax Seminar). The owners or general

partners usually will have a written partnership agreement to cover legalities of the business. For example, it includes who the partners are and their ownership percentages. The partners are taxed for their share of profits and losses at the individual level. Each partner can conduct business for the partnership for which the partnership is liable. The partners are personally liable for the debts of the partnership. If the partnership does not have enough money to cover the debt, then the creditors will go after the partners. If some of the partners are unable to pay, the creditors will go after the other partners who do have money and get the amount owed (Koelbl).

### **Limited Partnerships**

Limited Partnerships are the same as general partnerships except for the rule of liability and partners. Limited partnerships have two types of partners, general partners and limited partners. The limited partners who do not actively participate in the partnership operations are not personally liable for the partnership debt. Their only risk is the amount of capital they have invested in the limited partnership. The general partners are still personally liable for the partnership debt (Koelbl).

### **C Corporations**

C corporations or corporations are a legal entity that exists separately for its owners. To incorporate, articles of incorporation must be filed with the state. They must possess at least three of the following characteristics of limited liability, free transferability of interests, continuity of life or centralized management (Gear Up Tax Seminar). They have one major advantage of limited liability. This protects the owners from personally being sued or being responsible for the debts or loans of the corporation. They are only liable for their investments in their capital stock of the

corporation. Corporations are usually able to provide fringe benefits to shareholders or employees like term life insurance, medical reimbursement plans, and medical insurance premiums (Gear Up Tax Seminar). Corporations are usually taxed as a separate legal entity, which means they have double taxation (Koelbl). The corporation pays tax on their income and then the shareholders pay tax on the dividends that they receive (Gear Up Tax Seminar).

### **S Corporations**

In 1958, S corporations were introduced into federal tax law to give business owners some of the benefits of partnerships and some of the benefits of corporations. Business owners could elect to change their entity to an S corporation to gain protection against creditors that was provided by being a corporation but also being able to avoid the double taxation that comes with being a corporation. In 1986, S corporations became popular again when new rules for C corporations became less attractive as a business entity (Tucker, S Corporations). The S corporation has perpetual existence (Oster).

For a business to qualify as a small business corporation or S corporation, the business must be a domestic corporation with 75 or fewer shareholders, be an eligible corporation, and have only one class of stock. To become an S corporation, all corporate shareholders must consent to the election. The S corporation election must be made within the first three months that the business is operating. If the corporation revokes the election for any taxable year, it is terminated permanently (Tucker, S Corporations).

To be an eligible corporation, the S corporation must follow these requirements. The corporation must have 75 or fewer shareholders and there are certain requirements of the shareholders. A husband and wife are treated as one shareholder as long as they are

both U.S. citizens. If they were to get divorced, they are treated as separate shareholders if both own stock (Tucker, S Corporations).

There are limitations on who may be shareholders of an S corporation. An eligible shareholder includes any individual who is a U.S. citizen or resident alien, estates, certain trusts, charitable organizations, pension trusts (excluding IRAs) and employee stock ownership plans. Some ineligible shareholders include C corporations, non-resident aliens, partnerships, and foreign trusts. Since 1997, S corporations have been allowed to own 100 percent of qualified subchapter S subsidiaries (Tucker, S Corporations).

The articles of incorporation determine if the S corporation will have more than one class of stock (Tucker, S Corporations). The stock of an S corporation is freely transferable, which means a shareholder can sell their interest without obtaining the approval of the other shareholders (Oster).

The aspect of taxation is one of the most attractive features of the S corporation. The entity itself is not taxed and only the shareholders are taxed (Tucker, S Corporations). The percentage of ownership determines the percentage of pass-through income. Another advantage of the S corporation is avoidance of self-employment taxes (Oster) and they are not subject to FICA tax on the net income, but only on the wages. If the shareholders take out distributions of profit they must take out a reasonable salary (Gear Up Tax Seminar).

### **Limited Liability Companies**

In 1977, Wyoming was the first state to adopt the limited liability companies (LLC) legislation and in 1988 the Internal Revenue Service determined that a Wyoming LLC would be treated as a partnership for federal income tax purposes. The limited liability company is an organization that was formed under state law to combine the advantages of corporation's limited liability and the advantages of partnership's

income tax treatment. IRS regulation states that multiple member LLCs are automatically treated as partnerships if formed in the U.S. after December 31, 1996, unless an election is made to be treated as a corporation. Single member LLCs are automatically treated as a sole proprietorship unless an election is made to be treated as a corporation (Mellon).

Limited liability companies seem to have the advantages of both corporations and partnerships. Unlike S corporations, LLCs are not limited on the number of members and can have non-U.S. citizens as shareholders. They can also be owned by C corporations, S corporations, trusts, partnerships, or other LLCs. LLCs usually have a limited life span. The death or withdrawal of member can cause the LLCs to automatically dissolve. The stock ownership interests of LLCs are not freely transferable. The members of LLCs would need the approval of the other members to sell their interest in the LLC. They also provide their members with protection from personal liability and allow for pass through taxation to the stockholders. LLCs can have many different classes of stock and the percentage of pass-through income is not tied to the ownership percentages (Oster).

### **Bankruptcy**

Although many business entrepreneurs want to avoid discussing bankruptcy and the chance of failure, it is an important issue that needs to be thought about before starting a business. They need to consider what will happen to them if they are personally liable for the debts of the business, if they have personally backed any of the business loans, or if they can be sued personally. When a company decides to file for bankruptcy, they have three types to choose from which include Chapter 7, Chapter 11 or Chapter 13.

Chapter 7 company bankruptcy, a liquidation filing, is the most common type of filing. This is usually the choice of bankruptcy

when there is no chance of reorganizing or turning the company around. At this point, the company is usually considered a lost cause. The company files the bankruptcy with the court and the court selects a trustee to oversee the liquidation and makes sure that the money goes to the creditors. After the attorney fees and creditors get paid, any money left over goes to the owner (Metro Statute Advisors).

When the company is profitable but has too much debt, they will usually file a Chapter 11 company bankruptcy. Chapter 11 allows companies to continue to run while the owners or stockholders and the creditors discuss and try to agree on reorganization. There are two concerns with Chapter 11. First the creditors usually end up owning most of the company and second the company usually cannot afford the legal fees associated with a Chapter 11 bankruptcy. When the company cannot afford the fees, the judge will convert them in to a Chapter 7 bankruptcy (Metro Statute Advisors). Usually four out of five firms do not survive a Chapter 11 company bankruptcy filing. They usually do not have the sufficient funds that are needed in order to pay the legal and court fees. The minimum a company must have is \$100,000 and most medium-sized companies need over \$1 million (Applegate).

Chapter 13-company bankruptcy is the filing for individuals and sole proprietorships. To qualify for Chapter 13 filing, there must be less than \$750,000 in secured debts and \$250,000 in unsecured debt. With Chapter 13, the individual plans a reorganization plan and the creditors do not have a vote on the plan. Chapter 13 allows the individual up to three years to repay the creditors (Metro Statute Advisors).

When the first sign of running out of money appears, take the time to think before going and filing for bankruptcy. Some alternatives or choices to avoid bankruptcy include individual negotiations with creditors, slashing costs, taking control of the cash spending, and selling receivables for cash. The

owner can talk to the creditors and sometimes get their debt reduced by 50% to 75% and get their payments stretched out over a longer time period.

## **Conclusion**

When thinking of buying or starting a business there are many aspects and alternatives to consider and choose. This chart provides a simplified overview of the comparisons of the different types of business entities.

From: Business Filings Incorporated Website.  
[www.bizfilings.com/learning/comparison.htm](http://www.bizfilings.com/learning/comparison.htm)

One of the first things to consider is the issue of liability and how much risk is involved in the business or industry. If it is a business where the possibility of being sued is high, the owner needs to consider how important it is to be protected personally if someone tries to sue. New business owners also need to personally protect themselves from being liable for the debts of the business if the business goes bankrupt or is sued. Another major issue is taxation. If the owner wants to avoid double taxation, they should avoid forming a corporation. These are the main two issues to consider when forming a business although there are other issues that need consideration. From the small business point of view, the entrepreneur should want the advantages of limited liability, as well as individual taxation. Someone considering forming a sole proprietorship could become a limited liability company and have individual taxation and limited liability. The limited liability company seems to be the most advantageous to someone who is considering forming a sole proprietorship or a partnership.

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