

Legal Considerations for Small Business

There are many legal and tax decisions that need to be made **before** you start your business. Each business and situation is different and unique. Consider what legal structure the business will take and if you will be

hiring employees. Research what federal, state, and local laws regulate your industry. An attorney and/or accountant can help you make these important decisions.

Business Licensing Requirement — Kansas does not require a license to start a business because it does not have a fictitious name statute. However, your business may fall under local, state, or federal license jurisdiction due to the specific trade or type of business. If you have any questions check with your trade, professional group, the municipality (city and/or county) in which you live, and the local health department to see if a license is required.

Trade-mark or Service-mark Registration — Anyone using a trade-name or mark may protect that design by filing with the Secretary of State. A \$25 fee protects the mark for 10 years, and it may be renewed as long as you are in business.

Zoning — Check with your city or county zoning commission to determine if local regulations prohibit the type of business you are contemplating. Federal air and water protection standards must be met as well as Occupational Safety and Health Act (OSHA) regulations and the Americans with Disabilities Act.

Federal Employer Identification Number — Partnerships and corporations, with or without employees, and sole proprietors with employees must obtain a Federal employer identification number (FEIN). This number identifies the employer for payment of federal employment taxes. To obtain this number complete and return an SS-4 form to the Internal Revenue Service.

State Employer Identification Number — Every employer in the state is required to withhold state employment taxes. An identification number for payment of these taxes is obtained from the Kansas Department of Revenue.

Retailers' Sales Tax Certificate Number — Every person, partnership, corporation, association, or organization who is engaged in the business of selling tangible personal property at retail; furnishing electrical energy, gas, or water; furnishing installation and repair services, and furnishing certain other enumerated services must apply for a Sales Tax Certificate of Registration. Registration forms are available from the Kansas Department of Revenue.

Forms of Business — The legal structure of your business can take one of several forms including: sole proprietorship, general partnership, limited partnership, corporation, S corporation, or limited liability company. If you are a group of professionals (doctors, engineers, lawyers, etc.) you may elect to form a professional association or limited liability partnership instead. Before you can select the proper legal structure, you should ask yourself the following basic questions:

- a. How much start-up money do I need?
- b. What will be the source of the needed funds?
- c. What skills are needed that I cannot provide?
- d. Are there other people available with the needed business skills?
- e. How much control do I want to have?
- f. How will the business be taxed, and how will applicable laws influence it?
- g. To what extent will I be responsible for debts or claims against the business?
- h. What will happen to the business if I am unable to work for any length of time?

There are many other things to consider that will affect this decision. You need to consider:

- a. What legal structure would insure the greatest adaptability for the business?
- b. What are the possibilities of attracting additional capital to finance growth?
- c. What are the costs and investments in starting the business, and how long will it take to recoup those costs?
- d. What are the goals of the enterprise and which legal structure can best serve its purposes?

Sole Proprietorship

A sole proprietorship is defined as a business which is owned and operated by one person, an individual taxpayer. To establish a sole proprietorship you need only obtain whatever licenses are necessary and begin operation. It is the most common form of small business organization. Most small businesses start out as a sole proprietorship and later select a form which better fits the business as it grows and develops.

Advantages

- Easy to start and cost of organization is low
- Few legal restrictions
- Owner receives all profits
- Owner has maximum control over operations
- Tax advantages to the owner in the form of business expenses because business losses offset personal income from other sources

Disadvantages

- Owner personally liable for all business debts
- Illness/death of owner endangers the continuance of the business
- Growth limited to personal motivation and experience of owner
- Problem of mixing personal/business affairs
- Difficult to obtain long-term financing

General Partnership

Some of the characteristics that distinguish a general partnership from other forms of business organizations are the limited life of the partnership, unlimited liability of the partners, co-ownership of the assets, mutual agency, share in management, and share in partnership profits. There are no formal filing requirements, but it is strongly suggested that you prepare and sign: (1) a buy-sell agreement, and (2) a partnership agreement. These documents should clearly state duties, capital contributions, procedures for sharing profits/losses, withdrawals of assets permitted, withdrawal of partner procedures, and procedures for dissolving the partnership. A general partnership is not a taxable entity, but must file an annual tax return.

Advantages

- Easy to organize
- Broader management base
- Income taxed once at the partner's tax rate
- Can establish fringe benefit programs for employee motivation or tax advantages
- Financial resources available from and liability shared by all partners

Disadvantages

- Personally liable for all business debts
- Illness/death/bankruptcy of one partner can dissolve the partnership
- Difficult to rid oneself of a bad partner
- Divided authority, one partner's decisions binding on partnership
- Difficult to obtain large sums of capital

Limited Partnership

A limited partnership consists of one or more general partners and any number of limited partners. Assuming compliance with the statutory formalities, the limited partner risks only his agreed investment in the business. The limited partner is generally not subject to the same liabilities as a general partner, so long as he or she does not participate in the management and control of the enterprise or in the conduct of its business. The Revised Uniform Limited Partnership Act of 1984 (KSA:56-la01 et seq.) requires special registration and the words "Limited Partnership" or the abbreviation "LP" to be used in the business name. Two or more people must execute a limited partnership certificate and file it with the Secretary of State along with a fee of \$150. An annual franchise fee must be paid (\$20 to \$2500 based on the partner's net capital accounts). Each limited partnership must have and maintain, in Kansas, a registered office which may or may not be the place of business and a Kansas resident agent which may either be an individual, a domestic corporation, or the limited partnership.

Advantages

- Limited partners liable to extent of investment
- General partners able to acquire more capital
- Continuation of partnership in contract

Disadvantages

- One general partner has unlimited liability
- Limited partners cannot participate in management and/or operation of business
- Agreement must be filed with state

Corporation — (C Corporation)

The corporation is the most complex business structure. As defined by Chief Justice John Marshall in a famous decision in 1819, a corporation "is an artificial being, invisible, intangible, and existing only in contemplation of the law."¹ In other words, a corporation is a distinct legal entity, separate from the individual who owns it. It is formed by the authority of state government. Corporations which do business in more than one state must comply with federal interstate commerce laws and with each state's laws in which they operate. The procedure required to form a corporation is: (1) Subscriptions to capital stock must be taken and a tentative organization created. (2) Then approval must be obtained from the Secretary of State in the state the corporation is to be formed. This approval is in the form of a charter for the corporation stating the powers and limitations of the enterprise. Kansas charges a filing fee of \$75. An official copy of the incorporation papers must be filed with the Registrar of Deeds in the county where the corporation is located. (3) You must then register as a foreign corporation in other states where you hope to conduct business.

Advantages

- Liability limited to amount of each stockholder's investment
- Easy to raise capital since ownership is readily transferable and many stockholders can participate
- Perpetual existence
- Able to hire people with professional skills
- Possible to offer more fringe benefit programs to employees
- More flexibility in tax planning

Disadvantages

- Extensive recordkeeping and reporting
- Heavily regulated by state and federal government, must file annual report
- Double taxation on profits passed through as dividends
- More expensive to organize than other forms of business
- Must be formally dissolved if you quit business

S Corporation

Many small businesses elect subchapter S status (IRC 1371-1379). The purpose is to permit a "small business corporation" to elect to have its income taxed to the shareholders as if the corporation were a partnership. Conditions for making and maintaining an S corporation election are: (1) the corporation cannot have more than 75 shareholders (individuals, estates, and certain trusts and other organizations as described in the tax code), (2) no non-resident alien shareholders are allowed, (3) only one class of outstanding stock may be issued, (4) all shareholders must consent to the election, and (5) a specific portion of the corporation's receipts must be derived from active business rather than enumerated passive investments in the United States. No limit is placed on the size of the corporation's income and assets. An S corporation election is generally attractive for eligible corporations if the shareholders' tax rates are lower than the corporation's tax rate and the corporation distributes to the shareholders a significant portion of its earnings.

Advantages

- Profit or loss passed through to shareholders
- Income is taxed only once
- Stockholders have limited liability
- Easier to raise capital

Disadvantages

- Regulated by state and federal government
- Limited to one class of stock
- Limited to 75 shareholders
- Must meet S corporation requirements for entire year

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Limited Liability Company

The limited liability company (LLC) is a flexible business entity combining the corporate advantage of limited liability with the pass-through tax treatment of a partnership. Wyoming was the first state to draft legislation for the Limited Liability Company in 1977. In 1988 LLC's received their first IRS ruling (Rev. Rul. 88-76, 1988 1 C.B. 360) stating that LLC's can be taxed as partnerships. In July of 1990, Kansas became one of the first states to draft legislation enabling the creation of limited liability companies. In most states, two or more persons may form a limited liability company. They are the members (owners-partners) entitled to participate in management in proportion to their contribution of capital. The LLC is virtually "unlimited" as far as who may be a member (owner). Securities offered by an LLC are exempt from registration if the number of members does not exceed 35. The name of the business must use the words "limited company," "L.C.," "limited liability company," or "L.L.C.," as part of its name. Articles of Organization are filed with the Kansas Secretary of State with a \$150 filing fee.

Advantages

- Liability limited to amount of investment
- Pass through tax treatment
- Operating agreement spells out rights, duties, and responsibilities of members

Disadvantages

- Organization costs may be high
- Can sell stock only to "members"
- May not be recognized by other states

Something else to consider ... Franchise

A franchise is a legal arrangement whereby you may pay a fee to own and operate a business using the name and business plan of the franchisor. Terms of the agreement vary widely. The franchisee must then establish a legal entity for the franchise. It can be a sole proprietorship, partnership, limited partnership, corporation, S corporation or limited liability company. Most franchise agreements are written so as to give broad powers to the Franchisor (seller) and very little latitude to the Franchisee. Be sure to consult your attorney before signing any documents or paying any money. Negotiate or counter-offer the agreement and eliminate any parts that you find offensive or unfair.

Advantages

- Professional management help
- Advertising help
 - National (radio, TV)
 - Local (store opening blitz)
 - Good image
- Contract spells out all details of arrangements
- Banks may be more willing to lend money based on record of franchisor

Disadvantages

- High initial franchise cost
- Percentage of sales as royalty
- Owner often limited in changing merchandising concept, name or source of product
- May be difficult to sell business or building
- Lack of personal identification with business
- You may suffer if other franchise holders are not successful

Information prepared by the Washburn University SBDC for educational purposes only.
Specific technical questions should be discussed with an accountant and/or attorney.

Sources of Information

¹ Quoted in Lowell B. Howard, *Business Law*, Woodbury, N.Y.: Barron's Woodbury Press, 1965, p. 332.
Module 5, *Starting a Business/Recordkeeping*, Study Guide and Instructor Guide, Internal Revenue Service.
Module 10, *Starting a Business/Recordkeeping*, Study Guide and Instructor Guide, Internal Revenue Service.
Starting a Small Business in Kansas, Kansas State University Small Business Development Center.
Steps to Success: A Guide to Starting a Business in Kansas, Kansas Department of Commerce.
Trade-Mark/Service-Mark Registration, Kansas Secretary of State.