



## **Legal Questions about Starting a Business**

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# Answering your legal questions about starting a business

How should I organize my business? How is it formed, operated, and taxed?

## How should I organize my business?

Choosing the form of legal organization for your business is similar to buying a new car. You have to know what models are available and which features and options you desire. There are four basic “models” or types of business organizations: sole proprietorships, partnerships, limited liability companies, and corporations. The key features a business owner should consider are liability protection and desired tax treatment. Some business organizations offer liability protection for the owners. Others do not. Some business organizations are taxed as a separate entity. Others are merely conduits and all of the income and expenses flow through to the owners.

A lawyer can help you determine which type of business organization is best for your business, and can help draft important agreements – such as shareholder, partnership, and operating agreements – that will help you manage your business.

## SOLE PROPRIETORSHIP

### What is a sole proprietorship?

It is a business with one owner who makes the management decisions. The owner and the business are one and the same, with a common identity. Sole proprietorship is the simplest business organization.

### How is a sole proprietorship formed and operated?

There are almost no legal formalities to forming a sole proprietorship. If the proprietor has employees, the main step is obtaining a federal employer identification number (EIN) from the IRS by filing a Federal Form SS-4. If the proprietorship has no employees, the owner can use his or her Social Security number as the business identification number. However, the IRS still prefers that the proprietorship obtain an EIN.

### How is a sole proprietorship taxed?

Even if a sole proprietor obtains an EIN for business, the proprietorship is not a separate taxpayer. All of the income and expenses of the proprietorship are reported on Schedule C of the owner’s individual federal income tax return and on Form 1 with the state. Although the

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owner of a sole proprietorship is not an employee, he or she is required to pay self employment tax and to make periodic estimated tax payments on income from the sole proprietorship. The sale of goods or services may be subject to sales tax, which must be paid to the state. If the proprietorship has employees in addition to the owner, the proprietorship must pay federal employment tax (FUTA), the employer’s share of Social Security, and the employer’s share of Medicare. The proprietor also must withhold income taxes, the employee’s share of Social Security, and Medicare from the employee’s income. The amounts withheld must be deposited with the government.

### Is a sole proprietor protected from liabilities of the business?

Since a sole proprietorship is the owner’s alter ego and not a separate legal entity, there is no liability protection for the owner. The owner is responsible for all of the business’s debts and obligations.

## PARTNERSHIP

### What is a partnership?

A partnership is simply an association of two or more persons, as co-owners, who carry on a business for profit.

## How is a partnership formed and operated?

There are three types of partnerships: a general partnership, a limited partnership, and a limited liability partnership.

In a general partnership, each partner has an equal voice in managing the business of a partnership. Each general partner can bind the partnership and the other partners. While a written agreement is not required, a written partnership agreement is a good idea, because it can specify the partners' rights and duties. The partnership agreement does not need to be filed or recorded with any government agency.

There are two types of partners in the limited partnership: general partners and limited partners. General partners manage the business and have authority to bind a partnership. Limited partners are in the nature of investors. They have very limited ability to manage partnership affairs. To form a limited partnership, a written document, called a Certificate of Limited Partnership, must be filed with and a fee paid to the Department of Financial Institutions (DFI).

A limited liability partnership is a form of a general partnership, with some modifications. A registration statement must be filed with the DFI and fees paid to register a general partnership as a limited liability partnership.

## How is a partnership taxed?

A partnership must obtain an EIN. The partnership itself is merely a conduit for income tax purposes. Although a partnership has to file its own federal income tax return (Form 1065 and Schedule K-1), the business itself is not taxed. The partnership also must file Form 3 with the state. Instead the net income or loss flows through to the partners, generally in proportion to their percentage of ownership. Each partner reports his or her share of partnership income or loss on Schedule E of his or her Form 1040. Partners are taxed on their share of partnership taxable income or loss, which do not necessarily coincide with the amounts distributed to them by the partnership. Income to partners that is not in the nature of wages is not subject to self-employment taxes. However, distributions that are for services rendered are subject to self-employment taxes. If the partnership has employees, the partnership must withhold income taxes, Social Security, and Medicare from its employees' wages. It must pay FUTA, Social Security, and Medicare. A partnership also may have to pay sales and use taxes.

## Is a partner protected from liabilities of the business?

A general partner is not protected and is liable for all the partnership's debts and obligations. In a general partnership, each partner can bind the partnership and incur liabilities for which each partner will be responsible. In

a limited liability partnership, each partner is a general partner but does not have liability for the actions of other partners. In a limited partnership, the general partner is responsible for all of the business's debts and obligations. The limited partners' liability is limited to the amount that they invested in the business.

## CORPORATIONS

### What is a corporation?

A corporation is a legal entity that is separate from its owners. It receives its legal existence from a charter granted by the state.

### How is a corporation formed and operated?

Anyone who wishes to form a corporation must prepare and file articles of incorporation with the DFI.

Once the corporation is formed, owners of the corporation, called stockholders, contribute money, property, or services to the corporation and in return they receive stock representing their ownership in the corporation. The stockholders elect a board of directors who are responsible for managing the corporation's affairs. The board of directors elects the corporation's officers who run the corporation's daily operations. The stockholders, directors, and officers may be, but do not have to be, the same people.

Since the corporation is an entity separate from its stockholders, directors, and officers, the corporation must observe certain formalities that are not required by a sole proprietorship or partnership.

### How is a corporation taxed?

For tax purposes, there are two types of corporations: subchapter C (a regular corporation) and subchapter S corporations. C corporations are separate tax payers. A C corporation pays taxes on its own income; the shareholders are not taxed on corporate income. The corporation files a Form 1120 with the federal government and a Form 5 (where the entire business income is attributable to Wisconsin) with the state. If income is distributed to shareholders in the form of dividends, the corporation does not receive a deduction for the dividend distribution, but the shareholders must pay tax on the income. This is referred to as double taxation.

A subchapter S corporation is generally not taxed. It is merely a conduit for tax purposes. All the income and losses flow through to the shareholders in proportion to their shareholding. As in a partnership, distributions do not determine the amount taxable to the shareholders. A subchapter S corporation, which may have no more than 100 shareholders and is subject to other requirements, files Form 1120S with the federal government and Form 5S with the state. Both regular C corporations and subchapter S

corporations must pay FUTA and the employer's share of Social Security and Medicare tax. The officers may, but are not required to be, employees of the corporation. The corporation must withhold an employee's share of Medicare and Social Security and withholding taxes and remit the withheld tax to the government.

### **Is a corporation owner protected from liabilities of the business?**

The stockholders, officers, and directors are not personally liable for the corporation's debts and obligations. However, stockholders often are required to personally guarantee bank loans and other obligations of the corporation. Also, if the corporation fails to deposit withholding taxes, officers and directors may be individually liable for the withholding tax. If a corporation violates environmental laws, the individual owners may have personal liability for the violation.

## **LIMITED LIABILITY COMPANIES**

### **What is a limited liability company?**

A limited liability company (LLC), like a corporation, is a distinct legal entity.

### **How is an LLC formed and operated?**

Although it is not a corporation, an LLC provides its owners with the same liability protection of a corporation. An LLC receives its existence by filing Articles of Organization with the DFI. The owners, called members, receive "interests" or "units" in the LLC in exchange for property, money, or services. Members usually enter into an Operating Agreement that defines the obligations and duties of the members and managers. The LLC's business may be run by "managers," who may or may not be members. If an LLC is managed by all of its members, the members have the same broad authority as a general partner in a general partnership. If the LLC is managed by one or more managers, their authority resembles that of a general partner of a limited partnership. The other LLC members are merely investors in the company.

### **How is an LLC taxed?**

An LLC can elect to be taxed as a C corporation or S corporation, but most LLCs do not make that election. Normally, an LLC is treated for tax purposes either as a sole proprietorship (if only one owner) or as a partnership (if two or more owners). If it is taxed as a sole proprietorship or partnership, the income and losses flow through to the LLC members. If it is taxed as a corporation, the entity itself pays the tax. If the LLC has more than one member it must apply for an EIN, and distributions to its

members may be partnership distributions and not subject to employment taxes. The LLC may, but is not required, to have employees. If it has employees, it is subject to the withholding rules discussed above. If the LLC is taxed as a partnership, it files Form 1065 with the federal government and Form 3 with the state. If it is to be taxed as a corporation, it files Form 1120 or 1120S with the federal government and Form 5 or 5S (where the entire business income is attributable to Wisconsin) with the state.

### **Is an LLC owner protected from liabilities of the business?**

LLC members and managers enjoy limited liability. They are not liable for the debts and obligations of the business, unless they guarantee the obligations or fail to pay withholding taxes as discussed above. If an LLC violates environmental laws, the individual owners may have personal liability for the violation.

### **Where can I get more help?**

There are a variety of state and federal agencies that can help you over the hurdles of starting a new business.

The Wisconsin Department of Commerce maintains information and offers free consulting services. Write to: 201 W. Washington Ave., P.O. Box 7970, Madison, WI 53707; or call (608) 266-1018 or (800) 435-7287. [www.commerce.state.wi.us](http://www.commerce.state.wi.us).

The Wisconsin Job Service provides a variety of free services to employers. Write to: Job Service Division, 1819 Aberg Ave., Madison, WI 53704; or call (608) 242-7400. [www.danejobs.com](http://www.danejobs.com).

The federal Small Business Administration can provide financial and other assistance. Contact the SBA at: 740 Regent St., Suite 100, Madison, WI 53715, (608) 441-5263; or 310 W. Wisconsin Ave., Room 400, Milwaukee, WI 53203, (414) 297-3941, [www.sba.gov](http://www.sba.gov). The Milwaukee SBA also sponsors the Service Corps of Retired Executives (SCORE), (414) 297-3942.

The Wisconsin Small Business Development Center provides noncredit management courses for small business owners, managers, and entrepreneurs. SBDC counselors offer free one-on-one advice for those businesses in need of specific management assistance. The center also conducts research, distributes information, and works with other state agencies offering specialized assistance. The SBDC state office is at 432 N. Lake St., Madison, WI 53706-1498. Call (608) 263-7794 to find the SBDC office in your area, [www.wisconsinsbdc.org](http://www.wisconsinsbdc.org).

If you plan to incorporate your business and need information about Wisconsin laws, contact the Wisconsin Department of Financial Institutions, Division of Corporate Consumer Services (CCS), P.O. Box 7846, Madison, WI 53707, or call (608) 261-7577. [www.wdfi.org](http://www.wdfi.org).

The Internal Revenue Service can provide several useful, free publications to help you comply with federal tax laws and acquire a federal employer ID number. Call (800) 829-1040 (individuals) or (800) 829-4933 (businesses), or visit [www.irs.gov](http://www.irs.gov). The Wisconsin Department of Revenue also can provide free publications and help you comply with state tax laws and acquire any necessary tax permits and identification numbers. Contact the DOR at 2135 Rimrock Rd., Madison, WI 53713., P.O. Box 8901, Madison, WI 53708, or call (608) 266-2776.

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