Doing Business in New York State — What Every Entrepreneur Must Know

By Darren Oved, Esq.

In New York State, there are presently several forms of business entity available to individuals interested in setting up their own businesses: the sole proprietorship, partnership, corporation, and limited liability company and limited liability partnership.

1. Sole Proprietorship

A sole proprietorship is a business that is owned by one person. The major benefits and drawbacks of a sole proprietorship form of business are as follows:

A. A sole proprietorship is the simplest and most inexpensive form of business to start and maintain. From a strictly cost perspective, it requires nothing more than just opening up shop. No forms must be filed with any state agency. There is no incorporation fee or filing fee that must be paid. In fact, one does not even need to consult an attorney, unless he/she wishes to use a fictitious business/assumed name, in which case a simple Assumed Name (DBA) Certificate must be filed.

B. In a sole proprietorship, the business's profits and losses are treated as personal profits and losses of the owner and thus taxed as personal income, on which the owner is taxed only once, unlike in a corporation where the business's profits are subject to double taxation, once at the corporate level and then again after distribution to the owner.

C. In a sole proprietorship, all of the owner's personal assets are subject to attack and vulnerable to seizure to satisfy any debts, judgments or obligations incurred in the business. Thus, if the sole proprietorship is sued and is found liable for a judgment, even if the business has no assets, the owner's assets may be used to satisfy any such judgment. This "unlimited liability" is perhaps the greatest drawback to the sole proprietorship and often prevents a sole proprietorship from accessing the additional sources of capital often necessary to expand a start up business.

D. A sole proprietorship, unlike a corporation, has no continuity of interest after the death of its owner. The business dies with its founder.

E. Finally, a sole proprietorship conveys an image of smallness, which many entrepreneurs strive to avoid in setting up their businesses.

2. Partnership

A partnership is generally defined as an association of two or more persons who carry on a business for profit as co-owners. A partnership can be created in one of three ways: (i) by written agreement; (ii) by oral agreement; or (iii) by operation of law (referred to as partnership by estoppel). Whenever the partnership form of business is utilized it is advisable for the partners to enter into a written partnership agreement setting forth the partners' respective rights and obligations to each other and the partnership. In the absence of a written partnership agreement, the provisions of the Uniform Partnership Act will govern. There is no single requirement that determines whether a partnership exists. Rather, most courts have adopted a three-part analysis of each case to see whether there is common ownership, sharing of profits and losses and a sharing of the management duties of the partnership.

The partnership form of doing business has much in common with the sole proprietorship method. The major benefits and drawbacks of a partnership form of business are as follows:

A. Like a sole proprietorship, a partnership's assets are only taxed once as ordinary/personal income to the partners. However, a partnership must file a federal tax return to demonstrate how profits and losses are divided among the partners.

Continued On Page 1

Doing Business in New York State

Continued From Page X

B. A major drawback of the partnership form of doing business is that each and every partner is responsible for the actions of every other partner. As a corollary to this rule, the personal assets of each partner can be used to pay for partnership-related liabilities. This is referred to as "joint liability" and means that partners share in the liability for the actions of the partnership and for every other partner.

C. Partnerships that have both general and limited partners are known as limited partnerships. In limited partnerships, which are more commonly used in real estate and motion picture transactions, the general partners have all the rights and liabilities of a partner in a general partnership but the limited partners (so named because of their limited involvement in the day to day operations of the partnership) liability is limited to the amount of their investment in the partnership. It is important to emphasize that if a limited partner becomes actively involved in the day to day operations of the partnership, they will lose their limited status.

3. Corporation

A corporation is a business entity that is commonly used by many start ups. For all intents and purposes a corporation is treated as a distinct and separate individual in the eyes of the law. It can own assets, contract, enter into agreements and be sued for their breach all in its own name. In short, the law allows a corporation to do anything that an ordinary individual can do. In addition, a corporation, unlike a sole proprietorship, has continuity of interest in that its existence is independent from the lives of its shareholders.

The main advantage of doing business in a corporate form is the "limited liability" it affords its shareholders. Unlike the sole proprietorship and partnership forms of doing business, a corporation's liability is limited to an individual's investment in the company (similar to a limited partner). Thus, if all corporate formalities have been properly followed, a shareholder does not generally have to worry about exposing his/her personal assets to satisfy the corporation's obligations.

The main disadvantage of a corporation is the fact that the income a corporation makes is taxed twice, the first time at the corporate level and then again after it has been distributed to the individual shareholders in the form of dividends. This "double taxation" may be eliminated in most cases by electing to be taxed as a subchapter S corporation (so named because of the subchapter it occupies in the Internal Revenue Code). Generally, an S corporation may not have more than 35 shareholders, all of whom must be individuals, estates or certain defined trusts. An S corporation may not have a non-resident alien as a shareholder and may not have more than one class of stock.

If eligible, an S election must be made with both the federal and state taxing authorities to be treated as an S corporation. Income will then "pass through" the corporation directly to the individual shareholder where it is only taxed once. Proper consultation with an accountant should be made when considering an S corporation election to determine whether the corporation is eligible and if the election is timely.

An additional minor drawback of the corporate form of doing business is that it requires the filing of a Certificate of Incorporation with the State in which the corporation wishes to do business and thus requires the cost of a filing fee.

A corporation's shareholders must appoint directors who then elect officers. These elections and actions that a corporation engages in are generally recorded in the corporation's minute book to demonstrate that the corporation has maintained a separate and distinct corporate form at all times and is thus entitled to enjoy the privilege of being treated as a separate entity. This can be very important when creditors attempt to "pierce the corporate veil" to attempt to get at an individual shareholder's assets to satisfy the corporation's obligations by claiming that the corporate formalities required by law were not properly followed.

Again, when two or more individuals are considering forming a corporation, a shareholders agreement should be entered into at the outset of the relationship clearly setting forth the rights and obligations of each of the parties vis a vis each other and vis a vis the corporation.

4. Limited Liability Company (LLC) and Limited Liability Partnership (LLP)

LLCs and LLPs are relatively new business entities. They were created to give effect to the best of both worlds of sole proprietorships and partnerships, i.e., single taxation, with the limited liability advantage of the corporate form. As with an "S" corporation, profits from an LLC or LLP are "passed through" to their members. Also, the limited liability protects the member from being sued for the negligent actions of their other members or partners. Generally, members can enjoy the benefits of an S

Continued On Page 2

Doing Business in New York State

Continued From Page X

corporation without the accompanying restrictions

Like corporations, LLCs and LLPs are formed by filing articles of organization with the State in which the LLC or LLP chooses to incorporate which will result in the added cost of a filing fee.

An LLP form of doing business is essentially identical to a general partnership, except for obtaining the added benefits of limited liability. In New York State, a general partnership whose partners are professionals may register as LLP. In both cases the name of the entity must contain the abbreviations LLP or LLC in their name.

As the foregoing clearly demonstrates, there are many considerations that affect the business form that an individual should use when starting up a business. It is incumbent upon any potential business owner to understand the distinctions, advantages and drawbacks between these entities before setting up shop. Prior discussion with experienced legal counsel at the outset of the venture can prove to be very beneficial in the long term.❑

Darren Oved, Esq. is a partner at the New York city based multidisciplinary law firm of Oved & Oved LLP.