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Legal Structure of a Business



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How a Business is Legally Structured

There are eleven forms of business organizations in Colorado. The following information is taken from Colorado Business Resource Guide Legal Structure:

http://www.state.co.us/oed/guide/pdf/Guide4_LegalStructureRegis.pdf

- Sole proprietorship
- General partnership
- Limited partnership
- Corporation
- S Corporation
- Limited Liability Company
- Limited Liability Partnerships and Limited Liability Limited Partnerships
- Limited Partnership Association
- Nonprofit Organization
- Cooperative
- Out-of-state Business

The form you choose will affect your ability to control and profit from the business, your liability for lawsuits and the debts of the business, and the taxes you pay. The "right answer" for your business depends on your business goals and your personal style. The following list includes issues to consider in setting up your business, but always review your situation with an attorney or a financial advisor. The Colorado Business Resource Guide - Advisors gives a good overview of choosing advisors:

http://www.state.co.us/oed/guide/pdf/Guide10_Advisors.pdf

- ❖ Make sure you check with Small Business Development Center <http://www.sbdc-larimer.com> for information on starting a business, one-on-one consulting and workshops.

1. Sole Proprietorship

This is the simplest form for a business owned by one person. It offers absolute authority to the owner. On the other hand, there's no one else to share the responsibilities and the potential liabilities.

Advantages:

- Least complicated form of business to start and the least expensive to establish.
- All decision-making and control remains in the hands of the single owner.
- No need to file a separate business tax return — business losses and gains are combined with personal tax items, and losses and business expenses are deductible, but all business expenses must be tracked and verified.

Disadvantages:

- Owner assumes unlimited personal liability for debts and lawsuits.
- If the business is unable to meet its financial obligations, creditors may pursue the personal assets of the owner. Owner's death or illness can endanger the stability of the business.
- The ability to raise capital is limited.

- If you are operating the business under a name other than your own full first and last legal names, the business name must be registered as a trade name with the Colorado Secretary of State.
- As a sole proprietor, you cannot use words or abbreviations in your name that indicate a corporation such as, limited, ltd., corporation, corp. or words that indicate more than one owner (such as, associates, group, partners).
- ❖ For more information about business formation in Larimer County, visit the Larimer County Virtual Courthouse: <http://www.larimer.org/info/business.htm>
- ❖ For the City of Fort Collins, see: <http://www.fcgov.com/business> .

2. General Partnership

In a general partnership, two or more persons agree to share ownership, management responsibilities, and liability for a business. In a general partnership, all partners have unlimited personal liability for partnership debt.

Advantages:

- Having partners means additional sources of capital and the ability to share ideas, skills, and responsibilities. Each general partner can act on behalf of the business.
- The partnership files an "informational return" but doesn't pay taxes — each partner reports his or her share of income or loss on quarterly tax returns, and losses are tax deductible.
- A general partnership is relatively easy to organize.

Disadvantages:

- General partners have unlimited personal liability. Creditors can go after personal assets.
- Partnership ends on death of a general partner and a new agreement is required each time a partner joins or leaves the business.
- It is often difficult to disengage from an uncooperative partner.
- A partnership must file a notarized *General Partnership as a Limited Liability Partnerships (LLP)* with the Colorado Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do>
- To protect against future disputes, prepare a formal written partnership agreement setting out how much capital each partner will contribute, how the business will be managed, how responsibility and authority will be shared, and how the profits will be divided. You may also decide to get business life insurance to ensure the continuity of the business if a partner dies. Consult an attorney for advice on a partnership agreement.

3. Limited Partnership

In a limited partnership, two or more persons agree to share ownership, management responsibilities, and liability for a business, but at least one general partner has limited liability protection. One general partner remains personally responsible for all the partnership's liabilities. In a limited partnership, the general partners are personally liable for

the partnership debt, while the limited partner has no such liability beyond his or her personal investment.

Advantages:

- A limited partner's risk is limited to his/her financial (cash and property) investment in the business.
- The general partners can retain personal control of the business while increasing the financial resources available to the businesses without incurring long-term debt.
- May raise capital by selling additional limited partnership interests in the business.

Disadvantages:

- The general partners remain personally responsible for all the liabilities and debts of the business.
- The limited partner(s) may not work in the business or participate in management without risking loss of limited liability status.
- A partnership must file a notarized *Certificate of Limited Partnership* with the Colorado Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do>
- You should consult an attorney for advice on a partnership agreement.

4. Corporation

This is the most complex and expensive way to structure a business, but it also offers important protections for the owners. A corporation is a legal entity that exists separately from the people who create it. A corporation is owned by its shareholders, and run by a board of directors elected by the shareholders. In a large corporation, the directors hire corporate officers to manage the day-to-day operations. In a small corporation, the directors and the corporate officers are usually the same individual(s). Corporations are created by filing *Articles of Incorporation* with the Secretary of State and by adopting bylaws: <http://www.sos.state.co.us/biz/FileDoc.do> There are certain formalities a corporation must adhere to, including procedures for annual shareholder meetings, the election of the board of directors, maintenance of corporate records, adoption of bylaws, complete separation of personal and business finances, and proper filings with the Secretary of State. These are important in order to preserve the corporate form.

Advantages:

- Except where shareholders are professionals who are always responsible for their own negligence, the liability of corporate shareholders is limited to the amount of their investment.
- A corporation has advantages in raising capital because of greater access to investors.
- Once a corporation has been established through the Secretary of State, no other business may register with the Secretary of State using the same name.
- Ownership is transferable and inheritable — the corporation doesn't fold if its owners change or die.

Disadvantages:

- Corporations are difficult and expensive to set up and dismantle.

- There are stricter legal rules than for other business structures. Power is limited by the articles of incorporation and bylaws, and a vote of the shareholders may be required for various decisions.
- As a separate legal entity, a corporation must maintain its own set of accounting records and file its own income tax returns.

Special Tax Considerations:

Corporate shareholders are subject to a form of double taxation. The corporation pays a corporate tax on earnings and each owner/shareholder pays personal income tax on any profits distributed to them. This is a special problem for small corporations controlled by their owners.

- ❖ Both the IRS and Colorado allow corporations with under 35 shareholders to elect to be a Subchapter S Corporation, treated as a partnership for tax purposes. This avoids the double taxation by the state and federal governments. Whether or not to make a Subchapter S election is a matter to be discussed with a tax advisor. It is a good idea to consult an attorney for help in setting up a corporation. It's possible, but risky, to do it yourself.
- ❖ A corporation must obtain approval from the Secretary of State to do business under a fictitious name. The name must be unique and, ordinarily, must contain the terms "ltd.," "corporation," "corp." or "inc." You should think of at least three name options, in case your first choice is taken.

Forms, detailed instructions, and additional information on forming a corporation are available from the Colorado Secretary of State:

<http://www.sos.state.co.us/pubs/business/main.htm>

- ❖ Alternatively, you should contact the Small Business Development Center in Larimer County: <http://www.sbdc-larimer.com>

5. S Corporation

An S Corporation is not a separate legal structure, but a special TAX status granted by federal law to a corporation to tax the business' income like a partnership or a sole proprietorship. A corporation elects S Corporation status by filing with the IRS on Form 2553, *Election by a Small Business Corporation*. This is the most complex and expensive way to structure a business, but it also offers important protections for the owners. A corporation is a legal entity distinct from its owners. This ensures continuity and protects the assets of the owners (i.e. the shareholders) from the liabilities and debts of the corporation.

Advantages:

- An S Corporation has all the general advantages of a regular corporation except it does not pay corporate income taxes.
- It divides the expenses and income among its shareholders.
- Individual shareholders report profits and losses on their personal income tax returns.

Disadvantages:

- To apply for S Corporation status, it must be a domestic corporation; it must only have one class of stock issued and outstanding; it may not have accumulated earnings and profits at the close of each three consecutive taxable years if 25% of its gross receipts for each year are passive investment income (royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities); it may have a maximum of 75 shareholders; it must have a tax year ending December 31; all shareholders must agree to elect to S Corporation status.
- An S Corporation loses the ability to deduct the full cost of medical insurance as a business expense.
- Corporate officers are still treated as employees.

To elect S Corporation status, discuss the decision with a tax advisor. If you want to go ahead, use *IRS Form 2553* and *Colorado State Form 106*. See Colorado Department of Revenue http://www.revenue.state.co.us/TPS_Dir/wrap.asp?incl=businesses

6. Limited Liability Company

A Limited Liability Company (LLC) offers "members" (essentially the same as shareholders) both the protections of a corporation and the tax advantages of a partnership. Limited Liability Companies are created by filing *Articles of Organization* with the Colorado Secretary of State: <http://www.sos.state.co.us/pubs/business/main.htm>. LLCs are NOT corporations. In an LLC, the owners are called members. The members may elect or hire a manager(s) to run the business. As in a corporation, the owner(s)/member(s) may elect themselves to be the manager(s).

Because LLCs are a new form of legal structure and various questions remain unanswered, it is recommended that you consult a knowledgeable attorney if considering the formation of an LLC.

Advantages:

- Members of an LLC are protected from personal liability in the same way as corporation shareholders, while the entity itself can have the flexibility of a partnership.
- The IRS has determined that LLCs may elect to be treated as partnerships or corporations for income tax purposes.
- An LLC in Colorado will be treated as a partnership if there are two or more owners, unless the LLC elects to be taxed as a corporation.

Disadvantages:

- Tax and liability treatment of an LLC is not uniform across state lines.
- There may be limitations on the transferability of ownership in certain situations. In that case, the IRS may treat the LLC as a sole proprietorship or partnership.
- A Limited Liability Company must register with the Colorado Secretary of State <http://www.sos.state.co.us/pubs/business/main.htm>.

7. Limited Liability Partnerships and Limited Liability Limited Partnerships

The Limited Liability Partnership Act became law on July 1, 1995. The intent of the law is to create a form of legal structure which is similar to S Corporations and Limited Liability

Companies. Registered Limited Liability Partnerships (LLP) and Limited Liability Limited Partnerships (LLLLP) limit a partner's personal liability in the business to their personal investment in the business, except in areas related to their personal professional conduct. LLPs and LLLPs will usually be taxed as partnerships but may elect to be taxed as a corporation. Both entities are created by filing a *Registration Statement* with the Colorado Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do>, The partners in the LLP and the LLLP are directly considered the operators of the business. There is usually no election of officers or managers as in corporations or LLCs.

Advantages:

- New businesses and existing general partnerships (currently registered with the Colorado Department of Revenue) may register as a Registered Limited Liability Partnership.
- Existing limited partnerships (currently registered with the Colorado Secretary of State) may register as a Registered Limited Liability Limited Partnership and gain liability protection for all partners without a complete reorganization of the business.
- Once an LLP or an LLLP has been registered with the Colorado Secretary of State, no other business may register with the Colorado Secretary of State using the same name.
- The intent of the law is to gain the benefits of the partnership form of business while limiting the personal liability of the owners.

Disadvantages:

- LLPs are primarily for businesses where all the owners belong to a single licensed profession, e.g., CPAs, attorneys, doctors, etc.
- It is a new form of legal structure and it is not a recognized form of legal structure in all states.

Anyone considering the formation of an LLP or an LLLP should consult a knowledgeable attorney.

8. Limited Partnership Association

The Colorado Limited Partnership Association Act created a new form of legal structure called the Limited Partnership Association (LPA) and became law on July 1, 1995. This new entity is created by filing *Articles of Association* with the Colorado Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do> .

Advantages:

- Its existence terminates upon the affirmative vote of all of its members or as otherwise provided in the bylaws and by filing articles of dissolution with the Colorado Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do> .
- The association's existence does not terminate upon the disassociation, death or bankruptcy of a partner.
- Under the Act, LLCs may convert to LPAs in the same fashion that they could convert to partnerships or limited partnerships under the Limited Liability Company Act.

Disadvantages:

- LPAs must have two or more persons as members of the business.
- Limited Partnership Association is a very new form of legal structure and, at this time, there are few interpretive guidelines.
- Anyone considering the formation of an LPA should consult a knowledgeable attorney.

9. Nonprofit Organization

Nonprofit is a term that refers to an organization that uses all profits to further organizational goals instead of distributing the profits to shareholders, organizers or owners. In Colorado, an organization may choose to be an Unincorporated Nonprofit Association or a Nonprofit Corporation.

Association vs. Corporation

- *Nonprofit Associations* are normally formed by clubs or other less formal groups that do not intend to seek any special tax-exempt status or to exist beyond the current members. If organized as an unincorporated nonprofit association, a constitution, articles of association or a written declaration of organization must be adopted by two or more persons, and the name must be registered with the Colorado Secretary of State: <http://www.sos.state.co.us/pubs/business/main.htm> . A trade name may be registered using Form DR592 or Form Cro592. To further clarify an association's nonprofit status, additional optional documents may be files with the Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do>.
- *Nonprofit Corporations* are tax-exempt or exist beyond the current organizers. It is easier to obtain tax-exempt status if organized as a corporation rather than an association. A Nonprofit Corporation must file articles of incorporation with the Secretary of State in accordance with the Colorado Nonprofit Corporation Act: <http://www.sos.state.co.us/biz/FileDoc.do> For the necessary forms to become a Nonprofit Corporation, contact the Secretary of State 1560 Broadway, Suite 200, Denver, CO 80202 (303) 894 2200: <http://www.sos.state.co.us/biz/FileDoc.do>

Tax-Exempt Status:

Submit Form SS-4, Application for Employer Identification Number to have the Internal Revenue Service (IRS) assign a Federal Employer Identification Number (FEIN) whether there are any employees or not. The FEIN is the basic federal tax ID number for the organization.

- Tax-Exempt Status is granted by the Internal Revenue Service (IRS) to determine the nonprofit's status for paying federal income taxes.
- Forming a nonprofit association or a nonprofit corporation does not automatically establish tax-exempt status.
- There are three types of tax-exempt benefits, and one does not automatically grant the other.
 - The first step to becoming tax exempt is determining federal tax-exempt status. Generally, only organizations that have received federal tax-exempt status under 501(c)(3) qualify for Colorado sales tax-exempt status. 501(c)(3) status is issued only to religious, charitable, literary or educational organizations, organizations that promote national or international amateur sports competition and organizations for the prevention of cruelty to children or animals. Contributions made to 501(c)(3) organizations are tax deductible

to the donor. Other organizations may become tax-exempt under subsections of 501(c). Publication #557, *Tax-Exempt Status for Your Organization*, is a useful IRS publication in determining an organization's tax-exempt status.

Organizations that wish to become tax-exempt under 501(c)(3) must file IRS package #123, *Application for Recognition of Exemption*.

Organizations that wish to qualify for all other types of 501(c) nonprofit status should refer to publication #557 for filing requirements. It may take six months or longer for IRS to process an application and issue a Letter of Determination establishing federal non-profit, tax-exempt status. Contact IRS at 600 17th St., Denver, CO 80202, or call 1(800) 829 1040 or go to their website at www.irs.gov.

- o After a 501(c)(3) letter of Determination is received from the IRS, apply to the Colorado Department of Revenue for a sales tax-exemption. A copy of the Letter of Determination, financial statements and documents confirming your organizational structure and function must accompany application Form DR 715. A Letter of Determination from the IRS does not guarantee Colorado tax-exempt status. For additional information, contact the Colorado Department of Revenue, Taxpayer Services Division at (303) 238-3278.
- o Some religious, charitable and educational nonprofit, tax-exempt organizations may qualify for property tax exemption. An organization must own real property to take advantage of this exemption. Organizations that would like more information should contact the Colorado Department of Local Affairs, Division of Property Taxation at 1313 Sherman, Room 419, Denver, CO 80203, or call (303) 866 2371.

Although *nonprofit tax-exempt* organizations may not pay income tax, they must still file tax returns. IRS Form 990 is used for federal income tax returns and DR 1120 for state returns. While there are a few exemptions, tax-exempt organizations are still responsible for all payroll taxes and all other employer responsibilities on employees and must collect appropriate sale tax when selling personal tangible products to the public.

Private Assistance for Nonprofits:

- The Colorado Association of Nonprofit Organizations (CANPO) is a statewide "trade association" for non-profits in Colorado. CANPO is a diverse group of more than 900 nonprofit members. It provides information programs, publications, and group purchasing services. CANPO helps charitable and philanthropic nonprofits manage their organizations and resources. It represents the nonprofit sector and serves as a bridge between the public and private sectors. The CANPO bookstore sells a number of useful publications including, *How to Form Your Own Nonprofit Corporation*, and *Fiscal Sponsorship: 6 Ways to Do it Right*. For more information, contact CANPO at 225 E. 16th Av. #1060, Denver, CO 80203, or call (303) 932-5710, 1(800) 333-6554. <http://www.coloradononprofits.org>
- Community Resource Center (CRC) helps start-up groups through the process of forming a nonprofit. CRC provides direct training, consultation and empowerment services to nonprofits, including leadership training for directors. CRC also publishes the *Colorado Grants Guide* and the *Colorado*

Funding Report. For more information, contact CRC at 655 Broadway, #300, Denver, CO 80203-0426 or call (303) 623-1540 or use their website: www.crcamerica.org or email: info@crcamerica.org.

10. Cooperatives

A cooperative is a legal organization that is formed by a group of individuals and/or businesses that desire to work together for their “cooperative” benefit. A cooperative has two unique characteristics.

- A cooperative allows a group of separate individuals or individual businesses to join together for a common purpose such as the bulk purchase of materials, for sharing office space or to sell common products.
- While a cooperative has to cover its costs to stay in business, it can focus its resources on meeting the needs of its user-owners, called members.
- Business decisions are made on the basis of what is in the overall best interests of the members.
- Each member maintains his/her status as an individual or individual business and the cooperative becomes a means to realize common business and personal goals.

A cooperative is NOT a form of legal structure. In a cooperative, each member generally has only one vote regardless of the amount of equity owned. This one-member, one-vote approach makes cooperatives very democratic. This can be viewed as an advantage or a disadvantage. Wealthy members can't buy control and all members have equal say in how the business is conducted. However, it does not take into account the amount of financial and/or time commitments made to the organization. In a non-cooperative business, people usually have voting power that is based solely on their equity investment. A cooperative may organize as an unincorporated association. This is the least formal method for organizing a cooperative. The only government requirement is the registration of a trade name with the Secretary of State: <http://www.sos.state.co.us/biz/FileDoc.do> A trade name may be registered using Form DR592 or Form Cro592.

- ❖ You must adopt and have available for members a constitution, articles of association or a written declaration of organization!

See Colorado Business Resource Guide for more information on forming a cooperative, and the advantages of organizing the cooperative as a corporation: <http://www.state.co.us/oed/business-resource-guide/index.cfm>

11. Out-Of-State Businesses

Any out-of-state business that will have an ongoing business in the State of Colorado must register with the Department of Revenue (<http://www.revenue.state.co.us/main/home.asp>) or the Secretary of State (<http://www.sos.state.co.us/biz/FileDoc.do>), based on its legal structure.

Doing business in Colorado is NOT defined by statute but commonly refers to any business with a physical location in Colorado and/or operation with will extend beyond 30 days.

All wages and income earned from work and operations conducted in the State of Colorado are subject to Colorado income tax regardless of the residency of the individual or the business. Employers must withhold Colorado income tax from employee wages and make the required estimated income tax payments for the business. Refer to Colorado Business Resource Guide, under Employer Responsibilities and the Income and Property Tax chapters for more information on filing requirements: <http://www.state.co.us/oed/business-resource-guide/index.cfm> .

Check with Small Business Development Center Larimer County (1215 S. Howes St., Suite 150) 970 498.9295 www.sbdc@frij.com Free one-on-one counseling and workshops.

Additional Library Resources

The resources below are available at the Library for checkout and for in-library use. Check the online catalog for more books on the same subjects or browse the 346 and 658 areas in the nonfiction stacks.

Electronic Resources

Search for articles on starting your own business by going to the Library's Business and Nonprofit Resource Center webpage: <http://library.fcgov.com/adult/business/>. Use Business Source Premier or Small Business Resource Center: <http://dalva.fcgov.com/screens/database.html#business>. Use keywords such as, corporation, Colorado, S Corporations, etc. These online databases provide access to newspaper and magazine articles, most of which are in full text.

For definitions, try <http://www.answers.com/main/business.jsp> or www.wikipedia.com .

Print Resources

Small Business Sourcebook MAIN BUSINESS REFERENCE section 658.02207 Small

How to Form a Corporation, LLC or Partnership in Colorado. MAIN BUSINESS REFERENCE and HARMONY REFERENCE sections 346.78806622 Brown W 2000

How to Start a Business in Colorado MAIN BUSINESS REFERENCE section and nonfiction section and HARMONY REFERENCE section 658.11 How 2007

Incorporate Your Business MAIN BUSINESS REFERENCE section and HARMONY section 346.73052 legal 2006

Form a Partnership: The Complete Legal Guide MAIN and HARMONY 346.730682 Form 2006