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Choosing the Right "Boat" for the High Seas of Business

By Marie Havenga



In Pennsylvania, 13-year-old Imani Scott sells African fashion accessories. A thousand miles due south in Daytona Beach, FL, 19-year-old Jayson Meyer operates a software company. Smack-dab in the middle of the country, Arthur Smith, 20, runs a Kansas-based all-star cheering academy. What could these young entrepreneurs who operate such diverse businesses in different states have in common? Each has had to make a crucial decision about his or her company's legal structure of ownership.

Preparing to Hoist Anchor

Businesses do not all fit in the same boat. Before setting sail on your voyage across the seas of entrepreneurship, it is a good idea to spend some time deciding which legal "vessel" will transport you safely to your business destination.

While the options for the legal structure of a new company are numerous, most youth-owned businesses fall into one of these four categories: sole proprietorship, partnership, S-corporation, or C-corporation. Sometimes youth-owned companies are structured as limited partnerships or limited liability companies. Each of these "boats" has different advantages and disadvantages when it comes to making decisions, risk of liability, income taxes, and legal and accounting fees.

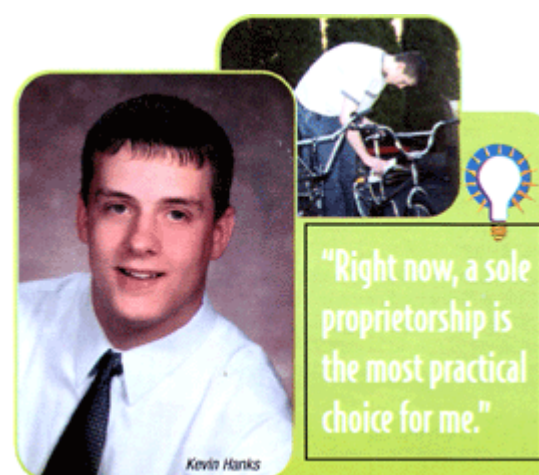
Sailing Solo — the Sole Proprietor

Kevin Hanks, 18, operates a bike-refurbishing business in Wilbraham, MA. Last year, he went online and filed a [DBA](#), registering his company as a sole proprietorship with the state of Massachusetts. A sole proprietorship means you are a one-owner operation — you have no co-owners who share the responsibilities, risks, or rewards.

Kevin sometimes worries about his liability risk as a sole proprietor. "If a kid buys a bike, falls off, gets hurt and says it's because the wheel I put on was loose, I could be liable," says Kevin, who sells most of his bikes through online auctions or from his Web site (www.Mass-Bikes.net). "I'm considering getting insurance real soon," Kevin says. If he were to be sued by a customer, Kevin could lose all of his business and personal assets.

On the plus side, a sole proprietorship is the easiest business entity to set up. There are no legal formation documents to file with the government. All profit or loss is reported directly on your personal income tax return, and you get to be the one who makes all the decisions about the business.

"Right now, a sole proprietorship is the most practical choice for me," Kevin says. "This is a lot simpler than a partnership or corporation." However, some youth under 18 find it hard to operate as sole proprietors because they are too young to sign legal documents.



Adding a Crew — the Partnership

Imani has been selling African fashion accessories — jewelry, scarves, purses, and hair adornments — for five years. Based in Philadelphia, PA, her company is known as Imani Scott Accessories.

After studying the various forms of business ownership, Imani decided on a partnership with her mother and father — mainly because she was underage and needed them to sign all the paperwork. Law students at nearby Temple University helped Imani and her parents construct their partnership agreement.

Like sole proprietorships, partnerships are relatively easy to form and have some nice advantages. For example, partners are able to pool their skills and resources in order to build a better business. Profits and losses may be divided among them by whatever percentage they choose. Income (and expenses) "flow through" to each of the partners individually, and taxes are simply paid on each partner's personal income tax return.

The main drawback is that each partner is personally responsible for the debts and liabilities of the company. If the business is sued, all of the partners stand to lose personal possessions and money, as well as the assets of the company.

Today, Imani is busy expanding her business to include greeting cards, stationery, and address labels. "You have to work hard when you're in business," says Imani, "but if you believe in your dreams, they will eventually come true." At some point in the future, Imani plans to incorporate her business.

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Mapping Your Course

Choosing the best legal structure for your business is one of the most important decisions you will make. Key factors to consider are the number of owners, costs of formation and maintenance, personal liability risk, income tax and other taxes, ability to raise money, ability to transfer ownership and assets, continuity of existence, and future needs of the company.

Each business structure has advantages and disadvantages in these areas. For example, sole proprietorships and partnerships can leave owners open to significant liability; and corporate structures are costly to form and maintain, while imposing double taxation on owners. For these reasons, [Daniel Anstandig](#), founder of Radio DAER, chose to structure his business as a limited liability company (LLC). An LLC is similar to an S-corporation, but an LLC is allowed to have an unlimited number of members.

The chart on page 21 will help you compare some of the advantages and disadvantages of the five most common legal structures for youth-owned businesses. Before you start your business, it is a good idea to get advice on these and other possible legal structures from a certified public accountant and a lawyer that specializes in business law.



Increasing the Fleet — the S-Corporation

Arthur runs Intense Cheer Etc., an all-star cheering academy that teaches kids of all ages cheerleading, spinning, jumps, and stances on the campus of Wichita State University. Trusting the knowledge of a business mentor, he set up his company as an S-corporation.

"The liability risk was a huge factor in determining the structure of Intense Cheer," Arthur says. Since all-star cheering teams participate in maneuvers that other teams cannot do because of safety concerns, he was wise to consider the risks. With an S-corporation, Arthur and his shareholders stand a better chance of not losing personal assets if sued. "We limited a lot of liability by choosing an S-corporation," Arthur says. "I'm very satisfied with the choice."

On the other hand, corporations have much higher formation costs than sole proprietorships or partnerships. Arthur spend about \$2,650 in attorney, accounting, and filing fees to obtain "S-corp" status.

In the eyes of the government, a corporation is an independent legal entity separate from it's owners. Corporations have to file articles of incorporation, elect a board of directors, hold directors' and shareholders' meetings, keep corporate minutes, and allow shareholders to vote on major decisions. Because corporations have to keep detailed financial record and follow numerous regulations, Arthur will also have to pay more for accounting and tax preparation every year.

Although an S-corporation is limited to having 75 shareholders, it offers important tax advantages. Income and losses from an S-corporation are passed through to shareholders, so Arthur pays taxes on his business earnings only once — on his individual income tax return. "there are some taxes we don't have to pay as an S-corporation," Arthur explains. "Already I see the benefits, and most of them are financial."

Sailing the High Seas — the C-Corporation

From his third-floor office overlooking Daytona Beach, Jayson set his sights on distant horizons when choosing to classify Meyer Technologies, Inc. as a C-corporation. "I looked at where I want to take the company, and that's how I made the decision," says Jayson. "If I had wanted to stay small and privately run, I would have chosen an S-corporation. Since my goal is to go public, I thought a C-corporation was the best way to go."

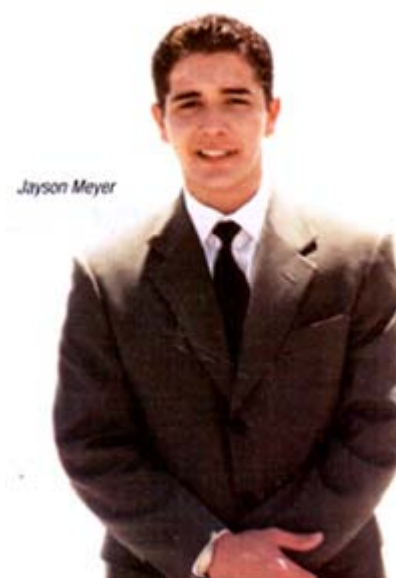
When a C-corporation *goes public*, the company raises money by selling stock to interested investors in the general public. Subsequently, investors can hold the stock they own and "hang on for the ride," or they can sell the stock to other investors through one of the national stock exchanges. Going public is a complicated and highly regulated process that requires the assistance of knowledgeable financial and legal professionals.

Liability also played a part in Jayson's decision to form a C-corporation for his business, which specializes in Web-based medical billing systems for physicians. "I'm a shareholder and president of the board of directors, but I have less personal liability as a C-corporation, and that's one aspect I looked at," he explains.

Since Jayson incorporated in May 2000, the company has continued to grow rapidly. Meyer Technologies now has 12 employees, and Jayson has freed himself from corporate paperwork by hiring an accountant. He is also laying the groundwork for taking the company public. "We want to grow and add additional board members," he says.

Some business owners don't like C-corporations because profits from the company are taxed twice — once on the corporate level, then again on individual shareholders' tax returns when they report salaries or dividends. Jayson, however, doesn't see this as a big problem. "I have a salary from the company and a profit-sharing plan," says Jayson. "I get taxed once personally, and the corporation gets taxed on the money it has."

"If I were still a sole proprietor, like I was when I started, I'd probably have more direct income," Jayson continues, "but my goals for the company are to continue building it. So far, being a C-corporation has benefited us greatly."



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Five Common Legal Structures for Business Ownership			
	Characteristics	Some Advantages	Some Disadvantages
Sole Proprietorship	<ul style="list-style-type: none"> • A business owned by one person or by a husband and wife • No legal formation documents required • Most popular business structure • Easy to create and operate 	<ul style="list-style-type: none"> • No legal fees to form or to continue paying annually • You can operate under your own name or a business name • You make all the decisions • All business income or loss "flows through" to your personal tax return 	<ul style="list-style-type: none"> • You are personally responsible for all the work, all the debts, and all the risk • If sued, you could lose your personal belongings and money, as well as business assets • No stock; difficult to transfer ownership • The business assets pass to your heirs if you die, rather than staying in the business
General Partnership	<ul style="list-style-type: none"> • A business owned by two or more people called partners • A written partnership agreement is not legally required, but a very good idea to have • Usually operates under a business name 	<ul style="list-style-type: none"> • Shared ideas, capital, and resources may offer a stronger base for business success • Profit or loss may be divided however the partners choose • Although a partnership must file its own tax returns, each partner's share of income flows through to his or her own income tax return 	<ul style="list-style-type: none"> • Partners can disagree and have personality conflicts • All partners are personally responsible for the debts of the company • All partners are responsible for any negligence • If sued, partners can lose personal assets, as well as business assets • No stock; restrictions on transfer of ownership
S-Corporation	<ul style="list-style-type: none"> • Sometimes referred to as a Subchapter S-Corporation • Can be privately held or owned by multiple individual shareholders (up to 75) • Created by filing articles of incorporation with the appropriate state agency • Exists as a single legal entity entirely separate from its owners • Bylaws of the corporation tell how it will be run 	<ul style="list-style-type: none"> • Provides legal protection for the shareholders' personal assets • Shareholders generally are not personally liable for debts of or claims against the corporation • Can raise money (capital) by selling stock • No double taxation; profits and losses are passed through to shareholders and included on individual tax returns • Has continuous existence regardless of death or change of ownership 	<ul style="list-style-type: none"> • Costs just as much as a C-Corporation to form • Strict accounting and financial reporting is required • Must have corporate board of directors' and shareholders' meetings • Cannot have more than 75 shareholders and they all (with a few unusual exceptions) must be individual legal residents or citizens of the U.S. • Can only sell common stock, following strict government regulations
C-Corporation	<ul style="list-style-type: none"> • A business that can be owned by single or multiple shareholders • Created by filing articles of incorporation with the appropriate state agency • Exists as an artificial, single legal entity entirely separate from its owners • Can be privately held by shareholders, or "go public" with shares being traded on the stock market • Bylaws of the corporation tell how it will be run 	<ul style="list-style-type: none"> • Provides legal protection for the shareholders' personal assets • Shareholders generally are not personally liable for debts of or claims against the corporation • Can raise money (capital) by selling stock • Allowed to sell both common stock and preferred stock • Has continuous existence regardless of death or change of ownership 	<ul style="list-style-type: none"> • Legal fees to form a corporation are high; there are annual recurring costs • Government requires strict accounting and financial reporting • Corporate profits are taxed, and shareholders' earnings (dividends) are taxed as well, resulting in double taxation • Board of directors' meetings and shareholders' meetings must be held • Selling shares of stock must follow strict government regulations
Limited Liability Company (LLC)	<ul style="list-style-type: none"> • A legal entity that exists separately from its owners • Created by filing articles of organization with the appropriate state agency • An operating agreement (similar to a partnership agreement) tells how the company will be run 	<ul style="list-style-type: none"> • Risk is generally limited to the amount of capital an owner invests in the business • Members generally are not personally liable for debts of or claims against the company • No double taxation; profits and losses flow through to members' individual tax returns • Foreign investors allowed 	<ul style="list-style-type: none"> • Can have "members," but can't go public • May not be recognized in all states • Single members not allowed in some states