

Three Principle Types of Business Formation

1. Sole Proprietorship

1. Simplest form of business
 2. Owner pays tax at personal level
 3. Management completely at owners discretion
1. Unlimited liability: owner personal liable for all debts
 2. Legally is not a separate entity

2. General Partnership

1. Ease of formation; created by agreement of parties:
 - Partnership agreement
 - Operating rules
 - Assignment of voting rights
 - Unanimous consent by partners
 2. Equal voice in management; unless stated otherwise in agreement
 3. Flow-through entity; partners pay pro rata share of income/loss on personal returns
1. Partners have unlimited liability; down to personal assets
 2. Not treated as an entity except for limited purposes

3. Corporation

1. Created by state statute
 - Articles of incorporation
 - Bylaws - *RULES OF MANAGEMENT*
 - Proxy
 - Board resolutions
 2. Legal entity separate and distinct from its owners; limited liability
 3. Perpetual existence
 4. Shareholders elect directors who set policy and hire officers
1. Double taxation; taxed at corp. level and shareholder level in the form of dividends
 2. More difficult and costlier to form

Limited Partnership

1. Created by state statute
 2. Consists of one or more general partners, who manage, and one or more limited partners; who have no voice in management
 3. General partners have unlimited liability, limited partners limited to investment
 4. Flow-through entity for tax purposes
1. More difficult and costlier to form
 2. Not treated as an entity except for limited purposes
 3. No voice in how business in run; for investment club impracticable

S Corporation Status

1. Created by state statute (1982); are regular corporations in legal sense
 2. Elects with IRS to be taxed as a partnership on the Federal level
 3. Perpetual existence
 4. Shareholders elect directors who set policy and hire officers
1. Shareholders must be individuals, estates and some trusts; no corps. or partnership
 2. Must have only one class of stock
 3. Fewer than 35 shareholders; raised to 75 in 1997
 4. No nonresident aliens
 5. Some states do not recognize S corp. status; pay state income tax

Limited Liability Company

1. A hybrid form filed under state statutes
 2. Partners can participate in management of business
 3. Limited liability
 3. Taxed as a partnership; flow through entity
 4. Partners may be nonresident aliens, partnerships or corporations
1. Relatively new; few court or tax cases as yet
 2. Unlimited liability may be only in your state
 3. No state statutes in all states; not recognized in all states yet

CORPORATIONS

Corporations are creatures of statute, an artificial being, existing in law only and neither tangible nor visible. It is a legal entity created and recognized by state law with rights and responsibilities. When an individual purchases a share of stock in a corporation, that person becomes a shareholder and an owner of the corporation. Responsibility of the overall management of the corporation is entrusted to a board of directors, which is elected by the shareholders. Corporate officers and other employees are hired by the board of directors to run the daily business operations of the corporation. Corporate profits are taxed by state and federal governments. Corporations can do one of two things with corporate profits; retain them or pass them on to shareholders in the form of dividends.

Incorporation Procedures

State chartering- first step is to select a state in which to incorporate in. State incorporation laws differ and it is best to select the state with the most advantageous tax or incorporation provisions.

Articles of incorporation - primary document needed to begin incorporation. Includes basic information about the corporation and serves as a primary source of authority for its future organization and business functions. It includes such things as:

- Corporate name
- Duration of existence
- Nature and purpose
- Capital structure
- Internal organization
- Registered office and agent
- Incorporators (names of people filing for business)
- Certificate of Incorporation
- First organizational meeting (adopt bylaws-rules management)

Classifications of Corporation

Domestic Corporation - a corporation is referred to as such by its home state; the state it incorporates.

Foreign Corporation - a corporation formed in one state but doing business in another state.

Alien Corporation - a corporation formed in another country, but doing business in the United States.

Public Corporation - one formed by the government to meet some political or government purpose. Cities and towns that incorporate are common examples. This also includes federal government organizations such as the US. Postal Service, Tennessee Valley Authority and AMTRAK.

Private Corporation - created either wholly or in part for private benefit. Most corporations are private. Although they may sever a public purpose, such as a utility, they are owned by private person rather than by the government.

Non-profit Corporations - corporations formed without a profit-making purpose are called nonprofit, not-for-profit or eleemosynary (charitable) corporations.

Close Corporations - is one whose shares are held by members of a family or by relatively few persons. Also called closely-held, family or privately held corporations.

S-Corporations - are regular corporations in the legal sense. S corporation status is an election filed with the IRS that gives closely held companies the ability to avoid double taxation. The S corporation becomes a flow through entity for taxing purposes. Taxable items flow through to the shareholder/owner personal tax return. (Congress enacted the Subchapter S Revision Act, 1982). Thus it has the limited liability feature of a corporation without being double taxed; corporate level and shareholder level.

Qualifications Requirements for S Corporation

- Must be a domestic corporation

- Shareholders must be individuals, estates, or certain trusts. Corporations, non qualifying trusts and partnerships cannot be shareholders.

- Must only have 35 or fewer shareholders; raised in 1997 to 75 shareholders

- Must have only one class of stock.

- No shareholder of the corporation may be a nonresident alien.

Partnerships

A partnership is an association of two or more persons to carry on as co-owner of a business for profit. It is ordinarily formed by an explicit agreement among parties (not state statutes). Courts usually look for the following three essential elements of partnership implicit in this definition:

- Sharing of profit of losses

- A joint ownership of the business

- An equal right in the management of the business

The Uniform Partnership Act governs the operation of partnerships in the absence of an express agreement and has done much to reduce controversies in the law relating to partnerships.

Except for Louisiana, all of the states including the District of Columbia have adopted the UPA.

The revised partnership act significantly changes the rules governing partnership termination by providing that a partnership no longer terminates every time a partner withdraws from the partnership.

As a general rule, agreements to form a partnership can be oral, written, or implied by conduct. Some must be in writing to be legally enforceable within Statute of Frauds. Practically speaking, the provisions of any agreement should be in writing.

Under the UPA, all partners have equal rights in managing the partnership unless stipulated differently in the agreement. Partners stand in a fiduciary relationship to one another; to act in good faith for the benefit of the partnership. The majority rule controls ordinary matters, day to day operations of business. Unanimous consent of the partners is required in changing the essential nature of the partnership; such as altering the agreement or admitting a new partner.

Since partnership is a flow through entity for taxing purposes, all income and loss items flow through to the partner's personal tax returns. The main drawback to a partnership is the unlimited liability down to the personal assets of the partnership.

Form

Essential Characteristics

Sole Proprietorship

1. The simplest form of business; used by anyone who does business without creating an organization. The owner is the business.
2. The owner pays personal income taxes on all profits.
3. The owner is personally liable for all business debts, unlimited liability.
4. Created at will by owner.
5. Legally it is not a separate entity.
6. Duration is determined by owner, automatically dissolved on owner's death.
7. Management is completely at owner's discretion.

General Partnership

1. Created by agreement of the parties.
2. Not treated as an separate entity except for limited purposes.
3. Partners have unlimited liability for partnership debts.
4. Each partner has an equal voice in management, unless otherwise provided for in the partnership agreement.
5. Capital contribution of each partner is determined by agreement.
6. Each partner pays a pro rata share of income taxes on the net profits of the partnership, whether or not they are distributed; the partnership as a flow through entity files an information return only (Form 1065 and K-1s).
7. Terminated by agreement, action of partner (e.g. withdrawal), operation of law (e.g. death or bankruptcy), or by court decree.

Limited Partnership

1. Must be formed in compliance with statutory requirements.
2. Consists of one or more general partners and one or more limited partners.
3. Only general partners can participate in management Limited partners have no voice in management.
4. General partners have unlimited liability for partnership losses; limited partners are liable only to the extent of their contributions.

Corporations

1. Created by state-issued charter.
2. Legal entity separate and distinct from its owners.
3. Shareholders have limited liability; that is they are not personally liable for the debts of the corporation.
4. Shareholders elect directors, who set policy and appoint officers to manage corporate affairs.
5. The corporation pays income tax on net profits, shareholders pay income tax on disbursed dividends. Double taxation.
6. Can have perpetual existence.
7. Share of stock can be transferred.

Other Business Forms

1. **Joint Venture-** an organization created by two or more persons in contemplation of limited activity or single transaction. Otherwise, similar to a partnership.
2. **Syndicate-** an investment group that undertakes to finance a particular project; may exist as a corporation or as a general or limited partnership.
3. **Joint Stock Company-** a business form similar to a corporation in some respects (perpetual existence, transferable shares of stock, management by directors and officers) but otherwise resembling a partnership.
4. **Business Trust-** created by a written trust agreement that sets forth the interests of the beneficiaries and obligations and powers of the trustee(s). Similar to a corporation in many respects. Beneficiaries are not personally liable for the debts or obligations of the business trust.
5. **Cooperative-** an association organized to promote an economic service without profit, to its members. May take the form of a corporation or a partnership.
6. **Limited Liability Company-** a hybrid form of business organization that has the limited-liability feature of corporations but the tax benefits of partnership. Unlike limited partners, LLC members participate in management. Unlike shareholders in S Corporation, members of LLCs may be corporations or partnerships, are not restricted in number, and may be nonresident aliens.

Legal and Tax Questions & Answers
Refer to Chapters 17 and 22

Why do we form as a General Partnership?

The General Partnership formation is:

Easy formation

Low organizational costs

flow through entity for tax purposes, no double taxation

Flexible

What about the unlimited liability that is found in General Partnership?

Many prospective partners are concerned about the unlimited liability feature in general partnerships. Personal liability is restricted to acts of a partner conducted in the course of partnership business. So if you, as a partner in an investment club, are sued due to an unrelated event, the partners and the partnership are not liable. An investment club is set up for one business activity only; buying and selling securities. As long as the club maintains this business, they greatly reduce any exposure to a lawsuit.

What about a Limited Liability Company (LLC)?

LLCs are a hybrid between a corporation and a partnership. They have the limited liability feature of a corporation without being double taxed. The IRS has ruled LLCs will be tax as a flow through entity and as such each member is responsible for their share of the club's earnings/losses on their personal tax returns. However, LLCs are a relatively new type of business formation and as such they have not been tested in either the state or tax courts. Also, not all states have statutes on their books for LLCs as yet. At last reading approximately 45 states have statutes for LLCs. Finally, the limited liability may only be available in the state you are operated the business.

What problems do we face on the state level?

All states, except Louisiana, have approved the Uniform Partnership Act or Modified Uniform Partnership Act. However, each state has slight variations, and a prospective club should investigate what the particular requirements are in their state. Most states have a limit on the number of members that a partnership can have or a dollar limit on the assets held within the partnership. As a general rule, the NAIC model partnership agreement limits the number of partners from 15 to 20. Clubs will need to file their club, as a business, in the state they operate in under the Assumed or Fictitious Name Act, however, most state securities commissions and the SEC do not require a general partnership to file as a security (several states may have some requirements).

The tax issues on a state level should also be research by the prospective club. NAIC has compiled a list of all states including any required state tax form and phone and address of the appropriate government office to contact. Eleven states have no filings; many states have a threshold that first must be met before any filing is required.

Can we change our partnership agreement or modified the sample in the Official Guide?

Again, one of the advantages of a general partnership is the flexibility of the agreement. It is never set in stone. As long as you do not break any laws in the state you operate in, the agreement can be written to meet the desires of the partners. As a rule, majority will rule when voting on day to day occurrences of the partnership. To make changes to the agreement itself or admit a new partner, a unanimous consent by all partners is necessary. As an example, review article 16A of the Mutual Club s agreement. To meet the needs of the partners, they allowed trusts to be used in the partnership. However, for the Mutual Club, which is an all male club, they stipulated that the trust can have only one grantor and trustee; the partner. This then does not allow for the chance of a female to enter the club. Mixed clubs would alter this article to allow for multiple trustees. Many clubs change the withdrawal procedures, withdrawal fees, size of club, or admittance of new partner procedure.

Can partnership have beneficiaries?

No. Beneficiaries are found in trusts or wills or are decided by the courts in the absence of any written document. An interest in a business can not have a beneficiary. You would set up a trust and put your club account in the trust. Or, the will can stipulate how the assets are distributed.

How should we pay off a deceased partner?

You would follow the same rules set in the agreement as for a full withdrawal of a partner. The assets are valued with a dollar value established on the deceased partner s account. A check is cut in the name of the deceased partner, (or however the account is listed) and mailed. This relieves the club from any exposure. The agreement must be addresses to determine how and when the account is paid out.

Why not use the Limited Partnership agreement that appears in the Official Guide?

Read the opening sentence of the agreement: This agreement of limited partnership, effective XX, by and between the undersigned as General Partners to: XXXXX and XXXX Bank, Trustee of the Individual Retirement Trust Accounts, Master Trust agreement.

This agreement was included in the Official Guide for those clubs wishing to maintain IRAs within the club. The limited portion is for the benefit of the bank that handles the IRA account. For the remaining accounts in the club, unlimited liability still exists.

What tax return is required to be file with the Department of Treasury, Internal Revenue Service?

General partnerships are required to file an informative partnership tax return Form 1065 and K-1s on all partners. The return is only informative; there is no check attached. The 1065 reports all taxable pieces earned by the club during the current year. The K-1 reports only the partner s pro rata portion of the taxable pieces. The return must be filed by April 15 for all calendar year clubs. A copy of each partner s K-1 must also be given to the partner who then commingles the amounts with their own on their personal tax return. Remember that general partnerships are flow through entities. The IRS will render extensive fines on all clubs who do not file their returns on time; \$50 per partner for up to five months. Interest penalties accrue on the fine after that point.

What are the operating rules?

Operating procedures help define the partnership agreement with addressing the detailed day-to-day operations of the club. Remember that bylaws pertain to corporations. They deal with the rules of management of the business and are filed along with other documents in the articles of incorporation.

Why is article 21, Forbidden Acts, included in the partnership agreement?

The forbidden Acts are included to help reduce the risk of liability exposure. They define acts that are not allowed by the partners. For example, article 21 (a) forbids a partner from placing the club in debt. i.e. take out a loan using the club as collateral; article 21 (b) does not allow a partner to sell or give his/her interest to an outside party without the unanimous consent of all partners; article (c) does not allow the club to purchase stock on margin.

What does article 14, Broker Account, mean?

Many clubs do not allow a broker to be a partner, or if they do, they do not act as the club's broker. Many brokerage firms also have rules on their brokers acting in a dual position. The club runs the risk of exposure to the insider trading rules and posing a possible conflict of interest.

However, this article goes on to assist the club with the buying and selling of securities without the need for all partners to sign. NAIC worked with the Securities Transfer Association to establish Rule 3.0610. This rule permits clubs operating as partnerships to transfer securities directly into and out of the club's name with the signature of only one partner.

**STATE REQUIREMENTS
FOR PARTNERSHIP TAX FILING**

STATE	PHONE #	STATE FORMS	ADDRESS TO WRITE FOR FORMS
ALABAMA	(334) 242-1000	FORM 65	Alabama Dept. of Revenue P.O. Box 327470, Montgomery 36105
ALASKA		NONE	
ARIZONA	(602) 542-4260	FORM 165	Arizona Dept. of Revenue, Corp. Audit Section 1600 West Monroe, Phoenix 85007-2650
ARKANSAS	(501) 682-7751	AR 1050	State of Arkansas Forms Dept. P.O. Box 3628, Little Rock 72203-3628
CALIFORNIA	1-800-852-5711	FORM 565	Tax Forms Request Unit, Francise Tax Board P.O. Box 307, Rancho Cordova 97541-0307
COLORADO	(303) 534-1209	FORM 106	Colorado Dept. of Revenue 1375 Sherman St., Denver 80261
CONNECTICUT	(860) 566-7033	CT-1065	Department of Revenue Services 25 Sigourney St., Hartford 06106-5032
DELAWARE	(302) 739-4231	FORM 300	State of Delaware Revenue Division P.O. Box 1401 T. Collins Bldg., Dover 19901
DIST. OF COLUMBIA			
FLORIDA	(904) 922-3676	INTANGIBLE PROPERTY TAX RETURN	Tax Payer Assistance Box 7443, Tallahassee 32314-7443
GEORGIA	(404) 656-6315	FORM 700	Georgia Income Tax Div., Dept. of Revenue P.O. Box 740399, Atlanta 30374-0399
HAWAII	(808) 587-4242	FORM N-20	State of Hawaii, Dept. of Taxation P.O. Box 259, Honolulu 96809
IDAHO	1-800-972-7660	FORM 65	Idaho State Tax Commission P O Box 56, Boise 83756-0201
ILLINOIS	(217) 782-3336	IL-1065	Illinois Department of Revenue Springfield 62794
INDIANA	(317) 486-5103	IT-65	Indiana Dept. of Revenue 100 N. Senate Ave., Indianapolis 46204-2253
IOWA	1-800-367-3388	IA 1065	Iowa Dept. of Rev. and Finance P O Box 10457, Des Moines 50306
KANSAS	(913) 296-4937	K-65	Taxpayer Assistance Bureau P.O. Box 12001, Topeka 66612-2001
KENTUCKY	(502) 564-4581	FORM 765	Revenue Cabinet Frankfort 40620
LOUISIANA		NONE	
MAINE	(207) 626-8475	FORM 1065-ME	State of Maine Dept. of Taxation 24 State House Station, Augusta 04333-0024
MARYLAND	1-800-638-2937	FORM 510	Revenue Administration Division Rev. Administration Ctr., Annapolis 21411-0001
MASSACHUSETTS	1-800-392-6089	FORM 3	Mass. Department of Revenue 100 Cambridge St., Boston 02204
MICHIGAN	1-800-367-6263	SBT	Michigan Treasury Department Lansing 48922
MINNESOTA	1-800-657-FORM	FORM M-3	Minnesota Tax Forms Mail Station 1421, St. Paul 55146-1421
MISSISSIPPI	(601) 359-3600	FORM 86-105	Mississippi State Tax Commission P O Box 960, Jackson 39205

STATE	PHONE #	STATE FORMS	ADDRESS TO WRITE FOR FORMS
MISSOURI	1-800-877-6881	FORM MO 1065	Missouri Dept. of Rev. Tax Admin. Bureau P.O. Box 840, Jefferson City 65105-0840
MONTANA	(406) 444-2837	PR-1 PARTNERSHIP	Income Tax Division, MT Dept. of Revenue P.O. Box 5805, Helena 59604-5805
NEBRASKA		NONE	
NEVADA		NONE	
NEW HAMPSHIRE	(603) 271-2192	NH 1065	New Hampshire Dept. of Rev. Admin. 61 S. Spring St., P.O. Box 637, Concord 03302-0637
NEW JERSEY	1-800-323-4400	NJ-1065	State of NJ, Dept. of Treasury Division of Taxation CN269, Trenton 08646-0269
NEW MEXICO		NONE	
NEW YORK	1-800-225-5829	IT 204	NYS Tax Dept., Taxpayer Assistance Bureau W A Harriman Campus, Albany 12227
NORTH CAROLINA	(919)733-4682	D-403	North Carolina Dept. of Revenue P.O. Box 25000, Raleigh 27640-0640
NORTH DAKOTA	1-800-638-2901	FORM 58	Office of State Tax Comm., State Capitol 600 East Boulevard, Bismarck 58505-0599
OHIO		NONE	
OKLAHOMA	(405) 521-3108	FORM 514	Oklahoma Tax Commission, Inc. Tax Division 2501 Lincoln Blvd., Oklahoma City 73194-0009
OREGON	1-800-356-4222	FORM 65	Oregon Dept. of Revenue P.O. Box 14999, Salem 97309-0990
PENNSYLVANIA	1-800-362-2050 (717) 787-8346	FORM PA-65	Commonwealth of Pennsylvania Dept. Rev., Bureau Ind. Tax, Harrisburg 17128-0509
RHODE ISLAND	(401) 277-2934	RI-1065	Division of Taxation One Capitol Hill, Providence 02908-5801
SOUTH CAROLINA	(803) 737-4705	SC 1065	South Carolina Tax Commission Box 125, Columbia 29202
SOUTH DAKOTA		NONE	
TENNESSEE		NONE	
TEXAS		NONE	
UTAH	(801) 297-2200	TC-65	Utah State Tax Commission 210 North 1950 West, Salt Lake City 84134-0270
VERMONT	(802) 828-2515	FORM 106	Vermont Department of Taxes 109 State Street, Montpelier 05609-1401
VIRGINIA		NONE	
WASHINGTON	1-800-647-7706	COMBINED EXCISE TAX RETURN	Dept. of Revenue - Taxpayer Account Admin. P.O. Box 47476, Olympia 98504-7476
WEST VIRGINIA	1-800-422-2075	BFT 120	W. Virginia Dept. of Tax & Revenue P.O. Box 3784, Charleston 25337-3784
WISCONSIN	(414) 227-4440 (608) 266-1961	FORM 3	Wisconsin Dept. of Revenue P.O. Box 59, Madison 53785-0001
WYOMING		NONE	