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## EC90-429 Legal Considerations

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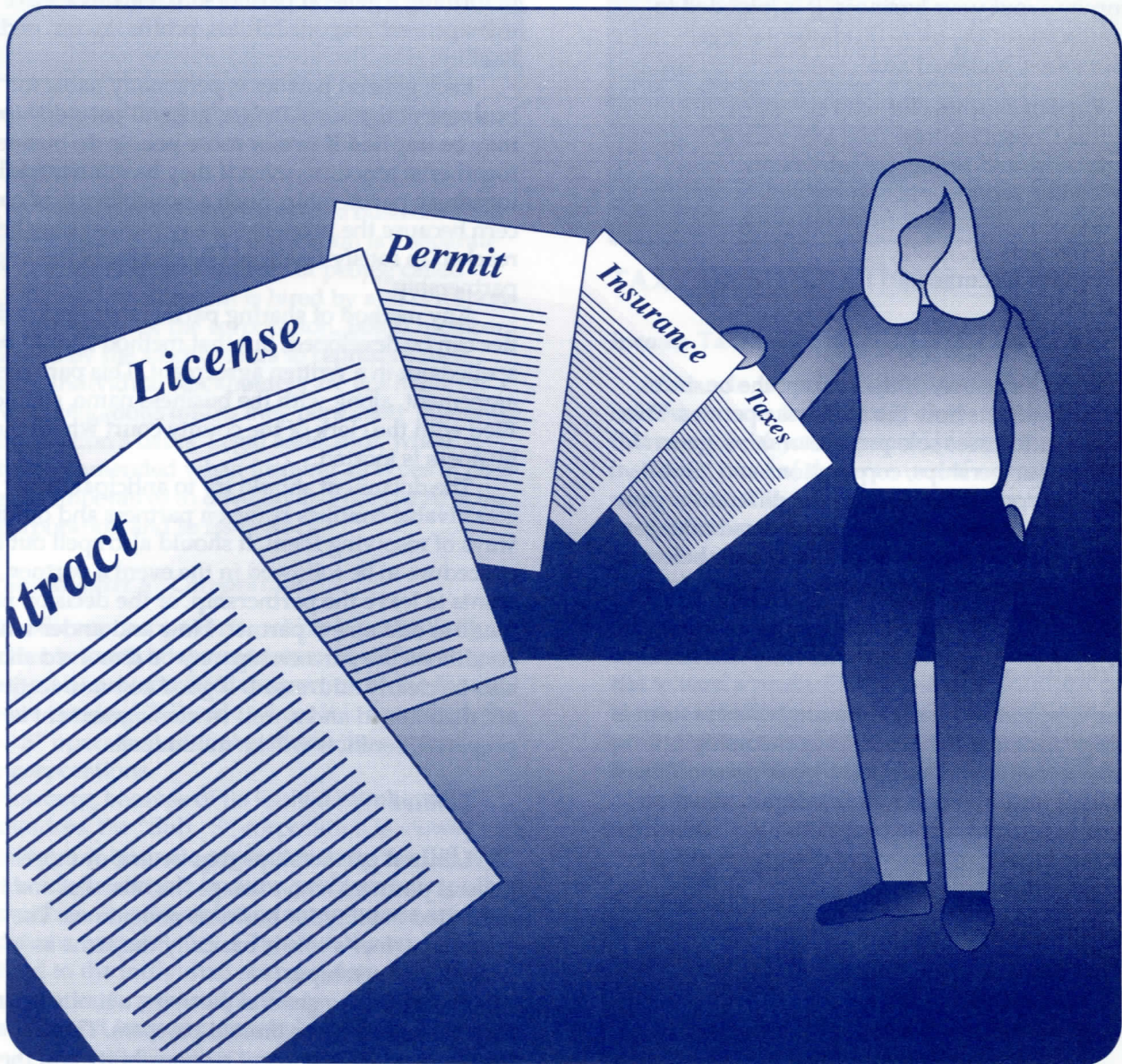
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# Legal Considerations



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# LEGAL CONSIDERATIONS

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Before starting a business, you must understand the basics of the legal environment in which businesses operate. Laws and regulations differ based on the type of business, individual situations, and many other variables.

This publication is not a substitute for consulting an attorney about your business. It is intended to point out some of the more fundamental legal considerations. Included are:

- 1) Type of Business Structure
- 2) Tax Considerations
- 3) License and Permit Requirements
- 4) Zoning Restrictions
- 5) Insurance
- 6) Contracts
- 7) Lender Documents

## BUSINESS STRUCTURES

Business structure, or the form of the business, dramatically affects how the business operates. This publication addresses sole proprietorships, general and limited partnerships, corporations and "Subchapter S" corporations. Each of the different organizational forms have advantages and disadvantages. You will need to weigh these pros and cons before beginning the new venture and decide which form best meets your needs.

### Sole Proprietorship

The simplest and most common business form is the sole proprietorship. A sole proprietorship is a business owned and controlled by one person. There are no legal requirements and few legal restrictions involved in forming a sole proprietorship. Since there is only one owner, management disagreements are avoided in this business form.

#### ADVANTAGES

- Minimum legal restriction.
- Less paperwork.
- Owner alone receives profits.
- Earnings are personally taxed.

#### DISADVANTAGES

- Unlimited personal liability.
- Limited ability to raise capital.
- Business usually terminates at owner's death.

## Partnership - General and Limited

### General

A general partnership is owned and operated by two or more people. There are few legal restrictions in forming a general partnership. Partners share management responsibilities, profits, losses, and liability.

Each general partner is personally liable for business obligations. In fact, general partnerships may be implied if two or more people do business together at any time, even if they have no intention of forming a partnership. Such a possibility is of concern because the property of any partner may be reached to satisfy financial obligations of the implied partnership.

Any method of sharing partnership responsibilities can be developed, but that method should be spelled out in a written agreement. This partnership agreement, along with the business name, should be filed with the clerk of the county court where the business is located.

The document should try to anticipate any conceivable conflicts between partners and outline ways of resolving them. It should also spell out the procedure to be followed in the event a partner wants to leave the partnership, or the decision is made to add a new partner. How and under what conditions the partnership may be dissolved should also be clearly addressed. If good communications are maintained and a well written agreement is prepared, conflicts will be minimized.

### Limited

Limited partnerships require one or more general partners who manage the business and have unlimited liability for business obligations. The general partner's role is basically the same as in general partnerships.

In addition to general partners, a limited partnership has one or more limited partners. These investors have no management responsibility and their liability is limited to the amount of their investment in the business. Under this form of business a well written, legally binding agreement is essential. A limited partnership certificate must be filed with the Nebraska Secretary of State's office (Address in Resources section).



### ADVANTAGES

- Simple to establish.
- Draw upon the financial strength of all partners.
- Losses and expenses are tax deductible.
- Earnings are personally taxed.

### DISADVANTAGES

- Unlimited liability for the general partner(s).
- Business terminates upon the death of a general partner, although not when a limited partner dies.
- In case of bankruptcy, the general partner with more personal assets will lose more.

## Corporation and "Sub-chapter S" Corporation

### Corporation

The most complex and expensive business form is a corporation. Simply, a corporation is a separate legal entity owned by a number of people called stockholders. Management is hired by and is responsible to the board of the corporation. Board members are elected by the stockholders to represent their interests. Individual stockholders are not liable for business obligations unless they personally guarantee the corporation's debts. Legal assistance, while highly recommended when forming all types of businesses, is imperative to develop and file the Articles of Incorporation and to issue stock.

### "Sub-chapter S" Corporation

Another corporate form, which is particularly attractive to small business owners, is a "Sub-chapter S" corporation. Named for the portion of the Internal Revenue Service (IRS) code where it is described, the "Sub - S" operates and is structured the same as other corporations.

However, because of its limited number of stockholders, the "Sub - S" corporation is viewed as a special type of business organization by the IRS and thus avoids the double taxation problem facing other corporations. Earnings of such corporations are not taxed at the corporate level. Instead, the tax burden is shifted to the individual shareholders. The "Sub - S" corporation is required to file tax returns allocating profits and losses to shareholders.

### ADVANTAGES

- Limited liability.
- Business continuity unaffected by death.
- Ease of ownership transfer.
- Possible income tax benefits, if profits are reinvested in the business.
- In the "Sub-S" only, earnings are personally taxed and expenses and losses are deductible.

### DISADVANTAGES

- High initial organization costs. (Due to legal fees)
- Liable for annual net asset taxes.
- State and federal laws restricting operations.
- Possible difficulty in re-selling shares.
- Double taxation. Except for the "Sub-S" (Corporation pays taxes on profits and stockholders pay taxes on the same money when received as dividends.)

## TAX CONSIDERATIONS

### Income Taxes

As a sole proprietor, partner or "Sub - S" shareholder, you can legitimately claim tax deductions that can reduce your personal income taxes. In these instances, most of the expenses of operating a business, whether in a separate location or from your home, farm or ranch, are legal income tax deductions, but you must:

1. Be in business with the intention of earning a profit, not merely as a hobby. The IRS must be satisfied that your enterprise has at least the **potential** to earn a profit. One of the tests that they use involves checking to see if the business has made a profit during three of the last five years of operation. It is also possible to convince them of this potential in other ways, but the burden of proof is on the business owner(s).
2. Register your business name with the Secretary of State's office or clerk of the county court where the business is located. (If the business is a corporation, the name will automatically be registered with the Secretary of State.)
3. Declare all sales income and be able to document revenue in case of an audit.
4. Be able to prove that you use your home or office (or a portion thereof) exclusively and regularly as your principal place of business.
5. Record and document expenses to justify deductions taken.



A partial list of currently allowable business deductions follows:

**Business Use of Your Home**

A percentage of utilities, insurance, repair, home improvement expenses, and depreciation on the buildings.

**Travel**

Some or all of your mileage; plane, train, or cab fare; meals away from home; hotel bills.

**Bad Debts**

Uncollectible debts arising from your business venture.

**Insurance**

Premiums for personal and product liability, bonding, vehicle insurance, home owner's rider for business use of the home.

**Educational Expenses**

Workshop fees, course tuition, books, subscriptions, dues to professional organizations related to the business.

**Depreciation**

Depreciation on property used exclusively in the business that has a useful life of more than one year, such as office furniture, office equipment, vehicles and computer equipment.

**Supplies**

Office equipment and supplies, product materials.

**Salaries, Wages and Benefits**

Wages, salaries and benefits for children, spouse or other employees.

**Self-Employment Tax**

The self-employment tax is the social security tax for individuals who work for themselves, such as sole proprietors, farm and ranch owner-operators, and members of a partnership. The tax is figured and reported on a schedule SE form and attached to your federal income tax return.

As of 1990, the self-employment tax rate is 15.3 percent on all earnings up to \$50,400 per year. Specific rules apply to persons who receive both wages and self-employment income.

**Other Taxes**

If you employ family members or other employees, you will be liable for various employment taxes. Rules vary according to whether the employee is a member of your immediate family and, sometimes, by type of work. For the most up-to-date information sources, see "For More Information" below and the Resources section of this publication.

Sales, production, importation or use of certain

items, such as alcoholic beverages, tobacco products, firearms, tires, communications facilities or services and others are subject to payment of federal excise taxes. To determine any excise tax liability for your business, contact the Internal Revenue Service.

**For More Information**

Consult your tax advisor and request Bulletin 334 "Tax Guide For Small Businesses", from the IRS or from an accountant who works with small businesses. The IRS also distributes an entire set of publications called "Your Business Tax Kit", which can be obtained free by calling their toll free number in Omaha, 1-800-424-1040. See the Resources section of this publication for other helpful information on this topic.

**NOTE:** Tax laws change periodically and sometimes substantially, so check with your local IRS information office or tax advisor frequently for changes in the law.

**Sales and Use Taxes**

State sales taxes are payable on sales of tangible products you produce and on sales of goods to consumers. Some sales are exempt from sales taxes, such as sales to wholesalers or other vendors. The Nebraska Department of Revenue regulates applicable state taxes. A copy of the regulations and assistance in answering specific questions can be obtained by contacting the Nebraska Department of Revenue, (see Resources).

Information on city or county sales taxes, if applicable, is also available from the Department of Revenue, or you can contact the appropriate city or county clerk's office.

**License and Permit Requirements**

Federal, state and local governmental bodies regulate business with permits, trade regulations and labeling requirements for several reasons. A prime concern is protecting the public from dangerous substances and fraud. Regulations are also created to protect businesses from unfair or illegal competition.

In Nebraska, certain types of businesses are licensed for tax purposes and must have the proper licensing in effect before conducting business in the state. Contact the Nebraska Department of Revenue office closest to you for information on these licenses. A business impacting the environment may require water or air quality permits from the Nebraska Department of Environmental Control. (Contact information for both of these agencies is included in Resources.)

Investigating various license, permit and product labeling requirements before beginning business will prevent unexpected problems later.



Businesses producing food or textile products, for example, are subject to stringent labeling requirements. Food production is also regulated by various health permits.

Some sources of information, such as the State Department of Agriculture and the University of Nebraska Food Processing Center for food products and the Nebraska Game and Parks Commission for hunting and fishing enterprise licenses, are included in the Resources section of this publication.

Consulting an attorney for advice on the proper agency or agencies to contact for information pertaining to your specific business is a good idea. State and national trade associations can also be excellent sources of licensing information. For example, the Nebraska Lodging Association and the Nebraska Bed and Breakfast Association would be useful contacts for a Bed and Breakfast business. See Resources for these addresses.

### Trademarks

A trademark may be a word, name, symbol or any combination of these, used to identify and distinguish the goods of a business from others. Trademarks are issued to legally protect the identification mark, since it would be unfair if competitors were allowed to cash in on another's business reputation by using the same name or symbol.

If you would like to be sure that no one else can use your business name or logo within Nebraska, consider registering your trade name and/or trademark with the Nebraska Secretary of State. Such registrations are currently valid for ten years and only apply to use within Nebraska. Current fees are \$100 for each registration. If your business is a corporation, any other corporation will be prohibited from using its name within the state. Therefore, additional registration of the name in Nebraska is not necessary.

If you do business in other states and want to protect your trademark there as well, you must apply to the Patent and Trademark Office of the U.S. Department of Commerce in Washington, D.C. This federal trademark registration is currently valid for twenty years.

### Patents

Patents are legal documents that give the patent holder exclusive rights to an invention. Patent rights preclude others from making, using, or selling the invention. Patents cover inventions of a mechanical or utilitarian nature. For example, if you develop a new type of machine for cleaning and packaging bird seed, you might seek to obtain a patent to protect your invention. Patents are issued for a period of seventeen years, after which they cannot be renewed.

### Copyrights

A copyright is a form of protection provided to authors of "original works of authorship" including literary and artistic works. A copyright protects authors and artists by forbidding others to duplicate or reproduce their literary or artistic work unless authorized. For example, a programmer who develops computer software might seek to have the programs protected with a copyright.

To properly protect your work, a notice must be fixed to the work consisting of the word "copyright", the abbreviation "copr" or the symbol © followed by the year of publication or creation and the name of the owner of the copyright. The copyright would appear as follows: © Jane Smith 1986.

You can also register your copyright for a small fee by contacting the Copyright Office of the Library of Congress (Address in Resources). This registration remains in effect for the life of the author plus fifty years.

### For More Information

The Nebraska Technical Assistance Center at the University of Nebraska-Lincoln College of Engineering can provide preliminary patent, trademark and copyright information. Contact information for the Center is included in Resources. For legal advice, however, you must consult a patent attorney.

Since requirements for obtaining trademarks, patents and copyrights change periodically, write for the latest information and applications to the specific sources listed in the Resources section.

### Zoning Restrictions

Zoning ordinances are created, regulated, and adjusted by city and county government. They prohibit location of certain types of businesses in the home for health or safety reasons. They also regulate the operations of businesses that are allowable under the current zoning of a property, whether it's zoned residential or commercial.

Zoning questions are usually handled by the local building inspector or a planning and zoning department of the city or county. If no such authorities exist in your community, there still may be zoning restrictions in force. Contact the city administrator or town clerk to be sure. After identifying the present zoning of the property where you intend to locate your business, research the restrictions in that zone.

Also investigate any protective covenants that may be in effect on the property. These could also restrict its business use. In some cases, the zoning authority is willing to grant a variance, but a variance must be applied for and defended in a variance hearing.



## Insurance

There are many different types of insurance. Some of the more common types which may apply to your business are:

1. *Personal Liability* - Protects against claims made by persons who suffer bodily injury on your premises.
2. *Product Liability* - Protects against lawsuits from customers using your product(s).
3. *Fire* - Can cover replacement of equipment and inventory as well as rebuilding or repairing the business location. Check your existing homeowner's insurance policy carefully to see if it will cover business use of your home. Many policies will not do so without addition of special coverages.
4. *Crime/Theft* - Reimburses for losses due to burglary, robbery, employee theft.
5. *Automobile* - Check your current auto policy to see if it covers business use of your vehicle(s).
6. *Disability* - Provides income if you are unable to work for an extended period. It is especially important if you are the major family breadwinner.
7. *Business Interruption* - Compensates for earnings lost while the business is closed due to major disasters such as fire, storm, flood or theft.
8. *Life* - Provides coverage for death or major injury. Important if you have dependents.
9. *Workers' Compensation* - By Nebraska law, if you have one or more employees, you are required to carry this coverage for them. You, as the business owner, may elect to carry workers' compensation on yourself, if you wish, by filing a written election with your insurance carrier.

It's the job of your insurance agent to help you put together an adequate and affordable insurance package for your individual business. Look for an agent who will "go to bat" for you in the event a catastrophe or lawsuit occurs. Since rates, coverages and service vary a great deal between companies, don't be afraid to shop around for the best package deal.

Because of recent high court awards, especially in areas like product liability, many insurance companies are refusing to write insurance in areas that they deem "high risk". When coverage is available, premiums are often extremely expensive. If you receive an estimate from your insurance agent that seems completely out of line with your budget, discuss with him or her how you might change your product or service to reduce potential risks and thus lower insurance costs.

Another important point to be aware of when buying insurance, is the amount of notice that your company is required to give you before canceling coverage. Abrupt cancellation can leave you unable to do business until you can find another carrier.

Read the "Notice for Cancellation" clause in the policy carefully. In some areas of the country, abrupt cancellation has recently been a major problem for certain businesses, such as licensed home day care facilities.

## Contracts

Important agreements should be in writing to have proof of the terms of the agreement. An agreement involving a significant amount of money, including the sale or purchase of goods or materials, should be in writing. In Nebraska, the following contracts **must** be written in order to be enforceable in a court of law:

- 1) A sales contract for more than \$500.
- 2) Real estate contracts, including leases for more than one year.
- 3) Contracts that cannot be performed within one year.
- 4) Promises to guarantee the repayment of another person's debts.

If such contracts are not written, it is extremely difficult (and unusual) to have them enforced in court.

If you sign a written contract, you are bound by its terms even if you don't understand them. If you have any questions regarding a contract (especially **before** you sign one), contact an attorney.

## Lender Documents

Most lenders require the usual business financial documents; a **balance sheet**, **profit and loss (income) statement**, and a **cash flow projection** to apply for credit. Some lenders will accept a business tax return for part of this information. For information on preparing and analyzing these financial documents, see the Resources section and consult a financial advisor, such as an accountant or bookkeeping service.

If a loan or line of credit is granted, the lender will require a number of documents to be signed. These may include a note, security agreement, financing statement, business form documentation, and a guarantee.

**Demand notes**, the most commonly used form of note, give the lender the right to call (demand immediate payment of) the note if they feel that the assets securing the note (collateral) or business conditions have deteriorated.

A **security agreement** gives the lender, in the case of loan default, the right to take possession of the specific assets that you have pledged as collateral to secure the loan.

A **financing statement** informs other lenders that the assets in question are already pledged, so that they will not make another loan on the same ones.



**Business form documentation** tells the lender how loans are to be handled and who can pledge business assets in your company. The lender needs this to verify that you are indeed authorized to take out a loan for your business.

A **guarantee** is a pledge of personal assets to the debt of the business. Anyone who signs such a pledge faces the possibility of losing their personal property if the business is unable to pay its obligations. Some new business owners seek to avoid guaranteeing business loans with personal assets by forming a corporation. Almost all lenders, however, will require a guarantee from the owner(s) of any newly organized corporation because the firm has no credit history to support its ability to repay the loan.

### Acknowledgments

Business owners Marilynne Bergman and Kass Riordan; Sandra D. Hatter, UNL Extension Agent; and George H. Pfeiffer, Associate Professor, UNL Department of Agricultural Economics; for their editing assistance.

### Resources

#### Publications of Interest to Small Scale Business Owners

Brabec, Barbara, "Zoning Problems of Homebased Business Owners", NATIONAL HOME BUSINESS REPORTS, Vol. VI, No.1, Spring 1986

Duffy, Margaret A. (1987) **TURN TALENT INTO DOLLARS THROUGH HOME-BASED BUSINESS**, University of Massachusetts Cooperative Extension, Amherst, Massachusetts

Edwards, Paul and Edwards, Sarah (1985) **WORKING FROM HOME**, Jeremy P. Tarcher, Inc., Los Angeles, California

Forbes, Franklin S., Jenkins, Michael D. (1988) **STARTING AND OPERATING A BUSINESS IN NEBRASKA**, Grants Pass Oregon, Oasis Press (Distributed by Nebraska Business Development Center, Publications Division, 1313 Farnam, Suite 132, Omaha NE 68182)

Internal Revenue Service. "Business Use of Your Home", Publication 587, 1989, Department of the Treasury, Washington, D.C.

Internal Revenue Service. "Tax Guide for Small Business", Publication 334 (Rev Nov. 89), Department of the Treasury, Washington, D.C.

Internal Revenue Service. "Tax Information on S Corporations", Publication 589, 1989, Department of the Treasury, Washington, D.C.

Internal Revenue Service, "Your Business Tax Kit" (Comes in versions for sole proprietors, partnerships and corporations), Department of the Treasury, Washington, D.C.

**A GUIDE TO DOING BUSINESS IN NEBRASKA** (1989) Nebraska Department of Economic Development, Lincoln, Nebraska (Free Publication: For a copy call 1-800-426-6505)

**MANAGING MAIN STREET BUSINESS: A COMPREHENSIVE MANAGEMENT EDUCATION PROGRAM FOR SMALL BUSINESS** (1990) University of Nebraska - Lincoln Extension, Lincoln NE (Notebook of materials for the six-week course. Contains worksheets on goal setting, marketing, and financial analysis. Call 1-800-332-0265 "Managing Main Street Business" for details.)

Nebraska Department of Revenue, "Nebraska Sales and Use Tax Regulations" Revised and Reissued 9/86, Lincoln, Nebraska

Niemeyer, Shirley, "Custom Sewing Business Regulations—Home Furnishings" Home Furnishings/Interiors Fact Sheet #37, (1990), University of Nebraska Extension, Lincoln, Nebraska

Rowe, Barbara R. and Bentley, Marion T., **COPYRIGHTS, PATENTS AND TRADEMARKS: A HOME-BASED BUSINESS WORKSHOP** (1989) Utah State University Cooperative Extension Service, Logan, Utah

U.S. Small Business Administration, **HOW TO BUY OR SELL A BUSINESS**, MP #16, SBA Publications, Denver, Colorado

Zetocha, Dale and Winge, Jane (1986) **HOME-BASED BUSINESS...IS IT FOR ME?** North Dakota State University Cooperative Extension Service, Fargo, North Dakota.



## Useful Addresses

Copyright Office  
Library of Congress  
101 Independence Avenue S.E.  
Washington, D. C. 20559  
(Hotline: to request application forms only  
(202) 287-9100)

Internal Revenue Service  
106 South 15th Street  
Omaha, NE 68102  
(402) 422-1500  
(Call toll free for forms and information  
1-800-424-1040)

Nebraska Bed and Breakfast Association  
Rose Ann Foster or Nora Houtsma  
c/o Bed & Breakfast of the c/o Rogers House  
Great Plains 2145 B St.  
P.O. Box 2333 Lincoln, NE 68502  
Lincoln, NE 68502 (402) 476-6961

Nebraska Business Development Centers  
University of Nebraska at Omaha  
1313 Farnam, Room 132  
Omaha, NE 68182  
(402) 595-2381  
(Call for the location of the Center that serves your  
area)

Nebraska Department of Agriculture  
P.O. Box 95064  
301 Centennial Mall South  
Lincoln, NE 68509  
(402) 471-2341  
(For food products contact: Bureau of Dairies &  
Foods (402) 471-2536)

Nebraska Department of Environmental Control  
301 Centennial Mall South  
P.O. Box 98922  
Lincoln, NE 68509-8922  
(402) 471-2186

Nebraska Department of Revenue  
301 Centennial Mall South  
Lincoln, NE 68509  
(402) 471-2971 or 1-800-742-7474

In addition, the Department maintains regional  
Taxpayer Assistance Offices. Call 1-800-742-7474 for  
the location nearest you.

Nebraska Food Processing Center  
60 Filley Hall  
University of Nebraska-Lincoln  
Lincoln NE 68583-0919  
(402) 472-5791

Nebraska Game and Parks Commission  
Attention: Jim Mitchell, Upland Game Specialist  
Wildlife Division  
P.O. Box 30370  
2200 N. 33rd St.  
Lincoln, NE 68503  
(402) 471-5439

Nebraska Lodging Association  
c/o James Moylan, Executive Secretary/Counsel  
100 Continental Building  
19th & Douglas  
Omaha, NE 68102  
(402) 341-4876

Nebraska Secretary of State  
Corporation Division  
State Capitol Bldg.  
Lincoln, NE 68509  
(402) 471-4079  
(Incorporation in Nebraska, Nebraska Trademark  
and Trade Name Registration)

Nebraska Technical Assistance Center  
W191 Nebraska Hall - UNL,  
Lincoln, NE 68588-0535,  
(402) 472-5600 or 1-800-742-8800  
(Contact for preliminary patent, trademark and  
copyright assistance)

Patent and Trademark Office  
U.S. Department of Commerce  
Washington, D.C. 20231  
(U.S. Patents and Federal Trademarks, for  
Nebraska-only trademark/tradename registration,  
contact the Nebraska Secretary of State)