

**Legal Cost of Making Money:
The Legal Process of
Starting a Sole Proprietorship in
Armenia and California**

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Abstract

Doing business is an activity which directly involves the lives of a very large majority of individuals present in an economy – entrepreneurs, employers, employees, investors, etc. Starting a business is the gateway for entering the private business sector, and the laws and rules which regulate this gateway have significant influence on the business environment of a given economy. As the sole entrepreneurship/proprietorship (used interchangeably) is the most common business organizations, this paper specifically focuses on the legal process associated with forming this type of business. Through comparing the legal process of starting a sole proprietorship in California, USA, and Armenia, the paper advances to making recommendations for facilitating sole entrepreneurship formation under Armenian law.

Keywords: Sole entrepreneurship, sole proprietorship, limited liability company, (facilitating) starting a business, reform, informal business sector

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Introduction

Each economy has laws and legal regulations on the process of starting a business, some laws being cumbersome, while others being fairly simple. Although there are various types of business organizations, small businesses generally account for a vast majority of new jobs created¹ and make up a substantial percentage of the business entities in operation².

This paper focuses on one specific type of business organization: the sole proprietorship, or the sole entrepreneurship³. First, the author takes the sole proprietorship as the most common form of doing business and studies the law of starting a business as a sole proprietor in California, USA, and the Republic of Armenia. The paper points out the relative simplicity of starting a sole proprietorship under Californian law and the administrative steps connected with becoming a sole entrepreneur under Armenian law. Afterward, the method of taxation and the tax statement forms required of sole proprietors in CA and Armenia are discussed. Finally, the paper makes recommendations as to sole entrepreneurship formation laws in the Republic of Armenia with the purpose of simplifying them, thus facilitating the process of starting a business and aiming to reduce the informal business sector in the Armenian economy.

The topic of this paper is important as it touches upon one of the fundamental activities carried out by persons in a country – business. Having a healthy economy and seamlessly regulated private business sector are important indicators of successful governance of a country. Such aspects are directly connected with the lives of a very large majority of individuals residing in the country – entrepreneurs, employers, employees, investors, and other actors in the business sector.

Further, the topic of the paper is important since it concentrates on the one aspect of business which is a gateway to having a healthy economy and well-regulated sector – *starting* a business. As noted, it singles out the business organization which is the most common form of

¹ Since 1989, small business has created 93.5 percent of all net new jobs in the United States, <http://www.nsba.biz/docs/bythenumbers.pdf>, accessed March 19, 2010

² See footnotes 15 and 16.

³ “Sole proprietorship” and “sole entrepreneurship” are used interchangeably in the paper.

doing business in Armenia. By choosing this specific subject matter as its focal point, the paper strives to discuss an issue which may influence the lives of several people.

The timeliness of this paper is attached to its ultimate aim. **Ultimately, this paper aims to facilitate the starting of business.** Being an indicator of efficient and conducive legal regulation, the ease of starting a business will in turn lead to several other positive consequences: encouraging more people to form a business organization (mainly, a sole entrepreneurship), providing an incentive for investors to make investments, raising trust towards the legal framework and the enforcement of that framework, reducing the informal business sector in Armenia, etc. All these will be outgrowths of the main thrust of this paper – discussing the issue of and propounding recommendations on *making it easier to start a business*, which remains its most important goal.

Part I: Legal Process of Sole Proprietorship/Entrepreneurship Formation

This part of the paper will focus on the legal process of forming a sole proprietorship. It will first present and discuss the concept of the sole proprietorship. Afterward, the respective laws and regulations of California and Armenia will be studied.

Chapter 1: The Concept of the Sole Proprietorship

Before presenting the legal process of forming a sole proprietorship under Californian and Armenian law, let us first introduce the concept of a sole proprietorship according to various sources.

Renowned legal dictionaries provide the following definitions of “sole proprietor”. According to Black’s Law Dictionary, a sole proprietorship is:

[a] form of business in which one person owns all the assets of the business in contrast to a partnership, trust or corporation[.] ... The sole proprietor is solely liable for all debts of the business.⁴

Other legal dictionaries define a “sole proprietorship” by distinguishing it from other types of business organizations, *e.g.*, as “a business or financial venture carried on by a single person and which is not a trust or corporation”⁵ and as “a business owned by an individual, as distinguished from ownership by a corporation, a partnership, or any form of group ownership.”⁶ Caselaw also provides a similar definition which distinguishes the sole proprietorship from other types of business organizations. “A sole proprietorship is a business form in which an individual -- rather than, for example, a partnership or corporation -- owns the business.”⁷

⁴ Black’s Law Dictionary 1392 (6th ed. 1990)

⁵ Barron’s Law Dictionary 478 (4th ed. 1996)

⁶ Mellinkoff’s Dictionary of American Legal Usage 606 (1992)

⁷ *In re San Juan Dupont Plaza Hotel Fire Litig.*, 45 F.3d 569, 573 (1st Cir. 1995)

Such definition is also mirrored in the definitions provided by organizations actively engaged in the marketplace. According to the National Futures Association, the industry-wide, self-regulatory organization for the U.S. futures industry, a sole proprietorship is:

A form of business organization in which an individual is fully and personally liable for all the obligations (including debts) of the business, is entitled to all of its profits and exercises complete managerial control.⁸

FindLaw, a leading provider of online legal information and Internet marketing solutions for law firms⁹, starts by distinguishing the sole proprietor from other business organizations, as noted above. It states that a “sole proprietorship is a one-person business that is not registered with the state as a corporation or a limited liability company (LLC)”¹⁰, *i.e.*, that the sole proprietorship is neither a corporation nor an LLC. An important aspect of the sole proprietorship is that “[it] is not considered separate from its owner,”¹¹ hence, the owner and the business entity are one and same. This bears the result that “the owner of a sole proprietorship is personally liable for the entire amount of any business.”¹² Basically, all the obligations of the sole proprietorship may be fulfilled by reaching to the personal property of the owner, even if such property has not been included in the business.

An extensive list of the advantages and disadvantages of starting a business as a sole entrepreneur is provided by Business.gov, the U.S. Government's official website for small businesses, and the U.S. Small Business Administration, an independent federal government agency:

⁸ www.nfa.futures.org/BASICNET/glossary.aspx, accessed February 26, 2010

⁹ http://company.findlaw.com/company_info.html, accessed March 18, 2010

¹⁰ <http://smallbusiness.findlaw.com/business-structures/sole-proprietorship/>, accessed February 26, 2010

¹¹ *Ibid.*

¹² *Ibid.*

*Advantages of a sole proprietorship*¹³

- **Easy and Inexpensive.** For inexperienced entrepreneurs, sole proprietorships are a practical incorporation option - they are generally the least expensive and simplest business structure. Similarly, they are also easy to dissolve if the business does not go as planned.
- **Control of Operations.** Sole proprietors are in complete control of their business. Within the parameters of business laws and regulations, owners have the right to make all operating decisions regarding their business as they see fit.
- **Receive and Allocate Income.** All income generated by a sole proprietorship is received by the owner to keep or reinvest according to their discretion.
- **Simplified taxation.** Such profits from the business flow directly to the owner's personal tax return.

*Disadvantages of a sole proprietorship*¹⁴

- **Unlimited Liability.** With the privilege of total control, sole proprietors also assume unlimited liability. Owners are legally responsible for all of their business's financial obligations, meaning the owner's personal assets can be used to help satisfy debt incurred by the business.
- **Funding Difficulties.** Sole proprietorships are often at a disadvantage when it comes to raising capital. Because sole proprietorships tend to start small and can be relatively unstable, investors are typically not drawn to them. Start-up capital is often limited to a combination of personal assets and loans.
- **Attracting Employees.** Sole proprietorships tends to be less attractive to prospective employees because they generally do not offer as many employment benefits. Also, they may have a hard time attracting high-caliber employees or those that are motivated by the opportunity to own a part of the business.

¹³ <http://www.business.gov/register/incorporation/sole-proprietorship/> and http://www.sba.gov/smallbusinessplanner/start/choosestructure/START_FORMS_OWNERSHIP.html, accessed February 26, 2010

¹⁴ Ibid

- **Non-deductible benefits.** Some employee benefits such as owner's medical insurance premiums are not directly deductible from business income (only partially deductible as an adjustment to income).

Regardless of the disadvantages, and primarily by virtue of the advantages, the sole proprietorship remains the most widespread form of doing business in several economies, including the United States (72% of all business organizations, as of 2007)¹⁵ and Armenia (55% of all business organizations, as of February 1, 2010)¹⁶. Hence, facilitating the process of starting business as a sole entrepreneur in Armenia should positively impact the business density (*i.e.*, the number of businesses as a percentage of the working age population (ages 18-65)¹⁷).

¹⁵ Table 1.— Number of Businesses, Business Receipts, Net Income, and Deficit by Form of Business, Tax Years 1980-2007, published by the IRS, <http://www.irs.gov/pub/irs-soi/80ot1all.xls>

¹⁶ Table 1.5 – General data on the legal entities (including enterprises) and sole entrepreneurs present in the state unified registry of legal entities, published by the National Statistical Service of the Republic of Armenia, http://armstat.am/file/article/sv_01_10a_150.pdf

¹⁷ *Klapper, Lewin and Quesada Delgado*, "The Impact of the Business Environment on the Business Creation Process", 2009

Chapter 2: Starting a Sole Proprietorship in California, USA

As a benchmark for the research of this paper, the legal process of starting a sole proprietorship in the USA (California specifically) is chosen. The reason for this is that the United States ranks fairly high on the ease of starting a business¹⁸ in general. Furthermore, the process for starting business as a sole proprietor is highly simplified and requires almost no registration procedure on the part of the proprietor, as described below. Given this very basic and almost no-hassle procedure, studying U.S. regulations on the matter will provide certain insight on improving the process in Armenia.

a) Registering with the state

The State of California, like several other states of the U.S., does not require registration of sole proprietors with the state. As noted on the webpage of California's Secretary of State, "[n]o formation documents are required to be filed with the California Secretary of State."¹⁹ However, the page also notes that "[o]ther state filings may be required depending on the type of business" and that regardless of not registering with the state, the sole proprietor may have to "register with the city, county or other local government entity in which the principal place of business is located." The webpage also provides its definition of the sole proprietorship as follows:

A sole proprietorship is set up to allow an individual to own and operate a business. A sole proprietor has total control, receives all profits from and is responsible for taxes and liabilities of the business.²⁰

This absence of formal registration is also affirmed by Business.gov on its webpage for all U.S. states in general, noting the following: "[u]nlike other business structures, when forming a sole proprietorship, you do not need to register your business with the state."²¹

¹⁸ According to the Doing Business 2010, a publication of IFC, The World Bank, the United States ranks 8th on the ease of starting a business.

¹⁹ <http://www.sos.ca.gov/business/be/starting-a-business-types.htm#sole>, accessed February 28, 2010

²⁰ Ibid

²¹ See footnote 6

b) *Registering with the city, county, or local governmental entity*

As to registration with the city, county, or local governmental entity, such procedures vary. This paper will not go into detail on this matter, but will suffice itself with the example of the City and County of San Francisco. In San Francisco, sole proprietors are required to register their business with the Office of the Treasurer & Tax Collector within fifteen days of starting to do business²². There are no other legal procedural requirements as to starting the business (besides obtaining necessary permits and licenses depending on the type business – which is not within the scope of this paper – and filing for doing business under a fictitious/assumed name – which is discussed below).

c) *Registering a fictitious business name*

The procedure for filing for a fictitious business name is more uniform among cities, countries, and local governmental entities. According to a California state guide²³, if a sole proprietor will be doing business under a name which does not include her/his surname (*e.g.*, Mary Johnson conducting business as “Johnson Dry Cleaning” does include her surname) or under a name which suggests the existence of additional owners (*e.g.*, “Johnson and Co.”, “Johnson and Sons”)²⁴, then the proprietor is required to register a *fictitious business name statement* (D.b.a. or “doing business as”) with the county clerk of the county of the owner’s principal place of business, or, if he has no place of business in this state, with the Clerk of Sacramento County²⁵. Fictitious names are not filed with the Secretary of State’s Office, but rather with the city and/or county clerk and/or recorder.

The filing for a fictitious business name is regulated by *Chapter 5. Fictitious Business Names*, Sections 17900-17930 of the *California Business and Professions Code* (the “Code”).

²² <http://sftreasurer.org/index.aspx?page=22>, accessed February 28, 2010

²³ Kawahara et al, “Setting Up Business in California: A Guide for Investors”, July 2009

²⁴ California Business and Professions Code (the “Code”) Section 17900(a)(1)

²⁵ Code Section 17915

The fictitious business name statement must be filed within 40 days of the commencement of business or before the statement on file expires.²⁶ Within 30 days after filing a fictitious business name statement, the registrant must publish the statement in a newspaper of general circulation in the county of its principal place of business.²⁷ The notice must appear once a week for four successive weeks.²⁸ Within 30 days of the last publishing date, the registrant must file an affidavit of publication with the county clerk's office.²⁹

The fee to file a fictitious business name statement varies depending on the county or city where it is filed.³⁰ For example, for Los Angeles County the fee for a first-time filing is \$23.00 for one business name and two registrants (owners – not applicable in case of the sole proprietor, which has one³¹ owner).³²

d) Taxation of the sole proprietor

According to the Internal Revenue Service (“IRS”), the tax collection agency of the U.S., the sole proprietor is considered as a self-employed individual. As mentioned on the webpage, a person is self-employed if s/he carries on a trade or business as a sole proprietor³³. Consequently, as a self-employed individual, one is required to file a single separate form (noted below) along with one's Form 1040, the U.S. Individual Income Tax Return³⁴. Basically, this means that the individual does not file for one's business's taxes separately, on a separate tax return, but incorporates the figures of the business in one's individual income tax return form.

²⁶ Code Section 17910

²⁷ Code Section 17917(a)

²⁸ Code Section 17924(a)

²⁹ Code Section 17917(d)

³⁰ See footnote 16

³¹ With the exception of a married couple which files a joint tax return and where both spouses actively engage in the business together. In such instances, there may be two owners.

³² http://rrcc.lacounty.gov/CLERK/Business_Name.cfm, accessed February 28, 2010

³³ <http://www.irs.gov/businesses/small/article/0,,id=115041,00.html>, accessed March 18, 2010

³⁴ <http://www.irs.gov/businesses/small/selfemployed/index.html>, accessed March 18, 2010

Along with the Form 1040, a separate schedule is filed: the Schedule C, Profit or Loss from Business form, or Schedule C-EZ, Net Profit from Business form.³⁵ Other forms may also need to be filed, depending on the business carried out. Also, unless the individual is a nonresident or resident alien and does not have and is not eligible to get a social security number (“SSN”) and unless the individual pays wages to one or more employees or files pension or excise tax returns, such individual’s SSN may be used as her/his taxpayer identification number³⁶. Essentially, this frees the sole proprietor from an obligation of registering as a taxpayer with the IRS. Along with the simple taxation procedure discussed in the previous paragraph, this aspect further facilitates commencing to do business in the U.S.

Given the discussion above, starting a business as a sole proprietor in California is quite simple:

- registration with the state is not required;
- registration with country/clerk/local gov. entity varies, may involve submitting a form, which in most cases can be done by postal or electronic mail;
- if the registrant will be doing business under a name which does not include her/his surname or which suggests the involvement of other owners, then a Fictitious Business Name Statement should be filed with the country/clerk/local gov. entity;
- the proprietor is taxed as an individual, incorporating her/his business figures into her/his own tax return submissions.

³⁵ Ibid

³⁶ Publication 334 (2009), *Tax Guide for Small Business, (For Individuals Who Use Schedule C or C-EZ)*, Ch. 1: Filing and Paying Business Taxes, <http://www.irs.gov/publications/p334/index.html>, accessed March 18, 2010

Chapter 3: Starting a Sole Proprietorship in Armenia

The legal procedure for conducting business as a sole entrepreneur in Armenia is uniform, as opposed to the variations among local governmental entities in California. It is completely regulated by laws and regulations, which may make the details of the process more accessible for prospective entrepreneurs. However, despite these aspects, the Armenian legal process does seem to be relatively more complicated and cumbersome than the Californian process.

Before discussing the legal process, let us first present the concept of the sole entrepreneur under Armenian legislation. According to the RA Law "On the Sole Entrepreneur"³⁷ (the "SE Law"):

The sole entrepreneur is the natural person who has the right to carry out activity individually, in her/his name and at her/his own risk, without forming a legal entity, with the main objective of obtaining profit (income) through using property, selling goods, performing work, or providing services.³⁸

A very important attribute of sole entrepreneurship is also set in the SE Law, which provides that "the sole entrepreneur is liable for her/his obligations by the property s/he possesses, excluding such property upon which execution shall not be levied, according to law."³⁹ This mirrors the language of Art. 27, RA Civil Code⁴⁰.

As can be noticed, the definition of the sole entrepreneur provided by Armenia law is very similar to the definition of the sole proprietor provided by the State of California. Having portrayed the essential equivalence of the CA sole proprietor and the Armenian sole

³⁷ RA Law No. HO-167, adopted on 3 Apr 2001

³⁸ Art. 1, SE Law

³⁹ Art. 9, SE Law

⁴⁰ RA Code No. 239, adopted on 5 May 1998, as amended through 16 Sep 2009

entrepreneur, let us now turn to the Armenian legal process for starting business as a sole entrepreneur.

a) *Registering with the state*⁴¹

In order to assume the capacity of a sole entrepreneur, natural persons must undergo state registration⁴². Prior to starting business, sole entrepreneurs must register with the RA State Register of Legal Entities, as provided by the RA Law “On the State Registration of Legal Entities”⁴³ (the “State Registration Law”).

The process for state registration is as follows. The registrant must submit the following for the State Register:

- petition for registration, which includes the name, passport information, place of residence and state registration, term of activity (unlimited, unless noted otherwise⁴⁴);
- photocopy of the passport;
- photograph;
- receipt of state dues payment.⁴⁵

The registrant undergoes registration at the division of the State Register corresponding to her/his place of residence or state registration.⁴⁶ The required state dues payment is three-fold⁴⁷ of the basis state due (1,000 AMD), which equals 3,000 AMD⁴⁸. The State Register is obliged to register the sole entrepreneur within two business days of submitting the documents.⁴⁹

⁴¹ As opposed to the discussion on the process in California, where “state” was used in the meaning of “a state of the United States,” as an administrative division, in this section, “state” is used in the meaning of the national government.

⁴² Art. 3, SE Law

⁴³ RA Law No. HO-169, adopted on 3 Apr 2001, as amended through 8 Jun 2009

⁴⁴ Art. 4, SE Law

⁴⁵ Art. 21(4), State Registration Law

⁴⁶ Art. 5(2), State Registration Law

⁴⁷ Art. 16(2), RA Law “On State Dues”, No. HO-186, adopted 27 Dec 1997, as amended through 17 Sep 2009

⁴⁸ Approximately \$7.80, as of February 28, 2010, \$1 = 384.65 AMD

⁴⁹ Art. 16(1), State Registration Law

b) Registering as a taxpayer

Within one month of state registration in accordance with Armenian law, sole entrepreneurs are obliged to submit a taxpayer's registration petition with the tax authorities⁵⁰.

For this purpose, the following documents shall be submitted:

- photocopy of the certificate of state registration;
- photocopies of the passport and social card (if present);
- taxpayer's registration petition filled in by the sole entrepreneur.⁵¹

The sole entrepreneur is registered as a taxpayer within one business day of submitting the documents required by Art. 8(2), Taxpayers Registration Law. Registration is conducted at the division of the tax authorities/inspectorate which serves the same territory as the division of the State Register where the sole entrepreneur was registered.⁵²

The Taxpayers Registration Law also provides for registering as taxpayers natural persons which are not sole entrepreneurs.⁵³ This provision of the law will be expanded upon in the section of the paper on recommendations for RA law reform.

Given the discussion above, starting a business as a sole entrepreneur in Armenia requires certain registration steps:

- the sole entrepreneur must first register with the State Register, submitting a petition, photograph, photocopy of the passport, and state dues receipt;
- the sole entrepreneur must then register with the tax authorities as a taxpayer, submitting a petition, photocopy of passport and social card, and a photocopy of the state registration certificate.

⁵⁰ Art. 7(1), RA Law "On Registering and Removing Organizations and Natural Persons as Taxpayers", No. 215-N, adopted on 11 Oct 2007 (the "Taxpayers Registration Law")

⁵¹ Art. 8(1)(2), Taxpayers Registration Law

⁵² Art. 7(3), Taxpayers Registration Law

⁵³ Art. 7(2), Taxpayers Registration Law

Part 2: Reforming the Process of Starting a Sole Proprietorship in Armenia

The paper presented and discussed above the legal procedural requirements of starting a sole proprietorship in California, USA and in Armenia.

For the purpose of recapitulation, the two processes are outlined below. Afterwards, legal provisions stipulating the consequences of doing business without state registration are presented, and the issue is illustrated through Armenian caselaw. Finally, on the basis of the comparison of the Californian and Armenian process, and given the drastic consequences of non-registration, certain recommendations for facilitating the starting of a business are discussed.

Chapter 4: A Brief Comparison of the Two Legal Processes

Starting a sole proprietorship in California requires:

- there is no one step that is definitively required in starting business as a sole proprietor. Instead, certain steps *may* be required, as presented below.

Starting a sole proprietorship in California may require:

- registering with the county/clerk/local governmental entity in order to start business. This requirement is usually uniform regardless of the type of business organization starting to conduct business (sole proprietor, LLC, LLP, corporation, etc.). Also, it mostly only involves submitting a form, which in most cases can be done by postal or electronic mail;
- filing a Fictitious Business Name Statement with the county/clerk/local governmental entity. This step is contingent upon the name to be used for doing business. It is required if the registrant will be doing business under a name which does not include her/his surname or which suggests the involvement of other owners;
- registration with the State of California is not required.

Registering as a taxpayer in California:

- the sole proprietor doesn't have to take certain steps to register as a taxpayer with the IRS (contingent upon business activities conducted, as provided above). Instead, s/he is taxed

as an individual, with her/his business financial figures included into her/his own tax return forms.

Therefore, starting business as a sole proprietor does not definitively require any certain step. However, steps may be required with the local governmental entity. **Depending on the county/clerk/local governmental entity and the name chosen for business, there may be *no* required steps to start conducting business as a sole proprietor, drastically facilitating the starting of a business.**

The legal process of starting business as a sole entrepreneur in Armenia is the following:

Starting a sole entrepreneurship in Armenia requires:

- submitting the documents required by statute to the RA State Register and undergoing state registration as a sole entrepreneur;
- submitting the documents required by statute to the tax authorities and undergoing registration as a taxpayer.

These two steps are mandatory by law and must be carried out by the natural person in order to assume the capacity of a sole entrepreneur.

Chapter 5: The Consequences of Non-Registration

RA law establishes legal consequences for conducting business activity without state registration (conducting illegal business activity) in the RA Code on Administrative Violations⁵⁴ (the “Administrative Code”) and the RA Criminal Code⁵⁵ (the “Criminal Code”).

According to the Administrative Code, conducting illegal business activity, which includes (but is not limited to) conducting business activity without state registration (except as provided by law), bears a fine of 15- to 30-fold of the minimum wage.⁵⁶

Conducting illegal business activity is also qualified as a crime and proscribed by the Criminal Code. According to the Criminal Code, conducting illegal business activity, which includes (but is not limited to) conducting business activity without state registration (except as provided by law) and which causes significant damage⁵⁷ to persons or organizations or the state is punished by a fine of 300- to 500-fold of the minimum wage or by two to three months of arrest or by a maximum of one-year detention, depriving of the right to hold certain offices or conduct certain activity up to a period of one year.⁵⁸ Harsher punishment may be enforced in case more damage is caused or the crime is committed by an organized group.⁵⁹

Illegal business activity is also proscribed by the RA Law “On Taxes”⁶⁰ (the “Taxes Law”). According to the Taxes Law, conducting illegal activity, which includes (but is not limited to) conducting business activity without state registration or without taxpayer registration, gives rise to a fine in the amount of 50% of the sales turnover (total income) resulting from such activity, as calculated in accordance to tax legislation.⁶¹

⁵⁴ Adopted on 6 Dec 1985, as amended through 29 Oct 2009.

⁵⁵ No. HO-528-N, adopted on 18 Apr 2003, as amended through 4 Feb 2010.

⁵⁶ Art. 169, Administrative Code; the fine equals to 15,000 to 30,000AMD.

⁵⁷ According to Art. 188(4), Criminal Code, “significant damage” is amounts to 500- to 1000-fold of the minimum wage at the time the crime was committed, equal to 500,000 to 1,000,000AMD

⁵⁸ Art. 188(1), Criminal Code; the fine equals to 300,000 to 500,000AMD.

⁵⁹ Art. 188(2)-(3), Criminal Code

⁶⁰ RA Law No. HO-107, adopted on 14 Apr 1997, as amended through 27 Oct 2009

⁶¹ Art. 26, Taxes Law

RA legislation also provides for conducting inspections for various purposes, including checking the state registration status of the individual conducting business activity.⁶² According to the Inspection Law, the person(s) conducting the inspection is obliged to notify the economic entity to be inspected at least three business days before the inspection, unless, among other cases, in the case of conducting an inspection for the purpose of checking the state registration or taxpayer registration status.⁶³ This provides legal basis for competent authorities to organize and conduct unexpected inspection of individuals conducting business activity. The repercussions of this possibility is discussed in the recommendations section.

Finally, these provisions are not dormant but are actually being enforced. Recent rulings of the RA Court of Cassation on cases involving illegal business activity include Decision on Administrative Case No. VD3/0169/05/08 (individual conducting business activity without state registration, fined in violation of Art. 26, Taxes Law), Decision on Administrative Case No. VD/0054/05/09 (individual conducting illegal business activity, case remanded). The issue is discussed in detail in the RA Court of Cassation Decision on Administrative Case No. VD2/0416/05/08. In the decision, the Court rules that, pursuant to Art. 26(2) of the Civil Code and Art. 26 of the Taxes Law:

“the natural person is obliged to register as a sole entrepreneur and to register as a taxpayer with the tax authorities in accordance to RA legislation in case of conducting any kind of business activity. Not following this requirement bears certain unbeneficial consequences for the natural person. [...] Therefore, any activity conducted by the natural person with the purpose of gaining profit, without registering and being registered as a taxpayer with the tax authorities as established, is considered to be illegal activity.”

Further, in an abovementioned case, the Court also stresses that in order to consider a specific activity to be business activity, a necessary aspect is the initial intention to gain profit, not the actual instance of gaining profit.⁶⁴

⁶² RA Law “On Organizing and Conducting Inspections in the Republic of Armenia” (the “Inspection Law”), No. HO-60, adopted on 17 May 2000, as amended through 4 Feb 2010

⁶³ Art. 3(3), Inspection Law

⁶⁴ RA Court of Cassation Decision on Administrative Case No. VD3/0169/05/08

Given the above legal provisions and case reference, it can be inferred that taking *any step in furtherance* of an initial intention to gain profit, without undergoing state registration and/or taxpayer registration, is proscribed by law and bears legal consequence, up to punishment as a crime.

Chapter 6: Towards Easier Business

Given these brief comparison and the consequences of non-registration, we can make the following recommendations for reform in Armenian law:

1. **Removing state registration of the sole entrepreneur:** The purpose for state registration of the sole entrepreneur is not clear. Specifically, it is not clear what added value requiring such a step would have.

In contrast to registering legal entities (*e.g.*, LLC) where the State Register carries out the function of checking and validating the documents submitting by the registrant, in the case of the sole entrepreneur, the State Register does not check/validate the documents submitted by the registrant (*i.e.*, photocopy of passport (if present), petition, state dues, and photograph). The State Register is obliged to register the registrant in the state unified register within two working days of document submission, making registration of sole entrepreneurs a technical task. Given the technical nature of this step, it burdens the state with unnecessary expense to carry out this procedural function.

Further, given the legal proscriptions of so-called “illegal business activity” (which covers business activity which would have been legitimate but for the fact that the individual conducting such activity has not undergone registration as provided by law), burdens the process of starting a business with a bureaucratized and heavily regulated framework which rests on a presumption of guilt. That is, requiring business individuals to register and punishing them if they fail to register presumes that individuals, if left out of state oversight (operating in the “black market”), will necessarily resort to illegitimate business activity (in the sense of conducting activity which is illegal in essence/content) and will evade taxes.

Moreover, the legal framework allows for discretionary targeting of individuals conducting illegal business activity. This statement is not based on statistical evidence, but is analytical and hypothetical in nature. The Inspection Law allows for inspections of business individuals without providing definitive criteria on when and in which specific cases such

inspections should be conducted. This lays ground for discretionary and predatory inspection of select business individuals which, again, may be found to be conducting “illegal business activity” simply because they have not undergone proper state registration, but are otherwise conducting business activity which is completely legitimate (the subject of which is not prohibited by law). This further strengthens the statement that the current regulatory framework rests on a presumption of guilt and unnecessarily burdens the process of starting a business. This, in turn, may be a significant disincentive for entrepreneurs to launch a business and for investors to invest, thus negatively impacting the condition of the economy.

Hence, it is advisable to *remove the requirement of state registration with the State Register* (or, alternatively, transfer the function to the tax authorities), saving the state budget much-needed resources which can be directed to more important purposes.

- 2. Reference to State Registration Law in SE Law *or* Separate law for sole entrepreneur registration:** Even if the state registration requirement is not removed, there is another issue that should be dealt with. Sole entrepreneurs are considered natural persons (inseparable from their owners, *i.e.*, the owner and the sole entrepreneurship are one and the same natural person). However, the process for starting a sole entrepreneurship is set out and regulated by the State Registration Law (as defined above), the full name of which is “RA Law on the State Registration of Legal Entities”. This may cause much confusion⁶⁵ with prospective sole entrepreneurs regarding their qualification under law (as natural persons instead of legal persons) and thus dilute the notion that they are inseparable from the sole entrepreneurship (and hence bear full personal liability for their business’s obligations).⁶⁶

A solution for this would be, preferably, to have a separate law on the state registration of sole entrepreneurship as natural persons (in the case that *Recommendation 1* is not followed).

⁶⁵ As was caused during the research conducted for this paper.

⁶⁶ To be more specific, the legal entity is an entity under law which is distinct from its owners; the sole entrepreneurship, a natural person, is not. Regulating the sole entrepreneurship registration process through a law which makes reference to state registration of *legal entities* may leave the impression that the sole entrepreneurship is also a legal entity, separate from the owner, which, clearly, is not the case.

Alternatively, the name of the State Registration Law may be changed to, for example, RA Law on State Registration of Legal Entities and Sole Entrepreneurs⁶⁷.

As a last resort solution – which, however, will not address the problem referred to above (impression of distinction of sole entrepreneurship and owner) but will guide the prospective sole entrepreneur in state registration – is including a reference to the State Registration Law in the SE Law. This will allow the registrant to find the respective regulation with relative ease.

- 3. Submitting registration documents (undergoing state registration) for sole entrepreneurship with tax authorities:** According to law, the sole entrepreneur must register as a taxpayer with the respective division of the RA Tax Inspectorate within 30 days of state registration as a sole entrepreneur. Although the state registration is conducted within two business days and the taxpayer registration within one business day, requiring two separate registration actions of the registrant creates substantial hassle.

Instead of requiring the registrant to visit two agencies for two separate registrations, it is advisable to legally provide for submitting state registration documents with the tax authorities (again, contingent upon disregarding *Recommendation 1*). Since the sole entrepreneur is nevertheless obliged to register with the tax authorities (a process which, in contrast to state registration, bears certain merit and is warranted, but the removal of which is also considered below in *Recommendation 4*), the law might as well join taxpayers and state registration into one process, carried out through the tax authorities.

This will save the registrant of the trouble of visiting two agencies, while ensuring that the state obtains the documents necessary for taxpayers and state registration. However, in order not to burden the tax authorities with a new function, either of the following steps may be taken:

⁶⁷ The object of the law covers not only commercial legal entities but also not-for-profit legal entities (NGOs, foundations, etc.). The sole entrepreneur is the only entity covered by this law which is not a legal entity, and this warrants the explicit inclusion of “sole entrepreneur” in the title of the law.

- a) the tax authorities may transfer the state registration documents to the (respective division of the) State Register, where the sole entrepreneur will be registered and entered into the state unified register; or
- b) the tax authorities may simply transfer the statistical data (e.g, number of sole entrepreneurs registered as taxpayers) to the State Register for statistical purposes.

If the main (or sole) merit of state registration is for statistical purposes (as supposed in recommendation (b) above), then the necessity for submitting state registration documents will be disqualified (as propounded in *Recommendation 1*) and the registrant may simply notify the tax authorities of its intention to register as a sole entrepreneur taxpayers (as is required by statute). This much alone – simply notifying of intention to do business as a sole entrepreneur instead of submitting state registration documents – is sufficient to gather and provide statistical data to the State Register.

4. **Removing taxpayers registration of the sole entrepreneur:** The paper recommends this step tentatively and with precaution, haven't fully researched the merit of taxpayers registration or the consequences of removing taxpayers registration with the tax authorities. Therefore, although presented as *Recommendation 4*, this is more accurately a suggestion for consideration and discussion, not a straightforward recommendation.

The Taxpayers Registration Law (as defined above) provides for the voluntary registration of natural persons as a taxpayer. The documents required for such registration are the same as for those required of a sole entrepreneur minus the photocopy of the state registration certificate⁶⁸. Thus, if *Recommendation 1* is followed, the registration requirements of sole entrepreneurs and natural persons not registered as sole entrepreneurs would be identical.

One option is to have natural persons which intend to do business as sole entrepreneurs to check a specific box on the taxpayers registration petition, thus differentiating them from

⁶⁸ Art. 8(1)(3), Taxpayers Registration Law

other natural persons undergoing voluntary registration and automatically conferring upon them “sole entrepreneur” capacity.⁶⁹

Another option would be, as noted in the title, to remove taxpayers registration altogether (as is under the laws of California). As mentioned above, this is a tentative suggestion made with precaution. Instead of requiring prior registration, individuals opting to conduct business in the capacity of a sole entrepreneur are obliged to make a respective note (*e.g.*, check the respective box) in their individual tax return forms which will include their business figures. Alternatively, the sole entrepreneur may submit an appendix attached to her/his individual tax return form, filing for taxes on his business activity. When asked whether it is preferable to remove the state registration requirement (as suggested in *Recommendation 1*) or the taxpayer registration requirement (as suggested in this recommendation), practicing business lawyer Mr. Hakob Martirosyan noted that removing the taxpayer registration requirement is more beneficial, as the issuing of a taxpayer’s identification code can be issued by the State Register upon registration of the natural person as a sole entrepreneur.

Joining *Recommendation 1* and *Recommendation 4* will drastically facilitate the legal process of starting business as a sole entrepreneur in Armenia, effectively removing the procedural requirements – state registration and taxpayers registration. Natural persons will be able to assume the capacity of a sole entrepreneur simply by notifying the tax authorities of this intention through their individual tax return filings.

⁶⁹ This will not “remove taxpayers registration”, as noted in the title of this recommendation, but would nonetheless facilitate the process of starting business as a sole entrepreneur.

The Bottom Line: A Conclusion

As discussed above, the legal process for starting a business in California has almost no requirements, while the process in Armenia stipulates a set of obligatory steps.

In the U.S., namely California, there may be no required steps to start conducting business as a sole proprietor, depending on the county, clerk, or local governmental entity and the name chosen for business. To the contrary, the Armenian process necessarily requires registration with the state at the State Register and registration as a taxpayer with the tax inspectorate.

The law is quite strict as to conducting illegal business activity, which is proscribed as an administrative offense and as a crime (if it causes damage exceeding a certain amount). It is important to note that an activity may still be considered illegal if the individual conducting such activity has not undergone due state and taxpayer registration, even though the subject of the business activity may be perfectly legitimate as to law but for non-registration. An individual conducting such activity not only bears the risk of being subject to an administrative penalty or criminal punishment, but also of being subject to discretionary inspections and a fine of 50% of the gross income resulting from such activity as unpaid taxes. Considering these measures, the regulatory framework for enforcing sole entrepreneur (state and taxpayer) registration rests on a presumption of guilt, *i.e.*, that although an individual may be conducting activity which is otherwise legitimate, the very fact that s/he has not registered (is not formally recorded on the state's "map") ascribes a wrong to her/him actions, making her/him liable for an administrative offense or worse, a crime.

Given such legal regulations – the mandatory process of starting a business and the consequences of failing to satisfy such requirements – certain recommendations have been made to facilitate commencing a business. One recommendation suggests removing the state registration requirement, which will not only make the process of starting a business easier, but will also ease the legal enforcement of that process (to the extent that an individual conducting legitimate business activity will not be in violation of law simply for not registering with the

state). A second recommendation suggests removing the taxpayers registration requirement, instead requiring sole entrepreneurs to file their tax returns with the tax inspectorate as individual. Another recommendation was revoking neither process, but instead combining the two – either entrusting the State Register to organize for taxpayers registration, or confiding the tax authorities of accepting and transferring the documents for state registration to the State Register.

All three recommendations are tentative in nature, and instead of being insisted, they are merely propounded for further discussion. Starting a business should be stripped of any legal requirement which unnecessarily burdens it. In facilitating this process, a strict cost-benefit approach should be assumed. Does the benefit provided by a specific legal requirement, *e.g.*, state registration outweigh the cost it incurs? If not, than such legal requirement should be revoked. Eventually, only those requirements should be left intact which are strictly necessary for state administration, tax collection, and market regulation. By reaching this level of ease of doing business, we will have clarified and raised trust towards the regulatory framework and enforcement of that framework, provided incentives for investors to invest and for business individuals to turn into sole entrepreneurs, reduced the informal business sector, and, **ultimately, vastly simplified the process of starting a business.**

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