

# **CHOICE OF BUSINESS ENTITY**

*Presented by*

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## Choice of Business Entity

### I. OVERVIEW

One of the most important decisions a business can make is which type of entity to use. Most clients wish to avoid personal liability for the obligations of the business (an attribute of corporations) and may also wish to personally deduct the losses of the business and avoid double taxation of the income of, and distributions from, the business (attributes of partnerships). For businesses with these objectives, the LLC may offer the best of both worlds. An LLC is treated as a partnership for tax purposes. At the same time, LLC members, like corporate shareholders, are not personally liable for the debts of the business.

Clients already operating businesses in partnership form may wish to convert to an LLC. Statutory conversion gives the attorney the option to convert an existing partnership to an LLC rather than forming a new entity to operate the business and merging or dissolving the partnership in a reorganization transaction. However, a corporation may not be converted to an LLC by statutory conversion. See chap 12.

For attorneys, accountants, and architects, the best form of entity may be the LLP. This entity offers both the elimination of vicarious liability of partners for partnership liabilities and the pass-through treatment of income and loss.

#### A. Sole Proprietorship

A sole proprietorship is nothing more than a business in which an individual engages in business personally rather than by means of a separate entity such as a corporation. The sole proprietorship avoids many of the formalities and reporting requirements associated with other forms of business organization. Because the proprietor is personally liable for the obligations of the business, a limited liability entity such as a corporation or an LLC may be an attractive alternative.

California permits the formation of single-member LLCs. Corp C §§17001(t), 17050(b). A single-member LLC is treated as a sole proprietorship for federal and California income tax purposes unless the LLC elects to be treated as a corporation.

## **B. Corporation (Including S Corporation)**

A corporation is a limited liability entity in that none of the owners (i.e., shareholders) is typically liable for the corporation's obligations by reason of being a shareholder. Corporations formed under California law are governed by California's General Corporation Law (Corp C §§100-2319).

The income of a corporation (unless the corporation is an S corporation; see below) is taxable, by both federal and state governments, at the corporate tax rate. See §2.22. Thus, a corporation and its shareholders are subject to "double taxation" because (1) the corporation pays tax on its income and is not allowed to deduct as an expense the dividends issued to shareholders, and (2) the shareholders pay tax on dividends received from the corporation.

Double taxation may be minimized in certain cases by the payment of salaries to shareholders and the use of shareholder loans. See §2.22. In addition, a corporation that retains most of its income may benefit from the corporate tax structure because the marginal rates applicable to corporations may be lower than the marginal rates applicable to individuals. See §2.22.

Qualifying corporations may ameliorate the effect of double taxation by making an S corporation election. See §§2.27-2.33. If a corporation makes a valid S corporation election, the corporation's net profits, losses, and tax credits are passed through (and taxed) for federal tax purposes to the corporation's shareholders without being taxed to the corporation. Thus, S corporations are treated similarly, but not identically, to partnerships.

There are certain restrictions on a business's ability to qualify as an S corporation:

To qualify as an S corporation, a corporation may not (IRC §1361):

--Have more than 75 shareholders;

--Have anyone other than an individual, an estate, a tax-exempt organization, or certain trusts as shareholders (corporate and partnership shareholders are not permitted);

--Have a nonresident alien as a shareholder;

- Have more than one class of stock, except that differences in voting rights are permitted;
- Be an insurance company;
- Be a foreign corporation;
- Be a domestic international sales corporation; or
- Have an IRC §936 election in effect (involving Puerto Rico and possession tax credit).

Once an S election is made, failure to meet the requirements will terminate the S election, which means that S corporation status may be inadvertently terminated. IRC §1362(d)(2). Once terminated, the election may not normally be made again for five years. IRC §1362(g).

### **C. General Partnership**

A partnership is an association of two or more persons to carry on as co-owners a business for profit. Corp C §16101(7). A partnership is an entity distinct from the partners. Corp C §16201. A change in partnership membership alone does not terminate the partnership. Corp C §§16701, 16801.

A general partnership has the following characteristics:

Each partner is an agent of the partnership and can bind the partnership in its ordinary course of business (Corp C §16301(1));

Each partner is personally liable for the obligations of the partnership (Corp C §16306); and

The partnership may be dissolved by the express will of at least half of the partners (Corp C §16801(1)).

A joint venture is an entity formed for a limited or temporary business purpose. Joint ventures have generally been treated as general partnerships under California law. LLCs may, however, become the entity of choice for many limited purpose business ventures.

A general partnership is generally not subject to federal income tax or California income or franchise tax.

#### **D. Limited Partnership**

A limited partnership is a partnership with one or more "limited partners" (partners designated in the agreement as limited partners who do not participate in the control of the business and who are not personally liable for the obligations of the partnership) and one or more "general partners" (partners who actively engage in the management and control of the business and who have unlimited personal liability for the obligations of the partnership). Corp C §15611®).

Limited partnerships formed in California on and after July 1, 1984, are governed by the California Revised Limited Partnership Act (CRLPA), codified in Corp C §§15611-15723. Limited partnerships formed in California before July 1, 1984, that have not elected to be governed by the new Act are governed by the California Uniform Limited Partnership Act, found in Corp C §§15501-15533. See Corp C §§15710-15714.

A limited partnership, like a general partnership, is generally not subject to federal or California income tax. Limited partnerships usually choose to be taxed as partnerships.

Unlike a general partnership, a limited partnership is subject to an annual franchise tax of \$800. Rev & T C §§17935, 23153.

#### **E. Limited Liability Partnership**

California authorizes the formation of LLPs by attorneys, accountants, and architects. Corp C §§16101, 16951-16962.

An LLP is a form of general partnership in which the liability of each partner may be limited. Under most LLP statutes, a partner is relieved of liability for the negligence, wrongful acts, and misconduct of another partner and of employees and agents of the LLP. Under the LLP statutes of many states other than California, partners are not relieved of liability for their own negligent or wrongful acts or misconduct or for the negligent or wrongful acts or misconduct of any person acting under their direct supervision and control. In most states, partners of an LLP remain liable for the contractual obligations of the partnership. In California and New York, partners in an LLP may avoid liability for contractual obligations as well. California's LLP law is unique in that a partner is liable for the partner's own torts but is not liable for the tort of another agent of the LLP merely by reason of the partner's supervision or control over the other agent. Corp C §16306(b), (e).

The partners in an LLP may agree by majority vote, or a different vote required in the partnership

agreement, to be liable as partners for specified obligations. Corp C §16306(d). In addition, a partner may guarantee or provide collateral for obligations of an LLP. Corp C §16306(h). In the case of an LLP engaged in the practice of law, the shield from liability afforded by an LLP does not apply to claims based on acts, errors, or omissions arising out of the rendering of legal services unless the LLP has a currently effective certificate of registration issued by the State Bar. Corp C §16306(f). See §2.13.

Other than for changes to its partnership agreement and compliance with filing, registration, and financial security requirements dictated by §§16951-16962, a California LLP is governed by California's general partnership statute (Corp C §§16100-16962) if it is a domestic partnership and by the foreign state or other jurisdiction's partnership laws if it is a foreign partnership transacting intrastate business in California.

A California LLP generally should be treated as a partnership for federal and California income tax purposes

## **F. Limited Liability Company**

An LLC is an unincorporated business organization whose members do not have personal liability for the debts of the LLC. LLCs formed in California are governed by the Beverly-Killea Limited Liability Company Act (Corp C §§17000-17655).

Like a partnership, an LLC is generally not subject to federal or California income tax.

An LLC doing business in California must pay an annual franchise tax of \$800, plus a statutory fee for any year in which the LLC's total income (essentially defined to mean gross revenues) is \$250,000 or more. Rev & T C §17942(a).

An LLC has certain advantages over a limited partnership and certain disadvantages. Although a limited partnership allows pass-through tax treatment, flexibility in financial structuring, and limited liability for limited partners, at least one person, i.e., a general partner, must be fully liable for the obligations of the business, and limited partners may not take part in the control of the business without jeopardizing their limited liability (although the two of you may effectively control the business through the general partner S-corporation that the two of you would own).

Unlike a limited partnership, no LLC owner ("member") need be personally liable for the business' obligations, and each member is permitted to manage the company and to take part in the control of its business without losing the member's limited liability. Only one information tax return needs to be prepared

each year which will result in some small savings on accounting fees. LLCs operating in California have one major disadvantage when compared to limited partnerships, however: the gross receipts tax.

An LLC must pay a tax of \$800 per year for the privilege of being an LLC regardless of gross receipts or net income. Rev & T C §17941. This amount is equal to the minimum tax imposed on corporations, including S corporations (Rev & T C §23153(a)), on limited partnerships (Rev & T C §17935(a)), and on limited liability partnerships (Rev & T C §17948(a)). New corporations are not required to pay the minimum franchise tax for their first taxable year, but this exception to paying the \$800 annual minimum tax does not apply to new LLCs. Rev & T C §23153(f).

Neither an LLC or a limited partnership pays any net income tax, but unless the LLC has total income of less than \$250,000, the LLC must pay an annual fee based on the total income (from all sources reportable to California) for the taxable year. This annual fee is in addition to the \$800 tax discussed above.

An LLC that elects treatment as a partnership for federal tax purposes will be treated as a partnership for California tax purposes as well. California subjects all LLCs doing business in California to an annual fee based on total income (which is defined to essentially mean gross revenues), as set forth in the following table (Rev & T C §17942):

\$900 for an LLC with annual total income of \$250,000 to \$499,999;

\$2500 for an LLC with annual total income of \$500,000 to \$999,999;

\$6000 for an LLC with annual total income of \$1,000,000 to \$4,999,999; and

\$11,790 for an LLC with annual total income of \$5,000,000 or more.

## **II. GENERAL BUSINESS FACTORS IN SELECTING MOST APPROPRIATE FORM OF ENTITY**

### **Ease of Formation; Transaction Costs**

The ease of forming a business enterprise and the associated costs depend more on the scope and complexity of the specific business venture than on the chosen form of entity. A general partnership formed to engage in a complex transaction, with detailed allocations of profits and losses and sophisticated management controls, may be much more complicated and costly to form than a one-shareholder corporation engaging in a simple business.

The simplest form of business organization is the sole proprietorship, discussed in §2.3. Because no filings, fees, or minimum annual taxes are required to establish and operate a sole proprietorship, its characteristics are not compared with those of the other forms of entities in the following sections.

## **1. Corporation**

Although corporations may be subject to more formalities than other entities, they may be the simplest and least expensive to form—primarily because the parties need not negotiate a detailed agreement governing the structure and operation of the corporation but may instead rely on the provisions of the General Corporation Law (Corp C §§100-2319). A detailed agreement or specially drafted articles of incorporation may be required, however, if the parties want to restrict the transferability or voting rights of corporate stock or provide for different classes of stock.

A corporation is formed by filing articles of incorporation with the California Secretary of State. Corp C §200. The articles must be signed and filed by the incorporator, who need not be a shareholder. Corp C §200(b). The filing fee is \$100. Govt C §12186(c). No minimum franchise tax must be paid when the articles are filed. Rev & T C §§23153, 23221(f). Estimated tax based on income must be paid by the fifteenth day of the fourth month of the corporation's first taxable year. Rev & T C §§23151, 19025.

After formation, directors must be elected by the shareholders or appointed by the initial incorporator (Corp C §§164, 300-317), officers must be appointed by the directors (Corp C §312), bylaws should be prepared and adopted (Corp C §§211-212), and shares of stock must be issued to the shareholders (Corp C §§400-423). The election of directors and officers, adoption of bylaws, initial issuance of corporate shares, and other organizational matters should be reflected in organizational minutes.

Within 90 days after filing the articles of incorporation, the corporation must file with the Secretary of State a Statement by Domestic Stock Corporation, providing the names and addresses of the corporation's directors and executive officers, the general nature of the corporation's principal business activity, and the address of the corporation's principal business office. Corp C §1502.

## **2. General Partnership**

Considering only formalities, forming a general partnership is simpler than forming a limited partnership, a corporation, or an LLC because neither a certificate nor articles is required. The partners should, however, enter into an agreement concerning the terms and conditions of their business association, because California's general partnership statute (Corp C §§16100-16962) provides only a skeletal framework for the operation of the partnership. Although it is advisable for the agreement to be in writing,



no such statutory requirement exists. The cost and complexity of the agreement depend on the structure of the partnership and the nature of its business. Depending in part on the number of parties and their respective roles in the venture, completing the agreement may involve extensive and extended drafting and negotiating (and, therefore, significant attorney fees).

Unlike limited partnerships and LLCs, general partnerships are not required to pay a minimum \$800 annual franchise or privilege tax to the State of California.

### **3. Limited Partnership**

A limited partnership is formed by filing with the Secretary of State, on the prescribed form (Secretary of State Form LP-1), a Certificate of Limited Partnership executed by all the general partners of the limited partnership. Corp C §§15621(a), 15624(a)(1). The filing fee is \$70. Govt C §12188(b).

Either before or after filing the certificate, all the partners must enter into a limited partnership agreement. Corp C §15621(a). The California Revised Limited Partnership Act (CRLPA) (Corp C §§15611-15723) permits the agreement to be oral. Corp C §15611(y). It is advisable for the agreement to be in writing, however, and it must address all material issues among the partners. The cost and complexity of the agreement depend on the partnership's structure and business.

Limited partnerships doing business in California are required to pay an annual franchise tax of \$800 for the privilege of doing business in California. Rev & T C §§17935, 23153(d)(1). Limited partnerships are not required to pay the tax when the certificate of limited partnership is filed; tax is paid on the due date of the limited partnership's tax return. Rev & T C §17935.

### **4. Limited Liability Company**

An LLC is formed by filing, on the prescribed form (Secretary of State Form LLC-1), articles of organization with the Secretary of State. Corp C §17050(a). The articles must be signed and filed by the organizer of the LLC, who need not be a member or manager of the LLC. Corp C §17050(a). The filing fee is \$70. Govt C §12190(b).

Either before or after filing the articles of organization, all members of the LLC must enter into an operating agreement. Corp C §17050(a). Although the operating agreement may be oral (Corp C §17001(ab)), it is advisable that the agreement be in writing, and it is essential that it address all material issues among the members. The cost and complexity of the agreement depend on the nature of the LLC and its business. As with partnership agreements, completing the LLC operating agreement may involve

extensive drafting and negotiating.

Within 90 days after filing the articles of organization, the LLC must file with the Secretary of State a Statement of Information (Secretary of State Form LLC-12), providing the name and address of the LLC's managers (if a manager-managed LLC) or its members (if a member-managed LLC), the general nature of the LLC's principal business activity, the name and address of the LLC's agent for service of process, and the address of the LLC's principal business office. Corp C §17060.

An LLC doing business in California is required to pay an annual franchise tax of \$800 for the privilege. Rev & T C §§17941(a), 23153(d)(1). Like limited partnerships, LLCs are not required to pay the tax when filing articles of organization; instead, they must pay it on or before the 15th day of the fourth month of the LLC's taxable year. Rev & T C §17941(c).

## Choice of Business Entity Tax Factors Comparison Chart

	<i>C Corporations</i>	<i>S Corporations</i>	<i>Partnerships</i>	<i>Limited Liability Companies</i>
1. Pass-through tax treatment ( <i>i.e.</i> , do the entity and its owners avoid "double taxation" on the earnings of the entity)?	No	Yes	Yes	Yes
2. Must the entity be structured to possess pass-through tax treatment?	N/A	No	No	No
3. S Corporation restrictions:				
(a) May the entity have more than 75 owners?	Yes	No	Yes	Yes

	<i>C Corporations</i>	<i>S Corporations</i>	<i>Partnerships</i>	<i>Limited Liability Companies</i>
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(b) May the entity have owners other than individuals, estates, and certain trusts (e.g., corporate or partnership owners)?	Yes	No	Yes	Yes
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(c) May the entity have nonresident alien owners?	Yes	No	Yes	Yes
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(d) May the entity have more than one class of stock or other ownership interest?	Yes	No (however, differences in voting rights are permitted)	Yes	Yes
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	<i>C Corporations</i>	<i>S Corporations</i>	<i>Partnerships</i>	<i>Limited Liability Companies</i>
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(e) May the entity be a member of an affiliated group (e.g., may the entity own subsidiaries)?	Yes	No (wholly owned S Corporation disregarded as separate entity; may own C Corporation subsidiaries but may not file consolidated return).	Yes	Yes
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4. Are contributions to capital taxed:

(a) To the entity?	No	No	No	No
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(b) To the contributor?

*C Corporations S Corporations Partnerships Limited Liability Companies*

(1) Property	Unless tax-free under IRC §351, a contributor will be taxed on the contribution of appreciated assets to a corporation.	Same as C Corporation.	Contribution of appreciated assets to a partnership may generally be made on tax-free basis.	Same as partnership (property of single-member LLC treated as owned by member).
(2) Services	Contribution of services for corporate stock is taxable under IRC §83; tax may be deferred if stock is subject to restrictions.	Same as C Corporation.	Contribution of services in exchange for a profits interest in a partnership is generally not taxable. Contribution of services in exchange for interest in the capital of a partnership may be taxed.	Same as partnership (services contributed to single-member LLC treated as services for member).
5. Method of accounting	C CorpS must generally use the accrual method unless gross receipts are less than \$5 million, and except for qualified pers	An S Corporation may use the cash method unless it is a "tax shelter."	A partnership may use the cash method unless (I) it has a C Corporation as a partner and gross receipts greater than \$5 million, or	An LLC may use the cash method unless it is a "tax shelter" (single-member LLC uses member's method of accounting).

service corp.

(ii) it is "tax shelter."

	<i>C Corporations</i>	<i>S Corporations</i>	<i>Partnerships</i>	<i>Limited Liability Companies</i>
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6. Taxable year	Fiscal year of the corporation's choosing, regardless of the taxable year of the corporation's owners (unless a personal service corporation).	Generally, the calendar year.	A partnership's taxable year must correspond to the taxable year of its majority or principal partners; if the majority or principal partners do not all have the same taxable year, the partnership must generally use the calendar year.	Same as partnership (single-member LLC uses same taxable year as member).
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7. Double tax on liquidation?	Yes	Yes	No	No
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8. Partnership tax features:

(a) May the entity make special allocations and pass through tax losses?	No	No	Yes	Yes (N/A to single-member LLC).
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*C Corporations S Corporations Partnerships Limited Liability Companies*

(b) May the "inside" tax basis of the entity's assets be stepped up on the death of an owner or on the transfer of an ownership interest?	No	No	Yes	Yes (N/A to single-member LLC).
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(c) Is an owner's basis in its interest in the entity increased by the owner's share of the entity's debt?	N/A	N/A	Yes	Yes (debts of single-member LLC treated as obligations of member).
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9. California tax treatment	Subject to California franchise tax. Must pay minimum tax of \$800 per year (no minimum tax in first year).	Pass-through entity. Subject to tax of 1.5% on net income. Must pay minimum tax of \$800 per year (no minimum tax in first year).	Pass-through entity. Limited partnerships must pay minimum tax of \$800 per year; general partnerships are not so required.	Pass-through entity. Must pay minimum tax of \$800 per year. Must also pay an annual fee based on gross revenues.
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