Choosing From Alternative Forms of Business Entities

Choosing which type of entity to use is among the most important decisions a business can make. 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 limited liability company may offer the best of both worlds. An LLC is generally treated as a partnership for tax purposes. At the same time, the LLC's members, like corporate shareholders, are not personally liable for the debts of the business.

However, LLCs are not always the best form of entity, even for a closely held business. There may be circumstances in which a corporation or limited partnership is a more appropriate form.

Starting a new business requires much thought. Discussion with an attorney and CPA is imperative. A business plan is helpful to have to guide you and a good resource is the Small Business Administration and their online sample format. Having counsel on your side is key to commercial leasing, employment regulations and handbooks, and raising money from investors. We are here to help you with proactive advice, planning, worksheets, and information. Planning ahead will achieve compliance early and allow you to be proactive and not reactive after a problem arises, which is costly.

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. However, *the proprietor is personally liable for the obligations of the business*, thus making a limited liability entity such as a corporation or LLC an attractive alternative.

Corporation (Including S Corporation)

A corporation is a limited liability entity, in that none of the owners (shareholders) are liable for the obligations of the corporation. Corporations formed under California law are governed by (Corp. Code §§100-2319).

The income of a corporation (other than an S corporation) is taxable, both by the federal government and California, at the corporate tax rate. Thus, a corporation and its shareholders are subject to "double taxation," because the corporation pays tax on its income and the shareholders pay tax on dividends received from the corporation, and the corporation is not allowed to deduct dividends as an expense.

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

Qualifying corporations can ameliorate the effect of double taxation by making an S corporation election. With an S corporation election, the corporation's net profits, losses, and tax credits are passed through (and taxed) to the corporation's shareholders, without being taxed to the corporation. Thus, S corporations are treated similarly, but not identically, to partnerships. There are important restrictions on the ability to qualify as an S corporation.

General Partnership

A general partnership is an association of two or more persons to carry on as co-owners of a business for profit that is not a limited partnership. A general partnership has the following characteristics:

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

(2) Each partner is personally liable for the obligations of the partnership.

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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. However, LLCs may become the entity of choice for many limited purpose business ventures.

A general partnership is generally not subject to federal or California income or franchise tax. For federal tax purposes, a partnership is any joint enterprise other than a trust or estate that carries on a business and is not organized as a corporation under state law.

Limited Partnership

A limited partnership is a partnership with one or more "limited partners" (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).

A limited partnership, like a general partnership, is generally not subject to federal or California income tax. Unlike a general partnership, a limited partnership is subject to an annual franchise tax of $ 800.00.

Limited Liability Partnership

An LLP is a form of general partnership in which the liability of each partner may be limited. A partner is relieved of liability for the negligence, wrongful acts, and misconduct of another partner. Employees, and agents of the LLP. *However*, 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. Partners of an LLP remain liable for the contractual obligations of the partnership.

Limited Liability Company

A limited liability company (LLC) is an unincorporated business organization whose members do not have personal liability for the debts of the LLC. A domestic LLC with one member is automatically disregarded for federal and California tax purposes unless the LLC files an election to be taxed as a corporation. A domestic LLC with two or more members is automatically classified as a partnership for federal tax purposes unless the LLC files an election to be taxed as a corporation.

An LLC doing business in California must pay an annual franchise tax *plus* a statutory fee.

Advantageous Uses of LLCs:

The favored tax treatment of the LLC, its limited liability features, and its flexibility for structuring financial and managerial operations make the LLC a form of business organization to be considered for a new business. An LLC can be particularly advantageous in the following situations:

Start-up businesses. Every start-up business should consider the LLC form of organization, whether it is a corner grocery store, real estate venture, or corporate high-tech joint venture.

Existing unincorporated businesses. Any existing business that is a partnership and any sole proprietor bringing in a partner should consider converting to LLC form. Generally, the conversion can be done without triggering income tax.

Venture capital investors. Because of the organizational and structural flexibility of LLCs, the ability to engage in management without fear of liability, and the ability to make special allocations and deduct losses, an LLC may be attractive to venture capital investors. An LLC may not be able to attract venture capital, however, if it restricts the right of investors to sell their ownership interests or if the venture capital investor is a partnership that has tax-exempt or foreign partners.

Real estate investments. LLCs are particularly attractive for real estate investments because LLCs combine limited liability and flexible management with the ability to pass through losses and deductions, make special allocations, and avoid double taxation on the sale of appreciated assets.

Joint ventures. An LLC can be an attractive alternative to a general partnership or corporation as a means of organizing a joint venture or "strategic alliance." LLCs are preferable to general partnerships because of the limited liability they provide to members (thus eliminating the need for a venturer to form a special-purpose corporation) and are preferable to corporations because of pass-through tax treatment and the avoidance of double taxation.

Estate planning. The LLC, by virtue of its partnership tax treatment, limited liability, and flexibility of management and financial structures, may prove to be a *valuable estate-planning tool for transferring ownership interests in businesses and real estate.*

Problem Areas for an LLC:

Although the LLC form of organization has many desirable features, it is not suitable for every business. An LLC may not be appropriate in the following situations:

Existing incorporated businesses. Converting a corporation into an LLC will generally result in a taxable liquidation of the corporation, even if the corporation has elected to be an S corporation. A statutory merger or conversion of a corporation into an LLC, for example, will ordinarily be treated as a liquidation of the corporation and a contribution of the distributed assets by the shareholders to the LLC. The tax cost of liquidating the corporation should be calculated and considered before deciding to convert the form of business organization from a corporation to an LLC.

Businesses planning to go public. With some exceptions, a partnership whose ownership interests are publicly traded is taxed as a corporation. An LLC that becomes publicly traded would therefore lose one of the primary benefits of being an LLC, *i.e.,* partnership tax treatment, and, compounding that loss, the capital markets might discount the value of an ownership interest because of unfamiliarity with LLC interests as compared to stock. An LLC could incorporate before going public and avoid this result, and for certain businesses, an initial period of operation as an LLC may be suitable. Until it incorporates, however, an LLC could not offer tax-favored incentive stock options and employee stock purchase plans, which are common ways of compensating and motivating employees working for a business intending to go public, and, as mentioned above, an LLC might not attract certain investors.

Professional practices. A California LLC is not authorized to practice a profession that, if practiced in corporate form, would have to be organized as a professional corporation.

Certain regulated businesses. An LLC may not be suitable for a business that requires a license, certification, or registration under California's Business and Professions Code. In addition, businesses in certain regulated industries may need to be in corporate form to comply with regulatory requirements.

Ease or Difficulty of Formation; Transaction Costs

The ease or complexity of forming a business enterprise (and the associated costs) depend more on the scope and complexity of the specific business venture than on the form of entity chosen. 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 will a one-shareholder corporation engaging in a simple business.

Corporation

Although corporations are perhaps subject to the most formalities, corporations may in many cases be the simplest and least expensive entity to form, primarily because the parties need not negotiate a detailed agreement governing the structure and operation of the corporation but can instead rely on the provisions of the Corporation Law (Corp C §§100-2319). *However*, if the parties want to restrict the transferability or voting rights of corporate stock, or provide for different classes of stock, a detailed agreement or specially drafted articles of incorporation are required.

A corporation is formed by filing articles of incorporation with the Secretary of State and paying the appropriate filing fee. *There is more to forming a corporation than simply filing the Articles!* The election of directors and officers, the adoption of bylaws, the initial issuance of corporate shares, and other organizational matters, should be reflected in organizational minutes as well as the Buy Sell Agreement (Shareholders Agreement) drafted. Ask me for the "*Myths of Corporation Formation"* article for a discussion of the completion of the formation requirements.

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An amount of at least $ 800.00 in estimated tax generally must be paid by the 15th day of the fourth month of a corporation's taxable year. However, a corporation is not subject to the minimum tax for its first taxable year. Thus, there is no prepayment of minimum franchise tax, and a new corporation will pay only an estimated tax based on earnings in its first taxable year. ***There are several deadlines for further filings due quickly after filing the articles, such as exempting stock from registration, statement of information, new 2024 Corporate Transparency Act filing, and S-election. It is recommended that counsel be engaged prior to filing the articles so they are done correctly, and the initial filing deadlines and requirements thereafter can be met.***

Limited Liability Company

An LLC is formed by filing articles of organization with the Secretary of State and the payment of a nominal fee. Whether the LLC is a member or manager managed LLC should be discussed with an attorney prior to filing so as to avoid wasting money filing amended articles.

Either before or after filing the articles of organization, all the members must enter into an operating agreement. The operating agreement governs the internal operations of the business and outlines the rights and duties of the members and managers. The cost and complexity of the agreement will depend on the nature of the LLC and its business and may involve extensive negotiating and drafting.

Similar to a corporation, ***there are several deadlines for further filings due quickly after filing the articles, such as exempting membership interests from registration, statement of information, new 2024 CA Transparency Act filing, and possible S-election tax status. It is recommended that counsel be engaged so the initial filing deadlines and requirements thereafter can be met.*** Ask me for the 2024 "*Corporate Transparency Act and New Reporting Requirements*" article for a discussion of the further regulations for businesses under the Corporate Transparency Act.

An LLC doing business in California is required to pay an annual franchise tax of $800.00. Like limited partnerships, LLCs are not required to pay the tax when filing the articles of organization, but to pay it on or before the 15th day of the fourth month of the LLC's taxable year.

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Following is a quick overview of entity taxation and is not meant to be a comprehensive discussion. Your tax situation is unique and should be discussed with your CPA. The information is provided so you may have a discussion with your CPA and understand which questions to ask and how your entity choice affects your taxes and tax reporting.

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Classification of Entities for Tax Purposes. The fundamental distinction between a corporation and a general partnership, limited partnership, limited liability partnership, or LLC is that a corporation (other than an S corporation) is subject to entity level tax while partnerships and LLCs classified as partnerships are as "pass-through" entities, in which items of income, loss, deduction, gain, and credit are not taxed at the entity level but are passed through to the partners or members.

Entities other than corporations and business trusts may elect to be classified as partnerships or corporations under the IRS check-the-box regulations. LLCs are generally classified as partnerships unless they elect to be taxed as corporations.

Tax Consequences of Formation. Neither a corporation, a partnership, nor an LLC is ordinarily taxed on the receipt of capital contributions (whether of cash, property, or services) by shareholders, partners, or members (as applicable). *However*, a shareholder, partner, or LLC member may be taxed on the contribution, depending on the nature of the contribution.

Contributions of Cash. A contribution of cash in exchange for shares of corporate stock, a partnership interest, or a membership interest in an LLC will not result in a taxable event for the contributing party.

Contributions of Property. The contribution of property in exchange for shares of corporate stock (including shares in an S corporation) is a taxable event for the contributing party unless the transaction constitutes a tax-free exchange under IRC §351 (transfers to a controlled corporation). If a contribution of property to a corporation is taxable, it will be treated as a sale of the property in exchange for the shares of corporate stock and the shareholder will usually be taxed on the difference, if any, between the shareholder's basis in the property and the property's fair market value.

The contribution of property in exchange for an interest in either a partnership or an LLC (assuming the LLC is treated as a partnership or disregarded for tax purposes) is generally not a taxable event and will not subject the contributing partner or member to tax liability. However, if the contributed property is subject to a liability, the contributing partner or member may recognize gain to the extent that the liability exceeds the sum of (1) the partner's or member's basis in the contributed property plus (2) the partner's or member's basis in the partnership or LLC before the contribution. Furthermore, a contribution of property to a partnership (and, presumably, an LLC) may be recharacterized as a sale of the property by the partner to the partnership, under the "disguised sale" rules of IRC §707(a)(2)(B).

Contributions of Services. Contributions of services to a corporation (including an S corporation) in return for unrestricted shares of stock will *generally be taxed to the contributing party as ordinary income to the extent of the fair market value of the stock received*, although subjecting the stock to restrictions may enable the shareholder to defer taxable income.

If a partner of a partnership or a member of an LLC taxed as a partnership contributes services to the partnership or LLC, as applicable, and receives in return an interest in the profits of the entity, but no interest in the underlying capital, in most situations the IRS will not take the position that the profits interest is taxable on receipt. Rev Proc 93-27, 1993-2 Cum Bull 343. If the partner or member receives a capital interest in the entity in exchange for services, however, the partner or member has taxable income. Reg §1.721-1(b)(1).

Entity Level Tax; Double Taxation. The net income of a "C corporation" (*i.e.*, a corporation that has not made an election to be an S corporation) is subject to taxation at the corporate level. Dividends distributed to shareholders are taxed to the shareholders at a rate of 15 percent (IRC §§1(h), 301), with no corresponding deduction to the corporation, resulting in the double taxation of corporate income distributed to shareholders. California does not have a preferential tax rate for dividends. Furthermore, if assets are distributed to shareholders, any gain inherent in the assets is recognized by the corporation on the distribution (IRC §311(b)), while losses inherent in distributed assets can be recognized only in a liquidating distribution, and then limitations apply (IRC §336(d)).

Double taxation often can be avoided by distributing income to shareholder/ employees as salaries or by using corporate earnings to pay interest on debt owed to shareholders or rents or royalties on property leased or licensed from shareholders. In each instance, while the shareholders have income, the corporation receives a corresponding tax deduction. These types of transactions are closely scrutinized by the IRS, so care should be exercised to ensure that the amounts paid are reasonable[1].

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[1] In considering the reasonableness of compensation "from the perspective of a hypothetical investor," courts in the Ninth Circuit apply a five-factor test, that takes into account: (1) the employee's role in the company; (2) compensation paid to similarly situated employees in similar companies; (3) the character and condition of the company; (4) whether a conflict of interest exists that might permit the company to disguise dividend payments as deductible compensation; and (5) whether the compensation was paid under a structured, formal, and consistently applied program. Elliotts, Inc. v Commissioner (9th Cir 1983) 716 F2d 1241, 1245. In O.S.C. & Assocs. v Commissioner (9th Cir 1999) 187 F3d 1116, the court held that a closely held corporation could not deduct compensation payments made to two employees who were also its shareholders because, even if reasonable, they were payments of dividends in disguise. In Label/Graphics, Inc. v Commissioner (9th Cir 2000) 221 F3d 1091, the court held that a corporation could deduct less than half of compensation paid to the corporation's president, key employee, and sole shareholder. In E.J. Harrison & Sons, Inc., TC Memo 2003-239, the Tax Court applying the Elliotts test disallowed deductions for approximately $ 1.8 million of $ 2.1 million in compensation paid over a three-year period to one of four officer-shareholders of a family business engaged in waste pickup and disposal services. Double taxation cannot be avoided by transferring appreciated property to an LLC or limited partnership and then distributing membership or limited partnership interests to the shareholders. In Pope & Talbot, Inc. v Commissioner (9th Cir 1999) 162 F3d 1236, the court held that the gain on a corporation's transfer of appreciated property to a limited partnership was determined

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Businesses that reinvest most of their income, rather than distribute it, may find the corporate tax structure more beneficial, because income left in the corporation for reinvestment in the business may be taxed at a lower rate than it would be in the hands of an individual shareholder. However, it may be dangerous to accumulate too much income inside a corporation. See IRC §§531-537 (accumulated earnings tax), and IRC §§541-547 (personal holding company tax)[2].

Inability to Utilize Losses. Corporate losses stay in the corporation, and cannot be deducted by the shareholders, as they can be deducted by partners, shareholders, and members in the case of partnerships, S corporations, and LLCs. Deductions must be postponed until the corporation has income and may be permanently lost.

S Corporation. To become an S corporation, an "S election" is filed with the IRS. The election has the effect of making the corporation a pass-through entity for federal tax purposes but does not change the nature of the entity as a corporation for state law purposes. An S-Election filing must be made shortly after filing the articles. Ask me for the article "*The Myths of Corporation Formation and Compliance, Part II, the "S" Corporation Explained.*"

Pass-Through Entity. The income and losses of an S corporation generally flow through to, and are taxed to or deducted by, the shareholders, retaining the character they had to the S corporation. Nonresidents are subject to California income tax on the amount of California source income they receive from S corporations doing business in California. \

Requirements to Qualify as an S Corporation. To qualify as an S corporation, a corporation cannot (IRC §1361):

- have more than 100 shareholders;
- have as a shareholder a person (other than an estate, or certain trusts and certain tax-exempt organizations, (corporate and partnership shareholders are not permitted);
- have a nonresident alien as a shareholder;
- have more than one class of stock.

An S corporation may own 100 percent of another S corporation or 80 percent or more of the stock of a C corporation, but an S corporation cannot elect to file a consolidated return with its affiliated C corporation under IRC §1504[3].

Distributions to Shareholders. A shareholder is taxed on their share of S corporation income, regardless of whether the shareholder receives that income. Distributions are not taxable to a shareholder except to the extent the money and fair market value of property distributed exceeds the shareholder's basis in his or her stock and the basis of debt owed by the corporation to the shareholder. IRC §1368[4].

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by the hypothetical fair market value of the property as if the corporation had sold it, not by the aggregate value of the interests received by the shareholders.

[2] Gain realized on a shareholder's disposition of corporate stock is generally taxed at a 15-percent rate. IRC §1(h). There is a 50-percent exclusion from gross income for gain on disposition of qualified small business stock as defined in IRC §1202. Significantly, the 50-percent exclusion also applies for California income tax purposes. However, an amount of gain equal to the gain excluded is taxed at a 28-percent rate rather than a 15-percent rate. IRC §1(h)(4), (7). Alternatively, gain realized on the sale of qualified small business stock may be rolled over to other qualified small business stock within 60 days. IRC §1045.

[3] Once an S election is made, failure to meet the requirements will terminate the S election, i.e., S corporation status can be inadvertently terminated. IRC §1362(d)(2). Once terminated, the election cannot normally be made again for five years. IRC §1362(g). However, inadvertent terminations may be waived under IRC §1362(f). Note that a qualified federal S corporation is treated as an S corporation for California tax purposes.

[4] However, the S corporation will recognize any gain on the distribution of property under IRC §311(b), but, except in liquidation, no loss. Normally, as with other S corporation income, the gain will flow through and be taxed to the shareholders. The amount of money and the fair market value of property distributed to a shareholder reduce the basis of their stock. IRC §1367. The shareholder takes a fair market value basis in distributed property under IRC §301(d).

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