

CHOICE OF BUSINESS ENTITY

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One of the most frequently asked questions by clients is: “What type of business entity should I use?” In other words what legal form should the business take and what legal entity will exist separate, distinct and apart from the owners and yet they still control the business? Traditionally the form was either a corporation or a partnership. However, these traditional entities now require consideration of such variations as the “C Corp” versus “S Corp”, simple partnership or limited liability partnership. Additionally we have a hybrid in the form of the limited liability company available. In fact the list of possible entities can be continued with variation almost ad infinitum.

Consequently the answer is not always easy and one must consider a myriad of different factors. Some of these include the type of business, age of the business, is the business in a growth or stable mode, the potential for liability and the extent of that liability (is the owner personally liable?), ability to obtain financing, raise capital, sell the business and remove old or admit new owners to mention some of the many considerations. Of course one must also consider tax factors including how the business and owners will be taxed on its income, who will be paying the taxes, will the company lose money initially and what is the potential for fringe benefits including retirement accounts. Eventually you must consider every aspect and fact concerning your business.

The information available to the Tax-Business Lawyer on all of these considerations is prolific including among other things courses, seminars and treatises. Tax and business lawyers spend years studying these factors and opining to their clients on a direction to take. However, armed with all this knowledge, their recommendation must still depend on you communicating to them your goals, present business circumstances and prospects.

My objective here is to give you an overview of the most popular business entities in use today. In ensuing articles we will break the Choice of Business Entities down into more detail and discuss some of the more subtle issues. However, don't be misled by the brevity and, hopefully, conciseness of my discussion. If you are considering forming or changing a business entity, gather your business facts and then consult with a qualified Tax-Business Attorney.

Now let's turn to the standard Choice of Business Entities. For our purposes we will consider five: 1. Sole Proprietorship, 2. C-Corp, 3. S-Corp, 4. Limited Liability Companies and 5. Partnerships - General and Limited in form. Holding to our objective in this first article we will discuss the meaning of these terms and seek to avoid commenting directly on the advantages, disadvantages and appropriateness of each for particular situations. In future articles we will discuss the latter issues and end this series with a final article containing a chart comparing each entity.

Sole Proprietorships.

A Sole Proprietorship (“SP”) is frequently chosen by default and the necessity to “do it now” by the owner. Basically a sole proprietorship is a business conducted and owned by an individual and is not otherwise legally organized as a legal entity. This results in title to property being held in the owner’s name. The consequence is direct and personal liability for all business debts and obligations. This also includes direct, absolute liability for all taxes – income, sales and withholding to mention the three most obvious.

Despite the disadvantages, it is by far the most frequently used form for doing business. There are some advantages such as low maintenance costs. However, in my opinion, it is a poor choice for a business having any prospect of complex, sophisticated business or financial dealings or a desire it survive the owner’s demise. We shall detail the advantages and disadvantages in a future article.

C-Corps.

The C-Corp is also known as a general business corporation and it is created in the United States under the particular state laws in which they are initially organized. The use of the term “C-Corp” is adopted from Subchapter C of the Internal Revenue Code of 1986 which covers corporate taxation. Over time the various states have adopted a similar basic structure but the corporate characteristics, duties and taxation can vary substantially depending on the particular state in which you incorporate.

Simply stated the corporate form results in a distinct legal entity that is autonomous, existing apart from its shareholders and possessing most of the powers of an individual. This means it can own and transfer property, has limited liability for its shareholders/investors, ease of selling interests (stock), continuity of interest, no pass through of income taxes and it can sue in court. Of course there are additional characteristics, advantages and disadvantages which will be discussed in future articles.

Although the basic actions necessary to incorporate are similar, it is important that you observe and follow corporate characteristics. Failure to follow protocol and ceremony can result in what is called “piercing the corporate veil” and leave you with what amounts to a sole proprietorship or general partnership. That in turn may lead to far ranging and expensive consequences. A simple example would be personal liability for intended corporate obligations.

S Corps.

The S Corp was designed to provide the insulation of the general corporate form of governance and the tax treatment of a sole proprietorship or general partnership. In other words it is hybrid. There are specific requirements and forms to file to qualify for

the tax treatment but the day to day formality and operation requirements of a C-Corp are observed for actual operation of the S-Corp.

After meeting the guidelines and filing requirements the S-Corp results in a pass through to the shareholders of all income and losses on a pro rata basis and avoids double taxation experienced in C-Corps. Since tax rates applied to a C-Corp are generally higher than individual rates the result is lower taxes. You can also convert your C-Corp to an S-Corp status if you meet the IRS filing deadlines.

An S-Corp is typically used in small business settings and may work better in that environment than a C-Corp. However, it does require more formality than a limited liability company which we will discuss next.

Limited Liability Companies.

Although first introduced less than thirty years ago, the Limited Liability Company (“LLC”) is now recognized in every state and has become extremely popular. It is another hybrid combining both corporate and partnership advantages while seeking to avoid the disadvantages of both. Initial formation is by filing Articles of Organization with the applicable state. These are typically short and simple in form and result in modest costs for formation.

The essence of the LLC is covered in the Operating Agreement (“OA”) which is signed by the owners, called Members in an LLC. The OA is similar to the By-laws of a corporation but most analogous to a limited partnership agreement. If the Members fail to establish an OA the applicable state has “default rules” established in the LLC section of its code of laws. These default rules may be undesirable for your particular business operations, so you want to make certain an acceptable OA is in place.

Another consideration is that the OA will establish how the LLC is run on a daily basis. Since most business is conducted by a group smaller than the total number of members you may want to establish Managers who will conduct daily business affairs. Additionally these Managers can function similar to a board of directors and, in turn, establish individual responsibilities similar to those of an officer in a corporation. You need to be certain an OA is in place and *read it closely and carefully thinking through the implications of what is stated.* The author has personally counseled Members of LLC’s who had not sufficiently reviewed the OA. Take your time and make certain it fits your needs, goals and objectives.

Partnerships - General and Limited.

As indicated in the above title there are two basic forms of partnerships – general (“GP”) and limited (“LP”). Both are a creation of state law and the general partnership is recognized in all states. A general partnership consists of two or more partners all of who carry unlimited personal liability for the partnership obligations unless a written

agreement varies or limits their individual liability. In some situations, this written agreement as applied to a GP may be of little use or benefit when dealing with third parties.

On the other side is the LP which contains many of the general partnership characteristics but has significant differences. The typical state requirements for attaining LP status are inflexible and if one fails to meet the requirements the failure results in GP status. A first step is to file with the applicable state, either the Secretary of State or the clerk of court in the county where established, and obtain a filing certificate. The information required varies by state but Georgia has strict and formal requirements both as to filing and content of document in order to form an LP.

(A note of caution. In this world of technology you can find “forms” and instructions to do almost anything along with a promise to save money. I suggest to you LP formation is not an area to attempt this. Consult with and retain a professional. The initial cost will most certainly offset the costs, expenses and liability associated with improper filing and or organization.)

Another characteristic of the LP is that it will contain a general partner or partners who conduct the day to day business. The limited partners are typically passive and looking for a return on their investment without management responsibility. In reviewing the documentation and particularly the OA you need to determine the exact role the limited will play and that of the general. Considerations differ based upon your intended status. For example as a limited partner can you participate in decisions and as the general partner do you want them to participate. Also the essence of the LP is that the general will suffer all the bad consequences as though it is a general partnership – personal liability for debts, etc. while the limited partners avoid these consequences and, hopefully, receive the expected return on investment.

Without detailing the precise reasons until another article, the author suggests that if you must use a partnership choose the LP and not the GP. That would be true whether you intentionally decide to be the general or limited partner in a LP.

This has been a brief overview of the typical Choice of Business Entities available for your consideration. However, as pointed out each of these entities contain sophisticated variations and can be “tailored” in most instances to fit particular needs. Also omitted from this article is a discussion of the various trust options for business dealings because they generally pertain to a different business setting and environment. As expected each form of entity has its own particular characteristics including pros and cons. As will be seen in future articles some entities are less desirable than others and should be infrequently used.

Future articles will consider the separate characteristics of each entity and detail what this author considers relevant to your consideration of choosing your business entity. The detail will include, among other things, maintenance costs, liability exposure and limitations, control, management, taxation, continuity of existence, dissolution,

financing, sale of the entity or its assets and the consequences of such a sale. The goal is to provide you with more detailed information so that, once informed, you can establish a business entity best serving your needs.

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