## Chapter 1

# Choosing Your Business Entity

### In This Chapter

- Flying solo: Sole proprietorships
- Getting a grip on partnerships
- Checking out corporations
- Looking into LLCs

When starting a business, you need to decide early on what legal form the business should take. The common choices are sole proprietorships, general partnerships, limited partnerships, C corporations, S corporations, and LLCs (Limited Liability Companies). Each entity has advantages and disadvantages, and the right choice depends on the nature of your proposed business and various tax and liability issues. In this chapter, I outline the key points that you need to know about choosing the right entity for your business.

FORM

Form 1-1 on the CD-ROM (and shown later in this chapter) summarizes the key differences between various types of business entities. You need to pay special attention to tax and liability issues.

| Characteristic | C Corporations | S Corporations | Sole Proprietorship | General Partnership | Limited Partnership | LLC |
|---|---|---|---|---|---|---|
| Ownership Rules | Unlimited number of shareholders allowed; no limit on stock classes | Up to 75 shareholders allowed; only one basic class of stock allowed | One owner | Unlimited number of general partners allowed | Unlimited number of general and limited partners allowed | Unlimited number of "members" allowed |
| Personal Liability of the Owners | Generally no personal liability of the shareholders for the obligations of the corporation | Generally no personal liability of the shareholders for the obligations of the corporation | Unlimited personal liability for the obligations of the business | Unlimited personal liability of the general partners for the obligations of the business | Unlimited personal liability of the general partners for the obligations of the business; limited partners generally have no personal liability | Generally no personal liability of the members for obligations of the business |
| Key Documents Needed For Formation | • Articles of Incorporation<br>• Bylaws<br>• Organizational Board Resolutions<br>• Stock Certificates<br>• Stock Ledger | • Articles of Incorporation<br>• Bylaws<br>• Organizational Board Resolutions<br>• Stock Certificates<br>• Stock Ledger<br>• IRS & State S Corporation election | • DBA filing | • General Partnership Agreement<br>• Local filings if partnership holds real estate | • Limited Partnership Certificate<br>• Limited Partnership Agreement | • Articles of Organization<br>• Operating Agreement |

**Form 1-1:** Comparison Chart for Different Business Entities, page 1 of 2.

| Characteristic | C Corporations | S Corporations | Sole Proprietorship | General Partnership | Limited Partnership | LLC |
|---|---|---|---|---|---|---|
| Tax Treatment | Corporation taxed on its earnings at the corporate level and the shareholders may have a further tax on any dividends distributed ("double taxation") | Entity generally not taxed as the profits and losses are passed through to the shareholders ("pass-through" taxation) | Entity not taxed, as the profits and losses are passed through to the sole proprietor | Entity not taxed, as the profits and losses are passed through to the general partners | Entity not taxed, as the profits and losses are passed through to the general and limited partners | Entity not taxed. (unless chosen to be taxed), as the profits and losses are passed through to the members |
| Management of the Business | Board of Directors has overall management responsibility and officers have day-to-day responsibility | Board of Directors has overall management responsibility and officers have day-to-day responsibility | Sole proprietor manages the business | The general partners have equal management rights, unless they agree otherwise | The general partner manages the business, subject to any limitations of the Limited Partnership Agreement | The Operating Agreement sets forth how the business is to be managed – a Manager can be designated to manage the business |
| Capital Contributions | Shareholders typically purchase stock in the corporation, either common or preferred | Shareholders typically purchase stock in the corporation, but only one class of stock is allowed | Sole proprietor contributes whatever capital needed | The general partners typically contribute money or services to the partnership, and receive an interest in profits and losses | The general and limited partners typically contribute money or services to the limited partnership, and receive an interest in profits and losses | The members typically contribute money or services to the LLC, and receive an interest in profits and losses |

**Form 1-1:** Comparison Chart for Different Business Entities, page 2 of 2.

# Setting Up Sole Proprietorships

Some businesses are formed as *sole proprietorships.* In this case, the business has only one owner — you. Sole proprietorships are easier to set up than corporations or other entities.

To establish a sole proprietorship, you typically need to file a *fictitious name certificate* at a local or state governmental office if you're doing business under a name different than your own. This certificate, in essence, notifies the world who the business's true owner is, such as "John Smith, d.b.a. Blue Vision Flowers." The *d.b.a.* abbreviation stands for "doing business as."

Sole proprietorships are not advisable if you plan to do any significant business because you face unlimited liability for the business's debts — a real disadvantage. Plus, you can have a difficult time growing the business and attracting investors to a sole proprietorship.

The following key points characterize a sole proprietorship:

- **Business transferability:** Selling your business involves selling the business assets and may be more complicated than selling a corporation.
- **Existence:** After you die or become disabled, the business may have difficulty continuing on, both legally and business-wise.
- **Expenses:** You must keep careful records of your personal expenses versus your business-related expenses. The IRS may challenge your handling of certain expenses if it thinks that those expenses may not be legitimate, deductible business costs.
- **Licenses:** You may need various business licenses, sales tax licenses, or permits.
- **Personal liability:** You have personal liability for all of the business's debts and obligations. If something goes wrong with the business, your personal assets (home, car, and bank savings) may be at risk.
- **Tax:** The IRS taxes you and your business as one for income tax purposes. Tax rates for corporations may be more advantageous than tax rates for individuals. (Check out the tax discussion in Chapter 6.)

# Creating a Partnership

You can set up your business as a partnership consisting of two or more partners. Partnerships come in three types: general, limited, and limited liability. Limited Liability Companies (LLCs) are similar in some ways to partnerships. I describe LLCs in the section "Helpful Hybrids: Limited Liability Companies" later in this chapter.

## General partnerships

General partnerships consist of two or more partners. You can create general partnerships with little or no statutory formalities, although you probably want to have a Partnership Agreement that sets forth the partners' rights and obligations.

WARNING!

Avoid general partnerships like the plague! Each partner in a general partnership may be liable for the debts and obligations of the partnership — not a good situation to be in if things go bad. If you insist on having a partnership, make sure that you have a well-drafted Partnership Agreement and a lot of insurance.

General partnerships tend to be easy to establish and can be more informal than business entities like corporations. But the disadvantage of the partners' horrendous unlimited personal liability more than offsets this advantage.

The following key points typically characterize general partnerships:

- **Personal liability:** The general partners have potential personal liability for the partnership's debts and obligations. If something goes wrong, your personal assets, not just the partnership assets, are at risk.
- **Control and management:** Unless limited by the Partnership Agreement, each general partner has an equal right to share in the management and control of the partnership.
- **Authority:** Unless limited by the Partnership Agreement, any partner can take actions and sign contracts that bind the partnership.
- **Owners and profits:** The owners of the business are partners and split profits and losses as they agree upon.
- **Number of owners:** You can have an unlimited number of general partners.
- **Formation:** General partnerships can be more expensive to form than corporations because you want a lawyer to prepare a detailed Partnership Agreement. Typically, you don't need to have any state filings to form a general partnership. Some local filings may be necessary if the partnership holds real estate.

  WARNING!

  Partnership Agreements can be very complicated. This area is one where working with a lawyer is definitely to your advantage.
- **Fiduciary relationship:** General partners stand in a *fiduciary relationship* with each other, meaning that partners generally must act with undivided loyalty, good faith, fairness, and honesty in dealing with each other.
- **Existence:** A general partnership doesn't last forever, and you can dissolve it at the end of a specified term, on the death of a partner, or on other events.

- **Transferability of interests:** You face real problems trying to transfer general partnership interests, and unless the Partnership Agreement provides otherwise, a person generally can't become a member of the partnership without the consent of all or most of the partners.
- **Tax:** The IRS taxes the partners, not the partnership, on partnership income (called *pass-through taxation*), thus avoiding the potential double taxation present in regular corporations. (For more tax details, see the tax discussion in Chapter 6.)

FORM

Form 1-2 on the CD-ROM includes a checklist of issues that you should consider when drafting a Partnership Agreement.

## Limited partnerships

A limited partnership consists of one or more general partners and one or more limited partners. The general partners typically get to make all business decisions, and the limited partners are typically passive investors.

Many businesses have used limited partnerships for owning real estate, restaurants, oil- and gas-related activities, and venture capital funds.

A limited partnership requires you to file an organizational form certificate with the Secretary of State. A Limited Partnership Agreement, setting out the rights and obligations of the general and limited partners, is also important.

TIP

Limited partnerships can raise money from passive investors while allowing the general partner to retain near total control of how the business is run. Limited partnerships can be good business structures, especially for real estate holdings, but LLCs (which you can find in the section "Helpful Hybrids: Limited Liability Companies" later in this chapter) or corporations are typically better for operating businesses.

The following key points typically characterize limited partnerships:

- **Limited liability:** Limited partners aren't personally liable for the partnership's debts and obligations, although their investment in the limited partnership is, of course, at risk for the payment of partnership obligations. The general partners have unlimited liability for the partnership's debts and obligations, and for that reason, the general partner shouldn't be an individual. Instead, consider having the general partner be a corporation or LLC.
- **Control and management:** Typically, the general partner has the say in all management decisions. However, the Limited Partnership Agreement can give the limited partners various voting rights, such as the right to approve the sale of the business or the right to remove and replace the general partner.

- **Fiduciary relationship:** The general partner has a fiduciary (trust) relationship to the limited partners and therefore has a legal obligation to look out for their interests.
- **Securities laws:** A limited partnership interest is usually considered a "*security*" under federal and state securities laws, requiring that you be in compliance with those laws. (See Chapter 4 for a discussion of securities laws.)
- **Number of owners:** You can have an unlimited number of owners.
- **Transferability of interests:** Transfer of interests typically requires the general partner's approval.
- **Profits and losses:** The Limited Partnership Agreement sets forth the partners' rights to profits and losses. You can split up profits and losses in any number of ways.
- **Tax:** The partners, and not the limited partnership, are taxed on partnership income *(pass-through taxation),* thus avoiding the potential double taxation that regular corporations may face.

FORM

If you're going to have a limited partnership, review Form 1-3 on the CD-ROM for a checklist of the items that you should consider including in a Limited Partnership Agreement.

## Limited Liability Partnerships

*Limited Liability Partnerships* (LLPs) are a new entity authorized by certain state laws. LLPs are basically general partnerships with a liability shield for partners. Liability shields come in two basic types: one for tort matters (like negligence claims), and the other to insulate the partners from the partnership's tort and contract obligations.

STATE BY STATE

In many jurisdictions, the law allows only professionals to use LLPs. For example, California LLPs typically are formed only by lawyers and accountants.

LLPs are typically taxed as *pass-through entities,* with the partners, not the entity, paying taxes on the business's earnings.

TIP

LLPs are useful in one primary sense — if you have an existing general partnership, and you can qualify for LLP status, you should absolutely convert to LLP status. Such a conversion has little downside, and you can start to protect the partners from the business's various liabilities.

For the most part, however, you should form new businesses as corporations or LLCs, rather than LLPs. (See the section "Helpful Hybrids: Limited Liability Companies" later in this chapter for a discussion of LLCs.)

# Corps Is Short for Corporation, Not Corpses

A *corporation* is a separate legal entity formed under a state corporation law. The corporation has shareholders who own stock in the company, a board of directors who have responsibility for overall management of the company, and officers who run its day-to-day affairs.

A key advantage of a corporation is that if it is properly formed and operated, the shareholders are shielded from the corporation's debts and liabilities. Should something go wrong, you only risk the amount that you have invested in the corporation. And, if someone sues the corporation, you're not personally responsible for any damages that a court may award (unless you fail to follow the rules for forming and operating the corporation, as I explain in Chapter 12).

The corporate business entity doesn't protect professionals, such as accountants, doctors, or lawyers, from personal liability for their negligence or malpractice, but it can shield them from personal liability for the acts of their co-owners.

The two main kinds of corporations are C corporations and S corporations. The difference between the two is in the type of tax treatment on the business's earnings. In a C corporation, the government taxes the business's income at the corporate level, and if the corporation distributes any dividends to the shareholders, the shareholders can also pay a tax on that income. This practice is sometimes referred to as *double taxation.* In an S corporation, the government considers that the business income has passed through to the shareholders who are then taxed on their *pro rata share* (the percentage that they own) of the corporation's income.

## C corporations

The word "corporation" usually refers to a C corporation. *C corporations* have limited liability and are well-understood entities that can accommodate many businesses. On the downside, corporations require that you follow a fair number of formalities and make several governmental filings. For C corporations, the double tax can be a real expense.


Form 1-4 on the CD-ROM contains a checklist of issues to consider when you decide to form a corporation. I tell you how to correctly form a corporation in Chapter 3.

TIP

Corporations make a lot of sense for new businesses — especially if you plan to grow the business and attract investors. Also, you can sell a corporation more easily than almost any other entity. And, if you have hopes of taking the company public, you almost surely have to make the business a corporation.

The following key points characterize C corporations:

- **Limited liability:** Generally, the shareholders, officers, and directors of the corporation aren't personally liable for the corporation's debts and liabilities. Of course, if a shareholder signs a guaranty for a corporate debt, personal liability can be a factor.
- **Perpetual existence:** In contrast to partnerships and sole proprietorships, corporations generally can last forever. However, a corporation may be dissolved by voluntary action.
- **Control and management:** A corporation's overall management is vested in the *board of directors,* a group of men and women whom the shareholders choose. The board of directors, in turn, elects the corporation's officers, who handle the business's day-to-day affairs under the board's general direction.
- **Shareholders' rights:** Shareholders typically have various rights, including the right to elect directors, receive information, inspect corporate records, vote on fundamental business decisions (such as mergers and liquidations), and share in distributions.
- **Owners and profits:** The owners of the corporation are the shareholders who have received stock in the corporation. Such stock is typically common stock, but it can sometimes be *preferred stock* (which grants the holders certain senior rights over the holders of common stock). When the company pays dividends, the common stock holders are entitled to a *pro rata* share of all dividends made to the common shareholders. The dividend rights for preferred shareholders depend on negotiations made in connection with the purchase of the preferred stock. (Chapter 4 discusses the differences between common stock and preferred stock.)
- **Corporate formalities:** You should observe various corporate formalities, such as maintenance of separate books, records, and accounts; completion of various governmental filings; and periodic meetings or written consents of directors and shareholders.
- **Stock transferability:** Shareholders' interests in a corporation are normally evidenced by stock certificates. You can impose reasonable restrictions on the transfer of stock (such as a right of first refusal on transfer) by contract or corporate charter documents. And federal or state securities laws can limit stock transfers.
- **Capital formation:** The corporate entity accommodates a wide variety of forms of capitalization, such as common stock, preferred stock, stock options, warrants, and convertible securities.

- **Employee stock ownership:** Corporations provide the best vehicle to give employees equity interests in the business. For example, stock option plans and common stock issuances are quite common in Silicon Valley–based corporations. Corporations allow tax-advantaged stock option grants, which aren't available for other entities.
- **Tax:** C corporations are taxed at the corporate level. The government taxes most dividends as income to the stockholders. (This practice is the *double tax*.)

## S corporations

*S corporations* are corporations that can meet certain requirements and that affirmatively elect to be taxed as an S corporation. An S corporation is a regular corporation, but the business's income passes through to the shareholders, and the shareholders pay income taxes based on their portion of the corporate income. This fact holds true whether or not the income has actually been distributed to the shareholders.

For federal tax purposes, if the S corporation has an operating loss, the corporation can pass these losses through to the shareholders to offset other income (subject to some limitations). However, you can deduct S corporation losses on your personal return only to the extent of your *basis* (generally, the amount you invested or have at risk).

S corporations are especially desirable for start-up small businesses. And the decision to be an S corporation isn't permanent; you can later revoke the election.

STATE BY STATE

Depending on your anticipated business operations and income, an S corporation may benefit you. Some states, however, don't allow for S corporation treatment or impose some special tax on S corporations for state tax purposes (although you can still be an S corporation for federal income tax purposes). Discuss this possibility carefully with your accountant or tax adviser before deciding on an S corporation.

In order to become an S corporation, you must follow a number of key rules, including

- **IRS election:** All shareholders must sign and file IRS Form 2553 with the IRS. You may also need to make an election with your state of incorporation. New corporations must file the IRS form by the 15th day of the third month of your tax year (basically, a 2½ month window).
- **Number of shareholders:** An S corporation can have no more than 75 shareholders.

- **One class of stock:** An S corporation can only have one class of stock, although certain differences can exist in voting rights among the shareholders.
- **Restrictions on the type of shareholders:** Generally, corporations, various trusts, and nonresident aliens may not be shareholders in an S corporation.

IRS Form 2553 — Form 1-5 on the CD-ROM — must be signed by all shareholders in an S corporation and filed with the IRS. Form 1-6 on the CD-ROM is a transmittal form to accompany the filing.

# Helpful Hybrids: Limited Liability Companies

A *Limited Liability Company* (LLC) combines many of the attractive features of partnerships and corporations.

You can form an LLC under a state *LLC statute,* which typically requires that you file an Articles of Organization with the Secretary of State and that the LLC's owners (referred to as *members*) enter into an Operating Agreement. The Operating Agreement functions in many ways like a partnership agreement and can cover many of the issues addressed by a corporation's bylaws.

The principal advantages of an LLC include the ability to limit the member's liability and to obtain pass-through tax treatment. Also, you don't have a limit on the number of investors in an LLC, as you do with an S corporation. The disadvantages of an LLC are that you can face more complications in the Operating Agreement and tax issues than you would for a corporation, plus investors (including venture capitalists) typically prefer to invest in a regular C corporation.

LLCs can be great vehicles for a new entity, but they can also get a little complicated, so make sure to consult with a competent attorney. Also, make sure that you have a good Operating Agreement.

The cost of forming an LLC varies with the circumstances and the state of organization. Some states, such as California, require an $800 minimum annual franchise tax, plus an annual, graduated fee based on the business's income. Legal fees for forming simple LLCs cost $1,000 or more.

The following key points characterize LLCs:

- **Limited liability:** The members of the LLC are generally not liable for the LLC's debts, obligations, liabilities, or the other members of the LLC. Investors in an LLC generally only have their share of the LLC's capital at risk.
- **Management:** An LLC may operate under whatever management arrangement the members want. For example, the members may decide to share management responsibilities or to elect one or more managers to handle the management.
- **Profits and losses:** The members of the LLC have more flexibility than they would in a corporation and are free to decide how to split up the LLC profits and losses. So, for example, they can allocate one member 40 percent of the profits, even though she may have only contributed 10 percent of the capital (subject to some tax rules).
- **Statutory requirements for formation:** To form the LLC, you must follow a number of state law requirements. For example, the LLC's name typically has to include the words *Limited Liability Company* or *LLC.*
- **Tax:** An LLC can choose from two taxation options:
    - **Pass-through taxation:** As they would a partnership, the government taxes the members, not the LLC, on business income.
    - **Taxed as a separate entity:** This form of taxation is like a regular corporation's tax procedures.

  In most cases, you should elect to be taxed like a partnership, thereby eliminating the potential double tax. The IRS has made this whole process easier with its "check-the-box" rules and forms for election.
- **Number of owners:** The number or types of members in an LLC is unlimited (unlike an S corporation). Some states require at least two members, but some states (such as Delaware) allow a one-member LLC.
- **Transferability of interests:** The terms of the Operating Agreement govern the right to transfer member interests. The transfer rights can be subject to various limitations.


Form 1-7 on the CD-ROM contains a checklist of items that you should review before drafting your Operating Agreement.

# Forms on the CD-ROM

Check out the following business entity forms on the CD-ROM:

| | | |
|---|---|---|
| Form 1-1 | **Comparison Chart for Different Business Entities** | A chart showing the key features of partnerships, corporations, and other business entities |
| Form 1-2 | **Checklist for Drafting General Partnership Agreements** | A checklist of items to consider when drafting a General Partnership Agreement |
| Form 1-3 | **Checklist for Drafting Limited Partnership Agreements** | A checklist of items to consider when drafting a Limited Partnership Agreement |
| Form 1-4 | **Checklist for Formation of a Corporation** | A checklist of items to consider when forming a corporation |
| Form 1-5 | **S Corporation Election Form (Form 2553)** | The IRS Form to elect S corporation status |
| Form 1-6 | **Transmittal Letter to IRS Enclosing S Corporations** | A sample letter to the IRS for use when sending the S corporation election |
| Form 1-7 | **Checklist for Drafting LLC Operating Agreements** | A checklist of items to consider when drafting an LLC Operating Agreement |