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A CLIENT'S GUIDE TO SELECTING THE BUSINESS ENTITY

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I. Introduction

One of the most important decisions in the lifecycle of any business is the choice of the business entity for the proposed enterprise. The selection of the proper form of business entity requires a careful balancing of tax and nontax considerations. In most cases, the choice will be made from among the following alternatives:

- a sole proprietorship, which is relevant only in situations where there is to be a single owner of the business
- general and limited partnerships
- limited liability companies ("LLCs")
- various corporate forms, including general business or "close" corporations

Other alternative business forms, such as business trusts, registered limited liability partnerships, or professional corporations, are generally only useful in specialized situations. Well-known entities such as joint ventures and Subchapter S corporations are really just special cases of the four business forms listed above.

The process of selecting the proper form of business entity generally requires a comparison of the entities in relation to a variety of distinguishing factors as they apply to the specific business and the requirements of the owners. While each form of business entity has its own unique legal framework and requirements as to formation and operation of the enterprise, many of the historic differences among the entities are eroding.

It is also important to remember that the choice of the business form does not itself guarantee the success of the enterprise, although the improper form may contribute to its ultimate failure. The proper form should provide a means for the participants to achieve the desired results and should not unduly constrain the freedom of the participants to establish a network of contractual relationships that suit their own unique business considerations.

The sole purpose of this publication is to assist business owners and managers in understanding the distinguishing factors among the most common types of business entities and some of the differences that need to be taken into account when selecting the form of entity for a new enterprise. While we believe that this information will be helpful, it should not be relied on as the exclusive resource in making the selection decision and readers are strongly advised to contact professional advisors before proceeding with formation and use of any of the entities described herein.

Also, please be aware that it is assumed that the selection is being made among entities formed under, and governed by, the applicable laws and regulation of the state of California. For



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example, any reference to the "Secretary of State" is to the California Secretary of State. State laws regarding business organizations may differ substantially and advice of local experts should always be obtained before selecting an entity that is to be organized under laws other than those of the state of California.

II. Distinguishing Factors among Business Entities

Each of the potential business entities can generally be distinguished by reference to the following issues and characteristics:

- (1) the formalities and procedures involved in forming and organizing the entity;
- (2) the manner in which the entity facilitates the fulfillment of the financing and credit requirements of the underlying business, either through the issuance of ownership interests or by credit arrangements based on the assets of the business and its owners;
- (3) the rights of the principals to participate in management of the activities of the enterprise, as well as the ability of the principals to enter into contracts and other arrangements with outside parties;
- (4) the allocation of profits and losses from the activities of the business among the principals;
- (5) the extent to which the principals will be personally liable for the debts and obligations of the business;
- (6) the ability of the owners to transfer their ownership interests in the enterprise without causing a disruption or termination of the business;
- (7) the effect of the death, withdrawal or retirement of any of the owners on the continued existence of the business; and
- (8) the income tax consequences associated with forming, operating, making distributions from, and terminating, the entity, as well as the income tax consequences of transferring an ownership interest in the business back to the entity or to another party.

II. Nontax Classification of Business Entities

A. SOLE PROPRIETORSHIP

The sole proprietorship, with a single owner, is clearly the simplest form of business enterprise. A sole proprietorship can be organized informally and is subject to minimal regulation. The proprietor owns all the assets used in the business, other than those that are rented from others, has absolute control over the management of the business, and retains all of the profits generated by the activities of the business. As with any form of business organization, the proprietor may enter into agreements with employees, landlords, and lenders to compensate them with a share of profits in lieu of fixed wages, rents, or interest. In addition, the proprietor must comply will all applicable permit and licensing requirements imposed under local, state,



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and federal laws. A proprietorship terminates upon the death or withdrawal of the proprietor or upon the sale of the underlying assets to another party.

In stark contrast to many of the other business organizations, a proprietor is liable as a principal on all the business contracts of the enterprise, including those made by employee-agents, and must bear all of the debts and obligations of the business, including liabilities for any torts committed by agents of the proprietor within the scope of their engagement, from his or her own personal assets. As such, use of a proprietorship is not generally recommended absent sufficient insurance and business activities that are highly unlikely to result in personal liability to the proprietor.

B. PARTNERSHIPS

A partnership is an association of two or more persons to carry on a business for profit as co-owners. While specialized partnership forms have been recognized, the two basic choices are the general partnership and limited partnership. A general partnership may (but should not) be created by oral agreement, and creation of a general partnership does not require the intervention of any public agency. In contrast, a limited partnership, which has two classes of partners (i.e., "general" and "limited"), can only be created by appropriate registration with the Secretary of State.

1. GENERAL PARTNERSHIPS

General partnerships originated under the common law and consist of two or more partners, referred to as general partners, each of whom is generally actively involved in the business. Formation of a general partnership does not require the completion of any statutory formalities; it simply requires the agreement of the parties, which can be inferred from their conduct as well as from any oral or written contract. Like proprietors, general partners are subject to unlimited personal liability for the obligations of the partnership. Unless limited by agreement, each general partner is entitled to participate fully in the management of the partnership business, and general partners stand in a fiduciary relationship to one another. New general partners cannot be admitted to a partnership without the consent of the other partners, and the death, withdrawal, or retirement of any general partner will cause dissolution of the partnership, although the partners may provide by contract to continue the partnership upon the occurrence of such an event.

2. LIMITED PARTNERSHIPS

In contrast to general partnerships, limited partnerships are a creation of statute and must therefore be organized under the statutory provisions imposed by the various states. In most cases, organization of a limited partnership requires the completion of strict statutory formalities



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including, in most jurisdictions, the execution and filing of a certificate of limited partnership with the appropriate state authorities. A limited partnership consists of one or more general partners and one or more non-general partners, referred to as limited partners. General partners of a limited partnership have the same rights of control and exposure to liability as general partners of a general partnership. On the other hand, limited partners are passive investors who contribute cash and other assets to the partnership for use by the general partners in the conduct of the business. Limited partners have few rights to exercise any degree of control over the partnership business. In turn, the liability of the limited partners is restricted to their investment in the business. The interest of a limited partner is freely transferable, and the death, withdrawal, or retirement of a limited partner has no effect upon the operation of the partnership business.

3. FAMILY LIMITED PARTNERSHIPS (FLP'S)

The following will briefly describe the advantages and disadvantages of the family limited partnership. Generally the family limited partnership helps reduce estate tax and settlement costs, protects family assets and provides for succession of ownership and control of property.

i. The Limited Partnership Provides for Management and Succession of Ownership

The family limited partnership has replaced the corporation as the preferred choice of entity to hold property and to pass it from one generation to the next. This is true for both tax and non-tax reasons. As far as tax issues are concerned, a limited partnership rather than an S corporation is a better choice for the taxation of interim and final distributions of appreciated property. In addition, a partner in a limited partnership may utilize partnership liabilities, thus allowing for more losses to be deducted. An S corporation has limitations upon the number and kinds of owners while limited partnerships do not. In addition to the tax reasons, there are practical reasons for having a family limited partnership.

The family limited partnership helps avoid intra-family disputes, because the limited partnership interest can generally be restricted to the members of the family. This is true even with a divorce. If the partnership interest was transferred in a divorce proceeding, it still would not be a valuable asset, as the recipient would not be able to dissolve the partnership, remove the general partner or force distributions of income from the partnership. A family limited partnership protects against third parties acquiring an interest in the partnership.

Specific management of the family business assets by proper "succession planning" can be accomplished with the family limited partnership. The general partners control the assets of the partnership, to the degree outlined in the partnership document, while the limited partners simply hold an interest without management authority in those assets. Planning the succession



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of general partners, often at death of the current general partners, can be set out in the agreement. Additionally, methods for dispute resolution among the general partners can be organized in order to establish patterns to minimize family conflict over the management of the assets

ii. FLP's and Asset Protection

Perhaps the use of a properly drawn family limited partnership to manage family assets such as ranches and rental real estate may be the best way to maximize the chance the family business will survive to the next generation and not "self destruct."

Under California law, the rights of a creditor seeking to execute a judgment or tax lien against the ownership interest of a debtor in a limited partnership is restricted. California Corp. Code Section 15674(a) provides that "an assignee of a partnership interest, including an assignee of a general partner, may become a limited partner if and to the extent that (1) the partnership agreement so provides, or (2) all partners consent." The limited partnership agreement can provide that the creditor is not allowed to become a limited partner. Without voting power, the creditor cannot remove the general partner or liquidate the limited partnership. The creditor would only receive a charging order. A charging order is a court order requiring that distributions of cash and property with respect to the encumbered partnership interest be paid to the creditor until the judgment debt is discharged. This can also be avoided if the family limited partnership holds non-income producing property, such as real estate and stock of the family owned business which does not pay dividends. Also, the general partner may be authorized to retain income as reasonable reserves.

If this is the case, all the creditor realizes from its charging order is an IRS Form K-1 at the end of each tax year and an income tax liability. If the spouse of a debtor holds her interest as separate property, and her conduct did not result in a judgment against her, her separate property interest may not be charged with a judgment debt against her husband. In short, a family limited partnership can make it extremely difficult for a creditor to obtain access to the assets of the limited partnership.

While a limited partnership protects the assets of the limited partners, the general partner may still be liable. A number of businesses which choose to use the limited partnership format and also wish to obtain maximum protection for the general partner have utilized an S corporation as the general partner. If properly formulated, the shareholders of the S corporation have their liability limited to the assets they have contributed to the corporation. Thus, both the general partner and the limited partners are protected.

iii. FLP's and Estate Tax Savings



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A basic precept in estate and gift tax law is that, for tax purposes, assets are valued at their "Fair Market Value." The Internal Revenue Code and the IRS regulations generally define "Fair Market Value" as that amount of money a willing buyer will pay a willing seller, neither being under any compunction to buy or sell, both with full reasonable knowledge of the facts. As a corollary to succession-management planning, family limited partnership interests, by definition, impact the legal ownership and management rights of the underlying partnership assets which, in turn, influence the values of those assets for estate and gift tax purposes.

iv. Gifts of Partnership Interests

An annual gifting program can be utilized in which capital account interests in the limited partnerships are given away instead of cash gifts. The gifts can qualify as a gift of a present interest subject to the annual gift tax exclusion. Individual gifts will also qualify for discounting. This is extremely helpful in estate planning.

v. Reduction of Probate Costs

A family limited partnership can be utilized with a revocable living trust to avoid probate costs of transferring title. The estate settlement cost savings can be significant. The usual situation which would facilitate this would be to have the family assets owned by the family limited partnership and then transferred to the living trust.

vi. Disadvantages

There are disadvantages to setting up a family limited partnership. A family limited partnership can be expensive to set up. Transferring assets to it may also trigger a due on sale clause in a mortgage. If the conveyed property is rental real estate, the partnership is not entitled to the \$25,000 passive loss under IRC Code section 469(i)(6)(C) that an individual owner may benefit.

Under California Law, the limited partnership cannot engage in the banking or insurance business. The partnership should not own a qualified retirement plan or individual retirement account as the transfer would be treated as a taxable termination. Because of the homestead exemption, a residence should not be transferred to the limited partnership unless the homestead exemption, as in the case of California, is insignificant.

Transfers to partnerships and trusts in the state of California may result in a change of ownership which would step up the property tax basis of the property otherwise protected by Proposition 13. Proper planning may reduce (but not eliminate) the risk of a change of ownership for property tax. Lastly, the estate and gift tax valuation issue may be subject to challenge by the IRS as described above.



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C. LIMITED LIABILITY COMPANIES

The LLC is a creation of state law that combines limited liability protection for all of the equity owners without sacrificing the right of any owner to participate in the management of the enterprise. In California, LLCs are governed by the Beverly-Killea Limited Liability Company Act.

An LLC is a separate, legal entity formed by filing articles of organization with the Secretary of State. LLC statutes contemplate, but do not require, the adoption of an "operating agreement" or "regulations" to govern the operation and management of the LLC.

The members may reserve all management powers to themselves, in which case the members become mutual agents for one another in much the same way as a general partnership. Alternatively, members may opt for the decentralized management of the corporate form by delegating management powers to one or more appointed managers, and the managers will be solely responsible for contracting for debts or incurring liabilities on behalf of the entity.

Regardless of the management structure of the LLC, as a general matter, neither the members of an LLC nor its managers are liable for the debts or liabilities of the LLC. Assuming that all of the statutory requirements are satisfied, the LLC member's liability to the LLC is generally limited to the extent of any unpaid capital contributions, including any capital required to be paid in the future on conditions stated in the articles of organization.

With respect to changes in ownership and continuity of existence, LLCs tend to be similar to general partnerships. In most cases, absent a contrary provision in the operating agreement, the LLC statutes provide that unless a proposed transfer has been unanimously approved by the other members, a transferee of a member's interest cannot participate in the management of the LLC or become a member, although the transferee is entitled to receive the share of profits attributable to the transferred interest. As for the death, retirement, or other event of withdrawal of a member of an LLC, the LLC will be dissolved unless the statute provides for continuation of the business by all or some portion of the remaining members.

While the LLC was originally an alternative to multi-owner entities such as partnerships, recent changes in LLC and tax laws have led to widespread recognition of single-member LLCs which provide limited liability for the owner-member and proprietorship tax treatment.

D. CORPORATE FORMS OF BUSINESS ORGANIZATION



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The corporation is the most widely used form of business organization in the United States. Several different types of corporations are recognized in California, including professional corporations and nonprofit corporations. However, for most new businesses, the relevant choices are the general business corporation or a statutory close corporation. The commonly mentioned "S corporation," which is discussed below, is a tax classification that may apply to either a general or close corporation.

1. Regular Business Corporations

A regular business corporation, like a limited partnership, an LLC, and all other corporate forms, is a creature of statute that is formed upon the filing of the appropriate documents with the Secretary of State. Each state has enacted elaborate rules that govern the management and operation of a corporation, although the shareholders, who are the owners of the corporation, are free to enter into additional agreements with respect to voting rights, compensation, and transfer of ownership interests.

A corporation has centralized management in that the decision-making authority is vested in a board of directors, whose members are elected by the shareholders. In turn, the directors select officers and other agents to assume responsibility for the day-to-day operations of the business. Shareholders may also be directors and officers of the corporation, although the shareholders are free to recruit independent managers to serve in such positions.

Assuming compliance with statutory formalities, shareholders enjoy limited liability with respect to the debts and obligations of the corporation, even if they participate in the management of the corporation as directors and officers. Ownership interests are freely transferable, although the shareholders may place reasonable restrictions on share transfers. Corporations have perpetual lives and, therefore, death or withdrawal of one or more shareholders will not automatically cause the termination of the corporation.

2. Statutory Close Corporation

Shareholders seeking the limited liability offered by the corporate form while eliminating a good deal of the various procedural formalities associated with a corporation may wish to utilize the "statutory close corporation" provided for in certain jurisdictions. The characteristics of a close corporation will vary from state to state, but statutes usually require that the corporation can only have a limited number of shareholders and that the shares be subject to various restrictions upon transfer. These close corporations are created by statute and are to be distinguished from such informal terms as "closely held" and "close" corporations, each of which refer to corporations "whose shares are not generally traded in the securities markets" but which may not have been organized under a state's specific close corporation provisions.



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A statutory close corporation is usually permitted to conduct its day-to-day operations pursuant to the terms of a detailed shareholders' agreement. As a result, shareholders are able to provide for a great deal of flexibility with respect to management of the business, voting rights, restrictions on the transferability of shares and the omission of corporate formalities. The use of the statutory close corporation does carry with it a number of risks and costs:

- (1) shareholders who are given managerial responsibilities will be subject to potential personal liability associated with acting as an officer or director;
- (2) the law with respect to statutory close corporations is not as developed as the law governing the general corporate form, leading to potential uncertainties with respect to the interpretation of the shareholders' agreement; and
- (3) the drafting of the shareholders' agreement may be quite costly.

III. Tax Classification of Business Entities

With the obvious exception of sole proprietorships, which are not separate tax reporting or paying entities, business entities are treated as either partnerships or corporations for tax purposes. Beginning in 1997, the Internal Revenue Service ("IRS") established new guidelines and regulations governing the determination of whether an entity is to be taxed as a partnership or a corporation. Previously, an entity such as an LLC or a limited partnership was taxed as a partnership only if it lacked certain corporate characteristics. The new rules essentially allow an entity other than a per se corporation to choose how it will be classified for tax purposes. These rules are referred to as "check-the-box" rules and are intended to simplify the classification process. Once a classification has been chosen, an entity may change the classification (generally once every five years). However, there may be a tax consequence for such a conversion. If an entity fails to elect a particular classification, it will be classified under a default system based not on corporate characteristics but on various other factors, such as the number of members, where the organization is formed (i.e., domestic or foreign), and, for foreign entities, whether its members have limited liability.

The laws and regulations governing taxation of business organizations and their owners are quite complex and the descriptions included herein should always be supplemented by expert advice from tax specialists. Both the IRS and California's Franchise Tax Board distribute various publications on taxation of self-employed persons (i.e., proprietors), partnerships, corporations, and LLCs.

A. Sole Proprietorships

For income tax purposes, a sole proprietorship is not treated as a separate entity, and the profits and losses of the business activity are reported on the owner's individual income tax return by preparation and filing of a Schedule C. The owner may deduct any reasonable and



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necessary expenses attributable to the business operations. Amounts paid to the owner are not considered salary and cannot be deducted. The annual profit or loss of the business is taxed at the business owner's applicable rate.

B. Partnerships

For tax purposes, partnerships (general and limited) are treated as conduit or pass-through entities unless an election is made to have the partnership treated as a corporation. As such, a partnership is not a taxable entity and does not generally incur a direct tax liability with respect to its business activities. However, the partnership must compute the amount of its gross income, gains, losses, deductions, and credits and must file an information return reporting these items. Additionally, the partnership must calculate the distributive share of each partner with respect to these various "tax items." Ultimately the distributive shares of each partner must be reported on the individual income tax return of that partner, whether or not the partner actually receives any money or property from the partnership.

A partner's distributive share is generally determined by the partnership agreement. If, however, those distributive shares lack substantial economic effect, the IRS has the power to reallocate the partnership items in accordance with the partner's deemed economic interest in the partnership. While the application of these reallocation rules is extremely complex, certain safe harbors have been established. In addition, the ability of limited partners to use partnership losses may be affected by the passive activity limitations because, by definition, limited partners will not be materially participating in the business.

C. Limited Liability Companies

For tax purposes, multimember LLC's are taxed either as a corporation or as a partnership. While the tax characterization of LLC's was, for some period of time, a matter that raised great controversy, much of the uncertainty has now been alleviated by the "check-the-box" regulations. Single-member LLC's are treated as proprietorships for tax purposes, unless corporate tax treatment is elected.



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D. Corporations

Depending on the circumstances, shareholders of a corporation may be subject to very different income tax rules. The default rules call for corporations to be taxed as a separate entity. In that situation, the tax is imposed on the taxable income of the corporation (sometimes referred to as a "C corporation," so named because taxation of their income is controlled by Subchapter C of the Internal Revenue Code) at the corporate tax rate. In computing taxable income, the corporation may deduct all ordinary and necessary expenses that are reasonable. However, dividend payments to the shareholders are not deductible. Thus, use of the corporate form may result in double taxation: once when the earnings and profits are taxed at the corporate level, and a second time when a dividend distribution is made. In many cases, this may not be a major issue for closely held corporations, because the shareholders are likely to also be employees of the corporation. Thus, revenues of the corporation can be paid out to the employee/shareholders as compensation, which is then deducted by the corporation. These payments may, however, be limited and may be examined more closely by the IRS.

It is important to remember, of course, that shareholders of a corporation may elect to have the corporation treated as a so-called "S corporation," which will cause the business activities to be taxed as a partnership (i.e., an S corporation is regarded as a conduit entity and is not subject to an entity level tax). Tax items associated with an S corporation are passed through to the shareholders and are reported by the shareholders on their individual income tax returns. The tax items are allocated to the shareholders based on their pro-rata shareholding in the corporation. Losses from an S corporation may be used by the shareholders to offset other income, although use of the losses is subject to the passive loss limitations under Internal Revenue Code Section 469. While the specific application of the passive loss limitation rules is very complex, the general rule is that passive losses cannot be used to offset nonpassive losses such as salary, wages, or income from an activity in which the taxpayer materially participates.

The ability to elect S corporation status is available only to corporations that satisfy certain criteria, including the following:

- an S corporation may not have more than 75 stockholders, all of whom must be individuals, estates, or certain types of trusts, and must be US citizens or resident aliens
- it must be a domestic corporation
- it cannot be used for banking
- only one class of stock is permitted

In light of these limitations, it is anticipated that business owners looking for both limited liability for all owners and pass-through taxation may opt for use of an LLC.



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IV. Advantages and Disadvantages of Various Business Entities

A. Sole Proprietorship

The main advantage to a sole proprietorship is its simplicity. Since the profits and losses of the business are reported by the owner on Schedule C of the owner's individual tax return, there is no separate income tax reporting requirement for the business. The business may, however, have to file returns and reports with respect to employment related taxes. If the business generates a loss, that loss may be used to offset other income on the owner's tax return. Any unused losses may be carried over to prior or succeeding years. However, a business that generates continued losses may be characterized as a hobby. In such instances, the owner may not be allowed to use those losses to offset other income.

The main disadvantage to a sole proprietorship is that it affords no limitation on the liability of the owner. Thus, the owner is personally liable for all of the debts, obligations, and liabilities of the business. Additionally, sole proprietorships are denied certain tax benefits available to other forms of business. These include nonqualified retirement plans, deferred compensation plans, stock option plans, medical and dental plans, accident and health plans, group term life insurance, cafeteria plans, and employee death benefits. These shortcomings have slowly led to proprietors selecting a single-member LLC as that option has become available in various states. Under current law, California does permit formation of single-member LLCs.

B. Partnerships

1. Advantages

There are three major advantages to operating a business in the form of a partnership. One of the advantages is that a partnership is not a taxable entity, but rather a conduit through which income and loss flows directly to the partners. Thus, the double taxation problem that is inherent in C corporations is avoided. Additionally, most income, deductions, credits, and other tax items retain their character in the hands of the partners. For example, depreciation on partnership assets can be deducted directly by the partners. Further, partnership losses may be used by the partners to offset other income (although this is subject to certain limitations).

Another major advantage of partnerships is that there is generally no recognition of gain upon formation, without regard to whether the entity is controlled by the transferor immediately



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after the exchange. There are, however, certain circumstances under which gain will be recognized. Also, upon liquidation of a partnership, there is gain only if the cash distributed exceeds the partner's basis in the partnership. A distribution of property does not result in taxation. Liquidation of a corporation, on the other hand, calls for a tax on whatever is distributed to the extent it exceeds the shareholder's basis in that shareholder's stock. Further, a liquidation sale by a corporation of its assets means a tax to the corporation (assuming the sale is at a profit) and then a second tax when the funds are distributed to the shareholders.

Finally, a partnership is also the most flexible of the major entities. Within certain limitations, the partners can structure their relationship as they please. Income and losses from varying sources can be allocated in unequal amounts to the various partners. Even specific tax items can be apportioned unequally. In a C corporation the relationship is set forth in the various classes of stock issued. It is even more restricted in an S corporation, where only one class of stock is permitted, and allocations of pass-through items must be made in accordance with the pro-rata shareholdings. The partners are generally free to devise their own structure and procedures for management of the business; however, limited partners in a limited partnership will be restricted as to their actual participation in management decisions.

2. Disadvantages

One of the main disadvantages to the partnership is that partners will be taxed on their share of income even if the partnership does not distribute funds, which may result in taxes having to be paid from assets or income from sources other than the partnership. Another disadvantage is that nonqualified retirement plans, deferred compensation plans, stock option plans, medical and dental plans, accident and health plans, group term life insurance, cafeteria plans, and employee death benefits are not available to partnerships. While a qualified retirement plan may not be adopted by a partnership for its owners, the partners may get the same benefit through adopting Keogh plans.

There are also major nontax disadvantages to a partnership. The most important is that general partners are jointly and severally liable for all of the partnership debts. That liability extends not only to the value of the partner's investment in the partnership, but to all of his or her personal assets. While most catastrophic liabilities can be insured against by a partnership, the risks of partnership form can still be significant. This general liability feature of the partnership works to undermine the entrepreneurial spirit. However, passive investors, unwilling or unable to be involved in the day-to-day management of the business, can be given limited partner status to cap their liability at the amount of their investment in the business.

In addition, the creation of new ownership interests and the transfer of those interests within a partnership can also be quite cumbersome, thereby reducing the attractiveness of the partnership form as the entity of choice in situations where there is to be a large number of



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owners and/or there is a desire to issue equity interests to employees and vendors. Problems are exacerbated in the case of a limited partnership, since limited partnership interests are securities for securities law purposes and thus are subject to additional regulation.

C. Corporations

The corporation is probably the best known and most common of the business entities. The general familiarity of all persons involved in commerce, finance and banking creates a feeling of acceptance and comfort when dealing with a corporation. For the foreseeable future--absent massive changes in federal and/or state tax laws--the corporation will remain the entity form of choice.

1. Non-tax Advantages

As a general proposition (to which there are some exceptions), a corporation's shareholders have "limited liability." They are not personally liable for the debts of the corporation, but rather can only see their investment rendered worthless (or diminished) should the creditor pursue the corporate debtor. However, in a start-up environment, where the new corporation may have few assets and no credit history, the reality is that the founders may well find themselves asked to personally guarantee such obligations, as a building lease, bank line of credit, or supplier credit. With fiscal success of the business, such guarantees may be expected to fall away.

Corporations enjoy relative ease in raising and operating capital and in transferring the ownership interest represented by its shares. In other words, it is relatively easy to buy and sell shares of stock as compared with the sale of assets or partnership interests. However, issuances and transfers of corporate securities must be done in a manner that complies with applicable federal and state securities laws.

Corporations also offer ease of control at both the ownership level and in the management area for the majority shareholders. Voting rights depend on applicable state law. In some states, a majority of the shareholders can elect all members of the board of directors. In other states, however, including California, cumulative voting provisions assure minority shareholders of some representations on the board. In either case though, the majority of the shares can control the board and the selection of the management team. The shareholders, as a class, have no right to participate in the day-to-day management of a corporation as, for example, partners would in a general partnership. Moreover, in corporate form, outside investors can be issued nonvoting preferred shares so that the founders, despite a much smaller cash investment, can retain voting control.

Finally, another unique facet to the corporate form is the ability to limit the personal liability of directors with respect to actions brought by or in the right of the corporation for



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breach of the director's duties to the corporation and its shareholders. The scope of protection is determined by applicable state law; however, it normally does not extend to intentional misconduct, bad faith acts contrary to the corporation's best interests, transactions from which a director derives improper personal benefit, reckless disregard of a director's duties, or an unexcused pattern of inattention to one's duties as a director.

2. Tax Advantages

Operating as a corporation can lead to a smaller tax bill than if the corporation did not exist. For example, the first \$50,000 of earnings can be left in the corporation to be taxed at 15%, and the remainder can be drawn as salary. Depending on the other income of the taxpayer, part of that might be taxed at 15% also, with the rest going into the 28% and higher brackets. If the taxpayer has other income, leaving even more earnings in the corporation may save taxes (although leaving too much in the corporation may result in accumulated earnings taxes being applied). Additionally, the ability to establish a deferred compensation plan, a medical plan, group term insurance, and death benefits plan might, combined, be worth several percentage points of tax. A corporate retirement plan also has several minor advantages over a Keogh plan.

In situations where the business may face a problem with respect to passive losses, a C corporation may be the entity of choice. Any corporation in which more than 50% of the stock is owned by more than five individuals is not subject to the passive loss limitations. Even one with five or fewer stockholders can offset passive losses against business income (this is not true of a personal service corporation). In contrast, if the owners have profits from other passive operations, a partnership may be preferable so that losses may be used to offset passive income.

3. Non-tax Disadvantages

Corporations may be more expensive to maintain than other business forms. Costs to incorporate, exclusive of professional fees, can run to \$2,500 depending on the state of incorporation. Prudence dictates that records be kept of meetings of directors and shareholders, as well as share issue and transfer records. For a start-up company, it is rare that the founders will have these skills, so they must either be purchased or deferred, with the later creating its own set of problems. Partnerships, on the other hand, require little documentation to maintain the entity.

4. Tax Disadvantages

The two major tax disadvantages to conducting a business in corporate form are double taxation and the tax imposed upon liquidation of the corporation. While double taxation is not a very attractive proposition, in practice, most corporations are small and are merely incorporated



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partnerships or sole proprietorships. In these types of situations, the corporation pays no tax at all, because the earnings are taken out by the shareholders in the form of deductible salary, bonuses, or other benefits. Dividend distributions are rarely, if ever, made so that double taxation never takes place.

The other major tax disadvantage to corporations is that the liquidation of the corporation is a taxable event to the stockholders. This is also true of mergers and consolidations that do not meet statutory requirements. Corporations may also be subject to additional rules if they become personal holding companies, if they fail to distribute earnings, if they issue preferred stock, or if they engage in many other actions covered by the Internal Revenue Code.

5. S Corporations

S corporation status may be available in certain situations, depending on the number and identity of the shareholders and their willingness to accept a relatively simple capital structure. Conducting business in the form of an S corporation avoids the problem of double taxation, since an S corporation is treated as a conduit entity in much the same way as partnerships. Therefore, an S corporation combines many of the best features of both a partnership and a corporation from a tax perspective. Limited liability is achieved through the corporate form, and the double tax of the corporate form is eliminated.

Operating the business in the form of an S corporation can be beneficial for family owned businesses. S corporations are ideal for spreading income among inactive family members, while avoiding many of the tax, legal, and operating problems that are experienced by family partnerships. The S corporation may also be a good choice during the early years of the entity when losses are expected. The losses may be used by shareholders to offset their other income, subject to the passive loss limitation imposed on inactive members.

S corporations also have certain disadvantages. The need to adopt a simple capital structure has already been mentioned, and the transferability of ownership interests will be limited by the need to insure that all shareholders satisfy the requirements listed in the Internal Revenue Code. Another disadvantage to S corporations is that the deductibility of certain fringe benefits is limited. Medical reimbursements, disability retirement benefits, premiums on group term life insurance, and cafeteria plans paid to a stockholder holding a 2% or greater interest in the corporation are taxable to the shareholder but not deductible by the corporation. Also, there are differences in the tax treatment of distributions to the shareholders of an S corporation that may result in the recognition of gain, where a similar distribution to partners of a partnership would not be a taxable event. Finally, an S corporation's income is taxed to the shareholders regardless of whether the corporation distributes funds to the shareholders for use in paying the tax liability.



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E. Limited Liability Companies

In many ways, an LLC offers the best of both worlds. It is an entity that affords all of its owners the limited liability of a corporation, yet, it can be taxed as a partnership if the owners so choose. While the concept of LLCs has been around for several decades, there has only recently been any significant interest shown in this entity. As it becomes more widespread, it is likely to be the entity of choice for small and medium-sized businesses, particularly since it is now possible for businesses formerly operated as proprietorships to secure the benefits of limited liability by organizing as single-member LLCs. In fact, LLCs have already become attractive vehicles for real estate ventures, joint ventures, venture capital funds, and international investments.

1. Advantages of LLCs Over Corporate Forms

The fact that an LLC can be treated as a partnership for tax purposes provides it with several tax advantages over C and S corporations. Of course, because it is treated as a partnership for tax purposes, an LLC will not be subject to double taxation and the members are free to allocate income and loss under the rules applicable to partnerships. Also, an LLC that is taxed as a partnership does not generally recognize gain or loss upon liquidation. Only the members may be subject to tax on distributions received from the LLC's liquidation. In addition, a C corporation may have a portion of the salary deduction for an officer-shareholder disallowed as unreasonable compensation. Any disallowed portion would typically be treated for tax purposes as a dividend rather than as salary. In contrast, a LLC member's income is either taxed as a guaranteed payment or as the member's distributive share of LLC income.

LLCs are often compared to S corporations, since both offer limited liability and pass-through taxation. In general, LLCs offer a great deal of flexibility in relation to S corporations. For example, while S corporations are subject to certain restrictions on the number and type of shareholders they may have, as well as the number and variety of ownership interests that may be issued, LLC's are not subject to any of these restrictions. In addition, S corporations may not hold more than 80% of the total voting power and total value of another corporation's stock. LLCs are not subject to this restriction. Furthermore, unlike LLCs, S corporations are not permitted to specially allocate income, gain, deduction, or loss among their shareholders or make disproportionate distributions to their shareholders. Finally, S corporations are subject to certain penalty taxes for built-in gains and excessive passive income that do not apply to LLCs.

On the nontax side, LLCs are attractive in that they are not subject to the same formalities as corporations, such as the requirements for calling and conducting meetings, and annually electing directors and officers. The rights, duties, privileges, and preferences of an LLC's members are usually defined in the operating agreement, which is not a publicly filed document. While amendments to the articles of incorporation of a corporation that may adversely affect one



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or more classes of stock generally require approval of at least a majority of all shareholders, amendments to an LLC's operating agreement may generally be done without a separate class vote unless specifically required in the operating agreement.

2. Disadvantages of LLCs in Relation to Corporations

While LLCs enjoy significant advantages over corporations, there are some disadvantages that need to be considered. For example, members of an LLC will not enjoy all the advantages of the numerous fringe benefits available to shareholder-employees of a C corporation. For example, members of an LLC: may not receive tax free life insurance and medical benefits; may not participate in a cafeteria plan established for the LLC's employees; and will find significant restrictions with respect to qualified retirement plans (e.g., inability to borrow from the retirement plan). Members of an LLC may also be subject to higher marginal tax rates than corresponding corporate tax rates.

In addition, until LLCs become more widely known and used, there may be practical inconveniences in using an LLC rather than a corporation for certain transactions or business activities. For example, banks are not accustomed to dealing with LLCs, and such unfamiliarity may delay or prevent the LLC from obtaining loans. There are likely to be many situations in which business promoters and investors will prefer the more formal structure and certainty of corporations over the relative uncertainty of LLCs.

3. Comparing LLCs to Partnerships

The most important distinction between LLCs and general partnerships is that the partners of a general partnership are personally liable for the debts of the general partnership whereas the members of an LLC generally have limited liability. Partners acting in the ordinary course of business may bind the general partnership. However, a member who is not acting as a manager has no power to bind a manager managed LLC in transactions with third parties. Finally, a general partner in a general partnership may cause a dissolution of the general partnership when no definite term or particular undertaking is specified. A member of an LLC does not have any such right.

The striking distinction between LLCs and limited partnerships is that while every limited partnership must have at least one general partner who is potentially liable for all the obligations of the partnership, all members of an LLC have limited liability regardless of their participation in the management of the business. While this problem can usually be resolved through the use of a corporate general partner, this increases the organizational complexity and administrative and compliance costs. Moreover, despite changes in the California limited partnership statute that permit greater participation in management by limited partners, limited



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partners may jeopardize their limited liability status if they actively participate in the business of the limited partnership.

V. Selection Process

Once the principals have a good understanding of the various alternatives available to them in the entity selection process, they should work with their professional advisors to collect and evaluate all the information necessary to make an informed decision. The legal or accounting professional will generally distribute a list of required information, including business and financial information on the proposed business and each of the principals. If possible, a business plan and detailed projections should be prepared so that proper consideration can be given to specific risks and amount and timing of profits and losses from the enterprise.

Once the information is collected, a good deal can be sorted out by asking the following basic questions:

- Are there any *nontax* factors that would *require* utilizing the corporate form? These might apply when the business activities are particularly risky or the principals intended to raise significant amounts of capital from outside investors.
- Will the business generate losses during the early years of operation that makes it desirable that one of the forms of "pass-through" entities (i.e., partnership or S corporation) be used?
- Are there any special tax planning considerations that must be taken into account? Anticipated transfers to family members for estate planning purposes may dictate the use of a limited partnership. If flexibility with employee benefits is desired, a corporation may be the best choice of entity.
- Are there any special *nontax* considerations that must be considered when no clear choice has emerged from the balance of the above referenced factors? Formation and administration costs are sometimes very important for very small businesses.

Even when a preliminary choice has been made based on the foregoing analysis, a variety of other issues must be considered, if not already taken into account. They include the following:

- The participation of various types of entities, such as a corporation, a nonresident alien, or certain types of trusts, may prevent use of a S corporation, as may the number of participants.
- Participants who must be actively involved in managing the business must be general partners, members, or shareholders, with the choice depending upon the need for limitations on liability from the entity itself, rather than from insurance. The degree of involvement in the business may also impact the deductibility of losses for partners under the "passive activity" rules.



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- Transfers of ownership interests may result in a variety of adverse tax consequences when the partnership form is used. Also, planning for the withdrawal, retirement, or death of a principal may have an impact on the form of business entity selected.
- The need to reinvest profits from the operation of the business may require using a C corporation, since the "pass-through" forms will tax the profits at the ownership level, thereby necessitating some distribution of assets to meet the current tax liabilities.
- If the principals are related to each other, any disproportionate relationship between the property and services contributed to the entity and the proprietary interests of the owners in the business may result in a reallocation of income between the parties if the partnership or S Corporation is used.

Evaluating each of these factors requires extensive consultation with professional advisors. They can assist the principals in comparing the various alternatives, often by reference to a chart that lists how each of the entities addresses specific tax and nontax issues. Software programs are also available to create projections of the anticipated tax liabilities for the entity and each of the owners based on an assumed selection of a particular organizational form.

The participants are not necessarily limited to a single organizational form. For example, there may be situations where certain elements of the business should be separated, perhaps because of the disparate functional skills associated with the activity or the degree of potential liability. A separate entity might also be formed to handle activities associated with a specific product line or in order to gain access to benefits provided for businesses organized in specific localities. However, before two or more entities are used, consideration must be given to the added complexities, including the need to keep multiple sets of books and records.

Selection and use of any entity organized under laws other than those of the state of California is also a possibility; however, as mentioned above, this decision should not be made with consulting experts in the law of the chosen jurisdiction. For example, businesses contemplating an eventual public offering of their securities may incorporate under Delaware law because of perceived advantages of Delaware corporate law as it relates to public companies. However, certain provisions included in California's corporations laws effectively override Delaware law until the specific conditions based on the number of shareholders and situs of business activities are satisfied.

Finally, the principals need to remember that while the initial selection of the form of business entity is important, changes in the form of entity can be made as the needs of the business and its owners evolve over the life of the enterprise. For example, California law allows for conversion of one form of entity into another with a minimum of regulatory paperwork as long as the economic interests of the owners remain essentially the same after the conversion. Also, a sole proprietorship may be converted into another entity to admit additional owners and/or limit the liability of the principals.



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VI. Documenting the Decision

Once the business entity has been selected, attention needs to turn to documenting the decision and actually completing the formalities of forming and organizing the entity. In the case of a corporation, for example, this means the preparation of the articles of incorporation, bylaws, shareholders' agreements, and organizational minutes and actions. The articles of incorporation will need to be filed with the Secretary of State. Legal counsel should be able to assist the principals in drafting all the required documents, often using much of the information collected to select the appropriate entity.

Documentation may be necessary even before the business is formed. For example, the principals should consider entering into some form of preformation agreement or letter of understanding which sets out their agreement regarding the key economic terms of the new business and legal relationships. This document should always cover the form of entity, and the principals can select from among the following examples:

Limited Partnership. We agree that the business will be organized and operated as a limited partnership under the laws of the State of California. Over the next two weeks, we will work with our counsel to prepare a certificate of limited partnership meeting the requirements of the State of California and prepare a limited partnership agreement that reflects our agreement regarding management of the business and allocation of profits and losses from the business.

LLC. We agree that the business will be organized and operated as a limited liability company under the laws of the State of California. Over the next two weeks, we will work with our counsel to prepare articles of organization meeting the requirements of the State of California and prepare an operating agreement that reflects our agreement regarding management of the business and allocation of profits and losses from the business.

Corporation. We agree that the business will be organized and operated as a corporation under the laws of the State of California. Over the next two weeks, we will work with our counsel to prepare articles of incorporation and bylaws meeting the requirements of the State of California and prepare a shareholders' agreement that reflects our agreement regarding management of the business. In addition, we shall cooperate in preparing and filing all documents necessary for the election of Subchapter S corporation status under the federal income tax laws.

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