Choosing the Right Business Entity for Your Company

Charles McClenaghan, Esq.
The Law Office of Charles H. McClenaghan, LLC
Charles@lawdublin.com
www.lawdublin.com

BUSINESS FUNDAMENTALS BOOTCAMP

Tactical Skills for the Growing Business

Choice of Business Entity

- Sole Proprietorship
- General Partnership
- Corporation
- S Corporation
- Limited Partnership
- Limited Liability Company (LLC)
  - Taxed as a disregarded entity
  - Taxed as a partnership
  - Taxed as a Corporation
  - Taxed as an S Corporation

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Choice of Business Entity

Primary factors driving the choice of entity decision...

1. Management Control & Duties
2. Tax Considerations
3. Asset protection
4. Flexibility
5. Cost to Form and Operate
6. Restrictions on Structure & Capital
7. Integration with estate plan

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Liability Protection

- **Why is it so important to structure your business for asset protection when you have or can buy liability insurance?**
  - Example: *National Real Estate Investor*, February, 2004; article on increased number of mold liability claims against owners of real estate.
  - Example: *Apartment Finance Today*; article on increased litigation by business owners due to the trend of insurance companies to exclude coverage for mold claims.
  - Example: Insurance companies denying coverage from lead based paint exposure, carbon monoxide poisoning, etc under general pollution exclusion

Corporations

- Pros
  - Inside out asset protection
  - Graduated tax rates
  - Dividends taxed at 5%-15% under the 2003 tax act
  - Medical reimbursement plans

- Cons
  - No outside-in asset protection
  - Double tax on sale
  - Year end tax planning to zero out earnings
  - Unreasonable compensation
  - Accumulated earnings tax
  - Strict corporate formalities required by statute & common law
  - Double taxation on operating income

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills
for the Growing Business

General Partnership

- Pros
  - Easy to form
  - Low cost to form and operate
- Cons
  - Unlimited liability to all partners for acts of entity and other partners

Limited Partnership

- Pros
  - Excellent asset protection
  - Pass-thru taxation
  - Maintain control even if ownership is gifted to or vested with another person or entity
  - Step-up in basis of underlying assets at death of a partner (IRC §754 election)
  - Inexpensive to operate
  - Flexible management and economic structures
- Cons
  - Expensive to form

Business Fundamentals Bootcamp
Tactical Skills for the Growing Business

Limited Liability Company

- Pros
  - Flexibility
  - Taxed as sole proprietor, partnership, corporation or S-corporation
  - Good asset protection vehicle (multi-member LLC)
  - Relatively easy and inexpensive to operate
- Cons
  - Questionable asset protection for single member LLC
  - Must carefully draft the operating agreement
  - Business mergers, divisions and reorganizations are more difficult

S Corporation

- Pros
  - Pass thru taxation
  - SE Tax minimization planning
  - Inside-out asset protection
  - Eligible for qualified plans, ESOP and other fringe benefits
  - Easy for business mergers & reorganization
- Cons
  - Restrictions on ownership
  - No outside-in asset protection
  - Strict corporate formalities required

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Management Structure

- Representative Management
  - (Corporate structure)
- Entrenched Management
  - (Limited partnership structure)
- Direct Management
  - (General partnership structure)

BUSINESS FUNDAMENTALS BOOTCAMP

Tactical Skills
for the Growing Business

Representative Management

- Corporations
- Manager Managed LLC (with elected managers)
- Useful to vest agency authority with designated persons
- LLC v. Corporation
  - LLC: management need not be elected each year by statute so operating agreement would need such provision
  - LLC: typically management is removed for cause only
  - LLC: manager need not be a natural person (another entity)
  - Corporation: established body of case law

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Entrenched Management

- Limited Partnership
- LLC with designated manager (default statute)
- Limited Partnership v. LLC
  - LLC: manager need not be a member of the LLC
  - LLC: manager typically removed for cause only or not at all
  - LP: general partner must be a partner

Direct Management

- General Partnership
  - Each partner has liability for claims and liabilities of the general partnership
- Limited Liability Partnership
- LLC (member managed)
  - Each member has the authority to bind the LLC and to conduct its usual business

Business Fundamentals Bootcamp
Tactical Skills for the Growing Business

Hybrid Management

- Flexibility of LLC statutes allow combination of various elements of the different management styles
  - E.g. can provide for entrenched management by a particular member until a certain event, then a shift of management to another, perhaps representative entity
  - E.g. could define the breadth or limits of management authority in the operating agreement
  - E.g. can structure the management authority different from the economic structure of the company
    - A member can have control without owning 51% of the entity

Authority of Owners

- Corporation:
  - shareholders have no authority to bind the company
- LLC:
  - Members of member-managed LLC have apparent authority to bind the LLC with transactions in the usual course of the LLC business
  - Members of a manager managed LLC have authority to bind the company?
- Limited Partnership:
  - General partner has apparent authority to bind the partnership with transactions in the usual course of the partnership business
    - Unless the 3rd party is aware of actual limitations (if any)
  - Limited partners generally do not have authority to bind the partnership (like shareholders of a corporation)
- General Partnership:
  - All partners have apparent authority to bind the partnership with transactions in the usual course of the partnership business

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Economic Structure

- **The amount and timing of distributing cash and property, and the recognition and allocation of profits and losses.**
  - **Corporation: each share has an equal right to distribution of cash and property, and receives an equal (proportionate) share of profits and losses**
  - **Partnerships and LLCs:**
    - **Flexibility to allocate profits and losses and make distributions in a manner other than "proportionately"**
      - **But must have "substantial economic effect"**
    - **Upon liquidation, equity is generally distributed according to capital accounts**

Economic Structure

- **Unequal allocations of profits, losses and distributions in an LLC taxed as partnership**

  Example

  – **Investor partner contributes $100,000 and service partner contributes services & manages business; clients desire to share profits 50/50**

  – **Service partner must receive a mere profits interest only, otherwise recognizes income in current year in amount of equity interest received**

  – **Allocate profits to service partner and losses and distributions to investor until capital accounts are equal, thereafter equal allocations**

    - **This is the method for a service partner to "buy in"**

Asset Protection / Liability

- Inside-out protection (vicarious individual liability against the owners for company obligations)
- Outside-in protection (ability of the creditors of an owner to reach the assets of the company)
- Generally, corporations and single member LLCs have no outside-in protection
- Multi-member LLCs and LPs have best outside-in protection

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Asset Protection / Liability

- Generally shareholders are not liable for the acts of its business managers, employees or agents
- However, there is a growing number of legal theories subjecting shareholders to liability

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Piercing the Corporate Veil

- **Courts are applying the piercing legal theories equally to corporations as well as limited liability entities**
  - ***Disregarding "entity formalities" is primary reason for courts to pierce the entity veil***
  - ***Corporate Shield™***
    - Observe formalities w/ formal maintenance plan
    - Convert formalities into valuable planning opportunities
    - Bring lawyer and CPA together with owners for annual planning meetings

Owner Liability

- **Direct personal liability**
  - **ones own negligence**
- **Supervisory Liability**
  - **<u>Negligent supervision</u> of an employee could result in direct liability against the owner**
  - **<u>Vicarious supervisory liability</u>**
    - Some states have statutes that impose liability for persons under one's supervision without such supervision being considered negligent

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Transferable Liabilities

- **Aiding and abetting**
- **Successor Liability**
  - **General rule is that buyer of assets is not liable for obligations of seller**
  - **Exceptions**:
    - Substantial Continuity Test
    - Substantive Consolidation
- **Securities Laws**

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Transferable Liabilities

- **When can the property of an entity be subject to the claims of the owner?**
  - **Charging Order**
  - **Judgment creditor or transferee may charge the transferable interest**
    - Transferable interest means profits, losses and distributions
  - **Court may order foreclosure**
  - **Exclusive remedy**

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

Tax Issues

- Check-the-Box regulations allow unincorporated entities to be taxed as corporation, S corporation, partnership or as a disregarded entity (sole proprietor)
  - Flexibility
  - Entity must otherwise qualify
  - Unlikely for LLC to lose a partnership tax status while status is more problematic for S corporation (inadvertent S corp. termination under many circumstances)
- Donald Alexander, former Commissioner of the IRS stated, “[n]o rational, reasonably well-informed tax professional would deliberately choose subchapter S over an LLC when there is a choice.”

Business Fundamentals Bootcamp
Tactical Skills for the Growing Business

Allocation of Income, Deductions, Distributions

- **Partnerships are ONLY entity where you can specially allocate tax consequence items and distributions**
- **S corporations cannot make special allocation**
  - **Considered 2nd class of stock & terminates S election**
- **C corporations pay tax and dividends are always pro rata (no special allocations)**
- **This flexibility feature is a big benefit to LLCs taxed as partnerships**

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills for the Growing Business

State Tax Issues

- Caution for business operating in many states
- Some states (i.e. Texas) impose entity level taxes on different entities
- Some states (i.e. California) impose franchise taxes on different entities
- Widely held multi-state LLC or partnership may require its owners to file tax returns in each state in which it conducts business

ANY FINAL QUESTIONS?

Charles McClenaghan, Esq.
The Law Office of Charles H. McClenaghan, LLC
Charles@lawdublin.com
www.lawdublin.com

Remember to Complete the Speaker Survey:
bfbootcamp.net /event name/ ‘click’ on speakers / select your speaker

BUSINESS FUNDAMENTALS BOOTCAMP
Tactical Skills
for the Growing Business