Entity Structure – How to determine the one that is right for your business

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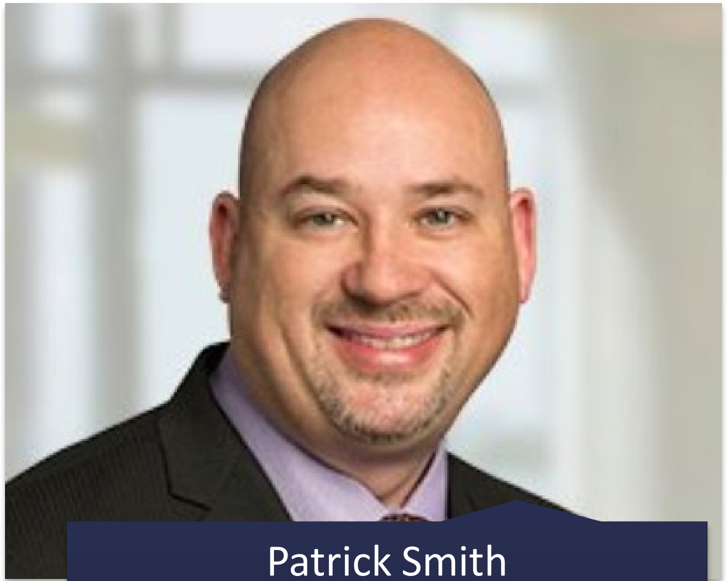

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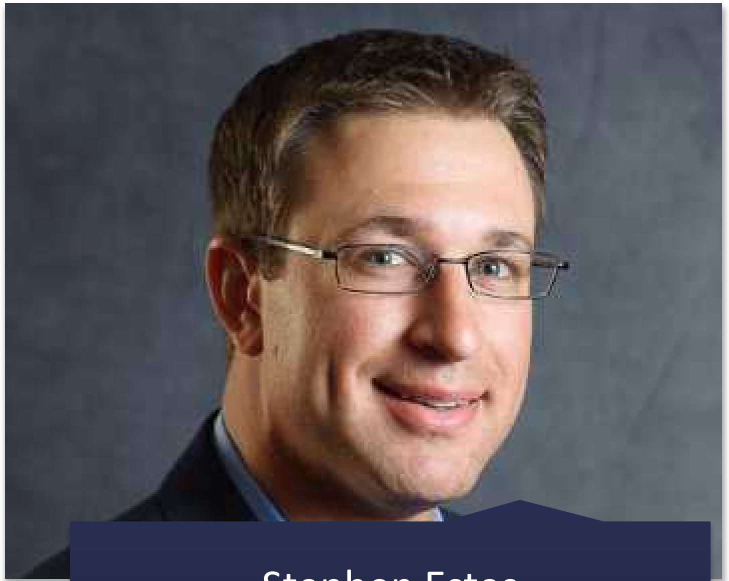

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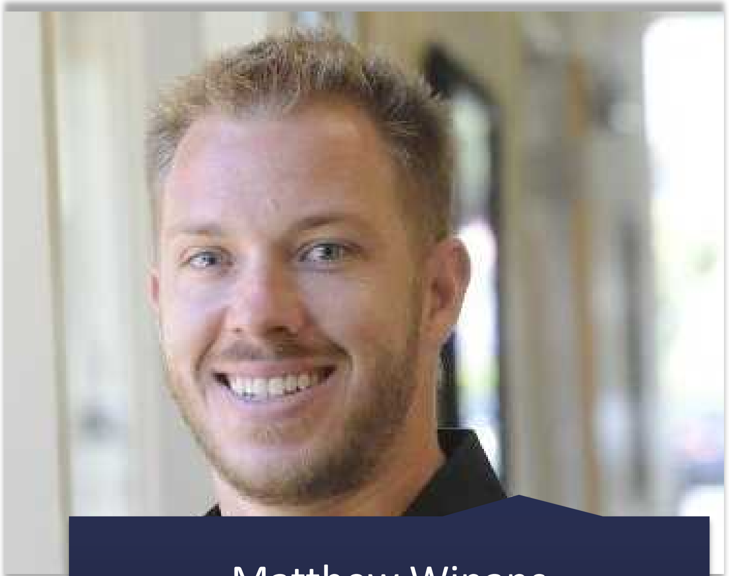

Matthew Winans

Principal, Tax

Learning Objectives

- By the end of the presentation, you will be able to:
  - Describe the pros and cons of different entity structures
  - Explain the considerations for each entity type

Agenda

- General Pro’s and Con’s by entity
  - Sole Proprietorships
  - General Partnerships (GPs)
  - Limited Partnerships (LPs)
  - C Corporation
  - S Corporations
  - Limited Liability Companies
- Experiences & Questions

Sole Proprietorship

- The most common and simplest form of business is a sole proprietorship. Many small businesses or “Mom and Pop” stores are operated in this formation. Sole proprietorships are reported directly on the individual’s personal income tax return on Schedule C. One interesting aspect that this arrangement creates is financing; since the business is under the owner’s name, its ability to generate capital depends solely upon the individual credit score of the owner.
- Advantages:
  - Ease of formation; no registration forms or required legal documents need to be filed with either the Federal or State governments.
  - No franchise or entity fees which are commonly required with other entities.
  - Owner can use solely his/her judgment in making the management decisions for the business.
  - No double taxation.

Sole Proprietorship - Continued

- Disadvantages:
  - The sole proprietor of the business can be held personally liable for the debts and obligations of the business. Additionally, this risk extends to any liabilities incurred as a result of acts committed by employees of the company.
  - Investors won't usually invest in sole proprietorships.
  - Most sole proprietorships rely on personal loans and personal assets to initially finance their business.
  - Schedule C's tend to have high(er) Internal Revenue Service Audit statistics.
- Businesses that often use this type:
  - Best for low risk businesses
  - Individual consulting businesses

General Partnerships

- In a general partnership partners divide responsibility for management and liability as well as the shares of profit or loss according to their operating agreement. Partners in a general partnership may be held personally liable for another partner's actions. Partners are assumed to have equal shares unless there is a written agreement that states otherwise. General partnerships are informal and easy to create. All income and loss is passed through the partnership and taxed at the individual level.
- Advantages:
  - Simple and inexpensive to create and operate.
  - Does not require state registration or fees.
  - No double taxation
  - Ease of filing
- Disadvantages:
  - Partners in a general partnership have unlimited personal responsibility for the business debts and liabilities including any judgments or lawsuits.
  - Partners are jointly and individual liable for the actions of other partners.
  - Limited life; the partnership may end upon the withdrawal or death of a partner.

Limited Partnerships: LP's

- Limited partnerships require at least one general partner who runs the business' operations. The limited partners typically are not active in business operations. A limited partnership is required to file with the Secretary of State and file various state reports. The general partner in a limited partnership has unlimited liability for the debts and liabilities of the partnership. The general partner can itself be a corporation or an LLC opening the door for creative structuring that mitigate liability issues to the promoters of the limited partnership. For tax purposes, a limited partnership functions similar to a general partnership, in that it is a pass-through operation with profits passing through to the partners, who then include their allocated income on their personal tax returns.
- Advantages
  - Flow through entity; no double taxation.
  - It is easier to attract investors as limited partners.
  - This arrangement allows general partners to use their expertise, make key decisions, and manage the business.
  - Limited partners can leave the business or be replaced, without the need for the limited partnership to be dissolved.

Limited Partnerships - Continued

- Disadvantages
  - There is more "red tape" than a general partnership via filings, formalities, and state requirements with limited partnerships.
  - General partners assume personal liability for all debts and liabilities of the limited partnership.
- Popular with VC/PE Funds

Corporations

- C-Corporations are a common and well-known choice of business entity. The entity's limited liability, ability to generate capital, and lack of ownership restrictions makes it an attractive form of business. The corporation is a separate legal entity that is owned by its stockholders. As corporations are their own entity, they have an unlimited life and are taxed at both the entity and individual level (double taxation). A corporation can have an unlimited number of stockholders, all of whom enjoy the limited liability of corporate ownership due to the legal nature of the separate entity.
- Advantages:
  - Limited Liability; stockholders' liability is generally limited to the amount of investment in the corporation.
  - Transfer of ownership easily facilitated by sale of stock.
  - Unlimited life of corporation.
  - Ease of raising capital through the sale of stocks and bonds.
  - Tax free benefits including retirement plan deductions, insurance, and travel.
  - Change of ownership is independent of management.

Corporations - Continued

- Disadvantages:
  - Double taxation; occurs at entity and individual level.
  - Requires timely and costly formal legal creation process.
  - Highly regulated at the state and federal levels.
  - Requires board of directors and is subject to many rules and regulations.
  - Owners cannot directly manage the corporation as the board of directors makes management decisions.
- Notable thoughts and considerations:
  - Qualified Small Business Stock gain exclusions only apply to C-Corporations
  - Not ideal entity for business exits structured as an asset sale.

Subchapter S Corporations

- S-Corporations are an attractive entity given that they have the limited liability of a corporation while enjoying the single level taxation similar to partnership-based entities. S-corporations do however; still face the burdensome formal legal creation process that C-Corporations endure. Furthermore, S-Corporations have significant restraints on the number and type of investors allowed to be stockholders. Specifically, S-Corporations cannot have non-resident (USA) shareholders, C-Corporations as shareholders, or more than 100 shareholders. Given these and many other restrictions that are imposed upon S-Corporations, many C-Corporations are ineligible for an S-Corporation Election.
- Advantages:
  - No double taxation; income taxed solely at the individual level.
  - Limited Liability; stockholders liability is generally limited to the amount of investment in the corporation.
  - Transfer of ownership easily facilitated by sale of stock.
  - Unlimited life of corporation.
  - Ease of raising capital through the sale of stocks and bonds.

S-Corporations - Continued

- Disadvantages:
  - Extensive ownership restrictions.
  - Requires timely and costly formal legal creation process.
  - Highly regulated at the state and federal levels.
  - Requires board of directors and is subject to many rules and regulations.
  - Many organizations are automatically disqualified including banks, some insurance companies, Domestic International Sales Corporations (DISC), and certain affiliated groups of corporations.
- Common businesses that use S-Corp
  - Single individual consulting services (vs. Sole Prop)
  - Very simple terms partnership (vs. GP due to restrictions in income and loss allocations and distributions)

Limited Liability Company: LLC’s

- Limited Liability Companies have been a traditional form of business since the 1970’s, however recent years has seen a surge in their popularity. LLCs contain similarities to both corporations and partnerships and are very flexible in their formation and operation. Business professionals generally believe LLC’s present a superior alternative to partnerships or corporations as with an LLC, the owners can have the limited liability associated with a corporation while still possessing the tax advantages of partnerships or an S-Corporation.
- Advantages
  - Ease of formation and flexibility of operations.
  - Limited Liability; protection of personal assets from business debt and obligations.
  - No double taxation; income taxed solely at the individual level.
  - No ownership restrictions, members can be corporations and/or foreign investors.
  - Flexibility of taxing entity type(s): Can elect to be taxed as a: Partnership, S-Corporation or C-Corporation.

Limited Liability Company - Continued

- Disadvantages
  - Limited life – not to exceed thirty years in some states.
  - Difficulty of raising capital; LLC's do not have the benefit of stock ownership and sales.
  - Ownership interest is not easily transferable.
  - State law and taxation differs significantly from state to state causing uncertainty with regards to how the courts will decide in certain matters of rules and governance
  - Limited tax deductions for member/owners as compared C-Corporations.
  - LLCs are required to pay an annual Gross Receipts Fee that ranges from $800 to $11,790. (CA only)

Additional Considerations

- Each business situation is unique and different. Best practice is to consult your tax advisor and discuss your specific situation, goals and intentions.
- Business licenses: some business licensing agencies forbid certain entity types.
- General Business entity notes:
  - Passthrough entities:
    - Individual members are required to pay tax on their distributive share of net income of the business regardless of whether or not any distributions are actually made to them.
    - Increases in basis via §754/§743/§734 are tax beneficial where-as for C-Corps they are not.
    - Multiple classes of stock – common pitfalls – profits interests, §83b elections, member vs. wage, etc.

  - C-Corporations
    - Tax at the entity level avoids tax distribution/cash flow complaints from the ownership group
    - Asset sales from C-Corporations are generally tax punitive in nature due to the double layer of tax.

Questions?

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