FACTORS IMPACTING CHOICE OF ENTITY

By

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A. General Plan.[2] In order to perform the "inform and advise" function of our job, the professional needs to first listen, and then, prompt clients to inform the professional about their business plans. Does the client have a business plan or executive summary, and how comprehensive and well thought out are they? Do they have a financial model, projections, and budgets? Lack of, or deficiency in, any of these business documents will significantly limit a professional's ability to perform, and may require some sort of disclaimer.

1. Industry Constraints. Certain industries limit or define the choice of entity by government regulations or statute. Banks, for example, must operate in a corporate form under California Financial Code § 102. Nonprofits or trade associations are generally restricted to corporate entities as well.

2. Venue. In what states and/or countries are the business assets, business operations and revenues located or generated.

3. Long Term Plans. Knowledge of the long-term plans of the clients will minimize the need to recast the business entity type, abandon the entity, or

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[2] How often during a phone call from, or an initial meeting with a client, do you hear the statement that he wants to form a corporation or a limited liability company in Delaware or Nevada? And possibly, the same client may tell you that the corporation should be an S Corporation? Probably, more times than you can remember. The simple facts are lawyers do not do practice medicine, clients often do not know the law, and in order for clients to make a decision they may have to live with a long time, they need to be informed and advised.

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take other unnecessary steps. The expectation or potential sale in the future will significantly reduce the advantage of a corporate structuring due to double taxation of the sale of the assets of the corporation.

4. Foreseeable Investors and Financiers. The need for outside financing and the type of investor/ financier will play a major role in determining the type of business entity to be used.

5. Expected Revenues and Anticipated Gross Profit. In order to adequately understand the tax ramifications and the jurisdictional advantages of the business entity, an advisor must understand where revenues (states and countries) will be generated and the projected gross profit ratio.[3]

6. Expectations of Employees and Others. Notwithstanding several of the above factors may suggest the use of a certain type of business entity, the expectations of the client and his employees, current and future, and the expectations of venture capitalist may have an overriding effect. This is very often the case with start up companies where the overwhelming need to hire employees (who are generally adverse to paying taxes on allocable income from a limited liability company ("LLC"), general partnership ("GP"), limited partnership ("LP") or S Corporation without any cash distributions) and their appetite for incentive stock options and non-qualified options may dictate the selection of "C Corporation", rather than some other business entity.

B. Pass Thru Income Tax Entities: Tax Rates and Fees.

1. GPs. GPs are the least expensive from an entity tax and fee perspective. California does not require GPs to pay an annual fee. Current formation

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[3] Large gross revenues and/or low gross profits businesses generally are not good factors for LLCs due to the Gross Receipts Tax

filing fee payable along with filing of Statement of Partnership Authority (Form GP-1) is $70. All income, deductions and credits of the GP are pass through to the partners for both federal and state income tax purposes.

2. **LPs.** LPs are relatively inexpensive from an entity tax and fee perspective. California requires LPs to pay an annual fee of $800. Current formation filing fee payable along with filing of Certificate of Limited Partnership (Form LP-1) is $70. All income, deductions and credits of the LP are pass through to the partners for both federal and state income tax purposes.

3. **LLCs and LLPs.** California requires every LLC and LLP to pay a fee of $800 per year, regardless of the gross receipts or net income. Current formation filing fee is $70. California, in addition to the $800 annual fee, imposes the following graduated annual tax[4] based on all income from all sources[5] that is reportable to the California:

Total Income (Gross Receipts)	Annual Fee
Less than $250,000	$ 0
$250,000-$500,000	$ 900
$500,000 -$1 million	$2,500
$1 million - $5 million	$6,000
$5 million or more	$11,790

[4] Historically, the fee schedule has been based upon an annual study prepared by the Franchise Tax Board of the cost California (i.e., lost tax revenues) of having adopted the LLC laws, resulting in frequent and dramatic fee increases and making it difficult to predict the estimated cost of doing business. Assembly Bill (AB) No. 898 (Stats. 2001, Ch. 391), amending Section 17942 and adding Section 17943 to the California Revenue and Taxation Code, took the power of changing the rate schedule from the FTB, and the rate schedule for the annual LLC fee is no longer subject to annual variance.

[5] AB 898 also clarified the application of the LLC fee to multi-tiered LLC structures. An LLC's "total income" will not include any allocation of income to that LLC from another LLC of which it is a member, so long as the income on which the allocation is based is already subject to the annual fee. In short, a dollar of income is only subject to the annual fee once, regardless of the number of LLCs reporting allocations of income based upon that dollar that is reportable to California.

All income, deductions and credits of the LLP are pass through to the partners for both federal and state income tax purposes.

C. Financing: Debt, Equity and Alternatives.

1. <u>Self-Financing/ Retention of Operating Capital</u>. If the client does not intend to use, and foresee the need for, third party financing and investors, then the main focuses will be the retention (build up) of operating capital. Many tax professionals will often recommend the use of a C Corporation by reason of its non-pass through tax attributes, employee benefits, and its progressive tax rate for the first $100,000 of taxable income (potentially saving up to $11,750 per year) specified in IRC §11, as follows:

Tax Rate	Taxable Income
15%	Under $50,000
25%	$50,000 but not exceeding $75,000
34%	$75,000 but not exceeding $100,000[6]
35%	Exceeding $100,000[7]

2. <u>Debt</u>. Banks, insurance companies, securitized "conduit" lenders, and other third party lenders generally are willing to lend monies to all of the business entities. However, "conduit" lenders, insurance companies and some real estate lenders have made it more difficult for general partnerships to borrow money. Such securitized

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[6] A corporation having taxable income in excess of $100,000 for the taxable year must recapture the benefit of the lower rates on the first $75,000 of taxable income. This recapture is accomplished by increasing the tax by 5% on the excess income over $100,000, limited to a total tax increase of $11,750. This is the amount of the total benefit of the lower tax brackets applicable up to the $75,000 level.

[7] In addition, a corporation with taxable income in excess of $15 million is required to recapture the benefit of the 34% rate by increasing its tax liability by the lesser of (1) 3% of the excess or (2) $100,000.

lending programs favor making loans to LLCs and limited partnerships with special bankruptcy provisions known as "Single Purpose Entity" provisions. Depending the nature of the lending market at the time, lenders generally look for as much security as they can possibly find and request personal guarantees from all or most of the equity owners when lending to an LLC or corporation.

3. Quasi-Debt. Quasi-Debt is debt containing elements of equity. The lender either participates in equity gains or receives stock, warrants or options in addition to interest. This type of debt often raises significant problems for "S" Corporations "one class of stock" limitation and the 75 shareholders limitation.

4. Equity. If the client envisions that the offering of stock in the business venture and such financing is a significant part of the business plan, the choice of business entity will be primarily focused on the expectation of the investors and the sophistication of the targeted investors.

a. Real Estate and Oil & Gas. Generally real estate, oil & gas, and other business ventures involve substantial risks, which are usually mitigated by tax sheltering or tax deductions. Because one of the major benefits of the investment is the sheltering of income, the investors, usually individuals, like to invest in business entities that can be classified for tax purposes as partnerships, generally limited partnerships and LLCs. These types of investments often times are offered on a "take-it-or-leave-it-basis" and generally are structured with certain preferred rates of return and rights, preferences and privileges based upon the appetite of the investment market at that time.

b. Start-Ups and Other Business Ventures. In general, the founders and employees of high tech start-up and other business ventures are not as interested in the tax benefits of the pass through entities of LLCs and LPs, as they are interested in equity participation benefits. They do not wish to have liability exposure. Furthermore, the traditional potential investors are more comfortable with the traditional stock equity of a "C" Corporation. The classical venture capital or angel investment deal is different from a private placement of other securities. Angel investors or venture capitalists are generally professional, sophisticated capitalists who are prepared to take high risks and are not as interested in sheltering income but rather obtaining capital gains.

5. <u>Leasing</u>. Equipment and personal property lessors are comfortable with leasing to any one of the business entities with relatively simplified documentation because the equipment lessor are generally looking to the credit worthiness of the entity and the security interest in the leased equipment. Landlords in real estate lease transactions look much more to the financial worthiness of the business entity and its owners. Often, particularly in a hot or landlord market, landlords insist on personal guarantees from the members of the LLC or the shareholders of a corporation (including venture capitalists), thereby reducing the limited liability benefit of a corporation and LLC. However, in a down market or tenant market, landlords, particularly smaller landlords, become more willing to take the risk of a business entity financial credit worthiness, and less of its members' or shareholders' credit worthiness, in order to secure cash flow.

D. Liability and Operational Implications.

1. General Liability.

a. Partnerships. General Partners of GPs and LPs have unlimited liability. Limited Partners are not liable for any obligation of a limited partnership unless named as a general partner in the certificate or, in addition to the exercise of the rights and powers of a limited partner, the limited partner participates in the control of the business. CCC § 15632. If a limited partner participates in the control of the business without being named as a general partner, that partner may be held liable as a general partner only to persons who transact business with the limited partnership with actual knowledge of that partner's participation in control and with a reasonable belief, based upon the limited partner's conduct, that the partner is a general partner at the time of the transaction.

b. LLCs and Corporations. Members of an LLC and shareholders of a corporation do not have personal liability exposure, except under theories of (i) “thin capitalization” - members and shareholders can become personally liable for failure to adequately capitalize the LLC or corporation, and (ii) “piercing the corporate veil” or “alter ego” - shareholders can be personally liable for the debts and liabilities of a corporation for failure to follow corporate formalities. LLC do not have the exposure for failure to hold meetings of the members. Closely held corporations can minimize the “alter ego” expose by electing in their Article of Incorporation to be a “close corporation” under CCC § 158.

2. <u>Liability for Co-Owners' Actions</u>.

a. **GPs and LPs.** The general partners have unlimited liability, and are jointly and severally liable, for the actions of their other general partners of the entity. CCC § 16306. The limited partners of a LP have limited liability protection to the extent of their capital contribution, unless the limited partner participates in management to such an extent that he is deemed to be a general partner. CCC § 15632. General Partners of an LP have joint and several unlimited liability. General Partners of either a GP or LP are liable for the acts of the other General Partners unless the third party claimant knew that the General Partner lacked actual authority to bind the partnership. CC §§ 16301 and 15643. Some of this liability exposure can be covered by insurance, such as fire and general comprehensive insurance. Right of contribution, agreement amongst partners, and guarantees can mitigate non-insurable hazards and debts.

b. **Limited Liability Partnerships ("LLPs").** LLPs can protect the personal assets of partners of architecture, public accountancy, and law firms from liability for obligations arising from real practice acts, errors, or omissions. Corp. Code § 16306(c). This limited liability protection does <u>not</u> affect a partner's liability to third parties for his or her own tortuous conduct or malpractice. Corp. Code §§ 15015(d) and 16306(e). LLP must comply with statutory security requirements totaling at least $100,000 per licensed person rendering professional services on behalf of the LLP, subject to an annul minimum and maximum total coverage. The minimum for all LLPs is $500,000 for LLPs with fewer than five licensed persons; the maximum for an

architecture LLP and a public accountancy LLP is $5 million and the maximum for a legal services LLP is $7.5 million Corp. Code § 16956(a).

c. Corporations. The most significant feature of a corporation (as of a limited partnership or limited liability company) is its protection from personal liability. If properly formed and operating, a corporate shareholder's liability is limited to the amount of the investment in the corporation. Further, because a corporation is a separate legal entity, its directors, officers, and employees ordinarily do not have any liability for the corporation's debts or other obligations (*see* Corp. Code § 300(d)]. Neither are they generally liable for the torts of criminal acts of one another, although directors, officers and other employees may be liable to the shareholders for a breach of their defined duties to the corporation (*see* Corp. Code § 300]

3. <u>Distributions</u>.

a. Partnerships. General Partners of a GP or LP, as discussed above, have unlimited liability.

b. LLCs and Corporations. Members of LLCs (CCC § 17254) and shareholders of corporations (CCC §§ 2008 and 2011) can have liability for distributions if certain (i) the retained earnings, (ii) 125% asset over liability, and (iii) current asset over current liabilities tests of CCC §§ 500 & 501 are not met after giving effect to such distribution.

4. <u>Dissolution - Statute of Limitations</u>. After the construction latent defects case, <u>Pacific Scene, Inc. v. Penasquitos, Inc</u>., 46 Cal. 3d 407, 250 Cal. Rptr 651 (1988), which circumvented the "ten year latent construction defect" statute through dissolving a corporation, the California legislature amended CCC § 2011 which provides

a statute of limitations for claims against liquidating distributions to shareholders of four (4) years after the effect date of dissolution.

5. <u>Officers and Directors Liability</u>.

a. Partnerships. General Partnerships do not have officers or directors.

b. Limited Liability Companies. No person who is a manager or officer or both a manager and officer of a limited liability company shall be personally liable under any judgment of a court, or in any other manner, for any debt, obligation, or liability of the limited liability company, whether that liability or obligation arises in contract, tort, or otherwise, solely by reason of being a manager or officer or both a manager and officer of the limited liability company. CCC § 17158(a). However, a manager of a limited liability company may agree to be obligated personally for any or all of the debts, obligations, and liabilities of the limited liability company if the agreement to be so liable is set forth in the articles of organization or in a written operating agreement that specifically references this subdivision, or pursuant to the terms of a written guarantee or other contractual obligation entered into by the manager, other than an operating agreement. CCC § 17158(b).

c. Corporations. Officers generally are not liable, except for certain criminal and securities fraud provision. Director liability can

6. <u>Taxes</u>. Upon termination, dissolution, or abandonment of a partnership, a registered or foreign LLP or a domestic or foreign corporate or LLC, any officer, member, manager, partner, or other person having control or supervision of, or who is charged with the responsibility for the filing of returns or the payment of tax, or

who is under a duty to act for the corporation, partnership, limited liability partnership, or limited liability company in complying with any requirement of this part, shall be personally liable for any unpaid taxes and interest and penalties on those taxes, if the officer, member, manager, or other person willfully fails to pay or to cause to be paid any taxes due from the corporation, partnership, LLP, or LLC. Rev & Tax Code § 6829.

E. Management Style.

1. GPs. The partners share equally in management and control unless the partnership agreement provides to the contrary. CCC § 16401 (f). Although the partners generally have a broad discretion in dividing management responsibilities, centralized management is difficult because each general partner has the authority to bind the partnership when dealing with third parties. This ability to bind the partnership gives third parties the belief that every partner has apparent, if not actual authority, unless the third party has actual knowledge the partner does not have authority to act for the partnership. CCC § 16301 (1). Unless otherwise provided decisions in the partnership are made by a majority vote; however, certain decisions require unanimous consent of all partners.

2. LPs. The general partners have the exclusive right of managing the LP, and the limited partners do not have authority to bind the partnership. In order to avoid liability, limited partners should not participate in control of the business. CCC §§ 15632 and 15636. In contrast to the restrictive role of the Limited Partners, members of an LLC may manage an LLC without losing their limited liability.

3. LLCs. LLCs may be managed by all of its members ("Member Managed LLC") or one or more managers ("Manager Managed LLC") CCC §§ 17150

and 17151. However the articles of organization require a declaration of the type of management. LLCs can have centralized management through the use of officers similar to presidents and vice presidents.

4. <u>Corporation</u>. One of the main advantages of a corporation is an organized centralized management structure. Control of the corporation varies widely depending upon the number of shareholders and the rights and privileges of various classes of stock. The shareholders elect the board of directors, and the directors appoint officers to manage the day-to-day business and implement board policy. CCC §§ 301 (a) and 312 (d). Shareholder decision-making is generally limited to approving major transactions including mergers and reorganizations, the sale or disposition of assets, and removal of directors.

F. Benefit Issues. More fringe benefits are available through a C corporation than a partnership, LLC or S corporation.

1. <u>Retirement Plans.</u> Even though the tax-qualifying retirement plan advantages to C corporations have been almost eliminated, a few differences still favor retirement benefits in C corporations. The maximum amount deductible as a retirement plan contribution by non-corporate entities for self-employed persons is limited to each person's self-employment income, reduced by the amount contributed to qualified retirement plans. I.R.C. § 404(a)(8). There is no such restriction for persons who participate in corporate retirement plans.

2. <u>Payroll Taxes.</u> Self-employed individuals pay a hospital insurance tax of 2.9% on compensation income (referred to as self-employed income), of which one-half is deductible. Under the existing regulations, a limited partner in an LP

will not have self-employed income with respect to the share of the LP's distributive income, but will have self-employed income to the extent you receive a guaranteed payment under §707(c) for services rendered to the LP.[8] A general partner in a limited partnership will have self-employment income with respect to the share of the LP's income attributable to the general partnership interest[9]. However, it is possible for the same individual to have both a general partnership interest (which may be a very small percentage) and a limited partnership interest (which may be a much larger percentage) in the same LP. This would essentially bifurcate your income for self-employment tax purposes.[10] The distributive share of the LP's income attributable to the partner's limited partnership interest will not be self-employment income.[11]

3. Separation of Owners Tax Plans. ______________________

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4. Stock Ownership Plans. Employment Stock Ownership Plans (I.R.C. § 409), incentive stock options (I.R.C. § 422), stock bonus plans (I.R.C. § 401(a)), or cash or deferred arrangements (I.R.C. § 401(k)) are available only to corporations.

5. Group Life Insurance. C corporation may provide life insurance up to $50,000 tax-free to employees under a group life insurance policy; in contrast, a partner, or S corporation shareholder who owns more than 2 percent of the shares ("2 percent shareholder") who receives such a benefit must include its dollar value when reporting taxable income. (I.R.C. §§ 79, 1372).

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[8] IRC §1402(a)(13)
[9] IRC §1402(a)
[10] IRC §1402(a)(13)
[11] IRC §1402(a)(13)

6. Medical and Disability Plans. C corporation generally may deduct premiums for medical plans. Employees receive a tax-free payment or reimbursement of their medical expenses and tax-free payments from disability insurance if they become disabled. I.R.C. § 105(b). Partners, LLC members, and 2 percent shareholders are specifically excluded from these benefits. I.R.C. §§ 105(g), 401, and 1372. General Partners, LLC members, and 2 percent shareholders, may deduct a percentage of their payments for medical insurance for themselves, their spouse and dependents, not to exceed the earned income from the business. I.R.C. § 401(c). Such a deduction is disallowed to any individual who is eligible to participate in any health plan provided by an employer of the individual, or his or her spouse. I.R.C. § 162(l)(2)(B). A partnership may deduct premiums paid to a partner and an S corporation may deduct premiums paid to 2 percent shareholders; the partner and shareholder would then be required to include the amount of premiums paid in income, but would be eligible to use the 30 percent deduction described above. I.R.C. § 162(l).

G. Dissolution Concerns. After the owners of a business entity have decided to discontinue business operations (e.g. discord amongst the owners or financial setback), all business entities generally proceed through a process of liquidating assets, if necessary; paying creditors; and distributing the balance to the owners. The major concerns are some of the same concerns raised during formation - (i) income taxation of the entity and owners, and (ii) personal liability of owners, management and directors. GP, LPs, and LLCs (treated as partnerships) avoid the double taxation problem of C corporations.

1. **GPs.** The GP's unlimited liability is best exhibited during the dissolution of the partnership. If the GP does not pay all of the creditors, and in particular, there are not enough assets to pay all of the creditors, the partners are jointly and severally liable for the payment of such debts. CCC § 16306. This unlimited liability can be especially painful to a partner, if such partner is not a limited liability entity and one or more of the other partners do not have sufficient assets to contribute toward the payment of the partnership debt. Even though a partner has a right of contribution from the other partners for their share of the GP's liabilities, such right of contribution is only as good as the financial condition of such partner.

2. **LPs.** LPs provide limited liability protection for its limited partners to the extent of each limited partner's capital contribution and obligation to contribute capital. The general partner has substantially the same liability expose as a general partner of a GP discussed above.

3. **LLCs.** Limited liability protection is available to all of the LLC members similar to that of a Corporation. To the extent the all of the debts of the LLC are paid in the proper order before distributions to the members, the members are protected from the claims of the LLC's creditors.

4. **Corporations.** To the extent that all of the debts of the Corporation are paid in the proper order before distributions are made to the shareholder, shareholders are protected from the claims of the creditors. CCC § 506. However, if a Corporation makes distributions without paying the creditors, the creditors have the right to proceed after the shareholders for such "illegal" distributions. CCC § 2011.