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legal update



underberg & kessler LLP

Selecting An Entity For Your Business

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In our bustling, mid-sized law firm, we regularly have the opportunity to counsel clients who want to start a new business venture. The clients that we see include individuals, families, groups of unrelated individuals and existing business entities wishing to expand. The businesses that we see are of all types -- from coffee shops to biotechnology research firms; from machine shops to software developers; from distributors to precision optics manufacturers. Yet, regardless of client or business type, we always start with the same issue -- what is the best form of legal entity for this entrepreneur's particular business?

Selecting the form in which the business will operate is one of the more important start-up issues that entrepreneurs make. The choice of entity impacts not only the business itself, but also the personal affairs of the entrepreneurs. While selecting the proper entity cannot ensure the success of a new venture, selecting the wrong entity can contribute to its failure.

In making the choice of entity decision, we review with our client their personal and business objectives and a variety of tax and non-tax legal considerations. Tax considerations for the entity and its owners and business owners' liability are, perhaps, the most significant factors that drive the choice of entity decision. Other factors we review include: the number of owners expected to be involved with the business; the owners' respective relationships to the business; the transferability of the ownership interests; financing plans for the business; exit plans for the owners; and the time, effort and expense of creating and maintaining the business entity.

We seldom recommend the sole proprietorship or partnership forms, because of the unlimited personal liability of the owners for the debts, liabilities and obligations of the business. As between the corporation and limited liability company, we consider the characteristics of each entity to determine the best fit for the business at hand.

Corporation

A corporation is a separate legal entity distinct from its owners and management. Management of the corporation is centralized. The shareholders elect a board of directors which sets general policy and direction. The board then elects officers who carry out the day-to-day operation of the business. Corporate capital structure can be simple or complex, and may include voting or non-voting common stock and multiple classes of preferred stock with varying rights and preferences. Where there are two

or more shareholders, we strongly suggest a written shareholders' buy-sell agreement, which addresses many aspects of the relationship between the shareholders.

Entrepreneurs incorporate for the shield from personal liability that it provides to its shareholders, directors and officers. It is important to note that this liability shield can fail if corporate formalities are not observed and that there are a few exceptions to the limited liability the corporation provides.

For tax purposes, a corporation may be classified as a "C" corporation or an "S" corporation. In either tax status, a shareholder who performs services for the corporation is considered an employee and is subject to employment taxes and withholding on his or her earnings.

A "C" corporation files a tax return and pays tax on its corporate profits. When the corporation distributes its profits as dividends, those dividends are taxable income to the shareholders, giving rise to what many call double taxation. In closely held corporations, this effect is minimized by having the corporation distribute its would-be profits to shareholder/employees as year-end bonuses. Losses are trapped inside the "C" corporation, but may be carried back to prior years or forward to future years to offset taxable profits.

Certain qualified corporations may file an "S" Corporation Election for federal and state tax purposes. While an "S" Election is effective, the corporation files an information return and corporate profits and losses flow through directly to the shareholders. Thus, double taxation of profits is avoided and losses flow to the shareholders to offset income from other sources.

Advantages of incorporation are: limited liability protection for shareholders; investors are accustomed to the corporate form for raising capital; management structure is centralized; a corporation may have perpetual existence; and corporate shares are easily transferable.

Disadvantages of incorporation are: double taxation of business profits, unless the "S" Election is made; and organization and operation of the entity is more formalized and costly.

Limited Liability Company

A limited liability company, or LLC, blends together the liability protection of a corporation with the flow through tax treatment of a partnership.

An LLC is an association of one or more persons or entities (members) who wish to conduct business together. There are no limitations on the type of persons or entities that can become a member or on the maximum number of members. Management of the LLC may be centralized, like the corporation, or by the owners, like a partnership. Where management is centralized, members designate managers with the authority to determine policy and carry out day-to-day operations. Because of the inherent flexibility in the LLC law, a written operating agreement establishes the relationship among the members and between the members and the managers.

An LLC is not taxed as a separate entity. The LLC files an information return and its profits and losses flow through to the members. Members are not considered employees of the LLC and are not subject to withholding or other employment taxes. However, members should make provisions with their accountants for quarterly estimated tax payments.

Advantages of the LLC are: the limited liability protection afforded to members; flow through of profits and losses to the members without need to meet the qualifications for an "S" election;

members are not subject to payroll formalities; losses of the business may offset against other income; and the LLC statute permits great flexibility in structuring the relationships among members and managers.

Disadvantages of the LLC form are: allocable profits of the LLC are taxed to the members even if no cash is distributed to them; and organization and ongoing operations of the entity are more formalized and costly.

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As between corporations and LLCs, there is no one-size fits all solution to the choice of entity decision. In general, we see that: a corporation can be employed to reduce the personal liability exposure of the owners or where the owners seek outside capital without sharing management responsibilities; and, an LLC can be used for entrepreneurs who seek both limited liability and flow through taxation. In our firm, the final choice is not made until we have spent sufficient time listening to our client, obtaining appropriate input from the client's accountant, and explaining to our client the pros and cons of each available alternative. Only then are we assured that we have found the right choice for this client pursuing this particular business.