

Business Entities: The Choice is Yours

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California businesses can choose to operate in many different forms. No one form is best for every business (or even a particular business throughout its evolution). Because each form of business organization has certain unique characteristics, a selection should only be made after careful consideration of the needs of the business and its owners.

General Considerations

In selecting a business entity, the organizers should consider which form is most advantageous for business law planning (especially the limitation of potential business liabilities to the owners) as well as which form provides the best tax planning benefits for their situation.

Business law considerations may include:

- sheltering the owners from exposure to liabilities of the business;
- formation and reporting requirements;
- ease of management of a particular business form;
- type of business activity engaged in;
- transferability of ownership interests;
- form which provides the most favorable debt and equity financing arrangements; and
- ease with which the entity might be merged, if circumstances change and another entity form becomes more advantageous.

Tax planning considerations may include:

- minimizing income taxes on business profits;
- maximizing the ability to utilize tax losses for the benefit of the business and owners (including the ability of owners to offset business losses against other income sources);
- minimizing income and estate taxes due to increases in the value of the business; and
- minimizing taxes upon merger or liquidation of the business.

Due to the variety of issues which should be considered, the advice of a business law attorney, and perhaps other specialists, is essential.

Business Organization Alternatives

The basic forms for conducting a business in California are:

- sole proprietorship
- general partnership
- limited partnership
- regular or “C” corporation
- small business or “S” corporation
- limited liability company
- foreign business entities

Other forms of entities with which our firm is experienced, but will not be discussed here, are trusts, joint ventures, non-profit (mutual benefit) corporations, and entities for certain professions such as accountancy, architecture, and law.

Significant Characteristics of Business Entities

Sole Proprietorship. While most California business entities can only be created by filing documents with the Secretary of State, and must be operated in compliance with the various statutes and regulations sanctioning their formation, a sole proprietorship exists whenever business activity is conducted by a sole owner in their individual capacity. A sole proprietorship is thus, the simplest form of business to set up and operate. It may do business under the owner’s name or a fictitious name (“DBA”), if certain requirements are met.

Even so, from a legal standpoint, the biggest drawback of a sole proprietorship is the lack of liability protection for the owner from the creditors of the business (except that which might be afforded by insurance). However, a sole proprietorship may easily be reorganized into a different business form, should it appear advantageous to do so.

Although the owner should maintain separate bookkeeping records, a sole proprietorship is not a separate entity for tax purposes and thus, no separate income tax return is required. Accordingly, income and losses of the business are reported on Schedule C of the owner’s income tax returns.

General Partnership. General partnerships are businesses conducted by two or more persons or other business entities who agree to share the profits and losses of that enterprise. Although a general partnership is treated as a separate entity, in California, one may be created without filing formation documents with the Secretary of State. Nevertheless, the partners should enter into a written agreement concerning the terms and conditions of their association. A statement of partnership authority may also be filed with the

Secretary of State but, such filing is optional. Generally, each partner has the authority to manage the business and to enter into agreements with third parties on behalf of the partnership. In spite of its ease of formation and operation, the main drawback to a general partnership is that each of the partners has unlimited liability for debts of the partnership.

Because the partnership exists as a distinct entity, it is required to file income tax returns but does not pay taxes on partnership income. The partnership income (and losses) are apportioned between the partners and “passed through” to them for treatment on their individual income tax returns.

Limited Partnership. Unlike general partnerships, a limited partnership must be formed and operated in accordance with state law and formation documents must be filed with the Secretary of State. The partnership must have one or more general partners, who manage the affairs of the business, and one or more limited partners, who do not actively participate in the business. As in a general partnership, each general partner has personal liability for partnership debts. However, limited partners avoid such personal liability so long as they are not active business participants.

Limited partnerships must file income tax returns and pay an annual franchise tax for the privilege of doing business in this state. As in a general partnership, profits and losses are “passed through” to the partners and taxed at that level.

Regular or “C” Corporation. A corporation can only be created under state statutes and is an entity distinct from its owners, who own shares of stock in the corporation. There are two types of corporations: regular or “C” corporations and small business or “S” corporations (“C” and “S” refer to sections of the Internal Revenue Code that set forth their distinguishing characteristics). The stock of a regular corporation may be owned by as few as one and up to an unlimited number of individuals or other entities. It may also issue multiple classes of stock.

Shareholders elect directors, who may or may not be shareholders, to govern the corporation. The board of directors, in turn, selects officers to manage the corporation’s daily affairs. In addition to California law, a corporation should be governed in accordance with its articles of incorporation and bylaws. Shareholders in a corporation have limited personal liability for debts of the business.

Because it is a distinct entity, a regular corporation must file tax returns. It is also subject to state and federal income tax at the corporate level and, regardless of whether it is profitable, must pay a minimum franchise tax to the state. If the corporation pays dividends to its shareholders, those dividends are subject to tax at the individual level. Thus, profits of the corporation may be taxed twice. However, an advantage of a regular corporation over other business forms is it may deduct, as a business expense, the cost of fringe benefits paid on behalf of shareholder employees.

Small Business or “S” Corporation. Small business or “S” corporations are formed and governed in the same manner as regular corporations. To be treated as a small business corporation, an election to do so must be filed with the Internal Revenue Service and the California Franchise Tax Board. Thereafter, a small business corporation is subject to certain restrictions including the type and maximum number (75) of shareholders permitted. In addition, it may only issue one class of stock. Like a regular corporation, its shareholders enjoy limited liability for business debts.

A small business corporation must file tax returns on its behalf, but pays no state or federal income tax, only a small annual franchise tax. As with other “pass through” entities, the small business corporation’s income and losses are “passed through” to its shareholders, in proportion to their ownership interests. This occurs regardless of whether income has actually been distributed to them. So long as shareholder employees of the business are paid a reasonable salary, corporate profits may be distributed to them and are not subject to employment taxes (such as FICA, Medicare, and SDI).

Limited Liability Company. A limited liability company (LLC) must be formed in accordance with state statutes and is governed as set forth in its articles of organization and operating agreement. LLC’s are similar to partnerships except, all members of an LLC (as owners are referred) enjoy limited personal liability. An LLC may be formed by one or more persons or entities and may be managed by either all of its members or one or more managers selected by the membership.

LLC’s must file tax returns and, although income is not subject to tax at the entity level, are subject to the payment of an annual franchise tax. As a “pass through” entity, profits and losses are taxed at the member level. However, as in partnerships, income and losses need not be allocated in proportion to ownership interests, an advantage over a small business corporation.

Foreign Business Entities. Business entities are classified by the state of California as domestic, having been formed within the state, or foreign, having been formed in another jurisdiction. Business entities formed and operated in other jurisdictions are subject to the law of that place, which may be more favorable in some respects than California law. In addition, the entity may not be subject to local income tax or annual franchise fees in that jurisdiction.

However, foreign business entities doing intrastate business in California generally must be “qualified” and are subject to California franchise tax. Under certain circumstances, foreign business entities doing substantial intrastate business, a majority of whose ownership is in the hands of California residents, may be required to adhere to California corporate law (e.g., with respect to maintaining operating formalities, disclosures, fiduciary duties, etc.). Thus, prior to selecting and forming an entity in a foreign jurisdiction with the intent of operating that entity within California, careful consideration to the above should be taken.

The foregoing has been a brief summary of the features of various entities available to California businesses. As noted above, many factors need be considered when choosing to operate a particular business in a certain form. Whether it is a start up or a going concern, our firm is experienced in counseling business owners and assisting them in making the choice most advantageous for their situation.

Disclaimer

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