

“DEMYSTIFYING THE BUSINESS ORGANIZATION”
or
PARTNERSHIPS, CORPORATIONS, S CORPORATIONS AND
LIMITED LIABILITY COMPANIES (OH MY!)

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I. INTRODUCTION

A. There are five "flavors" of business organization currently allowed under the laws of most states: the sole proprietorship, the general partnership, the limited partnership, the regular (or "C") corporation, the "S" corporation (or "Subchapter S Corporation") and the limited liability company or "LLC". Most states also allow limited liability partnerships or "LLPs".

B. There is no one "perfect" way to organize your business; each "flavor" involves certain tradeoffs and only you can weigh the pros and cons to determine which "flavor" is right for you.

II. THE SOLE PROPRIETORSHIP

A. This is what you are right now - a solitary human being engaged in a trade or business.

B. What's Good About a Sole Proprietorship?

1. You don't need a lawyer to set up a sole proprietorship; no startup costs.

2. The only piece of legal paperwork is a "trade name" or "fictitious name" certificate - and this only if you are doing business using a name other than your own name (you file this in the City Clerk's or Town Clerk's office in each town or city in which you maintain an office).

3. Taxes are easy too - you fill out Schedule "C" on your Form 1040 and pay taxes at your individual rate.

C. What's Bad About a Sole Proprietorship?

1. Unlimited personal liability for every business mistake you make - you breach a contract, you lose your house; you get into a traffic accident (that's not covered by insurance), you lose your house; you bake cookies that get people sick, you lose your house.

2. You can limit this risk by buying an umbrella liability policy, but this can get expensive depending on the nature of your business.

III. THE GENERAL PARTNERSHIP

A. A general partnership is formed when two or more "sole proprietors" agree to pool their resources and -- this is the key -- share profits and losses from the business (i.e. if two or more lawyers share office space and refer clients to each other but render separate bills for their services and keep what the client pays them, this is not a partnership; if they render a joint bill for their services and split the profits 50/50, that's a partnership).

B. What's Good About a General Partnership?

1. Easy to form and no startup costs; you don't need a written partnership agreement (legally) to form a general partnership - you can do it with a handshake (of course, if you do so there will be a lot of unresolved questions that may have to be resolved in the courts, which is why most people have a written partnership agreement even if the law does not specifically require one).

2. Taxes are easy, too - the partnership files an information return on Form 1065 but pays no taxes - each partner pays taxes on his/her "pro rata share" of the partnership's profits at his/her individual tax rate.

C. What's Bad About a General Partnership?

1. Unlimited personal liability, the same as a sole proprietorship, but with a twist - if A and B are partners, and B runs someone over with his car while on partnership business, both A and B lose their houses even though A had nothing to do with the accident. Lawyers call this "joint and several" liability.

2. Partnerships have what tax lawyers call a "phantom income" problem, in that the partners have to pay taxes on their "pro rata shares" of the partnership's profits even though the partnership did not pay them cash to pay the taxes with.

IV. THE LIMITED PARTNERSHIP

A. A limited partnership is a partnership with two tiers or classes of partners -- general partners who have unlimited personal liability for the things they do (or don't do) while on partnership business and "limited partners" who are liable only for the money which they contribute (or pledge to contribute) to the partnership.

B. Because relatively few "operating" businesses -- businesses which provide products or services -- use the limited partnership form, this outline won't go into the details (the limited partnership is, however, an excellent vehicle for certain "passive investment" types of business, such as real estate investment or oil and gas exploration).

C. Basically the "what's good" and "what's bad" aspects of limited partnerships are the same as they are for general partnerships, with the differences that (1) only the general partners have unlimited personal liability, (2) limited partners cannot participate in the management or operation of the limited partnership's business without becoming a general partner (and therefore "going naked" for anything bad that happens) and (3) limited partnerships are more complex than general partnerships and require more paperwork and legal expense. Lawyers like limited partnerships.

V. THE REGULAR OR "C" CORPORATION

A. A corporation, unlike a partnership, is a taxable entity -- when you form a corporation it is as if you have had a baby, with the difference that the baby pays taxes from the day it's born.

B. It's called a "C" corporation because it is taxed under Subchapter C of the Internal Revenue Code of 1986 (you had to ask).

C. What's Good About a "C" Corporation?

1. Limited Liability - generally, the owners of a "C" corporation (called "shareholders" or "stockholders") are liable only for the amounts which they contribute (or agree to contribute) as capital to the corporation, but will still be liable for their own negligence or stupidity.

EXAMPLE # 1: A and B are shareholders of ABC Corporation. A runs over someone with his car while on the corporation's business. The injured party may sue the corporation and win a judgment up to the amount of the corporation's assets (because that's all it has). The injured party may sue A in his/her individual capacity and take A's house away. But the injured party cannot sue B in any way unless it can be shown that B contributed actively in some way to his/her injury (for example, by serving A too much liquor which caused A to be intoxicated at the wheel).

EXAMPLE #2: A and B are shareholders of ABC Corporation. ABC Corporation enters into a contract with a supplier to buy 10,000 widgets, and then discovers that it doesn't have enough money to pay for the 10,000 widgets. ABC Corporation breaches and contract, and the supplier sues. The supplier may sue the corporation and win a judgment up to the amount of the corporation's assets, but the supplier cannot sue either A or B, even if A or B actually signed the contract as an officer or employee of ABC Corporation.

D. What's Bad About a "C" Corporation?

1. Expensive to form - legal expenses and filing fees are usually between \$1,000 and \$1,500 to form a corporation in most states.

2. Expensive to keep alive - if a corporation fails to pay taxes for X consecutive years or fails to file a report (and pay a fee) every Y years with the Secretary of State's office, the Attorney General comes along and "dissolves" the corporation (and your limited liability along with it). To add insult to injury, you are not informed that this has been done, so you continue blissfully in business thinking you have a corporation when you really don't.

3. If you don't use the corporation and treat it with respect, you lose the corporation; people suing you for something your corporation did will always try to argue they didn't know they were dealing with a corporation - if you conducted business in your own name, writing checks from your own checking account and accepting money in your own name that should have gone to the corporation, you can't argue it was really the corporation that should be sued and not you personally. Lawyers call this "piercing the corporate veil".

4. Lots of paperwork - when you have a corporation, you don't do anything; the corporation does everything. This means that for a corporation to do anything the shareholders (that's you) have to prepare written documents (called resolutions or "minutes") authorizing the directors of the corporation (again, that's you) to do the thing, and the directors have to prepare written documents authorizing the officers of the corporation (again, that's you) to do the thing. Resolutions are a pain in the neck, but if you don't do them you will be tempting the courts to say that you didn't treat your corporation with the proper respect so that creditors are allowed to get at your personal assets.

5. Taxes - because corporations are taxable entities, they pay taxes (albeit at a lower rate than you do yourself, in most cases); this means that any income which a corporation earns is taxed twice.

EXAMPLE: XYZ Corporation has two stockholders - A and B - and makes \$100 in net income for a particular year. The corporation pays 15% to Uncle Sam as federal income tax, and books the remaining \$85 as "net after-tax earnings". XYZ Corporation then resolves (remember those minutes?) to pay A and B the \$85 in the form of a dividend, and distributes \$42.50 to each of A and B. A and B each has to report that \$42.50 as income on their Form 1040 for the year and pay taxes on that \$42.50 at their individual rate. The result? If A and B are in the top tax bracket, that \$100 in corporate income has dwindled down to about \$26 in each of A's and B's hands after federal income taxes. Add state and local taxes to this calculation, and the tax "bite" becomes much larger.

VI. THE "S" CORPORATION

A. An "S" corporation is the same as a regular or "C" corporation with one important difference: it is not taxed by the federal government. This means that the "S" corporation is taxed just like a general partnership, but with the powerful advantage that stockholders in an "S" corporation have limited liability.

B. Some states and municipalities (such as New York City), however, do not recognize "S" corporations. This means that "S" corporations with offices in such states are taxed twice at the state level.

C. What's Good About an "S" Corporation? The same things that are good about a regular or "C" corporation.

D. What's Bad About an "S" Corporation? The same things that are bad about a regular or "C" corporation (except the tax part), with a couple of additions:

1. Because "S" corporations are taxed like partnerships, "S" corporations have the "phantom income" problem (if you've forgotten what this was, look under "What's Bad About General Partnerships" in the "General Partnerships" section of this outline).

2. "S" corporations have lots of icky little rules that you have to comply with if you don't want to be taxed as a regular or "C" corporation (note: if the IRS takes away your "S" corporation status you don't -- repeat don't -- lose your limited liability; the worst thing that happens is that you're taxed as a regular or "C" corporation). For example, you can't have anything but natural human beings as stockholders in an "S" corporation (forget parent-subsiary arrangements), you can't have more than 100 stockholders, all shareholders must be U.S. citizens or "Green Card" holders, and so forth.

3. "S" corporations file different forms with the IRS than regular or "C" corporations do, and have to report certain items of income differently; it is virtually impossible to operate as an "S" corporation without a darned good accountant. Accountants and lawyers both like "S" corporations.

VII. THE LIMITED LIABILITY COMPANY

A. The limited liability company, or LLC, has become the most popular alternative for small business formations since the IRS approved it in 1988. Virtually all states allow LLCs in some form.

B. What is an LLC? Well, it's basically an "S" corporation without all of the icky little rules that make "S" corporations unattractive for a lot of folks.

C. What's Good About LLCs?

1. Owners of an LLC (called "members") have limited liability - if A and B are members of an LLC and B runs someone over with his car while on LLC business, B may lose his/her house, but A will not lose his/her house unless A actively contributed to the injury.

2. Like partnerships, LLCs are simple to operate - there is no need to prepare resolutions or minutes to authorize people to do things (although banks and some other folks may still require you to do resolutions because they haven't gotten the idea yet); they just do them.

3. The costs of starting up an LLC are likely to be much less than forming a "C" corporation or an "S" corporation.

4. LLCs are taxed like partnerships, so there is no "double taxation" of an LLC's income.

5. If you are doing a lot of overseas business, the LLC format may give you an edge on your competition. Most foreign business organizations (such as the German GmbH and the Italian S.r.l.) are a lot closer in structure to an LLC than they are to a partnership or corporation; with an LLC you can give your managers the same titles as their European or Asian counterparts (Europeans especially cannot understand that in America one can be a "director" of a corporation and have absolutely no power to bind the corporation; in Europe business organizations are managed by their "directors", not by officers or mere employees).

D. What's Bad About LLCs?

1. Really not a lot -- while not perfect, LLCs are the closest thing to a "perfect" business organization the law has come up with to date.

2. Because LLCs are taxed like partnerships, they have the "phantom income" problem.

3. There are restrictions on what you can and cannot do if an LLC has employees -- for example, you may not be able to claim 100% deductibility for health insurance premiums.

4. It may be difficult for existing businesses to convert to LLC's - corporations and their shareholders incur "double taxation" upon liquidation, while general and limited partnerships formed to acquire or hold title to real estate (as many are) may incur transfer taxes and other fees upon converting to an LLC.

5. If your business is "high tech" or will seek outside capital within the first 12 to 18 months of operations, be aware that many investors (wrongly) associate LLCs with "small business, Mom and Pop, no growth potential" – while this perception is unfair, it is widespread, and you may want to consider becoming a "C" corporation instead (preferably in a high visibility state like Delaware).

6. LLCs are not recommended for businesses that will have a physical location in New York. When New York adopted its LLC statute in 1994, it included a burdensome "publication" requirement that drives up the costs of forming a New York LLC. While this requirement has been challenged in court, it may be a while before there's a resolution. In the meantime, it may actually be less expensive to form a corporation or S corporation in New York than an LLC! Also, keep in mind that LLCs located in New York City are subject to that city's "unincorporated business tax".

7. A growing number of states are imposing special taxes or "minimum taxes" on LLCs and other unincorporated business organizations. For example, Connecticut requires both domestic and foreign LLCs to pay an annual tax of \$250 whether or not they make money.

VIII. SO WHY SHOULD I EVEN CONSIDER A CORPORATION?

The LLC is wildly popular right now, but the corporation is far from dead. You should consider a corporation instead of a LLC when:

1. you are paranoid about losing your house to a business creditor. Just like a corporation's shareholders, LLC members enjoy "limited liability" for the LLC's debts, obligations, acts and omissions. Because LLCs are so new, however, the extent of this protection has not been tested in the courts to the same extent as it has for corporations. In extremely horrendous cases, it is possible that courts might be tempted to "pierce the veil" and subject LLC members to personal liability. So if you are engaged in a high-risk business activity (such as child care), you may want to consider a corporation, just to be safe.

2. if you expect to have a lot of employees very soon. While an LLC can have employees just like a corporation, there are limits to the types of deductible benefit plans and other "perks" you can set up for your employees. For example, under current law, a LLC with more than one member cannot set up a 401(k) plan. Corporations, on the other hand, can deduct just about all employee-related expenses.

3. if you expect to have a lot of health-related issues in the near future. Unlike corporate officer and employees, LLC members cannot deduct amounts they are reimbursed for medical and health-related expenses.

4. if you plan to seek venture capital very soon. When sophisticated or professional investors see the "LLC" designation after a company name, they tend to think "small time, Mom and Pop, will never grow big". This is a false view, as there is nothing in the law to prevent an LLC from growing big or even eventually going public. The bias against LLCs, however irrational, is strongly felt within the investment community. Accordingly, a new business that plans to seek venture capital or private equity funding ("angel money") within the first one to two years of its existence, should be set up as a corporation, preferably in a state like Delaware that offers a number of advantages to venture capital backed companies.

5. if you hate paying quarterly estimated taxes. LLC members, like all other self-employed people, are required to estimate and pay their federal and state income, withholding, Social Security, Medicare and other taxes in quarterly installments. If you are worried that you will not be disciplined enough to make these payments when they become due, you may want to consider forming a subchapter S corporation and making yourself an employee of the corporation. That way, while you won't save much on taxes, you can receive a regular paycheck and have taxes taken out of each paycheck, just like the good old days, and you won't have to worry about not having enough cash in the bank to make a large quarterly estimated tax payment.

6. if you hate paying Social Security and Medicare taxes. LLC members, like all other self-employed people, must pay “self-employment tax” consisting of income, Social Security, Medicare and other taxes. By forming an “S” corporation, and making yourself an officer or employee of the corporation, you may be able to separate your compensation into two pieces – your salary as an officer (which will be subject to income, Social Security, Medicare and other taxes), and the remaining share of profits (which will be subject only to income taxes). For example, if your subchapter “S” corporation has net income of \$200,000 this year, you may be able to treat \$120,000 as salary and \$80,000 as “passive” income. While you will have to pay Social Security and Medicare taxes (about 15.8%) on the \$120,000 “salary” portion, you will pay only income taxes (not Social Security or Medicare taxes) on the \$80,000 “passive” portion. This is very tricky, however, and your accountant will have to tell you the best way to do this to avoid triggering an IRS audit.

IX. LIMITED LIABILITY PARTNERSHIPS (LLPs)

A. Limited liability partnerships, or “LLPs”, are allowed in a growing number of states; while theoretically any business can operate as an LLP, this form of organization is best suited to lawyers, doctors, accountants and other professional practices, and to existing general partnerships that wish to achieve limited liability status with a minimum of legal expense.

B. An LLP is a general partnership in which the partners have limited liability for the acts and omissions of the other LLP partners; an LLP partner is always liable for his or her own negligence or willful misconduct.

C. An LLP partner also enjoys limited liability for contracts which he or she signs on behalf of the LLP.

D. An existing general partnership that converts into an LLP can continue to use its existing partnership agreement, usually without significant modification. This is an advantage for older partnerships that may have lengthy, detailed partnership agreements which the partners do not wish to re-negotiate at the present time.

E. In practice, LLPs are best suited to professional practices, particularly those with offices in two or more states (such as the so-called “Big 5” accounting firms). In some states, professionals are not allowed to conduct business in corporate or L.L.C. form. By reorganizing as an LLP in each state where it does business, a multistate professional practice complies with local laws, ensures consistent accounting and tax treatment in all states where it does business, and provides at least some limited liability protection for its partners.

X. CONCLUSION

A. Like we said at the beginning, there is no “perfect” way to organize your business activities. Each of the “flavors” discussed in this outline has pros and cons, and most lawyers will want to spend some time learning about your business plans before recommending that you consider one or the other.

B. Generally, the less you are concerned about limiting your liability, the less legal complexity and hassle you will be forced to live with. The more you are concerned about limiting your liability, the more complexity and hassle you will live with, and will have to learn to live with.

C. A good lawyer is someone who doesn't just “form the corporation” and then leave you to figure out the rest; a good lawyer is a good “teacher” who helps you figure out how to do the paperwork, keep the records, and otherwise avoid making the dumb mistakes that can get you into trouble.