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Choice of Organizational Form for the Start-Up Business

JOHN H. MATHESON*

Individuals embarking on new business ventures must choose a legal form under which to operate. They can form their business enterprises as sole proprietorships, general or limited partnerships, limited liability partnerships, limited liability companies, or corporations. State laws set forth the attributes of each organizational form. These include criteria for limited liability, centralized or decentralized management, transferability of interests, and duration of existence.

Before 1997, the issue of entity choice for the businessperson and legal counselor was tax-driven, and the determination to obtain pass-through tax treatment depended on the corporate resemblance test of the now-discarded Kintner Regulations.¹ Under the Kintner Regulations, unincorporated businesses were taxed as corporations if they had more corporate than noncorporate characteristics.

On January 1 of 1997, the law of business organizations changed dramatically, when the United States Treasury Department's Simplification of Entity Classification Rules became effective. The current system, sometimes referred to as the "check-the-box regulations," ended decades of manipulation of business organization forms to fit the requirements of the Kintner Regulations and obtain pass-through tax treatment. Only corporations and publicly traded organizations are taxed as separate entities. All other business organization forms have presumptive pass-through federal tax status. Check-the-box regulations reduced the impact of tax issues in the determination of the type of legal organization a business chooses to use.

This article introduces the basic business organization forms and some of the attributes of each that influence the choice of entity decision for the modern start-up business.

Sole Proprietorships

A sole proprietorship is a business owned by one individual and not through a separate entity. Creation of the sole proprietorship

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¹ Prior Treas. Reg. § 301.7701-2 (1993).

requires no organizational formalities and is not subject to any specialized statute. The substantive law of contracts, torts, and agency govern the sole proprietorship, including the personal liability of the owner for the obligations of the business. The proprietor has sole authority to manage the business that ends with the owner's death or decision to end the business. Ownership is transferable as any other personal property.

Most business owners will choose an organizational form that limits personal liability, making the sole proprietorship a less-favored choice.

Sole proprietors can make cash or property contributions to the business and can withdraw money or property from the business without tax consequences.

Sole proprietors report the results of business operations on individual tax returns by reporting all of the net profit from the business, whether or not the proprietor withdraws the amount or reinvests it in the business. In profitable businesses, overall taxable income increases and business income is taxed at the proprietor's marginal tax rate. If the business operates at a loss, the proprietor's overall taxable income decreases. Subject to certain limitations, such losses can offset the proprietor's income from other sources and result in tax savings.

Partnerships

General Partnerships

A partnership is an association of two or more persons who are co-owners of a business for profit. Formation of a partnership does not require a written partnership agreement setting forth the terms of the partnership nor even the explicit intent to form a partnership. Though certain exceptions exist, a person receiving a share of the profits of a business is presumed to be a partner in that business.

If an explicit partnership agreement exists, it will control the rights of the partners. If the agreement fails to address particular areas or there is no explicit partnership agreement, nearly every state has a partnership act that controls.² Partnership acts contain numerous default

² Versions of the Uniform Partnership Act are the basis of most state statutes -- <http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upa97fa.htm>. Summary and history: http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-upa1994.asp

provisions that govern the relationships among the partners, between the partners and the partnership, and between the partnership and third parties. To avoid unanticipated outcomes in the operation of the partnership, parties should approve a written partnership agreement before forming the partnership.

For example, if partners do not explicitly specify profit and loss sharing ratios, partnership acts provide that partners will share profits and losses equally. Partners who want a profit or loss structure different from this default provision should set forth an alternative structure in the partnership agreement.

All partners have an equal right to participate in the management of the partnership, unless they alter its management structure. They may choose to vest management rights in only a few partners and maintain a centralized management structure. Unless the desired management structure is clearly set forth in an agreement, the equal-authority default will apply.

High standards of behavior apply to partners, which include making full disclosure to fellow partners under appropriate circumstances and acting primarily for the benefit of the firm when acting in the partnership's usual course of business. While the enterprise continues, partners owe one another strict loyalty. Many actions permitted by those acting at arm's length are prohibited in a fiduciary relationship.

Fiduciary duties commence at the formation of the partnership and continue until partnership affairs are wound up and the partnership makes final distributions.

A partnership is a small group of business owners who actively participate in the business. Though a partnership is an entity separate and distinct from its partners, all partners in a general partnership are jointly and severally liable for the debts of the partnership - there is no insulation from personal liability. The partners are liable not only for claims involving their own misconduct, but also for the debts, obligations, and liabilities incurred by the partnership, and for actions of other partners in the conduct of the partnership business.

A partner admitted into an existing partnership is jointly and severally liable only for those claims arising subsequent to admission to the partnership.

Partners should consider exit strategies when forming a partnership and drafting a partnership agreement, because partnership interests are not transferable without the consent of all the other

partners. The partnership agreement could make the transfer of an interest contingent on receiving approval from a certain percentage of the partners. Or, the partnership agreement could eliminate all approval requirements, making the partnership interests freely transferable.

A partnership does not have a perpetual existence. In a partnership at will, a partner can dissolve the partnership at any time.

A court may dissolve a partnership. Upon application by a partner, the court may find that the economic purpose of the partnership is likely to be unreasonably frustrated, another partner has engaged in conduct with respect to the partnership that makes it not practicable to carry on the business in partnership with that partner, or it is not practicable to carry on the partnership business as outlined in the current partnership agreement.

Dissolution does not necessarily mean the partnership terminates immediately. The partnership continues after dissolution to wind up its business and terminates when the winding up of the business is completed. During this phase, the partnership completes its business, marshals its assets, pays its liabilities, and distributes its interests. An agreement between partners cannot prevent dissolution but can manage the consequences of dissolution. The partners also may agree to continue the partnership after dissolution rather than entering the winding up phase.

Two fundamental differences exist between the taxation of partnerships (and other non-corporate business entities) and corporations. First, a partnership is a flow-through entity, not a separate taxable entity. Corporations are subject to an entity-level tax, while partnerships are not. Second, partners are liable for tax on the partnership's income, even though there may be no distribution of the income. Shareholders in a corporation are liable for tax only upon the receipt of a distribution from the corporation. A partnership avoids the double tax effect because only the partners, not the partnership, have tax liabilities.

An illustration of the advantageous effect of the single tax:

Smith and Jones form a partnership as equal partners. The partnership earns \$1 million of taxable income for the taxable year. Smith and Jones each report \$500,000 gross income from the partnership. The \$1 million is subject to the maximum individual tax rate of 38.6%, creating a tax liability of \$386,000.

Assume instead that Smith and Jones formed Smith and Jones, Inc., as equal shareholders. The corporation earns \$1 million of taxable income for the taxable year. Since the corporation is a

separately taxed legal person, the corporation pays \$340,000 in tax, at the current corporate tax rate of 34%. Then, if the corporation distributes the \$660,000 after-tax earnings to Smith and Jones as a dividend, in cash, Smith and Jones must pay tax on the dividends. Assuming a 38.6% individual tax rate, Smith and Jones will pay almost \$255,000 in tax.

The combined corporate and shareholder tax on the corporation's \$1 million of taxable income is \$595,000, compared to \$386,000 if the organization operated as a partnership.

Although the partnership does not pay taxes, it files an information tax return, Form 1065.

The partnership nets its ordinary income and expense items resulting from trade or business activities to produce a single income or loss amount. The partnership files a Schedule K, on which it lists all items that must be reported separately to the partners. These items must be listed separately because they may affect individual partners' tax liabilities differently. Examples of separately stated items include charitable contributions, net short-term capital gains and losses, net long-term capital gains and losses, dividends eligible for a dividends-received deduction, and tax-exempt interest. Every partner receives a share of the partnership's income, gains, losses, deductions, and credits on his schedule K-1.

When a partner determines gross income for federal income tax purposes, it must include the partner's distributive share of income from a partnership.

The major disadvantage of a general partnership is that partners are personally liable for the obligations of the partnership. This leaves the personal assets of the partners unprotected and subject to attachment by creditors.

Another drawback is uncertainty under the partnership laws. They are not as detailed as most corporate statutes and they are not clear as to how various disputes or concerns will be resolved. Fewer court decisions interpret partnership statutes than corporate statutes, and this absence of judicial interpretation contributes to the uncertainty.

Limited Liability Partnerships

The limited liability partnership (LLP) is a new type of partnership, nonexistent before 1990, governed by special provisions of a state partnership statute.

Most of the attributes of general partnerships also apply to LLPs,

including the discussion of management structure, period of existence, transferability of interests, fiduciary duties and taxation. As the name suggests, regarding liability of the partners, LLPs have a distinct advantage over a general partnership.

LLP status appeals to members of professional partnerships because they can continue to function as general partnerships while limiting partners' vicarious liability for any malpractice committed by other partners. The LLP does not require the creation and administration of an entirely new type of business entity. Instead, it enables members to continue to hold themselves out as partners. Although LLPs initially were tailored to the needs of professional service practices, they have flourished outside the professional domain.

To create an LLP, partners file a statement of qualification with a designated state agency, usually the secretary of state. Existing partnerships, to achieve LLP status, must vote to amend the partnership agreement and file a statement of qualification.

This statement must include the name of the partnership, the address of the partnership's chief executive office and, if different, of an office in the state where the LLP statement of qualification is filed, a statement that the partnership elects to be an LLP, and a date of commencement. LLP status is effective on the later of the filing of the statement or a date specified in the statement. The name of the LLP must include "Registered Limited Liability Partnership," "Limited Liability Partnership," "R.L.L.P.," "L.L.P.," "RLLP," or "LLP."

LLP status is in effect initially through the end of the calendar year after the year of formation. To maintain LLP status, the LLP must file an annual registration.

Under many LLP statutes, the formation of an LLP protects partners against vicarious liability from both tort and contract claims arising during the partnership's registration as an LLP. The liability shield does not protect a partner from liability for claims based on his or her own wrongful acts, negligence, or misconduct.

Under certain circumstances, the partners in an LLP could lose the limited liability shield and be personally liable for partnership obligations.

Not all states have adopted similar limited liability provisions, and LLPs should not assume that other states automatically would defer to these provisions. So far, it is unclear whether other states will apply their own law or the foreign state's law to claims regarding an LLP formed under the foreign law.

In states with these provisions, the statutes govern all internal affairs of the limited liability partnership, including the liabilities of partners for the debts and obligations of the LLP.

It is a risk to operate as a general partnership, with no chance of protection from personal liability. All partnerships that formerly operated as general partnerships should become limited liability partnerships.

Limited Partnerships

A limited partnership is a creature of statute. It has one or more general partners and one or more limited partners. In a limited partnership, the general partners are in the same position as partners in a general partnership - jointly and severally liable for the debts of the partnership. Limited partners are distinct from the partnership and are usually liable only to the extent of their capital contributions.

Limited partners cannot participate in the management of the limited partnership without risking their limited liability status. If they participate in the control of a business, they can lose their limited liability and become personally liable. This prevents a limited partner from possessing ultimate decision-making responsibility. Individual state statutes may provide a great deal of protection for limited partners with regard to the activities in which they can participate.

Limited partnership interests are freely transferable. Unlike general partnerships, the transfer of an interest in a limited partnership does not require unanimous approval by the other partners. The sale or issuance of a limited partnership interest is treated as a sale or issuance of a security and the entity must comply with the relevant federal and state securities laws.

Limited partnerships do not enjoy perpetual existence. Dissolution occurs at the earliest of (a) the date specified in the limited partnership certificate; (b) the occurrence of events specified in the partnership agreement; (c) the written consent of all partners; (d) the withdrawal of a general partner, unless another general partner continues the business in accordance with the partnership agreement or with the consent of the parties; or (e) judicial dissolution. The limited partnership can agree to avoid a winding up and continue its existence.

General partners owe fiduciary duties to limited partners. A limited partner has the right to bring an action in the name of the limited partnership to recover if: 1) the general partners who have authority to do so refused to bring an action or 2) an effort to force the general partners to bring an action is unlikely to succeed. The plaintiff

must be a partner when he or she brings the action and when the transaction complained of occurred. This action is similar to a derivative suit in the corporate context.

Limited partnerships are rare outside of investment fund and family contexts. Their odd management structure, with both general and limited partners, penalizes limited partners for being active in the business. Limited liability partnerships and limited liability companies offer advantages similar to the limited partnership without this structure and its accompanying restrictions.

Limited Liability Companies

A limited liability company (LLC) is an unincorporated statutory entity that provides presumptive limited liability for all of its owners — its “members.”³ Under the typical LLC statute, because of the check-the-box regulations, an entity can be created with flow-through tax treatment, limited liability for its owners, perpetual existence, free transferability of interests, and a choice of management structures. These developments make the LLC the most appealing non-corporate entity for business organization purposes, making the LLC the entity of choice for closely held businesses in the United States

LLC statutes vary significantly from state to state and may be based on a partnership model, a corporate model, or some hybrid of the two.

Typically, one or more organizers can create an LLC. Most states allow an LLC to have only one member and do not limit the number of members allowed. Members may be corporations, partnerships, trusts, or individuals. Professional organizations, such as accounting and law firms, may organize as LLCs.

To achieve LLC status, “Articles of Organization” must be filed with the secretary of state or other designated office and LLC status commences on the date of filing. Articles of organization must include the LLC’s name, its address, the names and addresses of each organizer, and the period of existence if limited. The LLC’s name must contain the words “limited liability company” or the abbreviation “LLC.”

To maintain LLC status, the LLC must register annually. An LLC

³ National Conference of Commissioners on Uniform State Laws, Uniform Limited Liability Company Act: Limited Liability Companies, a Kind of Business Organization, http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-ullca.asp.
Summary and history:
http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-llpt97attupa1994.asp.

that fails to file its annual registration may terminate administratively. Loss of LLC status may cause the LLC's members to lose the limited liability shield, leaving members personally liable for any debts incurred after the termination of LLC status.

LLC status provides an organization with flexibility in determining its management structure. Statutes usually allow either a manager-managed governance structure or a member-managed structure. Through contractual agreements, an LLC can limit the management rights of some members. Members may adopt operating agreements specifying the relationship of its members and the manner in which the LLC will operate. The operating agreement is the principal governing document of the organization.

The transferability of the members' LLC interests depends on the type of rights involved. The interests in an LLC usually are divided into financial rights and governance rights. A financial right in an LLC often is freely transferable, while a governance right presumptively is not. Transfer of governance rights to a nonmember typically requires the unanimous consent of all other LLC members.

An LLC is liable for all company obligations, including liability resulting from the wrongful acts of its members or employees. LLC members are liable only to the extent of their capital contributions. This limited liability status remains in full force even in the event of a dissolution, winding up, and termination of the LLC. This protection will be lost only if a complaining party successfully pierces the LLC's limited liability shield.

The presumed duration of an LLC varies among LLC statutes. Some states provide partnership-like dissolution provisions, while others allow a stated of existence or presume a corporate-like perpetual duration.

Corporations

Historically, one advantage of doing business in the corporate form was the ability of the shareholders, as the owners of the business, to limit their personal liability for the business's debts and obligations. This liability shield protects the shareholders' personal assets from any loss incurred by the corporation, because a corporation is a distinct legal entity separate from its owners. Creditors must look to the corporation's assets to satisfy their claims.

Business parties who intend to use the corporate form must follow the proper corporate formalities or risk losing limited liability protection. Corporate law requires that all corporations have a governance group called the board of directors. Responsible for a

corporation's management, shareholders must elect the board of directors through regularly scheduled annual elections or special elections. Shareholders typically do not participate in the management of the corporation.

Centralized management is important in large, publicly traded corporations. With thousands of passive shareholders scattered throughout the globe, a shareholder is not likely to seek or be able to actively participate in the management of the typical multinational corporation. In smaller business entities, centralized management is a disadvantage, because their owners want to manage and their managers want to own.

Directors are fiduciaries to the corporation and have duties of obedience, care, and loyalty. Shareholders do not owe the corporation or each other any fiduciary duties.

An interest in a corporation is readily transferable, unless restricted by the owners. Free transferability of ownership interests is a definite advantage of the corporation, particularly a large one. Typically, only small, closely held corporations restrict the transfer of ownership interests.

Another advantage of the corporation is that it has a presumptive perpetual existence. Unlike a partnership, a corporation does not dissolve upon the occurrence of certain events or the passage of a certain period of time. Corporations need not be concerned that an unwanted dissolution or winding up may occur. The board of directors and the shareholders can determine when a corporation terminates its existence.

Shareholders in a corporation are presumed to be liable only to the extent of their contributions. They may be personally liable, however, under the equitable doctrine of piercing the corporate veil. To pierce the corporate veil, a complaining party must show that the shareholders employed the corporation as an "alter ego" and that use of the corporation was unfair or inequitable.

When third parties seek to pierce the insulation of the corporate form, it usually is in cases involving closely held corporations. Courts may perceive less of a justification for the protection of shareholders of closely held corporations from personal liability. Operating a corporation like a sole proprietorship can justify a court's removal of the limited liability veil.

Corporations are separate taxpaying entities, distinct from their shareholders. They are taxed annually on earnings. When the

corporation distributes its income in the form of dividends, the corporation's shareholders must report this income as well. The effect is double taxation – a major disadvantage of operating as a corporation. Because the corporation is a separate entity, many ongoing transactions between it and its shareholders are taxable events. When the corporation liquidates, any previously unrealized income, such as appreciation of corporate assets, is taxed at the entity level.

S Corporations

Recognizing these problems, Congress and the Internal Revenue Service created tax provisions that allowed small businesses to not be limited or guided solely by tax considerations when choosing an entity form. The result was the creation of S Corporations, governed by Subchapter S of the Internal Revenue Code.⁴

Subchapter S status combines the non-tax legal environment of regular corporations with taxation similar to that of partnerships. S Corporations enjoy many of the corporation's non-tax benefits while avoiding double taxation.

S Corporations are small business corporations that have made an election under section 1362 to become S Corporations. A corporation files Form 2553 – Election by Small Business Corporation to Tax Corporation Income Directly to Shareholders – to make the election.⁵ The Code specifies six requirements that corporations must satisfy in order to be an S Corporation:

1. It must be a domestic corporation.
2. It may have no more than 75 shareholders.
3. Shareholders must be individuals, estates, and certain types of trusts or certain tax-exempt organizations.
4. Shareholders cannot be nonresident aliens.
5. The corporation must not be an ineligible corporation, as are some insurance companies and financial institutions.
6. It may only have one class of stock.

⁴ I.R.C. §§ 1361-1363,
http://www.access.gpo.gov/uscode/title26/subtitlea_chapter1_subchapters_parti.html

⁵ I.R.S. Form 2553: Election by a Small Business Corporation,
<http://www.irs.gov/pub/irs-pdf/f2553.pdf>

Each of these criteria must be satisfied and all of the S Corporation's shareholders must consent to the election in writing. The election remains in effect unless the corporation voluntarily revokes the election or fails to satisfy any of the six small business corporation tests.

S Corporations are flow-through entities and are like partnerships for tax purposes. S Corporations report an ordinary income or loss amount as well as the corporation's separately stated items. The separately stated items are identical to those of partnerships. Each shareholder receives a pro rata share of the ordinary income or loss amount and of each of the separately stated items. The pro rata allocation method assigns an equal portion of each item to each day of the taxable year and then allocates that portion among the shares outstanding on that day.

Although the S Corporation is not subject to corporate income tax, it must file Form 1120S - U.S. Income Tax Return for an S Corporation - if it existed at any time during the tax year. Also, the S Corporation must give pertinent information to its shareholders and the shareholder's return must be consistent with the corporate return.

Conclusion

The LLP and the LLC are the newest and most popular types of business entities. All fifty states and the District of Columbia have enacted such statutes. The primary drawback of LLP or LLC status is that some uncertainty surrounds the manner in which LLP and LLC laws will be interpreted because of their short periods of legal existence.

Notwithstanding this uncertainty, it is difficult to conceive of any reason why knowledgeable and well-represented entrepreneurs would organize a firm as anything other than an LLP or LLC or a corporation that has made an S corporation election. Only in special circumstances should an entrepreneur use the traditional sole proprietorship, general partnership, or limited partnership.

ENTITY COMPARISON CHART

FACTORS	CORPORATION	PARTNERSHIP	LLP	LIMITED PARTNERSHIP	LLC
1. FILINGS					
A. Documents	Articles of Incorporation	None	Statement of Qualification	Certificate of Limited Partnership	Articles of Organization
B. Signers	Incorporator/s	N/A	Any partner	A general partner	Organizer/s
C. Filing Location	Secretary of State or designated state office	N/A	Secretary of State or designated state office	Secretary of State or designated state office	Secretary of State or designated state office
D. Fees	Yes	None	Yes	Yes	Yes
2. OWNERS, OWNERSHIP INTERESTS, AND LIABILITIES					
A. Owner Type	Shareholders	Partners	Partners	General and limited partners	Members
B. Severability	Yes (variety of series and classes)	Yes	Yes	Yes	Yes, divided into financial and governance rights
C. Transferability	Yes, unless restricted by Articles, Bylaws, or other Agreements	Requires approval of all other partners	Requires approval of all other partners	Yes, for limited partners. Requires approval of all other partners for general partner	Yes, as to financial rights. Assignment of governance rights requires approval of all other partners
D. Designation	Shares of stock	Partnership Interest	Partnership Interest	Partnership Interest	Membership Interest
E. Financial Rights	Equal to number of shares (plus options, warrants, etc.)	Equal share of profits and losses	Equal share of profits and losses	Based on Percentage of Contributions	Based on Percentage of Contributions
F. Voting Rights	Number of voting	Per capita	Per capita	As provided in	Based on Percentage

FACTORS	CORPORATION	PARTNERSHIP	LLP	LIMITED PARTNERSHIP	LLC
	shares			Partnership Agreement	of Contributions
G. Owners Liable for Debts of Entity (absent piercing)	No	Yes	No	No	No
H. Liability Shield Can be Pierced	Yes	N/A	Yes	Yes, if limited partner takes part in control of business	Yes
3. MANAGEMENT OF BUSINESS	Control of business delegated to board of directors	All partners or as delegated	All partners or as delegated	General Partners	Control of business delegated to board of governors
4. DURATION OF ENTITY	Unlimited, unless limited by state law or terms of charter	Specified term; or at will	Specified term; or at will	Specified term; or terminated by withdrawal of last general partner	Unlimited; specified term; or death, retirement, bankruptcy of a member Remaining members can agree to continue existence
5. TAXATION	Corporation, on its taxable income; Shareholders, on their distributions, unless S status elected	Partners, regardless of whether income is distributed to them	Partners, regardless of whether income is distributed to them	Partners, regardless of whether income is distributed to them	Members, regardless of whether income is distributed to them