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Bulletin #69, Selecting an Entity and Controlling It (July 25, 2003)

What is the difference between an LLC, an “S” corporation and a “C” corporation?

How should you legally run your business? What happens to the company if an owner leaves or dies?

In this *Contracts Bulletin*, we will briefly examine:

1. The various types of legal entities; and
2. How to properly control these legal entities.

The following is a general discussion of the law. The exact nature of legal entities varies from state to state, and you should consult with your attorney before making any decisions about the selection or operation of a business entity.

Types of Entities

There are six basic legal entities which can be used for the operation of a business. For each of the entities, we will briefly discuss the nature of the entity, and the advantages and disadvantages of operating a business under that type of legal entity.

Sole Proprietorship

Brief Description

This is the most basic legal entity. This is a single individual operating and owning an entity by him or herself. No documents are filed with the state.

Example of a Business Name: “John Smith HVAC Repair”

Advantages

1. This is the simplest and least complicated of any entity – there are no filing requirements with the state, and no documentation is required to demonstrate that the person operating the business is separate from the business entity.

2. The individual operating the business may run the business in his or her own name, or use an assumed name, again without any concern that the entity will be treated differently than the individual.

3. Tax reporting is straight–forward. Income and loss are reported on Schedule C of Form 1040.

Disadvantages

1. The person running the company is personally responsible for all debts and liabilities. If the business owes a substantial debt, the owner is personally liable, and will be responsible for the debt up to and including bankruptcy.

2. Sole proprietors cannot qualify for deductions of insurance, or other similar expenses, as would a business that was incorporated.

3. While there may be insurance coverage for claims, the owner is personally responsible for any liability in excess of insurance coverage.

4. The business owner is subject to both income tax and self–employment tax.

Recommendation

Builders and HVAC contractors should <u>never</u> operate as sole proprietors. In most states, builders have statutorily–imposed warranty obligations, as well as potential common law liability. A substantial judgment against a sole proprietorship would result in personal liability (potentially forcing personal bankruptcy). This liability could extend long after the individual running the sole proprietorship has retired or left the business. For example, in Minnesota, a contractor may be liable for up to 12 years following the completion of work.

General Partnership

Brief Description

A general partnership is an entity formed by two or more individuals. A general partnership can be created with or without signing a partnership document, and may be created with or without a state filing.

Example of a Business Name: "Smith & Jones HVAC Repair"

Advantages

1. Formation is easy. Once again, there is no state filing requirement to create a general partnership.

2. Two or more people who carry on the business will be considered general partners, even if there is no written partnership agreement.

3. No "corporate formalities" or "partnership meetings" are required to run a partnership.

Disadvantages

1. Partners will be jointly and severally liable for any liability of the business. This is true even if one partner makes the mistake or causes the problem giving rise to liability. The other partner will still be held personally liable for the debts of the business.

2. Partners must cover losses sustained by the business in proportion to their share of the profits (absent some other agreement). If a partner fails to contribute the amount necessary to satisfy the debts, the other partner must contribute the amounts necessary to offset the losses.

3. In the absence of a written agreement, partners can have misunderstandings and disagreements about ownership of the general partnership, division of profits and responsibilities for debts.

4. All of the disadvantages listed for "sole proprietorship" above apply for general partners.

Recommendations

HVAC contractors and builders should never operate as a general partnership. As discussed above, there is substantial and continuing liability under most states' statutes for warranties, as well as potential common law liability. Tax advantages, which previously existed for general partnerships, are now permitted for limited liability companies (discussed below).

Limited Partnerships

Brief Description

Limited partnerships (and all of the remaining entities described below) are created by filing with the state (usually with the Secretary of State's office) articles of formation and paying a filing fee. In limited partnerships, a general partner is personally liable for the acts of the general partnership, and the limited partners are investors, who play no direct and active role in running the business. The limited partners' liability is limited to the amount of their investment.

Example of a Business Name: "S&J HVAC Repair Limited Partnership"

Advantages

1. Prior to 1986, limited partnerships were very popular, because they presented substantial tax advantages. Although not as popular throughout the 1990s, investors are now returning to this form of investment, because limited partners are treated as "passive" investors, and are not subject to self–employment tax. Additionally, limited partners may also be able to include the partnership debt as part of their basis for tax payment purposes and may receive some passive losses generated by the business.

2. Limited partners are only liable to the extent of their investment (their capital contribution) in the limited partnership.

3. Limited partners are not responsible for the management of the business and have only limited rights to advise the general partner.

4. A limited partnership offers the business owner an opportunity to raise money from investors, provide liability protection to those investors, and stay in control of the business, without going to banks or other sources of capital where money may be unavailable or too expensive.

Disadvantages

1. A general partner is in control of the business, but is also personally liable for the debts of the business.

2. Limited partners receiving distributions from the business can be required to return those payments in the event there is substantial liability found against the limited partnership.

3. If a limited partner becomes too involved in managing or controlling the partnership, the limited partner can become a "general partner" by default subjecting the limited partner to unlimited personal liability.

Recommendation

Limited partnerships can be used when traditional ways for raising money are unavailable. These entities should be created carefully and require substantial consultation with your attorney before the parties proceed. A clear and detailed partnership document is essential.

Corporation

Brief Description

This is the best known and oldest form of a business entity. In some states, this is called a "C corporation" or in others it is merely known as a "corporation." Individuals invest in the company and become shareholders. Their personal liability is limited to the amount of their investment. Filing with the state is required (usually Articles of Incorporation) and a fee will be paid. Substantial corporate formalities must be implemented and maintained in order to obtain the benefit of corporate status (see next month's *Contracts Bulletin*).

Example of a Business Name: "S & J HVAC Repair Company"

Advantages

1. The primary advantage is that shareholders are not liable for the debts of the corporation. The shareholders' risk of loss is limited to the value of their investment.

2. The creation of a corporation is usually required in order to raise money through traditional means (e.g., borrowing from a bank) or engaging in more sophisticated transactions like an initial public offering.

3. Employee benefits, such as medical, disability, insurance and other costs, may be tax deductible.

4. A corporation is considered "perpetual" in duration. Therefore, even if an officer, director, or shareholder dies or leaves the company, the corporation continues to exist.

5. It is easy to transfer ownership of stock in corporations, whereas transfer of ownership of a "sole proprietorship" or a "general partnership" can be difficult (and in some cases impossible).

Disadvantages

1. Income from the business is subject to double taxation. That is, the corporation itself pays taxes (corporate tax) and the individuals, who make up the corporation, pay personal income tax.

2. While these tax disadvantages can be mitigated through careful coordination with an accountant and lawyer, there is still a higher general rate of taxation by operating as a C corporation.

3. Implementation and careful maintenance of corporate formalities is required, including conducting regularly scheduled meetings.

Recommendation

Large business entities, with substantial numbers of employees and large numbers of investors, generally operate as C corporations. As a practical matter, if you have a large business, it usually makes sense to operate as a C corporation.

S Corporation

Brief Description

While many of the entities described in this article are distinguishable by their names, an S corporation and a C corporation cannot be identified merely by looking at the proper name of the company. Instead, the identification of an S corporation is done by looking at the records filed with the state. Usually, an S corporation is permitted upon filing with the state (usually Articles of Incorporation) and the payment of a filing fee. Generally, S corporations will have a limited number of shareholders (none of which are corporations).

Example of a Business Name: "S & J HVAC Repair Company"

Advantages

1. There is no double taxation. Income and losses "flow through" the corporation directly to the owners.

2. An investor in an S corporation is <u>not</u> required to pay self−employment tax or tax on income distributed as dividends.

3. There is no personal liability for shareholders beyond the shareholders' investment.

Disadvantages

1. Generally, shareholders in S corporations do not receive increases in their basis for debt in the corporation.

2. S corporations have a limited number of shareholders (usually less than 75).

3. The owners of the S corporation are required to maintain proper corporate formalities.

4. Profits must be distributed to shareholders in accordance with their ownership interest. That is, if the shareholders each own one−third of the company, each should receive one−third of the profits, regardless of their actual contribution to the business. This inflexibility can be a major drawback.

Recommendation

An S corporation presents a useful middle ground between a C corporation and an LLC (discussed below). The decision of whether to proceed as a C corporation, an S corporation or an LLC is usually dependent upon the law of your state and the recommendation of your lawyer and accountant.

Limited Liability Company (LLC)

Brief Description

This legal entity is tremendously popular among individuals creating new and small businesses. LLCs also require a filing with the state and the payment of a filing fee.

Example of a Business Name: "S & J HVAC Repair, LLC"

Advantages

1. There is no requirement (in most states) that there be multiple shareholders (called "members" instead of partners or shareholders). That is, a single individual may create the entity.

2. The members of the LLC may manage the LLC much like a partnership. While the LLC is a corporate form, the members can operate the business with comparatively little formality, although (as discussed below and in next month's Bulletin) there are basic requirements which <u>must</u> be satisfied.

3. There is no personal liability for members. Only the entity is liable to the extent that there are debts or judgments against the company.

4. LLCs present substantial tax advantages through the ownership of real estate, and the accrual of depreciation in property through flow through tax liability.

Disadvantages

1. Owners are subject to self–employment tax.

2. Owners must still engage in appropriate corporate formalities.

3. The number of members is usually limited for LLCs.

Recommendation

This is usually an excellent entity if you are "starting out" in business. If one or two individuals want to start a new business or begin operating as a legal entity, LLCs usually present an excellent starting point. However, as discussed below, it is also crucial to enter into appropriate buy–sell or shareholder agreements.

Controlling the Entity

You have now selected the proper legal entity from the list above, and have consulted with your legal counsel and accountant. If you are a sole proprietor or LLC, you have no problem, because you have no partners. However, as the number of owners increases, so does the likelihood that a disagreement, death, or injury could throw the control and ownership of the entity into chaos.

Question: How are you going to control the entity during its operation, and if one of the owners voluntarily or involuntarily leaves the entity?

Answer: You need to meet with your attorney, and spend some time (and money) drafting a good agreement to handle management of the entity, and (most importantly) set up a system to buy out shareholders who leave the company.

Operating Agreement

At the time of corporate formation, your attorney should draft documents which indicate how board meetings and shareholder votes will occur to handle the governance of your entity. There should be clear provisions regarding how shareholders will vote, who controls the day–to–day management of the business, and how meetings will be conducted. This will permit the parties (hopefully) to handle without incident the day–to–day operations of the business and allow the necessary decisions to be made.

Buy/Sell Agreement

You have an Operating Agreement to handle the day–to–day operations of the business, but the following issues remain:

- What if someone quits or is fired?
- How do you buy out the person who has left?
- How much do you pay the heirs of an owner who has died?
- How do you determine the value of their interest in the entity?

In a publicly traded corporation (for example, on the New York Stock Exchange), a shareholder or his/her heirs may sell the stock at market value. However, in a privately–held company (which is the situation in most small and medium–sized companies), the questions listed above should be resolved at the time the entity is created or shortly thereafter.

It is always a good idea when the parties are getting along, to draft an agreement specifying how shareholders (or members) will be paid in the event they leave the company. If everyone is fighting, it is usually too late to decide the value of the shares. In that situation, litigation usually results, and the only ones who make money are the lawyers.

While the names of the agreements vary, the agreement that determines how a party's interests are divided in the event someone leaves the company is generally called a "Shareholder Control Agreement" or "Buy–Sell Agreement." These agreements should be drafted by your lawyer.

Most corporate attorneys have agreements they regularly use to assist their clients in creating a smooth transition in the event a shareholder quits, leaves or dies. Obviously, if someone leaves the company, the other shareholders will want the option to "buy out" the shareholder at a fair price. The key point is that it is infinitely better to discuss these issues with your partners and lawyer at the time the company is created (when everyone is getting along) than to wait until problems occur.

CONCLUSION

There is virtually no rational basis for anyone to run a business as a sole proprietor or general partnership. Whether you are a one person or a ten thousand person business, you must have some form of corporate identity. If your entity is a small LLC, its existence could save you from personal financial ruin. If you have a large company, you should already be operating as a corporation.

Besides creating the entity, you should be diligent in drafting the necessary documents to smoothly operate the business and avoid conflicts when shareholders leave the business. An ounce of prevention in drafting these documents can save pounds of money and allow you to avoid disagreements that are a part of business (and life)!

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