

## CHOICE OF ENTITY CONSIDERATIONS

### A Basic Guide to Entrepreneurs

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EXPAND YOUR EXPECTATIONS®

**B**efore commencing the operation of a business in the state of Georgia or any other jurisdiction, careful consideration should be given to the type of entity to be utilized by the business. The type of entity selected will depend on many factors. When making a choice of entity decision, both a legal and tax advisor should be consulted and provided with information such as your intent, your objectives, the type of business to be conducted, and the types of transactions that will be entered into. These factors should then be compared to the restrictions and flexibility of each type of entity to determine which entity best meets your organization's needs.

## Outline of Topics Covered

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- Organizational Structure
- Legal and Liability Structure
- Advantages and Disadvantages
- Tax Considerations



## Types of Entities

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In Georgia and most other states, businesses can be organized in one (1) of seven (7) business forms:

- Sole Proprietorship
- Corporation
- Limited Liability Company
- General Partnership
- Limited Partnership
- Limited Liability Partnership
- Limited Liability Limited Partnership



## Sole Proprietorships

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- **Definition:** A sole proprietorship is a business conducted in one owner's individual capacity without formal organization of a separate legal entity
- A creditor with a claim against a sole proprietor may have a right against all of the business owner's assets, whether business or personal. Thus, the owner's potential liability is said to be unlimited



## Sole Proprietorships

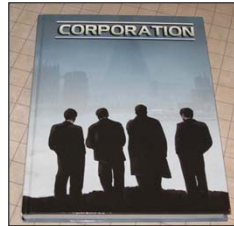
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- **Advantages:**
  - Simple to Create –No Formal Organizational Structure
  - Least Costly to Form
  - Singular and Total Decision-Making Authority
  - No Special Legal Restrictions
  - Easy to Discontinue
- **Disadvantages:**
  - Unlimited Personal Liability
  - Limited Skills and Abilities
  - Limited Access to Capital
  - Lack of Continuity of Business

## Corporations

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- **Definition:** A corporation is a separate legal entity apart from its owners (shareholders) which limits the liability of its owners and the persons who operate the company (officers and directors)
- Different Types:
  - C-Corporation
  - S-Corporation
  - Closely-Held
  - Privately-Held
  - Publicly-Held
  - Professional Corporations



## Corporations

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- Formation and Organizational Structure:
  - Articles of Incorporation or Certificate of Incorporation (Delaware)
  - Advertising the Incorporation of the Entity
  - Appointment or Election of Directors and Officers
  - Organizational Meeting of Directors
  - Issuance of Shares of Stock (considered "securities")
  - Adoption of Formal Bylaws
  - Shareholders' Agreement
  - Annual and Special Meetings of Shareholders and Directors
  - Registering a Trade Name or "d/b/a"

## Corporations

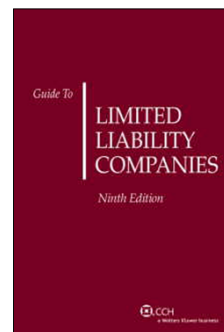
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- **Advantages:**
  - Limited Liability of Shareholders
  - Centralized Management
  - Ability to Attract Investment Capital
  - Continuation of Enterprise
  - Transfer of Ownership
- **Disadvantages:**
  - Time and Costs related to Formation and Organization
  - Corporate Formalities Must be Followed
  - Annual Registration
  - Potential for Loss of Control
  - Compliance with Applicable Laws

## Limited Liability Companies

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- **Definition:** A limited liability company ("LLC") is an unincorporated entity which limits the liability of its owners (generally known as members) and the persons who operate the company (generally known as managers) to their investments in the entity



## Limited Liability Companies

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- Formation and Organizational Structure:
  - Articles of Organization or Certificate of Organization (Delaware)
  - Admission of Members – Issuance of Membership Interests (considered “securities”)
  - Organizational Meeting of Members (optional)
  - Election of Managers (optional)
  - Adoption of Formal Operating Agreement (optional)

## Limited Liability Companies

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- **Advantages:**
  - Limited Liability of Members
  - Allows for Centralized Management or Management by its Members
  - Ultimate Flexibility in Organizational and Management Structure
  - Ability to Attract Investment Capital
  - Continuation of Enterprise
  - Transfer of Ownership
  - Flexibility with Respect to Allocating Income and Losses
  - Less Record Keeping Requirements Compared to Corporations
- **Disadvantages:**
  - Time and Costs related to Formation and Organization
  - Annual Registration
  - Potential for Loss of Control
  - Compliance with Applicable Laws

## General Partnership

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- **Definition:** A partnership is an association of two (2) or more persons who operate a business as co-owners for the purpose of making a profit



## General Partnership

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- Formation and Organizational Structure:
  - Simple to Create –No Formal Organizational Structure
  - Admission of Partners
  - Shared Decision Making Authority among Owners
  - Adoption of a Formal Partnership Agreement

## General Partnership

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- **Advantages:**
  - Easy to Establish
  - Low Organizational Costs
  - Usually Pairs Individuals up with Complimentary skills
  - Access to a Larger Capital Pool
  - Little Governmental Regulation
  - Flexibility in Management Structure (all partners have equal rights in the management and conduct of the partnership business)
- **Disadvantages:**
  - Unlimited Liability of its Owners
  - Difficulty in Transferring of Ownership
  - Lack of Continuity
  - Conflicts Related to Authority of Partners
  - Partners Bound by Law of Agency
  - Difficulty in Attracting Outside Investment
  - Decentralized Management

## Limited Partnership

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- **Definition:** A limited partnership is a partnership formed by two (2) or more persons, having one (1) or more general partners and one (1) or more limited partners. Generally, a limited partner assumes no personal liability for the debts and obligations of the partnership unless he or she participates in the control of the business
- A limited partnership requires that at least one partner be a general partner. Which will be liable for the debts and obligations of the partnership





## Limited Partnership

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- Formation and Organizational Structure:
  - Filing of Certificate of Limited Partnership with Secretary of State
  - Admission of General Partner(s) and Limited Partner(s)
  - Decision Making Authority is Vested in General Partner
  - Adoption of Formal Partnership Agreement

## Limited Partnership

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- **Advantages**
  - Limited Liability for its Limited Partners
  - A Corporation may Serve as a General Partner
  - Centralized Management
  - Usually Pairs Individuals up with Complimentary skills
  - Access to a Larger Capital Pool
  - Little Governmental Regulation
- **Disadvantages**
  - Unlimited Liability for its General Partners (joint and several)
  - Difficulty in Transferring Ownership
  - Lack of Continuity
  - Conflicts Related to Authority of Partners
  - Partners Bound by Law of Agency
  - Difficulty in Attracting Outside Investment

## Limited Liability Partnership

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- **Definition:** A limited liability partnership (“LLP”) is a **general partnership** that has elected to become a limited liability partnership in the office of the clerk of the superior court of any county in which the partnership has an office.
- An essential element of a LLP is the right to limit the personal liability of all partners for the liabilities of the partnership or other partners.
- Popular form of organization among professionals, particularly [lawyers](#), [accountants](#), and [architects](#)



## Limited Liability Limited Partnership

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- **Definition:** A limited liability limited partnership (LLLP) is a standard statutory **limited partnership** which elects to register as a limited liability partnership
- An essential element of a LLLP is the general partners (not just the limited partners) are afforded limited liability for the debts and obligations of the limited partnership that arise during the period that the LLLP election is in place
- Popular form of organization for organizations that hold or invest in real estate

## Tax Treatment of Entities

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The choice of the form of business organization is one of the most important decisions an entrepreneur can make

- Advantages and Disadvantages of Different Entity Types
- Tax Issues on Formation
- Tax Considerations and Operational Issues
- Taxation Upon Distributions of Assets or Disposition of Interest
- State Tax Considerations

## Taxation of Sole Proprietorships

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- **Advantages**
  - Simplest form of business entity with minimum compliance required
  - Can easily be converted to another entity type, usually without triggering a taxable event
  - Method of accounting
- **Disadvantages**
  - Most earned income is subject to Self-employment tax
  - Deduction of fringe benefits is limited



## Taxation of Sole Proprietorships

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- **Formation**
  - The formation of a sole proprietorship is not a taxable event
- **Operations**
  - The taxable year of the business is based on the taxable year of the owner
  - Income or loss from operations is reported on Schedule C of form 1040.
  - Owners of multiple business activities must report the income or loss from operations on separate Schedule C for each activity.
  - Owners are not considered employees of the business and most fringe benefits are disallowed.
  - Owners can participate in retirement plans
  - Most earned income is subject to the self-employment tax

## Taxation of Sole Proprietorships

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- **Disposition of interest**
  - The owner can sell all business assets to another person or entity
  - The business interest in a sole proprietorship cannot be sold
  - The sale price has to be allocated to all assets sold and each asset is treated as separately sold



## Taxation of C-Corporations

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- **Advantages**
  - There are generally no limitations or restrictions on who may be a shareholder of a C corporation.
  - Fiscal year may be elected for some C-corporations
  - Multiple classes of stock are permitted
  - Wide range of nontaxable fringe benefits for shareholders, who are also employees.
- **Disadvantages**
  - C-corporations are required to use the accrual method of accounting
  - Double taxation of income
  - Shareholders may be taxed on constructive dividends received for personal use of company assets
  - May be subject to the Accumulated Earnings Tax (AET) or Personal Holding Company (PHC) tax

## Taxation of C-Corporations

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- **Formation**
  - Ordinarily transfers of money and property to a controlled corporation may be structured on a tax-free basis (§351).
  - Only stock received in exchange is tax-free: gain may be recognized by transferor if property or cash is received in exchange ("boot").
  - Property subject to liabilities: the transfer of property subject to liabilities is generally not treated as boot received by the shareholder.
  - No loss can be recognized by shareholder for transfer of property to a corporation.
  - No gain or loss is recognized by corporation receiving the property.
  - The receipt of stock for services is taxable.
  - Basis: the income tax basis of the stock received is equal to the adjusted basis of the property transferred (liabilities transferred and boot must be considered).

## Taxation of C-Corporations

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- **Operations**
  - C -corporations are a separate taxpayer and file a separate income tax return (Form1120).
  - Income from C-corporations can be subject to “double” taxation: the corporation pays income tax on taxable income and receives no deduction for dividends paid to individual shareholders. The shareholders pay tax on the dividends received.
    - Tax planning can mitigate some of the “double” taxation issue.
  - Losses – any net losses of a C-corporations can be carried back or carried forward to future years, but cannot be used to offset other sources of income of the individual shareholders.
  - Capital gains and losses
  - Special taxes: Accumulated earnings tax, Personal Holding Company tax, Corporate Alternative Minimum Tax
  - Personal Service Corporations

## Taxation of C-Corporations

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- **Disposition of interest**
  - Most important consideration is the issue of double taxation
  - Sale of assets versus sale of stock
  - NOL considerations



## Taxation of Partnerships

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- **Advantages**
  - Single level of taxation
  - No limitation on who may be a partner
  - Method of accounting
  - Generally uniform state taxation
- **Disadvantages**
  - Complexity of applicable law
  - Usually have to use calendar tax year or year of majority owner.

## Taxation of Partnerships

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- **Formation**
  - Two or more persons are required: a person can be an individual (both US and non-US, C- or S-corporation, or any type of trust)
  - Generally the formation of a partnership is a non-taxable event for the partners (exceptions apply).
  - Contribution of property subject to liabilities
  - Additional rules apply when contributed property is appreciated or depreciated.

## Taxation of Partnerships

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- **Operations**
  - A partnership is a non-taxable entity also known as a pass-through entity.
  - Files a separate tax return (Form 1065)
  - The partnership must use a taxable year determined by reference to the partners' taxable years or a year reflecting the business purpose of the partnership.
  - Generally can use either the cash or accrual method of accounting
  - Losses may be deductible by partners to the extent of their basis in their investment in the partnership
    - Recourse vs. Non-recourse liabilities
    - At-risk limitations
  - Inside vs. Outside Basis
  
  - Special Allocations
  
  - Self-employment tax issues

## Taxation of Partnerships

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- **Disposition of interest**
  - General rule provides that a partner who disposes of his or her interest in a partnership is treated as disposing of a single asset, rather than a pro rata share of all of the underlying assets of the partnership
  - The gain or loss is generally capital in nature
  - An important exception to the general rule that a partnership is treated as an entity in determining the tax consequences of a taxable disposition of the partnership interest arises where the partnership owns assets described in Code Section 751 ("unrealized" receivables and inventory items).
  - Non-liquidating distributions of partnership property
    - Generally no gain is recognized upon non-liquidating distribution of property (if gain is recognized it is capital in nature)
    - If 751 assets are distributed, the gain is ordinary.
    - Neither the partner nor the partnership may recognize a loss in connection with a distribution of property.



## Taxation of LLCs

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- **Advantages**
  - Essentially any person can be a member of an LLC
  - Choice of taxation: partnership, C-corporation, S-corporation (if requirements met), or disregarded entity (if requirements met)
  - Special allocations (when taxed as partnership)
  - International tax issues
- **Disadvantages**
  - Complexity of applicable tax law when taxed as partnership
  - Some states may prohibit an LLC for conducting certain business activities
  - State taxation issues
  - International taxation issues
- **Formation, Operation and Disposition of Interest:**
  - Commensurate with type of entity the LLC has elected to become for tax purposes

## Effect of Subchapter S Election

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- **Advantages**
  - Single-level of taxation
  - Self-employment taxes
  - Can use cash method of accounting
  - Calendar or fiscal tax year
  - No special allocations: easier record keeping
- **Disadvantages:**
  - Most restrictions regarding ownership apply
  - Termination or revocation of S-election
  - No special allocations: less flexibility
  - Built-in gains tax and tax on passive income
  - Distribution of property to shareholders
  - State income tax issues

## Taxation of S-Corporation

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- **Formation**

- U.S. domestic corporation
- Limitations on eligible shareholders
  - Eligible: individuals who are US citizens or residents, certain trusts and charitable organizations, ESOPs, SMLLC owned by a US citizen or resident
  - Ineligible: Partnerships, C-corporations, multi-member LLCs, some retirement plans, Charitable remainder trusts
- Manner of making S-election
- Revocation of S-election

## Taxation of S-Corporation

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- **Operations**

- Self-employment taxes and reasonable compensation
- No special allocations
- Method of accounting
- Taxable year
- Fringe benefits for more than 2% shareholders
- Deduction of S-corporation losses:
  - Shareholder stock basis
  - Shareholder debt basis
- The Built-in Gains Tax
  - Generally does not apply to S-corporations that made a S-election at formation
- Distributions to shareholders: tax-free and taxable.
- Distribution of property to shareholder
  - Gain may be recognized at the S-corporation level (including built-in gain if applicable)

## Taxation of S-Corporation

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- **Disposition of interest**
  - Asset sales
    - Usually one level of tax to shareholder
    - Buyer of assets receives basis in assets purchased according to the purchase price allocation.
  
  - Stock sales
    - Selling shareholder realizes gain or loss
    - Buyer receives cost basis in the acquired stock
    - Option to consider a 338(h)(10) election and treat a stock sale as asset sale.

## Questions

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