CHOOSING THE BEST CORPORATE ENTITY STRUCTURE FOR YOUR BUSINESS

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Selecting the best corporate entity for your business can be daunting. What contributing factors should you consider? This article will provide a roadmap for the selection and creation of a business entity. It will focus on critical factors to consider when forming an entity, types of entities available and important characteristics of such entities. While this article will not discuss every topic that may be pertinent when creating an entity, it will provide entrepreneurs with a framework and practical considerations for doing so.

> In September 2016, our Legal Risk Management Tip, "Considerations When Forming a New Business," covered additional aspects which should be considered in conjunction with this article.

Creating a formal business entity is typically an initial consideration for any entrepreneur seeking to start a new business. It's equally important for current business owners who have either ignored such matters in the past, or whose business model may have changed since inception, to consider as well. However, sifting through information concerning different entity types - and the characteristics, advantages and disadvantages of each, can be overwhelming at times and seem like a herculean task.

To combat this feeling, it is important to remember that the business will dictate the type of entity to be selected, and not the other way around. As such, when approaching the concept of creating an entity, business owners should first look inward, and focus on the nature of the business, sales and marketing objectives, current and projected finances, short-term and long-term objectives, etc. Identifying these components, and having a clear vision for the operation of the business, will greatly help focus the entity search and help ensure the final selection is tailored to fit the needs of the business and its owners.

A. Types of Entities

There are several entity structures available to entrepreneurs. While the specific types of entities available for a business will sometimes vary based upon the state in which the business is domiciled and/or activities performed,[1] the most common types of utilized entities include limited liability companies ("LLC") and corporations.

Before discussing additional entities in more detail, it should be made clear that there is no requirement that a business form an entity prior to or while performing operations. Individuals who begin business operations without forming an entity will automatically be classified as a

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[1] For example, pursuant to the California Corporations Code §§ 13400-13410 and other applicable rules, certain licensed professionals (such as doctors, lawyer, psychiatrists and others) are unable to utilize a limited liability company when performing such services, and must incorporate as a "professional corporation" as such term is defined by relevant statute.

"sole proprietorship," while groups are classified as "partnerships." In these situations, there is no legal distinction between the business itself and its owner. Taxes are paid on profits of the sole proprietorship through the owner's personal income tax filings, and there are no corporate taxes in addition. The sole proprietorship and/or partnership usually operate under a trade name or "fictitious business name,"[2] but none are required. The main disadvantage of a sole proprietorship, as further described below as advantages to having an entity, is the unlimited liability it places on the individual owner(s). Should the business be sued, the owner(s) may be personally liable, thus allowing access to his/her personal assets (*i.e.*, home, investments, savings and so forth). Since there are no shares in a sole proprietorship that may be sold or transferred to another party, capital business investments are difficult to acquire. Any benefits the company would like to offer are also the responsibility of the owner. Finally, the entity will cease to exist upon the death of the owner, and any contracts that were then in place become null and void unless additional legal steps were taken to assign or transfer such contracts to another third-party.

For these reasons, most businesses choose to form an entity to house the operations performed. As mentioned above, while several different types of entity structures exist, the following gives a brief description of the most prevalent of entity types – corporations and LLCs.

1. **Corporations**

A corporation is a legal entity which exists separately from its owners. It can be owned by individuals, another business entity or a combination thereof. Ownership of the corporation is generally shared through stock. Corporations generally have four main characteristics:

- A corporation places limited liability it places on its owners (*see* Section B below for further information pertaining to limited liability);
- The personal assets of the owner(s) of the corporation generally are out of reach in a legal action taken against the business, and investor loses are limited to the amount of corporate contributions made;
- With limiting personal liability, raising investment capital for the corporation typically is more easily accessible; and
- The corporation will survive the death of the owner(s) unless otherwise dissolved. This allows for greater flexibility when it comes to devising an "exit strategy" for owners and/or selling the business.

Conversely, there are certain disadvantages of organizing as a corporation. The greatest disadvantage is the "double taxation" imputed on corporations. Double taxation often occurs because corporations are considered separate legal entities from their shareholders. As such, corporations pay taxes on their annual earnings, just like individuals. When corporations pay out dividends to shareholders, those dividend payments incur income-tax liabilities for the shareholders who receive them, even though the earnings that provided the cash to pay the

[2] Fictitious business names are typically required to be registered within the county(ies) where the business is domiciled. Such registration requirements vary by county, but typically include the filing of a form with the county, a filing fee and to have the name published in a general circular (such as a newspaper) for four consecutive weeks.

dividends were already taxed at the corporate level.[3] Business owners can elect to be taxed as an S-Corporation, however, by making appropriate filings with the Internal Revenue Service to prevent such taxation practices; that way, taxes only are imposed when the corporation pays out dividends to shareholders. Notably, however, there are several restrictions placed upon S-Corporations that may prevent certain owners from utilizing this tax relief structure.[4]

In addition to taxation considerations, corporations also are the most "governance" heavy type of entity. As such, strong dedication is needed in forming and maintaining a corporation through filings and detailed books and records (with continual updates to bylaws, meeting minutes, and notices, for example).

2. Limited Liability Companies

An LLC offers liability protection similar to that of a corporation but is taxed differently. It has the option to have taxes pass through to its owner(s) as a sole proprietorship or be taxed as a partnership without being regulated as a partnership. An LLC may be managed by one or more managers or one or more owners (typically referred to as members). It can be owned by individuals, another business entity or a combination thereof. LLCs are similar to a small business in its flexibility and ease of use, but gives the benefits found in more complex entities, such as corporations.

A primary advantage to an LLC is the limited liability it places on its owners while still allowing for tax advantages. As the company grows, it can convert easily to a corporation with generally little business interruptions. They may be structured not to terminate upon the death or withdrawal of a member, similar to a corporation. Company-making decisions are limited to the members' relative share in the LLC.

LLCs are not without certain disadvantages, however. Several states[5] impose a state franchise tax on the LLC. Locating investment capital can often be more difficult as compared to a corporation. In general, an LLC must include an operating agreement for management style. Problems may exist for the LLC that is located in a state that does not require an operating agreement. If the LLC implements more than two (2) of the four (4) characteristics of a corporation (listed above) the LLC may be forced to convert to a corporation.

B. <u>Initial Considerations for Creating an Entity</u>

There are several reasons why a business entity is beneficial when operating a business. Reasons such as liability considerations, tax implications and capital raising opportunities are some of the more prevalent and important of such reasons. A review of such concepts, and how they can

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[3] *See* http://www.investopedia.com/terms/d/double_taxation.asp

[4] Per the Internal Revenue Service, in order to qualify for S-corporation status, the corporation must meet all of the following requirements: (i) be a domestic corporation; (ii) have only allowable shareholders (may be individuals, certain trusts, and estates, but may not be partnerships, corporations or non-resident alien shareholders); (iii) have no more than 100 shareholders; (iv) have only one class of stock; and (v) not be an ineligible corporation (*i.e*. certain financial institutions, insurance companies, and domestic international sales corporations).

[5] This is imposed in the State of California.

greatly impact the type of entity selection considered, can be found in Jacko Law Group's "Considerations When Forming a New Business."

C. Choosing a State - Domestic Versus Foreign Registration

It is important to note that entity choices are state specific in that entities are not governed at the federal level, but rather, are organized at the state level. Each state has its own laws that govern the actions an entity may perform. Thus, you should carefully review the laws of the state in which your business is registered, as well as any additional states where registration of the entity may be required, to ensure your new entity is in compliance with applicable state law.

Some of the relevant variables to consider when deciding which state to incorporate in often include: formation fees, franchise taxes, state laws/court system, statutes of limitation and investors familiarity with the state. Often the question is raised of whether or not a company should be incorporated in in its home state, or in a state such as Delaware which offers unique business advantages such as a refined business law code, the existence of the Court of Chancery that focuses solely on business law matters and low or no state taxes on the business. The answer depends greatly on the nature of the business and the need to raise capital for business operations. Business owners should bear in mind that even if the company is incorporated in a foreign state, most states require the business to also register in the home state, and pay applicable fees and taxes as if the company had incorporated in that home state initially. There are also conflicts of law provisions that can arise for firms incorporated in Delaware, but domiciled in another state.

D. Conclusion

It is important for entrepreneurs to carefully vet whether to utilize an entity structure, which possible entity structure should be chosen and the practical considerations of creating the entity prior to engaging in business activities and periodically thereafter. Such decisions can be difficult and time consuming, but can go a long way to supporting the business venture and protecting the owner(s). Working with an attorney, tax professional and other professional advisers familiar with the process and practice of establishing an entity can greatly assist in this process.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com/News-Room/ for additional Legal Risk Management Tips.

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