

## **CHOOSING THE BEST FORM OF BUSINESS IN 2010**

**By Larry N. Murnane\***

Starting a new business involves several difficult decisions. One of the most complex of those decisions, with significant consequences, is choosing whether to operate the business as a sole proprietorship, partnership, corporation, or limited liability company ("LLC"). This decision should be based upon careful consideration of a number of factors, and a comparison of the advantages and disadvantages of these alternative business forms.

### **Sole Proprietorships**

A sole proprietorship is simply a business conducted by an individual rather than a separate entity such as a partnership, corporation or LLC. Key advantages to this form of business are: (1) it is relatively easy and inexpensive to form and operate; (2) it requires only one owner; (3) there are no separate franchise taxes or corporate formalities; and (4) there is no double taxation on income because the business profits and losses are simply passed through to the owner.

The primary disadvantage to a sole proprietorship is that the business owner has unlimited personal liability for the debts and obligations of the business.

### **Partnerships**

A partnership is an association of two or more persons who co-own a business for profit. Partnerships may be general or limited in form.

In a general partnership, each partner can bind the partnership by contract, and is personally liable for the obligations of the partnership. California does not require filing of a certificate or articles with the Secretary of State to form a general partnership. Although oral partnership agreements are permitted, the agreement should be in writing, and specify all the terms of the parties' business relationship. A general partnership is dissolved upon the death or withdrawal of any partner, absent a written agreement to the contrary.

A limited partnership is a partnership with one or more "limited partners" (partners who contribute capital but do not participate in the control of the business and who are not personally liable for the obligations of the partnership), and one or more "general partners" (partners who actively engage in the management and control of the business and who have unlimited personal liability for the obligations of the partnership). General and limited partnerships are usually not subject to federal or California income tax, (although limited partnerships are subject to an annual franchise tax, and are required to file a certificate of limited partnership with the Secretary of State).

The primary advantages and disadvantages of a partnership are similar to those of a sole proprietorship, in that profits and losses may be passed through to the partners, thereby avoiding double taxation on the income if the partnership is properly structured, but the general partners have unlimited personal liability. Limited partners generally have no liability beyond their partnership investment.

## Corporations

In contrast to a sole proprietorship or general partnership, a corporation is a separate entity that protects the business owner(s) from personal liability for business debts. In order to maintain the liability protection afforded by the corporate entity, the corporation should be adequately capitalized, and the officers and directors of the corporation should strictly adhere to the formalities of holding regular meetings and keeping accurate minutes and records.

The income of a standard "C" corporation is taxable at the corporate tax rate, which may be lower than the individual's rate, but may also cause the owners (shareholders) to pay double taxation -- once on the corporation's income, and again on the shareholders' dividends or distributions. In theory, a highly profitable corporation may actually save taxes for its shareholders by operating in C form, assuming the corporation's profits can be reasonably paid to the shareholders as salary or other compensation.

The double taxation of a corporation can be minimized in certain cases by paying salaries to the shareholders or by making an "S" corporation election. Upon making a valid S election, all corporate profits and losses are simply "passed through" proportionately to the shareholders in a manner similar to a partnership. If the S election is made upon formation, shareholders can also avoid two levels of tax on the sale or distribution to them of the corporation's assets upon liquidation, as the gain or loss will simply pass through to the shareholders to be taxed once. S corporation shareholders might also be able to reduce employment taxes by paying themselves some corporate profits in the form of dividends above their "reasonable" salaries. However, there are important restrictions on the ability to qualify for an S corporation election (e.g., 75 or fewer shareholders, with further restrictions on who can be a shareholder). Additionally, S corporation employee-shareholders do not receive tax-favored treatment for fringe benefits (other than retirement plans) if they own more than 2% of the outstanding stock. Benefits such as life, health and accident insurance will be currently taxable to such shareholders and may not be deducted by the corporation.

Although a corporation is fairly easy and inexpensive to form, it is usually required to pay a minimum State annual franchise tax of \$800. However, Assembly Bill 10, which was chartered on July 6, 1999, exempts every corporation that incorporates or qualifies to do business in California on or after January 1, 2000, from the minimum franchise tax (prepaid to the Secretary of State) for its first taxable year; however, the corporation must still pay income taxes on the income from the first year (if any).

Other advantages of a corporation over most partnerships and LLCs include the free transferability of corporate shares, and the continuity of business even upon the withdrawal or death of shareholders.

## **Limited Liability Companies**

LLCs are a relatively new form of business organization that may be treated like a partnership for income tax purposes, and like a corporation for liability purposes. Formation and operation of an LLC that is organized, registered, or doing business in California requires filings with the Secretary of State, and payment of an annual franchise tax of \$800, for the privilege of doing business in California.

Unlike S corporations, LLCs may have an unlimited number of owners (referred to as members), which may include corporate or non-resident owners. Additionally, as of January 1, 2000, California no longer requires LLCs to have a minimum of two members.

Since most business owners desire to avoid personal liability for business debts, and double taxation of the business income, an LLC may be the best alternative. A properly structured LLC provides protection against personal liability of its members, much like a corporation does for its shareholders. Although LLC members, like corporate shareholders, can be personally liable under certain limited circumstances, they cannot be personally liable for failure to hold meetings or to observe formalities pertaining to meetings, as shareholders can. An LLC is also typically treated as a partnership for tax purposes, allowing personal deductions for business losses, and thereby avoiding double taxation of the business income and distributions.

While an LLC has many advantages, it is not always the preferred choice of business entity. An LLC may have certain restrictions on the transferability of interests, and on the continuity of the LLC's life. In addition to California's annual franchise tax, LLCs are required to pay an annual fee based on total income from all sources reportable to this state for the taxable year, ranging from \$900 for total income over \$250,000, to \$11,790 for total income over \$5,000,000. Therefore, an LLC may not be economically practical for a business with large gross receipts and narrow profit margins. An LLC cannot deduct medical expenses for members, and the receipt of this benefit is considered income to the people insured, unlike for shareholder-employees of C corporations. An LLC might also be less desirable than a corporation when most income is going to be reinvested in the business.

On the other hand, an LLC would almost always be preferred to a general partnership. LLCs are also the preferred entities for real estate investments, because they combine limited liability and flexible management with the ability to pass through losses and deductions, to make special allocations, and to avoid double taxation on the sale of appreciated assets.

## **Conclusion**

Deciding on the best form of business requires careful consideration of such factors as ease of formation, transaction costs, liability of owners, tax consequences, ease of transferability of ownership interests, and the continuity of business, among others. The decision can have profound and lasting consequences on both the business and its owner. Therefore, before forming or starting a business, the owner should invest some time and effort, or consult with qualified professionals, to determine the most advantageous form of business.

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