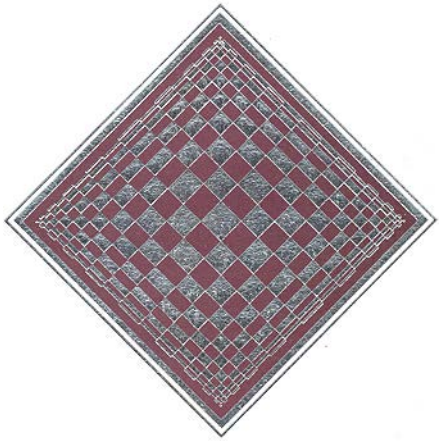

Guiding You Through the Legal Maze.℠

DETERMINING THE BUSINESS ENTITY

BEST FOR YOUR BUSINESS

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DETERMINING THE BUSINESS ENTITY BEST FOR YOUR NEW BUSINESS

One of the most important matters that a person needs to focus on in the early stages of starting a business is determining the type of business entity to own and operate the business. You need to address this issue, among many others, with the advice of an experienced business attorney in coordination with a certified public accountant.

Most individuals operate his or her business under one of the following entities:

1. Sole Proprietorship;
2. General Partnership;
3. Limited Partnership;
4. Joint Venture;
5. "C" Corporation;
6. "S" Corporation; or
7. Limited Liability Company.

While most new businesses are either an S corporation or a limited liability company, you should analyze each type of business entity to determine which is best for your business from a liability, tax, investment, legal, formation, operation and disposition perspective.

1. SOLE PROPRIETORSHIP

A sole proprietorship is a business owned by one person having unlimited personal liability for the debts of the business. Many small businesses operate as a sole proprietorship. The advantages include not needing a formal written document. No organizational document must be filed with the Florida Secretary of State or at the county level. However, if you do business in a name other than your own full name, you must comply with Florida's Fictitious Name Statute by publishing a notice in a newspaper within the county where the principal address of the business is located and filing an application for registration of fictitious name with the Florida Secretary of State.

A sole proprietorship is not subject to double taxation. It is not a separate tax paying entity. The sole proprietor is taxed as an individual only, with the income or loss reported on his or her individual Form 1040 tax return. There are also no securities laws issues as there are no other investors involved. In addition, upon the death of the sole proprietor, there is a step-up (increase) in the tax basis of the assets (for depreciation, gain or loss, and other tax purposes) to the heirs so that the business can sell the assets with little income tax liability, except due to future appreciation in the value of the assets.

The principal disadvantage of a sole proprietorship is that the proprietor has unlimited personal liability. Both the business assets and personal assets are at risk for the liabilities of the business. In addition, by definition, a sole proprietorship is not feasible if there is more than one owner. Furthermore, the death of the proprietor terminates the proprietorship, although the heirs

may continue to operate in business through a new and different entity. There is also less favorable tax treatment of fringe benefits than if, for example, the business is a "C" corporation.

2. **GENERAL PARTNERSHIP**

A partnership is defined as an association of two or more persons to carry on a business for profit as co-owners. One advantage is that a written partnership agreement (although advisable) is not necessary. Florida's Uniform Partnership Act sets forth the rights and obligations of the partnership and the partners. A written partnership agreement is not filed with the Florida Secretary of State or at the county level. However, there must be compliance with the Fictitious Name Statute. There is no double taxation as a partnership is not a separate tax paying entity. However, the partnership must file a partnership return with the IRS for informational purposes. Income or losses from the partnership must be reported on each partner's individual 1040. There are also no securities laws issues unless the partnership has a centralized management committee. In such event, passive partners who are not on the committee may cause their partnership interests to be "securities." Furthermore, Section 754 of the Internal Revenue Code permits the partnership to elect a step-up basis in the partnership interests upon transfer of a partnership interest in certain cases. The partnership agreement can include special allocations and disproportional tax benefits in favor of some parties at the expense of other parties.

The principal disadvantage of a general partnership is that each partner has personal, unlimited, joint and several, liability for partnership debts, including the acts of other partners. In addition, a partnership is dissolved by operation of law upon the death or incompetency of any partner or the transfer of any partnership interest. However, provisions in the partnership agreement could address the continuation of the business. Furthermore, in a general partnership there is generally no centralization of management. All partners have a say-so.

3. **LIMITED PARTNERSHIP**

A limited partnership is a partnership having one or more general partners and one or more limited partners. A limited partnership centralizes management in the general partners and limits the liability of the limited partners to the amount of capital they have invested in the limited partnership plus any liability they have assumed.

The limited partnership has been a common investment entity allowing passive investors tax advantages with limited liability as the liability of limited partners is limited to the extent of capital invested. It is a good capital-raising vehicle because of the "pass-through" of tax benefits, which can include special allocations and disproportional tax benefits in favor of the limited partners at the expense of the general partners. A limited partnership is not subject to double taxation as it is not a separate tax paying entity. However, a limited partnership must file a partnership return with the IRS for informational purposes. Although a detailed discussion is beyond the scope of this article, a limited partnership affords its partners a tax basis in their interest, which includes a share of the debt of the limited partnership.

If provided in the limited partnership agreement, a limited partnership can continue upon the death of the general partner. A limited partnership has centralization of management in its general partners. In fact, a limited partner cannot be involved in the control of the business without then exposed to unlimited liability. IRS Section 754 election is available to step-up the basis of the partnership interest upon a transfer of the partnership interest in certain cases. There are no restrictions on the types of partners as in the case of an "S" corporation. Individuals, corporations,

partnerships and foreigners can all be either general or limited partners. You can also have different types of partnership interests equivalent to several classes of stock to prefer certain partners to other partners. A limited partnership does not have to comply with the Fictitious Name Statute as a different filing with the Florida Secretary of State is required (*i.e.,* certificate of limited partnership).

Some of the disadvantages of a limited partnership include a filing requirement with the Florida Secretary of State and payment of filing fees and taxes, including an annual tax on invested capital. The limited partnership must have a certificate of limited partnership and a written limited partnership agreement. A limited partnership agreement is a complex legal document having significant tax issues. As mentioned above, limited partners cannot be involved in the control of the business; otherwise they may be considered general partners. There is unlimited joint and several liability of general partners, similar to a general partnership. There are also securities laws issues relating to the sale of limited partnership interests. The offering must be registered or an exemption from registration be applicable.

4. **JOINT VENTURE.**

A joint venture is really a general partnership organized to carry out a limited or specific purpose rather than a general purpose, usually between 2 companies. The advantages and disadvantages are similar to that of a general partnership.

5. **CORPORATION**

The reason most businesses operate under a corporation is the "umbrella" of protection it affords the owners (*i.e.,* shareholders) of the corporation. A corporation is a separate legal entity formed in accordance with state corporate laws. With certain exceptions, the liability of all shareholders is limited to the extent of capital contributions made to the corporation. Unless otherwise provided in the articles of incorporation, a corporation has perpetual existence. The death of a shareholder has no effect on the continuance of the corporation. Stock of a corporation is fully transferable but in small companies, there may be restrictions included in a shareholders' agreement (*e.g.,* right of first refusal).

A corporation is also a good vehicle to include fringe benefits to owners and employees such as group-term life insurance, tax deferred pension plans and medical reimbursement plans. A corporation has centralized management by virtue of its board of directors.

A corporation is formed under a state's corporation law statute either "profit" corporations or "non-profit" corporations. For purposes of U.S. and state income taxation, there are 2 types of "profit" corporations; a "C" corporation and an "S" corporation.

(a) **"C" CORPORATION**

A "C" corporation is subject to corporate taxation. It is called a "C" or "regular" corporation because it is taxed under Subchapter C of the Internal Revenue Code. There are no restrictions on the number or types of shareholders of a "C" corporation. You may have individuals, other corporations, partnerships or foreigners as shareholders. "C" corporations can have one shareholder or hundreds of thousands of shareholders (*e.g.,* General Motors). A "C" corporation may own other corporations ("subsidiaries") or be owned by another corporation ("parent"). A "C" corporation may have several classes of stock (*e.g.*, common and preferred). The golden rule for a small, closely-held "C" corporation is "never pay dividends!" This is due to the fact that double taxation, state and U.S.,

occurs first on corporate income and then U.S. income tax on dividends to shareholders (this combined tax can exceed 50%).

The current U.S. corporate tax rates are:

Over	**But not over**	**Tax is**	**Of amount over**
$0	$50,000	15%	$0
50,000	75,000	$7,500 + 25%	50,000
75,000	100,000	13,750 + 34%	75,000
100,000	335,000	22,250 + 39%	100,000
335,000	10,000,000	113,900 + 34%	335,000
10,000,000	15,000,000	3,400,000 + 35%	10,000,000
15,000,000	18,333,333	5,150,000 + 38%	15,000,000
18,333,333	___	35%	0

A Florida corporation solely doing business in Florida is subject to Florida corporate income tax. The tax liability is computed using federal taxable income, modified by certain Florida adjustments, to determine adjusted federal income. The corporation then subtracts an exemption of up to $50,000 to arrive at Florida net income. The Florida net income is taxed at the rate of 5.5%.

If the Net Income After Taxes is distributed to the shareholders as a qualified dividend, the dividend income of the shareholders is:

- Tax-free for those in the 10% and 15% brackets to the extent qualified dividend income remains within those brackets.
-
- Taxed at a 15% rate for those in the 25% up to 35% tax brackets.
-
- Taxed at a 20% rate for higher income taxpayers whose income surpasses the 35% tax bracket

Of course, the double taxation problem can be reduced through pre-tax deductions such as salaries and bonuses (if services are actually provided), interest on loans and rental payments, subject to being "reasonable."

In addition, there are filing fees and taxes, initially and on an annual basis. A "C" corporation is a separate tax paying entity and requires separate record keeping and tax returns. The issuance of stock has securities laws issues requiring the stock to be registered or the sale to qualify as an exempt transaction (*e.g.,* private placement).

(b) **"S" CORPORATION**

An "S" corporation is similar to a "C" corporation (both are created in the same manner under state law), except that an "S" corporation is generally not subject to corporate-level taxation - it is subject to only one level of taxation to its shareholders. It is called an "S" corporation because it is governed by Subchapter S of the Internal Revenue Code. All profits or losses are reported by the shareholders on their individual tax returns in proportion to their stock ownership interest in the corporation. Many small business corporations have elected to be taxed as "S" corporations to avoid the double taxation problem. The election of "S" status is done by the filing of IRS Form 2553 signed by all shareholders.

An "S" corporation has the same advantages as a "C" corporation including: (i) limited liability of shareholders of the extent of capital contributed; (ii) perpetual existence; (iii) free transferability of stock; (iv) availability of fringe benefits (but not to the same extent as a "C" corporation); and (v) centralized management. However, the principal advantage of an "S" corporation over a "C" corporation is the lack of U.S. income tax at the corporate level. Income tax is imposed only upon shareholders for U.S. tax purposes.

There are limitations on the number and types of shareholders of a corporation for the corporation to elect "S" status. The corporation is limited to 75 shareholders who are individuals (U.S. citizens or resident aliens). You cannot have corporations, partnerships or foreigners as shareholders. Only one class of stock is permitted. You can, however, have voting and non-voting common stock but not preferred stock. An "S" corporation may not have subsidiaries. While the corporation does not pay Federal income tax, you still must have separate record keeping for the corporation and file tax returns for informational purposes. The issuance of stock in an "S" corporation has securities laws issues.

6. **LIMITED LIABILITY COMPANY.**

A limited liability company is a relatively new type of entity but is increasingly popular, particularly if you are not eligible to be an "S" corporation (*e.g.,* an ineligible stockholder). The principal advantage of a limited liability company is that it will be taxable as a partnership for U.S. tax purposes if properly structured. There is limited liability of all owners (not just limited partners). It also affords the owners a tax basis in their interest which includes a share of debt of the company. The Internal Revenue Service has ruled that a Florida limited liability company would be taxable as a partnership. Nevertheless, a Florida limited liability company is subject to the Florida corporate tax, so it is not treated as a partnership for Florida income tax purposes.

Conclusion.

The following issues need to be addressed at the time the business entity is formed: (i) number of participants (stockholders, partners, members, etc.); (ii) types of participants (individuals, foreigners, trusts, partnerships, corporations); (iii) nature of assets and type of business; (iv) special legal restrictions; (v) ease and cost of formation and operation; (vi) capital requirements (equity and debt); (vii) personal liability of the participants for the debts of the business; (viii) centralization of management; (ix) tax consequences on formation; and (x) securities laws issues (*e.g.*, will there be passive investors?). Issues which arise during the operation of the business also need to be examined including: (i) management and control; (ii) personal liability of the participants for the debts of the business; (iii) anticipated credit and additional capital needs; and (iv) the tax consequences of the operation. In addition, issues that will arise upon the disposition of the business must also be

addressed including: (i) continuity of life; (ii) conveyance and restrictions on conveyance; (iii) potential estate tax and probate problems for the owners; and (iv) the tax consequences on the disposition of the business. Your responses to these issues may steer you towards certain types of entities over other types of entities.

Unfortunately, there is no perfect entity for operating a business. Each has its advantages, disadvantages and unique qualifications. You should examine each possible type of entity to determine which makes sense for your particular business situation.

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