Which Form of Entity is Best for My Small Business?

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Small businesses are not Fortune 500 companies. Every small business is as unique as the individual owners who run them. With that in mind, we've provided this "right sized" guide for your benefit.

The most common question of both new and existing small businesses is:
"Which form of entity is best for us?" C-Corporation? S-Corporation? LLC? The only proper answer to this question is and always will be: **it depends**.

<u>The Decision Process</u>
First, let's quickly rule out how <u>not</u> to decide on a business entity:

1) You saw an ad on television for an Internet-based company that forms corporations and LLCs, and their website said you should form _______;
2) Your friend's business is a corporation / LLC, and since you trust him/her, that must be best for your business as well;
3) You heard about forming a Nevada Corporation, Delaware LLC, etc., and since you'll save a fortune in taxes, that's the right way to go.

In lieu of reading mountains of materials on Corporations and LLCs, this straightforward guide will help point you in the right direction. As always, no preprinted document is ever a substitute for solid legal advice. Before making a final decision, you owe it to yourself and your company to consult with an experienced small business attorney to navigate this critical decision.

Second, let's establish which business entities are 99.9% wrong for any small business:
a) Sole Proprietorship;
b) General Partnership;
c) Limited Partnership;
d) Limited Liability Partnership.

An individual who starts a business is deemed to be a **Sole Proprietorship**. That means that all your personal assets can be used to satisfy any business liabilities. If your assistant drives to the bank to make a deposit and takes out a minivan with a family inside, the resulting damages will almost certainly exceed the limitations of their auto insurance, and probably your business' liability insurance as well. You, the sole proprietor, are personally liable for the excess damages. Not good.

Any two or more people who run a business are deemed by default to be a **General Partnership**. From a liability perspective, this is worse than a Sole Proprietorship. In a General Partnership, you are personally liable for all of your own business actions, plus those of all other partners. A classic example: Partner A tells Partner B: ***"Go out and look for office space for our business, but don't sign anything until we discuss it."*** Partner B finds a great space, but the broker says: ***"If you don't lock up this office suite now, the guy coming tomorrow certainly will".*** So, Partner B signs a five year lease for the space. Even though he directly violated his other partner's instructions, Partner B just bound both partners, individually, for all obligations under the lease, including five years of paying rent. What recourse does Partner A have? None.

A **Limited Partnership** does provide some liability protection, but only for the limited partners. Each Limited Partnership must have at least one general partner, and one or more limited partners. The general partner(s) can make any and all business decisions, but each also has unlimited personal liability for all actions of the partnership. The limited partners do not have any liability beyond their initial investment in the business, but they are also prohibited from participating in the day to day decisions of the business. If a limited partner crosses the line and starts to make management decisions, they become subject to the same liabilities as a general partner. So, for most small businesses, a Limited Partnership is really a bad idea. *Note: there is an estate planning vehicle known as a Family Limited Partnership ("FLP"), created primarily to reduce or eliminate estate taxes between family members. While FLPs have merit in very limited circumstances, they are not right for most businesses.*

A Limited Liability Partnership (LLP), in California, is restricted to licensed professionals in the fields of law, accountancy, or architecture. If not one of these, you don't qualify for an LLP.

That leaves the most common three entities as our remaining choices for business entities:
1) C-Corporation
2) S-Corporation
3) Limited Liability Company (LLC)

If properly formed and maintained, all three provide the **exact same liability protection**. That means, if you form any corporation or an LLC, your business liabilities are generally limited to your investment in the business. If you close your business with $100,000 in debts, your creditors generally cannot go after your personal assets to satisfy those debts. There are, however, four basic exceptions to that rule:

a) You sign a "personal guarantee" to a contract. A common example is a business premises lease, where the landlord requires you, the business owner, to execute a separate document guaranteeing all obligations under the lease. In all fairness, a landlord is not going to spend thousands of dollars in tenant improvements on a new company with no credit or track record. *Note: a good attorney can usually limit these personal guarantees in scope and duration, so please hire one before signing any commercial lease.*

b) A statute holds the business owner personally liable. A common example is payroll taxes. When your business withholds payroll taxes from employees' paychecks, the business owners are deemed to be fiduciaries, holding that money in trust for the government. Those fiduciaries are personally liable if withheld taxes are not paid. Worse, unpaid payroll taxes are usually not dischargeable in either a business or a personal bankruptcy. The message here: if absolutely necessary, slow pay your other creditors to pay the government its payroll taxes on time.

c) You take on liabilities without a good faith belief that you will be able to pay them back (also known as fraud). For example, if you sign a ten year office lease and your business turns south after three years, stuff happens. However, if you sign a contract to purchase a six-figure piece of equipment, and 10 days later when the bill is due you say: "Sorry, I just don't have it right now", you should expect a fraud lawsuit against the owners. Likewise, if the business owners take large salaries or dividends just before shutting down the company for lack of funds, expect the same.

d) You fail to properly form or maintain your corporation or LLC. Common examples can include: i) not holding corporate meetings or recording minutes; ii) failing to issue stock; or iii) not paying your annual franchise minimum tax. Bottom line: if you are going to go into business, spend a few dollars to have an experienced small business attorney explain your rights and responsibilities to you. It's cheaper than wondering why you lost your home to business liabilities.

Key Distinctions Between Entities

Assuming you stay away from the four exceptions above, the primary differences between C-Corporations, S-Corporations, and LLCs are: 1) **eligibility**; 2) **taxation**, and 3) **maintenance**.

First, eligibility. Any person, trust, or even another business entity can be a member in an LLC or a shareholder in a C-Corporation. However, S-Corporation shareholders are limited to natural persons who either U.S. Citizens or U.S. Residents. Further, S-Corporations are limited to 100 shareholders or less. These restrictions don't affect most small businesses owners, but if they do, find out sooner rather than later.

As for taxation, it's important to understand the following "default" taxation rules:

1) All newly formed corporations start out as C-Corporations;

2) If the shareholders desire, a C-Corporation can <u>elect</u> to be taxed as an S-Corporation by timely filing IRS Form 2553, inappropriately titled: "Election by a Small Business Corporation". There are limitations as to how frequently an S-Corporation can change back to a C-Corporation and vice-versa, so don't make this election lightly.

3) LLCs which are <u>single</u> member (also husband-wife in a community property state such as California) are considered to be a "disregarded entity" for tax purposes. This means that the owner is taxed the same as a sole proprietorship and files all business operations on Schedule C of their personal 1040/540 tax returns. Multiple member LLCs are by default taxed as a partnership. If the members of an LLC so desire, they can also elect to tax their LLC as a corporation by filing IRS Form 8832 "Entity Classification Election". It is further possible to further elect to tax an LLC as an S-Corporation, but this is rare.

C-Corporations

A C-Corporation is a completely separate taxable entity from the shareholder(s). This means that if a C-Corporation loses money, the shareholders cannot deduct those losses from other personal income. If the corporation makes money, it pays corporate taxes on all corporate income, AND then the shareholders pay personal taxes on all dividend income. The only way to avoid this "double taxation" is for the shareholders to take all of the profits out of the corporation each year in the form of a W-2 salary (which most do). All salaries are subject to full employment taxes, including FICA, Medicare, UI, SDI, etc. *Note: you should never, never hold title to real property in a C-Corporation. If it appreciates significantly and you wish to sell it, you'll face double taxation as the IRS won't let you pay yourself a "salary" to wipe out gains from a passive real estate investment.*

S-Corporations

An "S-Corporation" (more formally known a Subchapter S corporation) is known as a "pass through" entity. This means that the profits (and losses) pass through the corporation and flow down to the tax returns of the individual shareholders. If you're starting a new business and expect to lose money at first, S-Corporations are preferable to C-Corporations. Further, dividends paid to shareholders from an S-Corporation are only subject to personal income tax, and not to other employment taxes (FICA, Medicare, UI, and SDI). This can save the typical small business owner over 15% in taxes on dividend income. There is one catch, however. Shareholders who actively run the business must pay themselves a "reasonable" salary for their services. For example, a single shareholder S-Corporation has a profit of $200,000 per year, but the shareholder had to work 40 hours a week running the business to generate those profits. The IRS will require the shareholder pay themselves a reasonable salary of say (hypothetically) $75,000 per year subject to all employment taxes. The remaining $125,000 is only subject to personal income taxes, saving the shareholder some $18,750 per year in total employment taxes. S-Corporations in California do pay an annual state franchise tax of 1.5% of net income, subject to a minimum of $800 per year (the same $800 minimum that a C-Corporation or LLC pays).

Limited Liability Companies

Unless you elect otherwise, LLCs are complete pass through entities. A single member LLC is taxed as Sole Proprietorship, while a multiple member LLC is taxed as a partnership. Members will receive an IRS Form 1065 (Partnership) at the end of each year, and pay taxes accordingly. However, unlike an S-Corporation which only pays a 1.5% franchise tax on its profits, LLCs pay annual the flat $800 tax plus LLC fees based on their gross revenues. The first $250,000 in revenue is exempt from LLC fees, but the next $250,000 is $900, the next $250,000 is another $800, and these LLC fees go up from there. So, if you have annual sales of $2,000,000 in low margin products and only manage to net out $100,000, your LLC will still pay fees on the whole $2,000,000. LLCs which elect to be taxed as a corporation do not pay LLC fees, but do pay the same taxes as a corporation.

Maintenance

It provides little liability protection to file originating documents for a business entity and then fail to properly: a) complete the formation process; or, b) maintain it. Yet, thousands of California small businesses are guilty of this each year. Here is a highlight of the basic requirements of each after your Articles are filed with the Secretary of State:

1) Corporations:
    a. Issue stock (and pay for it);
    b. Register the sale of stock with the Department of Corporations;
    c. Hold initial Board meeting;
    d. Establish Bylaws;
    e. Hold annual meetings of the Board and the Shareholders (and record all meetings in minutes);
    f. File a Statement of Information every year;
    g. Execute all contracts and have all invoices in the name of the corporation;
    h. Don't comingle funds between the corporation and its Shareholders

2) LLCs
    a. Establish an Operating Agreement;
    b. Execute all contracts and have all invoices in the name of the LLC
    c. File a Statement of Information every two years;
    d. Don't deposit LLC income into the Members' personal accounts.

As you can see, the LLC's list is a lot shorter than the corporation list. The corporation list isn't necessarily complex to maintain, but it does require the shareholders/directors/officers (usually all the same people) to perform certain tasks and to calendar the annual meetings / minutes / statements. While this should not discourage most business owners from incorporating, if you know you are sloppy with deadlines and paperwork, this might be a factor in considering an LLC instead of a corporation.

The phrase: "Piercing the corporate (or LLC) veil" is overused. The mere failure to perform one or some of the above steps will not automatically expose shareholders or members to personal liability for business actions. However, a cumulative disregard for these requirements will slowly put a chink in the liability armor of any business entity. To be safe, be sure to dot the "I"s and cross the "T"s.

In Which State Should a Small Business Form their Entity?

Beginning with the premise that your California small business is not a Fortune 500 company, the answer is almost always: your corporation or LLC should be established in the same state where your business is physically located. Countless companies fall prey to the: ***"Incorporate in tax free Nevada"*** scam, and are sorry they did afterward. If your California business does incorporate (or form and LLC) in Nevada, it must still register that out of state entity in California, and pay the same taxes and fees here as any other California business. Plus, the business still has to pay all those annual "junk" fees in Nevada, which includes annual State filing fees and commercial fees to Nevada registered agents. Those businesses that do incorporate in Nevada, yet conduct their business in California, and then don't pay those taxes in

California, are **guilty of tax fraud**, plain and simple. Some have yet to be caught, but rest assured, the Franchise Tax Board is ruthless and constantly improving their detection methods.

A key element of the "Nevada tax scam" is the creation of a separate "management service company" in Nevada. The scammers tell the business to have their Nevada corporation charge their California business a hefty management service fee, so as to shift profits out of California and into Nevada. If your California business truly has brick and mortar office in Nevada, and you have bone fide Nevada employees managing your California company from Nevada, this strategy could have merit. However, few California businesses can meet this test. If you are planning to designate your vacation condo on a Las Vegas golf course as your Nevada business headquarters, you might consult a criminal defense attorney who specializes in tax fraud first.

What about Delaware? This state has long been regarded as business friendly, and does offer some of the best laws for liability protection of corporate shareholders and LLC members. The key here is that if you establish your entity in Delaware, but your business actually operates in California, then only Delaware's laws of internal governance will apply to your company. If you have multiple minority shareholders or members in multiple states, and seek to limit your protection from derivative suits, Delaware may be the way to go. For the other 99.9% of California small businesses, Delaware offers zero liability protection. The general rule is that liabilities are governed by the laws of the state where the act takes place, and not the state of incorporation or organization. If your California employee files a wage claim, the California Labor Commissioner will have jurisdiction, no matter where you incorporate. If your business enters into a contract and breaches it, the forum will almost always be the state where the contract was to be performed, irrespective of the state where the business is formed. If your delivery truck gets into an accident on a California highway, California's vehicle and negligence laws will apply.

Bottom line: there are extremely limited reasons for a California based business to incorporate or form an LLC outside of California. Before making the decision to do so, always consult with an experienced attorney who can advise you as to this delicate situation.

Crunching the Numbers

OK, so what does all this mean? More importantly, which tax structure will save me money? An understanding of each entity's tax characteristics can only point you in the right direction. As always, consult your tax advisor for the advice as to your unique situation. A good tax advisor will "crunch the numbers" for different forms of entities, and make a personalized recommendation for your business. If someone says: "I don't like LLCs" or "I always recommend S-Corporations", you should run to a different tax advisor.

To consolidate the advantages and disadvantages of C-Corporations, S-Corporations, and LLCs, see the table below:

	C-Corporation	S-Corporation	Limited Liability Co.
Income taxation on profits	Pays its own taxes; double taxation results if dividends paid after profits.	Pays only 1.5% state income tax; all profits and losses pass through to shareholders.	Pass through; taxed as sole proprietorship for single members and partnerships for multiple members.
Deductibility of losses	None (but can carry forward losses to future corporate profits).	Shareholders can deduct <u>if</u> they materially participate.	Members can deduct <u>if</u> they materially participate.
Minimum franchise tax	$800 per year *(waived for first year).*	$800 per year *(waived for first year).*	$800 per year *(<u>not</u> waived),* PLUS fees based on gross revenues.
Limitations on ownership	None.	No more than 100 shareholders; all must be U.S. Citizens or U.S. Residents.	None.
Apportionment of profits or losses / classes of ownership	Profits only are in proportion to share ownership percentage, but may have multiple classes of stock.	Profits or losses must be apportioned based on share ownership percentage; may only have one class of stock.	Flexible, may have multiple categories of membership.
Deductibility of insurance for members / shareholders	Health insurance for shareholders can be same as all other employees. Can discriminate in favor of officers on long term care insurance or unreimbursed medical expenses.	Partial deductibility.	Partial deductibility.
Depreciation / Section 179	Usually independent of the shareholders.	Can trigger Alternative Minimum Tax for shareholders.	Can trigger Alternative Minimum Tax for members.

<u>Final Analysis</u>

There is no such thing as a "right" or "wrong" form of entity for any company. Entrepreneurs should start by educating themselves, and then consult with the right small business attorney and tax advisor for a final decision.