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The Legal Forms of Organization

One of the key issues an entrepreneur must resolve at the outset of a new venture concerns the legal form of organization the enterprise should adopt. This decision is driven chiefly by the objectives of the entrepreneur and the firm's investors, in terms of tax status, exposure to legal liabilities, and flexibility in the operation and financing of the business. The choices are made difficult by the inherent tradeoffs in the law. In order to get the most favorable tax treatment, one must often give up some protection from liability exposure, flexibility or both.

This note will describe the various alternative forms of organization, and the advantages and disadvantages of each. This note will only cover the most fundamental elements of the various forms; a competent accountant or attorney should be consulted if such a decision presents itself.

Overview

The most prevalent legal forms of organization include:

- The sole proprietorship
- The partnership
    - general partnership
    - limited partnership
- The corporation
    - the "regular" C corporation
    - the S corporation (formerly Subchapter S)
    - the limited liability company

The two most basic differences between these various legal forms of organization are the tax status each is afforded, and the protection from liabilities each form offers to the owners. This can be seen most easily by briefly examining the C corporation and the sole proprietorship as legal forms.

Senior Lecturer Michael J. Roberts prepared this note as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. It replaces a previous note of the same title written by Michael J. Roberts under the supervision of Howard H. Stevenson.

Sole Proprietorship

The sole proprietorship is the oldest and simplest form of organization: a person who undertakes a business without any of the formalities associated with other forms of organization; the individual and the business are one and the same for tax and legal liability purposes.

The proprietorship does not pay taxes as a separate entity. The individual reports all income and deductible expenses for the business on schedule C of the personal income tax return. Note that these earnings of the business are taxed at the individual level whether or not they are actually distributed in cash. There is no vehicle for sheltering income.

For liability purposes, the individual and the business are also one and the same. Thus, legal claimants can pursue the personal property of the proprietor, not simply the assets which are utilized in the business.

The C Corporation

The "C" corporation is the most common form of large business organization for several reasons.

First, in contrast to the point made above regarding the sole proprietorship, the firm's owners are personally protected from liability. Thus, in the case of the Exxon Valdez, for instance, even if the damages against Exxon had bankrupted the company, the courts could not have pursued the individual shareholders for further damages—liability is limited to the extent of investment in the firm. There is a corporate shell or "veil" which can only be "pierced" in the event of fraud.

In exchange for this status, the C corporation is considered a taxpaying entity. Because the firm does not get any deduction for dividends paid, the earnings of a corporation are thus taxed twice: Once at the corporate level, and again at the individual level. The maximum rate on corporate income is 35%, so $1.00 of pretax corporate income becomes $0.65 of pre *personal*-tax income to the individual. Prior to mid-2003, this dividend income was taxed at normal, ordinary income rates, which approximated 40% once federal and state taxes are taken into account. Thus, $0.65 became $0.39 of after-tax personal income [.65-(40%x.65)]. Effective May 8, 2003, the tax law changed to reduce the federal taxation of dividends to individuals to a 15% rate. Thus, the average personal tax rate on dividend income (including federal and an average of state tax rates) is approximately 20%. This raises the amount an individual receives—after-tax—from $1.00 of corporate income from $0.39 to $0.52 [.65-(20%x.65)]. This double taxation creates incentives for those enterprises that anticipate distributing earnings to utilize a tax-advantaged form.

Other forms of organization can best be understood in relation to these two forms. After discussing the tax status and liability protection afforded by each of the other forms, we will return to discuss a series of other factors that distinguish these forms, and which should be considered when selecting a legal form under which to operate a business.

Partnerships

Partnerships are business entities that consist of two or more owners.

The General Partnership

A partnership is defined as "a voluntary association of two or more persons to carry on as co-owners of a business for profit." A partnership is more complicated than merely a collection of individuals. The partners must resolve, and should set down in writing, their agreement on a number of issues:

- The amount and nature of their respective capital contributions. One partner might contribute cash, another a patent and a third property and cash.
- The allocation of the business' profits and losses.
- Salaries and drawings against profits.
- Management responsibilities.
- Consequences of withdrawal retirement, disability, or death of a partner.
- Means of dissolution and liquidation of the partnership.

A partnership is treated like a proprietorship for tax and liability purposes. Earnings are distributed according to the partnership agreement, and taxes paid at the personal level on the partner's share. For liability purposes, each of the partners is jointly and severally liable. Thus, a damaged party may pursue either or both of the partners for any amount - the claim may not be proportional to invested capital or the distribution of earnings.

The Limited Partnership

Limited partnerships are a hybrid form of organization. A limited partnership is a partnership which has <u>both</u> limited and general partners.

- The general partner assumes the management responsibility <u>and</u> unlimited liability for the business and must have at least a 1% interest in profits and losses.
- The limited partner has no voice in management and is legally liable only for the amount of capital contribution plus any other debt specifically accepted.

In a limited partnership, the general partner may be a corporation (a corporate general partner). In situations where a corporation is the sole general partner, in order to ensure that there are sufficient assets to cover the unlimited liability which the general partner must assume, the corporate general partner must have a net worth of at least $250,000 or 10% of the total capitalization of the partnership, whichever is less.

Note that in a limited partnership, profits and losses may be allocated differently from each other. That is, even if profits are allocated 20% to the general partner and 80% to the limiteds, the limiteds may get 99% of the losses. However, losses are deductible only up to the amount of capital at risk. Note that the distribution of profits is subject to all sorts of creative structuring, such as that which is often observed in certain venture capital and real estate partnerships: the limiteds get 99% of the profits until they have gotten their capital back, and then the general partner gets 20% and the limiteds only 80%. This flexibility is an important advantage of the partnership form.

The S Corporation and the Limited Liability Company

The S corporation is a creature of the law which is afforded the tax status of a partnership, but the protection from legal liability of a corporation. And, a limited liability company is a new creature designed to afford the same benefits. By this point, you will have concluded that there is no free lunch, and that this advantageous treatment must come at some cost - the IRS being unlikely to give up its ability to tax corporate entities out of the goodness of its heart. And, indeed there are such limitations.

In order to qualify for S corporation status, the organization must meet a number of rather restrictive conditions:

- have only one class of stock, although differences in voting rights are allowed.
    - be a domestic corporation, owned wholly by U.S. citizens, and derive no more than 80% of its revenues from non-U.S. sources.
- have 75 or fewer stockholders.
    - derive no more than 25% of revenues from passive sources, i.e., interest, dividends, rents and royalties.
    - have only individuals, estates and certain trusts as shareholders, i.e., no corporations or partnerships.

The election of S corporation tax status requires the unanimous, timely consent of all shareholders. This status may be terminated by unanimous election, or if one of the above mentioned conditions is broken.

The limited liability company (LLC) is similar to an S corporation in that it enjoys the tax advantages of a partnership and the liability protections of a corporation. While state laws differ somewhat, an LLC is like an S corporation, with none of the restrictions on number or type of shareholders. The LLC is similar to a partnership in that the LLC's operating agreement (the equivalent of a partnership agreement) may distribute profits and losses in a variety of ways, not necessarily in proportion to capital contributions.

How To Decide

There are a number of criteria which can be used to help choose a legal form of organization.

Who will the investors and owners be? If the investors and owners will be a small group of individuals, a partnership of some form is clearly a possibility, as is an S corp. or LLC. If, however, it is anticipated that the business will require venture capital or other types of professional investors, a corporation may be more suitable. This is because venture capital firms cannot be shareholders in S corps (because the VC firms are usually partnerships, which can not hold shares in an S corp.). In addition, the potential tax liability of a flow-through entity makes VCs and their limited partners nervous. For this reason, VC's do not typically invest in LLCs. Finally, a corporation offers the most flexibility in incentive stock option plans, as well as various types of preferred securities, all of which may be important in a venture-backed, high potential venture. Finally, a public offering will most likely require a C corporation.

What are the capital requirements and cash flow characteristics of the business likely to be? If the venture is projected to create large losses in the early years, then there may be some benefit to passing those losses through to investors, if the investors are in a position to use them to offset income and thus reduce taxes. This would favor the partnership or LLC. Similarly, if the business intends to generate substantial cash flow and return it to investors as the primary means of creating value for investors, then a flow through entity is attractive. If however, the business will require cash investment over the long term, and value is intended to be harvested through a sale or public offering, then a C corp. is probably most attractive.

What is the time frame for the life of the business? Partnerships dissolve upon the death or retirement of any one of the partners. Corporations, on the other hand, have a continuity of life that goes beyond that of any of the management or investors.

Other Tax Issues

As you have no doubt gathered, tax implications are an important factor in the choice of an entity. Indeed, the incentives of the tax code gives rise to certain tactics which can be risky. For instance, the fact that distributed earnings of the corporation are doubly taxed gives rise to an incentive for the owners to pay themselves all of those profits as compensation, which is deductible as an expense to the cooperation (unlike dividends) and is thus, not taxed twice. The IRS has certain rules on "reasonable" compensation designed to protect against just such behavior.

Note that the tax on individuals in "flow-through entities" like partnerships and LLCs is on the share of income *earned*, not cash *distributed*:

- The income of the partnership is taxed at the personal level of the individual whether or not any cash is actually distributed.
- The distribution of cash out of income or retained earnings is not itself a taxable event. The only time when cash distributions are a taxable event is when the cash distribution exceeds the partners' basis in the partnership.
- The basis in equal to the amount of capital originally contributed, plus the amount of income on which tax is paid, less any cash distributions. (Example: An individual invests $100 in a partnership, and his share of income in 1 year equals $30. He must pay tax on this $30 at the personal rate. His basis is now $130. If he receives a $20 cash distribution, his basis drops to $110.)

Summary

Of course, a business may move through many forms in its lifetime. A sole proprietorship may become a partnership and finally a C corporation. A limited partnership may become an LLC and then a C corporation. Rest assured that each of these changes will require considerable legal work and administrative burden for the current management and owners of the firm. The advantages of the right form of organization at each particular stage certainly may warrant this series of changes. On the other hand, high-potential ventures on a fast-track do not want to lose time and focus by getting tied up jumping through these hoops in the last moments before a financing. Entrepreneurs would do well to consider the likely evolution of their business before selecting a form of organization, and should certainly consult with a qualified tax attorney or accountant before making this important choice.

Exhibit 1 Comparison of the various legal forms

	C Corporation	S Corporation	Limited Partnership	Limited Liability Company
Who pays tax on entity's earnings?	• Double tax: at entity and owner levels • Payouts to owners as compensation (deductible to entity, therefore taxed only to owners) limited by tax rules denying deductions for unreasonable comp. • Asset sales: taxed twice (up to 57.75% combined federal tax at entity and owner levels, unless owners are tax-exempt)	• Federal gov't and most states impose single tax at owner level • A few states (including Mass.) impose some tax at entity level • In a single-level tax regime, tax authorities have much less incentive to focus on unreasonable comp.	• Single tax at owner level • A very few states (and NYC) impose entity-level tax • In a single-level tax regime, tax authorities have much less incentive to focus on unreasonable comp.	• Federal gov't and most states impose single tax at owner level • A few states tax at entity level • In a single-level tax regime, tax authorities have much less incentive to focus on unreasonable comp.
Who is liable for entity's obligations?	• The gold standard: corporate shareholders rarely held liable for entity's obligations absent fraud • No escape from securities-law liability; limited protection from environmental claims	• As shareholders in a corporation, investors get same treatment as owners of C Corporation stock	• Must have at least one general partner with unlimited liability for unsatisfied obligations of entity • General partner can be a shell corporation (effectively yielding limited liability) • Limited partners escape liability (Delaware provides broadest protection), same issues as C Corp. with respect to environmental and securities law liability	• Drafters of statutes intended to give all equity owners the same liability protection as corporate shareholders • Liability limitations not tested in court, however, so cautious investors may be concerned
What kind of equity interests can be issued?	• Common and preferred stock; warrants • Can issue tax-favored incentive stock options (ISOs)	• Limited to a single class of stock; all shares must have identical *economic* rights (nonvoting shares OK), so all distributions	• Provides enormous flexibility in sharing profits and losses; can have multiple classes of interests	• Treated as partnerships for tax purposes if properly structured • Same flexibility; same complexity

	• State corporate statutes and tax rules regarding constructive dividends effectively limit flexibility in structuring equity	must be proportional to share holdings (No preferences) • Employee options (including ISOs) are safe, as are plain vanilla warrants if out of the money both when issued and when transferred • Discounted warrants or other arrangements intended to provide a return mimicking preferred stock may constitute a prohibited 2d class of stock	• Cost: complexity caused in part by decades of anti-tax shelter rules • No ISOs, and all employee options are problematical; in theory (unlike corporations), exercise of employee options should trigger taxable gain to existing owners	• No ISOs, same issues with employee options as limited partnerships
Limitations on who can own equity?	• Effectively, no limitations outside of heavily-regulated industries (*e.g.*, FCC limitations on foreign ownership of media companies) • The only practical vehicle for publicly-traded businesses	• No more than 75 shareholders • All must be individual US citizens or residents, types of certain trusts or certain otherwise tax-exempt entities (charities, pension funds, etc.) willing to pay tax on their shares of the S. Corp income; No other institutional investors (e.g., partnerships or taxable corporations); no non-US persons can be shareholders	• No limits on who can own interests • Not appropriate for **foreign** investors unless they are willing to file US tax returns (or unless the entity's activities are limited to investing in stocks and securities) • Not appropriate for **tax-exempt** investors unless they are willing to file "Unrelated Business Taxable Income" returns and pay taxes (unless the entity foregoes borrowing and limits its activities to investing or trading in securities and/or lending) • Venture capital funds often have both tax-exempt and foreign	• Again, treated as partnerships for tax purposes if properly structured • Same issues with foreigners and tax-exempts

			partners.	
Can entity make tax-free distributions?	• Generally not possible if entity is profitable • Distributions of cash usually treated as made out of profits; if so, taxable as dividends (ordinary income, not capital gain) • Distributions of appreciated property trigger tax at entity level on appreciation and at owner level at dividend rates on value of properly received	• Owners taxed on entity's earnings as those earnings accrue can receive distributions of these previously-taxed earnings without incurring additional tax • Distributions of appreciated property trigger tax on appreciation (though only at owner level) • Not an appropriate vehicle for pooled investments (owners cannot take their shares of assets in kind without triggering tax.	• Owners taxed on entity's earnings as those earnings accrue can receive distributions of these previously-taxed earnings without incurring additional tax • Distributions of appreciated property can be made without triggering any tax, subject to complex anti-abuse rules	• Again, treated as partnerships for tax purposes if properly structured
What happens to losses generated by the entity?	• Warehoused and carried forward as net operating losses (NOLs) to be used against future earnings • NOLs subject to limitation if entity undergoes "ownership change" (NOL limitations have little economic effect if company is growing rapidly in value) • Venture capitalists generally favor preserving NOLs for benefit of entity	• Owner/managers may be able to use their shares of the entity's losses to offset wages and also other income not attributable to entity • "Passive loss" and "at risk" rules limit ability of an owner who is an individual to use entity's losses to offset income and gains from other sources if those losses exceed the sum of the owner's paid-in capital (including direct loans to entity) and proportionate share of the entities' undistributed profits	• Owner/managers may be able to use their shares of the entity's losses to offset wages and also other income not attributable to entity • "Passive loss" and "at risk" rules limit individual owners' ability to use entity losses, but *other* investors not subject to these rules can shelter income with entity losses	• Again, treated as partnerships for tax purposes if properly structured

What are likely exit strategies for investors?	• Asset sales are not tax-efficient unless entity has useable NOLs to offset income and gain it realizes on those sales • Stock sales (IPO or private) are best for investors; sales generally result in capital gains taxed at favorable rates	• Allows flexibility to sell assets without triggering more than one level of tax (buyers often pay more because they get tax basis step-up and additional future depreciation) • Conversion to C Corporation status can be done tax-free, so conversions followed by IPOs are common	• Easy to sell assets without triggering two levels of tax • Roll-up into C Corporation for IPO often can be accomplished tax-free, but can be very complicated to structure	• Same issues as limited partnership
What operational problems are peculiar to the entity?	• None	• Hard to structure investments by venture capitalists and other institutions without risking forfeiture of S status. • No flexibility in allocating economic benefits (all must be per share)	• None, other than complexity	• None, other than complexity