



PROTECTING MY LIFE'S WORK: CHOOSING THE PROPER FORM OF BUSINESS ENTITY

David S. Rosenbaum

"I'm a business owner (or soon to be one) what type of entity should I choose?"

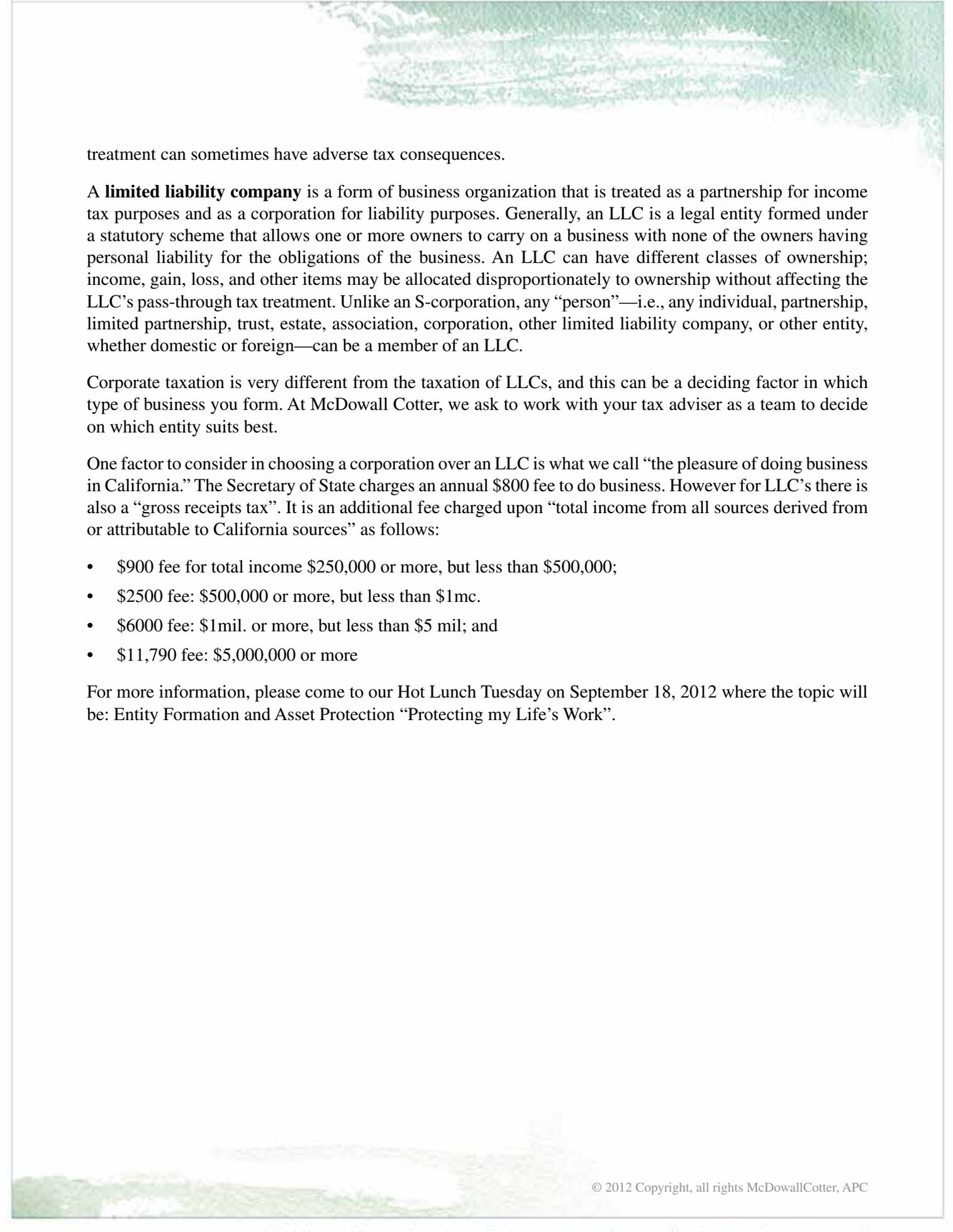
At McDowall Cotter, we make two classifications: "non-asset protection" and "asset protection" entities. General partnerships and sole proprietorships fall into the former; corporations and limited liability companies fall into the latter. We look at asset protection as keeping your life savings away from business creditors, judgment creditors and the IRS.

A **sole proprietorship** is the simplest form of business organization, in which an individual engages in business personally and without either co-owners or the use of an entity such as a corporation. A sole proprietorship avoids many of the formalities and reporting requirements of business entities, but *the business owner is personally liable* for the debts and obligations of the business.

California law defines a **general partnership** according to the corporations code as "association of two or more persons to carry on as co-owners a business for profit; the "persons" may be individuals, corporations, limited liability companies, or other partnerships." *General partners are personally liable*, jointly and severally, for all debts and obligations and most wrongdoing of the partnership, unless agreed otherwise by the claimant or provided by law, and except for any partnership obligation incurred before a person is admitted as a partner. Corp C §16306(a)-(b). A judgment against a partnership may not be satisfied from a partner's separate assets unless there is also a separate judgment against the partner individually, or under other specified circumstances. Corp C §16307(c)-(d). All partners have fiduciary duties of loyalty and care to each other. Corp C §16404.

Conversely, in a **corporation**, *shareholders are not personally liable* for corporate debts and obligations unless the shareholders: personally guarantee corporate debts or obligations; engage in tortious conduct; receive improper distributions; are subject to "alter ego" claims for commingling personal and corporate matters; or breach duties to other shareholders or the corporation. Shareholders who also serve as officers and directors may have additional liability exposure due to the additional control they have over corporate matters.

An S-corporation allows pass-through tax treatment and limited liability for all owners, S-corporation status limits the parties' flexibility in structuring their financial arrangements because of the requirements that the corporation have no more than one class of stock (IRC §1361(b)(1)(D)) and that items of income, gain, loss, deduction, or credit be taken into account in accordance with the shareholders' prorata share of the corporation's stock (IRC §1366). Furthermore, only individuals who are U.S. citizens or resident aliens, estates, certain types of trusts, and certain tax-exempt organizations are permitted to be S-corporation shareholders (IRC §1361(b)(1)(B)), and an S-corporation will lose its pass-through tax treatment if an ineligible entity becomes a shareholder. There are further asset protection benefits associated with corporations like setting up a 401k or other defined benefits plans. Finally, the pass-through income tax treatment offered by an S-corporation differs somewhat from that of a partnership, and this different



treatment can sometimes have adverse tax consequences.

A **limited liability company** is a form of business organization that is treated as a partnership for income tax purposes and as a corporation for liability purposes. Generally, an LLC is a legal entity formed under a statutory scheme that allows one or more owners to carry on a business with none of the owners having personal liability for the obligations of the business. An LLC can have different classes of ownership; income, gain, loss, and other items may be allocated disproportionately to ownership without affecting the LLC's pass-through tax treatment. Unlike an S-corporation, any "person"—i.e., any individual, partnership, limited partnership, trust, estate, association, corporation, other limited liability company, or other entity, whether domestic or foreign—can be a member of an LLC.

Corporate taxation is very different from the taxation of LLCs, and this can be a deciding factor in which type of business you form. At McDowall Cotter, we ask to work with your tax adviser as a team to decide on which entity suits best.

One factor to consider in choosing a corporation over an LLC is what we call "the pleasure of doing business in California." The Secretary of State charges an annual \$800 fee to do business. However for LLC's there is also a "gross receipts tax". It is an additional fee charged upon "total income from all sources derived from or attributable to California sources" as follows:

- \$900 fee for total income \$250,000 or more, but less than \$500,000;
- \$2500 fee: \$500,000 or more, but less than \$1mc.
- \$6000 fee: \$1mil. or more, but less than \$5 mil; and
- \$11,790 fee: \$5,000,000 or more

For more information, please come to our Hot Lunch Tuesday on September 18, 2012 where the topic will be: Entity Formation and Asset Protection "Protecting my Life's Work".