Tax And Liability Dictate Business Form

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You might start a business by quitting your day job, hiring employees, leasing space, and having a grand opening party. Or, you may start out part time in your garage or in cyberspace. Either way, you may think it doesn't matter whether you operate through a corporation, partnership, limited liability company (LLC), or individually as a sole proprietorship.

The question of which business entity is appropriate for a particular venture involves an analysis of many different areas of the law. Lawyers and business people need to consider state law, which typically dictates the requirements for a particular entity. An individual also should consider federal law for a variety of issues, not the least of which is the tax character of the particular business entity chosen.

This article reviews some of the advantages and disadvantages of the various entities available for conducting business. In particular, we try to provide readers with the tax implications of choosing one of these business forms. Each type of entity has a unique mix of tax, liability, and other issues. Therefore, one size does not fit all.

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Business Basics: Limit Your Liability

Why have a separate business entity at all? There are many reasons to do business through a separate entity, but chief among them is limited liability. In general, the various corporate forms may shield an individual from personal liability for the acts and omissions of the business.[1]

For example, let's say you start making widgets in your garage that make computers run at lightening-fast speed. You name your fancy new widget technology: "World Wide Widgets" and sell them on eBay. If you were running the business as an individual, and one of those widgets explodes or causes an accident, you would be sued individually. If you properly create an entity to run the business (and properly operate through that business), the entity would be liable in the first instance, and your individual liability would be limited.[2] If World Wide Widgets operates as a corporation, the corporation is liable for debts, bad widgets, or computers that combust once the fancy widget is installed. That means the corporation's assets are principally at risk, not your house, the kids' college fund, etc.[3]

In some circumstances, creditors can "pierce the corporate veil" to reach your personal assets, but this usually requires proof the entity is undercapitalized, underinsured, or otherwise not functioning as a commercially reasonable separate legal entity.[4] As long as you observe a few key formalities, the separate status and liability of World Wide Widgets will usually be respected.

However, while entity choice can provide some protection, it is not a substitute for insurance. Once you have selected the appropriate business entity, that business should consider purchasing insurance to cover anticipated business risks. Such insurance provides various types of protection, including general liability, products liability, employee fidelity, workers' compensation, unemployment insurance, and, in appropriate cases, director and officer insurance. Of course, this is not an entity choice or a tax concern but simply a matter of good business practice.

Going it Alone: Sole Proprietorship

If an entrepreneur chooses not to form a business entity to run the business, he or she will operate as a proprietorship, the oldest form of business. A sole proprietorship requires no magic language to form. It is not a separate legal entity.[5] The worker simply starts making widgets. While proprietorships are a common way to test the waters of the business world, operating as a sole proprietor isn't good in the long term.

Thus, the greatest shortcoming of a proprietorship is that it does not protect the proprietor from the debts and obligations of the business.[6] There are, however, benefits to a sole proprietorship. It is easy, simple, and cost effective to create. Furthermore, anyone can be a sole proprietor. Indeed, most independent contractors are treated as sole proprietors. A proprietorship can only have one owner

although husband and wife are now considered one for this purpose.[7]

In terms of mechanics, all the income and expenses of a sole proprietorship go on Schedule C to your Form 1040. You pay tax on your profit, or if you lose money, you offset it against your other income (such as salary and interest). As a sole proprietor, you may also be liable for self-employment tax if your net earnings from self-employment are $400 or more.[8] The tax rate on the earnings of a sole proprietor is a hefty 15.3% (12.4% social security tax plus 2.9% Medicare tax) and must be reported on Schedule SE to the Form 1040.

But be careful. If World Wide Widgets has losses for a few years in a row, the IRS may question the nature of your enterprise. Indeed, the IRS may argue your losses are nondeductible hobby losses.[9] The key is to determine whether, based on the facts and circumstances of your activity, you had a profit motive in engaging in the activity.[10] Additionally, Schedule C is generally regarded as the most likely of all tax forms to be audited.[11] This makes sense since (without a separate legal entity) there may be a natural tendency for proprietors to mix personal and business assets and expenses.

Beware of Double Tax

After a sole proprietorship, the most classic business entity is the corporation. Like an LLC or limited partnership, a corporation begins its life through a simple filing with the secretary of state.[12] Its owners are the shareholders. They elect a board of directors and the directors in turn elect officers. Corporations offer limited liability and an orderly structure that most people understand. Additionally, the units of ownership—shares of stock—can (subject to compliance with securities laws) be freely traded.

There are good reasons IBM, Google, Apple, and General Motors are all corporations. For big and public companies, it is the only viable alternative given the restrictions on other entity forms. Such a structure allows the issuance of shares, provides equity for the corporation, and ensures investment potential for the general public.

For tax purposes, the Internal Revenue Code defines corporations broadly to include "associations, joint-stock companies, and insurance companies."[13] Large corporations are known as "C corporations" since their activity is largely governed by subchapter C of the Internal Revenue Code. It is the tax structure of most corporations that limits their appeal.

Corporations are separate legal entities and are *separately* taxed at up to a 39.5% rate.[14] If the corporation pays dividends to shareholders, it doesn't get a tax deduction because dividends are after-tax payments by the corporation. Nonetheless, the shareholders are taxed on the dividends, either as ordinary income or, in some cases, as qualified dividends entitled to a capital gains rate of 15%.[15] This means that corporations effectively pay "double tax," once by the corporation and once by shareholders.

Of course, many corporations don't pay dividends, so you might think an end-run is to let a World Wide Widgets grow for thirty years and then sell, yielding a whopping capital gain to you upon retirement. Not so fast. There are generally still two levels of taxation. First, a corporation may be treated as selling its assets, incurring gain (and tax) at the corporate level.[16] Of course, corporations aren't entitled to the lower capital gain rate, so this gain is taxed at 39.5%. Thereafter, the proceeds that have been taxed at the corporate level are distributed and, upon receipt by the shareholders, are again subject to tax, probably subject to capital gain rates.[17]

Partnership Basics

Given the double tax imposed on corporations, pass-through entities—partnerships and LLCs—are often more attractive. A general partnership can be formed with a handshake. Better practice is to reduce the agreement to a written form, as oral agreements foment disputes. For tax purposes, a partnership is a business entity that is not a corporation and that has at least two owners.[18]

With a general partnership, each partner has personal liability.[19] A limited partnership has one or more general partners and one or more limited partners.[20] The latter are usually investors not actively running the business. Limited partners might lose their investment, but their other assets aren't at risk. Only the general partner(s) in a limited partnership have unlimited risk. You can get around the general partner's unlimited liability by having a corporation as the general partner. If that corporate partner's capital is inadequate, though, there can still be a kind of piercing the veil or alter ego liability.

To get the benefits of limited partnership treatment, you must file a certificate and pay annual fees.[21] Formalities count; if you fail to observe them, you'll be treated as operating a general partnership (meaning more liabilities). Furthermore, limited partners must be careful not to act too much like general partners. By making day-to-day business decisions, a limited partner can wind up with general partner liability.[22]

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Pass-Through Tax Treatment Is Better

Corporate double tax makes pass-through entities like partnerships more attractive. Unlike C corporations, partnerships are not subject to a tax at the partnership level.[23] Rather, each partner takes into account his distributive share of the partnership's income, gain, or loss in determining his or her income tax liability.[24] Furthermore, partners can normally contract to receive their respective portions of the partnership's income, gain, and loss according to whatever allocation they please, as long as it has substantial economic effect.[25]

For an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. If there is an economic benefit or burden that corresponds to the allocation, the partner to whom the allocation is made must receive the economic benefit or bear such economic burden.[26] If the partnership agreement provides for an allocation of income, gain, loss, deduction, or credit to a partner that does not have substantial economic effect, then the partner's distributive share of the income, gain, loss, deduction, or credit is determined in accordance with the partner's interest in the partnership.[27]

Additionally, provided the proper election is in place, new partners in a partnership are allowed to assume a special basis in assets of the partnership based on that new partner's particular interest in the partnership's respective assets.[28] These factors make the partnership entity highly flexible. It also helps that the default corporate form, at least under the Internal Revenue Code, is now a partnership structure. Indeed, under the "check the box regulations," all entities (other than a corporation under local law) will be taxed as partnerships unless the entity makes an affirmative election to be taxed as a C corporation.[29]

Above all, the single level of taxation makes pass-through tax treatment better even if you lose money. In most cases, the partners receive Forms K-1 from the partnership reporting their share of the income or loss on their own tax returns. In contrast, if your corporation loses money, the corporation is entitled to the losses, not the shareholders.

Most start-ups lose money before they make it, leaving losses locked up in the company that can only be used in the future if it later turns a profit. This may cause you to think a partnership is always better, but not for everyone.

After all, the amount reported on a Form K-1 by a partnership may not actually be paid to the member or partner. What if you receive a K-1 saying your share of the profits from World Wide Widgets was $300,000, but World Wide Widgets does not distribute any of the cash to you? You have income, but no cash. Most partnerships will pay out at least enough cash to enable members/partners to pay their tax, but it's not legally required.

Thus, it is clear that the pass-though entity possesses many characteristics that make it preferable to the typical C corporation with double taxation. However, pass-through treatment is not unique to partnerships. LLCs receive it too, as (in modified form) do S corporations.

Don't Forget S Corporations

There's one type of corporation that does receive pass-through tax treatment, and it's popular for small businesses: the S corporation. It is just like any other corporation, so there's no special type of articles or bylaws. But you do have to file a one page "S election" with the IRS (and the California FTB).[30] An S corporation is taxed almost like a partnership because an S corporation can face corporate tax like C corporations if it previously was a C corporation and, subject to certain limited exceptions, elected S status within the last ten years.[31]

An S corporation can have no more than 100 shareholders,[32] only domestic shareholders (US citizens and resident aliens),[33] generally individual shareholders,[34] and a calendar (not a fiscal) year.[35] If there are multiple classes of stock, then only differences in voting rights are allowed.[36] For most small businesses, these criteria are easy to meet. If the owners are more comfortable with the corporate form rather than with a partnership or an LLC, an S corporation can be a good choice.

S corporations have been around since the 1950s, long before the more flexible LLC was available. Unfortunately, the accounting rules for S corporations are complicated,[37] and it is hard for existing C corporations to convert to S status. Many of these rules can be avoided if you start out from the beginning with an S corporation. To do this you usually must file your S election with the IRS within 75 days of forming your corporation.[38]

LLCs Are Most Flexible

By far the most flexible business entity is the LLC. Adapted from European countries, most states enacted LLC legislation in the 1980s and early 1990s, and today LLCs exist in every state. They are closest to limited partnerships, but there is no general partner. Everyone is a "member" (not a partner), and there is almost infinite flexibility.

The IRS first recognized the pass-through character of LLCs in 1998 under the Wyoming Limited Liability Company Act.[39] Since that time, LLCs have become increasingly popular

combining the shield of limited liability with the flexibility of the pass-through entity structure.

You can have different classes of members, different voting rights, different capital requirements and management roles, and more. LLCs start with a simple fill-in-the-blanks form filed with the secretary of state, listing only skeletal information.[40] The longer agreement is an "operating agreement" and is similar to a limited partnership agreement. In large part, LLCs have replaced limited partnerships as vehicles of choice for passive investments (like holding real estate) and for small business.

For tax purposes, LLCs have many advantages. They receive pass-through tax treatment, and investors don't need to worry about acquiring unlimited liability if they are too involved. However, some sales of interests in an LLC can be taxed less favorably than a disposition of stock in an S corporation. If 50% or more of the total membership interests in an LLC are transferred in any twelve-month period then it "terminates" the LLC for tax purposes, which is a major headache.[41]

Despite these drawbacks, from both a liability and a tax perspective, choosing an LLC for World Wide Widgets may be a good option for a variety of reasons.

Remember Accounting

No matter which entity form you choose for World Wide Widgets, you also need to be cognizant of accounting issues. In general, taxpayers and entities have two choices with respect to accounting for income and expenses: cash vs. accrual.

As a cash basis taxpayer, you (or your entity) would include income when it is actually or constructively received and account for expenses in the year in which they are actually made.[42] This is typically how most individuals account for their income and expenses.

Alternatively, you may be able to account for the income and expenses of World Wide Widgets as an accrual basis taxpayer. In fact, the IRS believes the accrual method is more accurate, and big businesses are nearly always on the accrual method. On the accrual method, you have income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.

For purposes of accounting for liabilities, you can deduct expenses in the year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.[43] As an accrual basis taxpayer, you're more likely to be able to accelerate the time at which you can deduct expenses.

There are a variety of limitations on accounting methods. For example, unless its gross receipts are less than $5,000,000 for any taxable year, a C corporation cannot account for income and expenses as a cash basis taxpayer.[44] Similarly, while generally a partnership can choose to account for income or expenses on either the cash basis or accrual method, if one of the partners is a C corporation meeting the $5,000,000 gross receipts test, that partnership cannot choose the cash method.[45]

Weighing Advantages and Disadvantages

Now that you have the choice of entity building blocks, the hard part is weighing the plusses and minuses for World Wide Widgets. A C corporation may make no sense for a small business like World Wide Widgets due to the double tax that will be paid currently or when it is sold. If you are sure that your widget company will "go public," it should be a C corporation, but it's easy to transition from another entity (such as an LLC or S corporation) to a C corporation when the time comes.

Besides, if you incur losses during the first few years of widget production, you'll want to claim them personally, favoring an S corporation, LLC, or partnership. As between S corporations and LLCs, LLCs are more flexible. S corporations have more complicated accounting limitations on the losses a shareholder can claim, as well as a passive income tax. In contrast, an LLC is a pure pass-through with fewer tax traps than S corporations. Yet LLCs don't have the many decades of authority and practice experience of corporations, partnerships, or even S corporations.

Conclusion

Whatever type of business you start or run, the key is the business itself, not the structure through which it operates. You can probably make any of these choices work, no matter which you select (or which you inherit). Still, you'll want something that complements your operation, not that is at odds with it. And taxes, both federal and California, should be considered.

Whatever you choose, if you later sell the business or change it significantly, there's often a way to ameliorate some of the tax and other disadvantages noted here. So get expert help when the time comes, and don't feel like whatever entity you choose is engraved in stone. ■

Endnotes

1 *See, e.g.*, CAL. CORP. CODE §§ 410, 423, and 506.

2 If one operates a business as one's alter ego, then an individual may ultimately be found liable for the entity's conduct; however, alter ego liability is the exception, not the rule. While

the concept of alter ego or "piercing the corporate veil" are mentioned in this article, it is beyond the scope of this article.

3 Other types of liability may attach as well. These include joint and several liability as well as vicarious liability.

4 Courts may disregard the corporate veil where there is: (1) gross undercapitalization; (2) failure to observe corporate formalities; (3) nonpayment of dividends; (4) insolvency of debtor corporation; (5) siphoning of funds from the debtor corporation by the dominant stockholder; (6) non-functioning of officers and directors; (7) absence of corporate records; and (8) the corporation is merely a facade for the operations of the dominant stockholder. See *Am. Bell, Inc. v. Fed'n of Tel. Workers*, 736 F.2d 879 (3d Cir. 1984).

5 Note that sole proprietors who operate under a fictitious business name in California do have to comply with the California state fictitious business name statement requirement. See Cal. Bus. & Prof. Code § 17910.

6 *Trustees of Amalgamated Ins. Fund v. Sheldon Hall Clothing, Inc.*, 862 F.2d 1020 (3d Cir. 1988).

7 See I.R.C. § 761(f), added by the Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28.

8 I.R.C. § 1402.

9 *See* I.R.C. § 183.

10 *See* Treas. Reg. § 1.183-2.

11 *See* United States General Accounting Office, Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, *IRS AUDIT RATES: Rate for Individual Taxpayers Has Declined but Effect on Compliance Is Unknown*, GAO-01-484 (April 2001).

12 See Cal. Corp. Code § 200.

13 I.R.C. § 7701(a)(3).

14 I.R.C. § 11.

15 I.R.C. § 1(h)(11).

16 I.R.C. §§ 336 & 338.

17 I.R.C. § 331.

18 Rev. Rul. 2004-77, 2004-2 C.B. 119.

19 Cal. Corp. Code § 16306.

20 Cal. Corp. Code § 15611.

21 Cal. Corp. Code § 15621(a).

22 *See Holzman v. De Escamilla*, 86 Cal. App. 2d 858 (1948).

23 I.R.C. § 701.

24 I.R.C. § 702(a).

25 I.R.C. § 704(a).

26 Treas. Reg. § 1.704-1(b)(2)(ii).

27 I.R.C. § 704(b).

28 I.R.C. § 754.

29 Treas. Reg. § 301.7701-3.

30 IRS Form 2553.

31 I.R.C. § 1374(d). Note that section 1251 of the Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, added I.R.C. § 1374(d)(8), which reduces the recognition period from 10 years to 7 years for corporate tax on sale of appreciated assets in 2009 or 2010 by S corporations that once were organized as C corporations.

32 I.R.C. § 1361(b)(1)(A).

33 I.R.C. § 1361(b)(1)(B).

34 I.R.C. § 1361(b)(1)(C).

35 I.R.C. § 1378.

36 Treas. Reg. § 1.1361-1(l)(1).

37 California imposes a special tax of 1.5% on the net income of each S corporation. *See* Cal. Rev. & Tax. Code § 23153.

38 I.R.C. § 1362(b)(1).

39 Rev. Rul. 88-76, 1988-2 C.B. 360.

40 *See, e.g.*, Cal. Corp. Code § 17051.

41 *See* Cal. Rev. & Tax. Code § 64(c)(1); I.R.C. § 708(b)(1)(B).

42 *See* Treas. Reg. § 1.446-(1)(c)(i).

43 *See* Treas. Reg. § 1.446-(1)(c)(ii).

44 I.R.C. § 448(b)(3).

45 *Id.*