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Choice-of-Entity Decision Guide - Non-TaxConsiderations

This Non-Tax Considerations section of the Choice-of-Entity Decision Guide summarizes the state law principles that influence the choice-of-entity decision. Topics discussed include formation, capitalization and contributions, owner liability for entity obligations, protection of entity assets from the owner's creditors, control of the business enterprise, continuity, transferability, and dissolution. The Guide allows practitioners to review these non-tax considerations on an item-by-item basis in order to determine which choice of entity will best achieve a client's non-tax objectives.

Section 1.01 Sole Proprietorship

(a) Formation

The sole proprietorship is the simplest type of business entity to form. Few legal formalities are required. Because a sole proprietorship is not incorporated, there is usually no need to file documents with the state in order to form the sole proprietorship. But if the sole proprietorship will be operated under a trade name or fictitious business name, it may be necessary to register the name with the state. State law will treat the business and the owner as a single entity.

***Important Note*:** As the name implies, a sole proprietorship has only one owner. If there is more than one owner, the business will generally be treated as a partnership unless another form of entity is created.

(b) Capitalization and Contributions

Because state law does not recognize a sole proprietorship as an entity separate from its owner, there is no formal capitalization of a sole proprietorship. The assets of the owner and assets of the sole proprietorship are one and the same.

(c) Owner Liability for Entity Obligations

Sole proprietorships offer no protection for obligations of the businesses. The owner is personally liable for the debts, obligations, and liabilities of a sole proprietorship. This is a significant disadvantage to this type of business entity.

(d) Protection of Entity Assets from Owner's Creditors

Because a sole proprietorship is not treated separately from the owner, the sole proprietorship offers no protection for the entity assets from the owner's creditors.

(e) Control

Because a sole proprietorship is not treated separately from the owner, the owner has complete control over the affairs of a sole proprietorship.

(f) Continuity, Transferability, and Dissolution

The business of a sole proprietorship continues until the owner's death or disability, bankruptcy, or decision to end the business. In most situations, the owner can sell or transfer the business without restriction by simply transferring the assets to the new owner. But if the sole proprietorship involves a professional practice, the transfer may be restricted to eligible owners. Because a sole proprietorship is not recognized as separate from the owner, there is no need to dissolve the sole proprietorship when it ceases to conduct business.

(g) Privacy

Because a sole proprietorship is not treated separately from the owner, there are no laws requiring access to the business records of a sole proprietorship.

(h) Transition to Other Entity Form

Transitioning to an incorporated business from a sole proprietorship is simple. The owner simply contributes the business assets of the sole proprietorship to the form of entity that he or she chooses in exchange for an interest in that entity.

Section 1.02 Corporation

(a) Formation

A corporation is recognized as a legal entity separate from its owner. To form a corporation, the owner (or owners) must file documents with the state. The documents usually include, at a minimum, articles of incorporation. The owner should also adopt bylaws to govern the affairs of the corporation and reflect the formation of the corporation in the organizational minutes.

(b) Capitalization and Contributions

Corporations are initially capitalized by transferring property to the corporation in exchange for shares of stock in the corporation. As a matter of corporate law, there is no limit on the number of shareholders that the corporation may have. The corporation's stock may be divided into different classes of shares (such as preferred stock and common stock), each with their own right to voting and distributions.

***Important Note*:** As discussed in the Choice-of-Entity Decision Guide (Tax Considerations), federal tax law places important restrictions on the types and number of shareholders that a Subchapter S corporation may have and requires the corporation to have a single class of stock. A careful review of these restrictions is essential if the shareholders are considering an election to be treated as an S corporation for federal tax purposes.

(c) Owner Liability for Entity Obligations

Under state law, shareholders of a corporation are generally protected from liability for the corporation's obligations. The corporation is treated a separate entity and is solely responsible for its own debts and obligations. But this veil of protection may be pierced if, for example, the shareholders fail to follow corporate formalities, commingle personal and corporate funds, engage in fraudulent behavior, or inadequately capitalize the corporation to the detriment of creditors. Shareholders are also personally liable for any loans or other obligations that they personally guarantee.

(d) Protection of Entity Assets from Owner's Personal Creditors

Creditors of a shareholder may acquire the shareholder's shares in the corporation, in which case the creditor will succeed to the shareholder's rights to distributions and management of the corporation. If the shareholder had a sufficient quantity of shares to liquidate or dissolve the corporation or force distributions of assets from the corporation to the shareholder, then the creditor will acquire those same rights. On the other hand, if the shareholder had nonvoting shares that conferred few rights or benefits, the creditor will only acquire the limited rights that the shareholder had.

***Important Note*:** If protection of entity assets from the owner's personal creditors is important, a charging-order-protected entity (such as a limited liability company or limited partnership) should be considered.

(e) Control

Control of a corporation is determined primarily by the corporation's articles of incorporation and bylaws, within the limits established by state law. State law also fills in the gaps for situations where the articles of incorporation and bylaws are silent. While the laws of most states have similar provisions regarding control of the corporation, there are some state-by-state variations that should be considered, such as the amount of control required to liquate, dissolve, or sell substantially all of the corporation's assets.

(f) Continuity, Transferability, and Dissolution

Corporations exist until they are dissolved. Dissolution can occur by the shareholders, by creditors, or by the state for failure to file periodic reports. The shareholders are generally free to transfer their stock unless restricted by the articles of incorporation or bylaws or by agreement between the shareholders. State law may prohibit an absolute restriction on transferability.

***Important Note*:** As discussed in the Choice-of-Entity Decision Guide (Tax Considerations), federal tax law places important restrictions on the types of shareholders that a Subchapter S corporation may have. If the shareholders are considering an election to be treated as an S corporation for federal tax purposes, the owners should consider restricting the transfer of shares in the corporate bylaws or through shareholder agreements.

(g) Privacy

A corporation's articles of incorporation and annual reports are filed with the state and can generally be viewed by third parties. The corporation's bylaws, minutes, resolutions, and other books and records are not publicly accessible, but may be obtained and reviewed by shareholders of the corporation in some circumstances.

(h) Transition to Other Entity Form

In some circumstances, a corporation may be converted to another form of entity through a cross-entity merger or reorganization. As a general rule, though, it is easier to convert *to* a corporation from a noncorporate entity (such as a limited liability company or partnership) than *from* a corporation to a noncorporate entity.

Section 1.03 Limited Liability Company

(a) Formation

A limited liability company (LLC) is recognized as a legal entity separate from its owner for state-law purposes. To form an LLC, the owner (or owners) must file documents with the state. The documents usually include, at a minimum, a certificate of formation (also called articles of organization). The owner should also adopt an operating agreement to govern the affairs of the LLC.

***Important Note*:** Although a single-member LLC (SMLLC) is recognized as a legal entity separate from its owner for state law purposes, it may be treated as a disregarded entity for federal tax purposes.

(b) Capitalization and Contributions

An LLC is initially capitalized by transferring property to the LLC in exchange for a membership interest in the LLC. An LLC can have different classes of membership interests, each with its own right to voting and distributions.

(c) Owner Liability for Entity Obligations

Members of an LLC are generally protected from liability for the LLC's obligations. The LLC is treated as a separate entity and is solely responsible for its own debts and obligations. But this veil of protection may be pierced if, for example, the members commingle personal and company funds, engage in fraudulent behavior, or inadequately capitalize the LLC to the detriment of creditors. Members are also personally liable for any loans or other obligations that they personally guarantee.

(d) Protection of Entity Assets from Owner's Personal Creditors

State law typically permits creditors of a member to obtain a charging order against that member's LLC membership interest. A charging order, which is issued by the court, directs that distributions of income or profits that would otherwise be paid to the debtor-member should instead be paid to the creditor.

In most states, a charging order confers only the right to receive distributions. It does not give the creditor the right to vote or otherwise participate in the LLC's management. As a result, the creditor cannot force the LLC to make distributions. If the LLC makes no distributions, the creditor receives no payments. This makes the charging order an unattractive remedy for creditors.

In almost half of the states, the charging order is the only remedy to creditors of the LLC. This means that, as a general rule, LLCs generally offer a higher degree of protection of company assets from an owner's personal creditors.

Important Note: It is important to understand the rationale for charging-order protection. Charging orders are intended to protect the other owners of the business from loss due to a single owner's personal debts. Recognizing that this rationale might not apply when there is only one owner, some bankruptcy courts have set aside charging-order protection in situations where the company had only one owner. *See In re Albright,* 291 B.R. 538 (Bankr. D. Colo. 2003); *In re Modanlo*, 412 B.R. 715 (D. Md. 2006). If protection of entity assets from an owner's personal creditors is important, consider a multiple-member LLC.

(e) Control

Control of an LLC is determined primarily by its certificate of formation (also known as articles of organization) and operating agreement, as well as any agreements between the members. State law provides a default system of rules that apply in situations that are not governed by these organizational documents.

State law generally allows for two types of limited liability companies. A *member-managed LLC* is managed by the members as a whole. Each member has the right to act on behalf of the company and most company affairs are decided by vote of the members. In contrast, a *manager-managed LLC* is managed by one or more designated managers; these managers may or may not be members. The non-managing members are treated like passive investors in the company, with either limited rights or no rights to manage the day-to-day affairs. Some states require the type of LLC to be selected on the formation documents.

While the laws of most states have similar provisions regarding control of the LLC, there are some state-by-state variations that should be considered.

(f) Continuity, Transferability, and Dissolution

In some states, limited liability companies exist until they are affirmatively dissolved by the members, either by unanimous or majority consent. Other states treat withdrawal of a member as an event that triggers an automatic dissolution, even if the remaining members agree to continue to operate the company.

Members are generally free to transfer their membership interests unless restricted by the formation documents or by agreement between the members. State law may prohibit an absolute restriction on transferability.

Important Note: Unlike an entity classified as a Subchapter S corporation, ownership of an LLC is generally not restricted to specific classes of members. A corporation or other business entity *can* serve as an owner of an LLC. This makes an LLC the preferred form of entity for businesses with corporate owners that are seeking to avoid double taxation. See the Choice-of-Entity Decision Guide (Tax Considerations) for more information.

(g) Privacy

An LLC's formation documents and annual reports are filed with the state and can generally be viewed by third parties. The LLC's operating agreement, minutes, resolutions, and other books and records are not publicly accessible, but may be obtained and reviewed by members of the LLC in some circumstances.

(h) Transition to Other Entity Form

In some circumstances, an LLC may be converted to another form of entity. This could involve a distribution of assets to the members followed by a contribution of those assets to the new form of entity, or through some other form of cross- entity merger or reorganization. More and more states offer statutory conversions from another form of entity to an LLC.

Section 1.04 Partnership

(a) Formation

A partnership is recognized as a legal entity separate from its owner for state-law purposes. There are several different types of partnerships, including:

> **General Partnership** – A partnership with only general partners. Each general partner takes part in the management of the partnership and is personally liable for obligations of the partnership.
>
> **Limited Partnership** – A partnership with both general and limited partners. General partners manage the partnership and are personally liable for partnership obligations. Limited partners do not participate in the day-to-day management of the partnership and are not personally liable for partnership obligations.
>
> **Limited Liability Partnership** – A limited liability partnership is a hybrid form of partnership in which each partner can participate in the day-to-day management of the partnership, but without personal liability. It is similar to an LLC.

Partnerships are formed by agreement between the partners. General partnerships can often be formed without any need to file documents with the state. Limited partnerships and limited liability partnerships usually require a certificate of partnership to be filed with the state.

(b) Capitalization and Contributions

A partnership is initially capitalized by transferring property to the partnership in exchange for a partnership interest in the partnership. A limited liability partnership can have different classes of partnership interests, each with their own right to voting and distributions and level of liability for obligations of the partnership.

(c) Owner Liability for Entity Obligations

The liability of partners for obligations of the partnership depends on the type of partnership.

> **General Partnership** – The general partners are personally liable for the debts and obligations of the partnership, including debts incurred by their partners. Because of this broad liability, general partnerships are usually a poor choice of business entity.
>
> **Limited Partnership** – The general partners are personally liable for the debts and obligations of the partnership, but the limited partners are not.
>
> **Limited Liability Partnership** – No partners are personally liable for the debts and obligations of the partnership (similar to a LLC).
>
> ***Important Note*:** By using a corporation or LLC to serve as general partner, a limited partnership can approximate the liability protection offered by a limited liability partnership or LLC. As with other forms of business entities, limited partners are personally liable for any loans or other obligations that they personally guarantee.

(d) Protection of Entity Assets from Owner's Personal Creditors

State law typically permits creditors of a partner to obtain a charging order against that partner's partnership interest. A charging order, which is issued by the court, directs that distributions of income or profits that would otherwise be paid to the debtor-partner instead be paid to the creditor.

In most states, a charging order confers only the right to receive distributions. It does not give the creditor the right to vote or otherwise participate in the partnership's management. As a result, the creditor cannot force the company to make distributions. If the company makes no distributions, the creditor receives no payments. This makes the charging order an unattractive remedy for creditors. In many states, the charging order is the only remedy to partnership creditors.

(e) Control

Control of a partnership depends on the partnership agreement, the type of partnership involved, and state law. Control of a general or limited partnership is vested in the general partners, and each has the right to act on behalf of the partnership. Control of a limited liability partnership is determined by the partnership agreement. While the laws of most states have similar provisions regarding control of the partnership, there are some state-by-state variations that should be considered.

(f) Continuity, Transferability, and Dissolution

General partnerships are usually dissolved by the death or withdrawal of one of the partners unless the parties have agreed to continue the partnership business. The continuity of a limited partnership or limited liability partnership depends on the provisions of the partnership agreement.

Most states allow a limited partner to transfer a limited partnership interest without triggering dissolution. But the withdrawal of a general partner from a limited partnership will cause dissolution unless there is a continuing general partner or the remaining partners agree in writing to continue the business and, if necessary, elect a new general partner.

Partners are generally free to transfer their partnership interests unless restricted by the partnership agreement or other agreement between the partners. Transfer of a partnership interest usually requires consent of the remaining partners. State law may prohibit an absolute restriction on transferability.

(g) Privacy

A partnership's partnership agreement, books, and records are not publicly accessible, but a certificate of formation and other reports filed with the state can generally be viewed by third parties.

(h) Transition to Other Entity Form

In some circumstances, a partnership may be converted to another form of entity. This could involve a distribution of assets to the partners followed by a contribution of those assets to the new form of entity, or through some other form of cross-entity merger or reorganization.