183 State Street, Floor 2
Boston, MA 02109

(617) 752-2371 (Main)
(617) 934-4310 (Fax)

www.tempusfugitlaw.com

ISSUES TO CONSIDER IN CHOOSING A BUSINESS ENTITY

- One member or multiple partners?
- Flexibility in daily operations of the company.
- Voting and managerial rights of the partners.
- Protection of organizers' personal assets from business liability.
- Need to raise capital.
- Taxation.

SOLE PROPRIETORSHIP

Overview

- Business activities are not separated from the individual owner.
- Best suited for single-owner business that does not have tax concerns and for which potential product and/or service liabilities are minimal.

Pros

- An owner has sole control over the business.
- Simple and inexpensive to create and operate.
- The company is disregarded as an entity for taxation purposes. The income, deductions, and expenses are paid by the owner. S/he reports these on his/her personal income tax return.

Cons

- Owner has unlimited personal liability for business activities and the creditors can go after the owner's personal assets in order to satisfy the debt.
- Access to capital and other business resources is limited by owner's assets or ability to get loans.
- The business operations are wholly dependent upon the owner's performance. This is risky in the case of the owner's illness or other inability to continue working.

GENERAL PARTNERSHIP

Overview

- The company is not separated from its owners and the partners are personally liable for the business activities.
- Best suited when there are multiple owners and all of them are going to manage the company and potential product, and/or service liabilities are minimal for the business.

Pros

- Simple and inexpensive to create and operate.
- The company does not pay taxes. Income, deductions, and credits pass through to each partner in portions set forth in a partnership agreement, and then each partner pays applicable taxes on his/her personal income.

Cons

- Partners are personally liable for business debts and lawsuits, including (most importantly) the actions of other partners.
- It is hard to remove and/or change partners without dissolving the partnership and reforming, unless it is otherwise specified in a formal agreement. The entire business venture dissolves upon separation of a single partner, making it difficult to deal with an uncooperative partner.

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LIMITED PARTNERSHIP

<u>Overview</u>

- Has two or more owners, at least one of whom is a general partner and one is a limited partner. The company is a separate legal entity from its owners.
- Best suited for two or more owners, at least one of whom seeks a passive investment with no participation in daily management of the company.

<u>Pros</u>

- The company does not pay taxes. The taxes are reported and paid by each partner separately on his/her personal income statement.
- Liability of a limited partner can be limited to the extent of his/her investment to the company. His/her personal assets not invested in the company are safe.
- Limited partners do not participate in the management.

<u>Cons</u>

- General partners are personally liable for business debts and lawsuits, including the actions of other partners.
- It is hard to remove general partners without dissolving the partnership, unless it was otherwise agreed upon and formally documented. This makes the partners dependent on each other's cooperation.

LIMITED LIABILITY COMPANY

<u>Overview</u>

- Business is a separate legal entity from its owners.
- Best suited for single- or multiple-owner company needing liability protection and single-level taxation.

<u>Pros</u>

- Liability is limited to the extent of the owner's investment. His/her personal assets are protected.
- Profits and losses may be allocated differently than owners' contributions upon an agreement between them.
- Capital can be raised through the sale of company interest.
- The entity does not pay taxes. The income, deductions, and credits are applied to the members in portions set forth in an LLC agreement and the members report these on their personal income tax returns. The members, however, are taxed on allocations, not distributions of the profits, meaning they owe taxes even if they decided to reinvest the profits rather than take it for themselves.
- No strict formalities like those of a corporation, though certain procedures should be followed to ensure optimal results for the LLC and its members. (See below for LLC formalities.)

<u>Cons</u>

- Raising capital can be difficult. The sale of membership interests in an LLC can create concerns and challenges for investors because not everyone wants to become an LLC member.

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LLC "Formalities"

While a "formal" set of rules is not a requirement outlined by any state for an LLC, the concerned and astute business man or LLC member will understand that there are LLC formalities to be followed and adhered to in order to fully enjoy the benefits afforded by the LLC.

- Having a well written Operating Agreement in place, with well-defined roles for members, well outlined distribution guidelines, and operational and taxation rules.
- Adequate records for all transactions and business engagements, as well as properly written minutes of meetings (at least one state, Tennessee, requires an annual meeting of the members). List of members, past and present, articles of organization, tax returns for the past three years, bank statements, resolutions authorizing activities that, either by law or under the terms of the operating agreement, require a vote of the members, etc. Are all examples of the types of records and written agreements that should be properly maintained by the LLC
- Adequate capitalization for the company and maintaining proper operating capital

These are but a few, though vital, suggestions of formalities that should be observed. Other actions, or lack thereof, that could lead to the piercing of the LLC veil include:

- Actions not covered in the Operating Agreement of an LLC--this is tantamount to disregarding the LLC formalities. Although an LLC is technically not required to observe formalities in the same manner that a corporation is, its actions should be completely guided by the operating agreement, and this agreement is taken into consideration by the courts and tax authorities when a determination is made as to the operation of the LLC.
- Deficient or inadequate capitalization is another important deficiency that a court or tax regulator will examine when determining the intent of the LLC and its member's and will usually factor heavily in their decision to pierce the veil. It is important that an LLC be properly capitalized and funded, and that the members manage the funds properly in order to run business properly. Siphoning too many assets or capital and leaving too little in the coffers to satisfy creditors or company operations may lead to a veil-piercing determination.
- Co-mingling of funds is a bad idea in any form of corporation or LLC. Any sense of co-mingling of funds or accounts will almost certainly lead to an "alter-ego" determination by the courts or a tax regulatory board and will lead once again to veil piercing--thereby risking personal assets and stripping members of the liability and asset protection. It is a best-practices act to make certain that separate accounts are maintained and monitored.
- The amount of discretion shown by the members should be metered to ensure that all actions are deemed to be in the best interest of the LLC or the business. Personal agenda's should come secondary to the LLC as a whole, lest it be determined that it was formed for an express personal agenda and not a business goal.
- The LLC should never be treated as an extended personal account of its owners or members. The courts and tax regulatory boards regularly examine the financial dealings and workings of an LLC to determine whether it is a working business or an independent profit center for its owners or members. If it is deemed an independent profit center, the veil could be pierced and there can be tax penalties and liabilities against the owner or members personally.

An LLC should pay and guarantee its own debts, unless specifically outlined in the operating agreement for specific requirements for such things as the rental or leasing of real property, etc. At times, if an owner or member regularly guarantees or pays debts, he will have been shown to act as an alter ego of the LLC and hence will cause that LLC to lose its separate entity status. Owners

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should not pay or guarantee the debts of their own LLC unless it is specifically outlined in the operating agreement for specified purposes.

Other uses of LLCs

- *Holding personal real estate*. Mixing business and personal assets into a single entity exposes personal assets to the judgment creditors of the business. Ideally, individualized LLCs should be used for holding particular assets. The LLC, therefore, can act as a shield entity with ease of management and restrictive rights of future creditors. Whenever feasible, separate LLCs should be used with each piece of investment property. This usually insulates assets and prevents cross-liability, keeping all of the eggs out of one basket.
- *Holding business real estate*. The operations of an active business should be owned separately from the real estate upon which the business operates. If, for example, a restaurant patron suffers damages resulting from food poisoning and wins damages in a lawsuit not covered by insurance, he becomes a judgment creditor. If separate LLCs are used for the business operations and the real estate, the judgment creditor may only be entitled to a judgment lien against the operational business, not the real estate. To best protect the owner's assets in this scenario, the operating entity should lease the real estate from a separate entity whose sole purpose is to own the real estate. From apartment buildings to office buildings to strip malls, LLCs are often used in major real estate deals.
- *Financing through an LLC*. Frequently, real estate investors use a single member single purpose LLC to hold property. Often securitized loans require specialized LLC operating agreements for financing at the best rates to allow the loan to be bundled into a fund that is traded on the stock market.
- *Holding tangible personal property*. "Hotter" assets, such as boats and planes, are more prone to accidents and the resulting liability than relatively passive real estate. While this does not shield the individual operator for liability from his own personal acts/omissions, it does provide a level of protection stemming from problems with the vessel. In that case, personal liability will be shielded by the liability of the LLC, the holding entity. For these reasons, it is wise to title a "hot" asset, like a boat or plane, in an individual's name.
- *Holding intangible assets*. It is very common to hold intellectual property, such as patents, trademarks, and copyrights with an LLC. These sometimes avoid tangible or intangible property taxes in other states. Additionally, people often hold domain names and online assets in the name of an LLC. The rights are then licensed from these holding entities to the operating entities.

CORPORATION

Overview

- Business is a separate legal entity from its owners, who are the shareholders.
- Best suited for single- or multiple-owner business seeking both limited liability and established procedures for management and funding.

Pros

- Limited owner liability for business debts and lawsuits (owners are only liable in certain situations when owner's activities are egregious). Liabilities are limited by the company's assets and the shareholders' personal assets are protected.
- Capital can be raised through the sale of stock rather than looking for a bank or personal loans.

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- Tax deductible fringe benefits, including health insurance and retirement plans.

Cons

- Many administrative formalities in managing the company (for example, mandatory shareholder and director meetings, documentation of every major decision, and maintenance of records).
- Double taxation. A corporation pays taxes on earnings as an entity, and then shareholders pay personal income tax on any distributions (dividends) to them from the company.

S CORPORATION

Overview

- Usually a closely-held company.
- Best suited for small or family businesses seeking to avoid double-taxation imposed on a corporate entity.
- S corporations preserve limited liability and have established procedures for business operations and funding.

Pros

- All of the advantages of a regular corporation, plus:
- Only one level of taxation. The company does not pay taxes on income; only shareholders pay personal taxes, but they do owe taxes on business income even if the profits are not distributed to them and are instead reinvested in the company.

Cons

- S corporations may not have more than a statutorily determined number of shareholders (MA = 75), all of whom must be U.S. citizens or permanent resident aliens.
- Shares cannot be publicly traded.
- Stock is limited to one class.
- Generally, another corporation, LLC, or partnership cannot be a shareholder.
- Administrative duties may be expensive and complex for small business owners to set up, operate, and dismantle the company.

NOT-FOR-PROFIT CORPORATION

Overview

- Managed by a board of directors, trustees, and/or employees. No shareholders or investors. A not-for-profit corporation has a public purpose and all income and profit is permanently dedicated to that purpose and may not be shared with private persons.
- Best suited for a business organized for charitable, educational, artistic, scientific, or religious purposes.

Pros

- Corporation does not pay income tax.
- Donations made to a s. 501(c)(3) not-for-profit corporation are tax deductible for the donor.
- Tax deductible fringe benefits, including health insurance and retirement plans.
- Sales and property tax exemptions may be available.

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- Managers' liability for business obligations is limited – lawsuits are brought against the company rather than the individuals.

Cons

- Any profit which a not-for-profit corporation earns on the products/services it provides or on the investments it makes must be applied to the operation of the corporation and cannot be distributed to its members, officers, or directors.
- Expensive and difficult to create. Many additional filings with the IRS are required to obtain a tax exempt status.
- Administrative duties may be complex to set up, operate, and dismantle the company.
- No shareholders. Corporate assets are deemed to be owned by the public (upon dissolution of corporation, its property must be transferred to another not-for-profit corporation or to the state).