


What is the right
business entity
for me?






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Many new ventures start out as sole proprietorships or partnerships, but often convert to other entities as business matures. Although it is imperative to *consult with an attorney and a tax advisor* regarding the appropriate selection of an entity, answers to some preliminary questions can be found here...

What are the choices?

Entrepreneurs may choose from a myriad of entities, including:

- Sole Proprietorship
- Partnership (either General or Limited)
- Corporation (either C or S)
- Limited Liability Companies


Other choices abound, depending upon the locale in which the business will be operated.


Why is this important?

While a business structure may be dictated by law or practicalities, the decision to elect one type of entity over another hinges primarily upon tax and legal consequences. An improper selection may have unintended results and unacceptable costs.

Can the choice be changed?

Election of a particular entity must be made at the outset but may be changed later. The transition from one type of entity to another may occur as a matter of course, such as when a sole proprietor invites another





individual to join in the venture, or by deliberate election when operations, tax considerations, and legal implications mandate.

What are the basic characteristics of each entity?

Sole Proprietorship


Available only to an individual who seeks to operate independently and exercise exclusive control of the business, a sole proprietorship is the simplest, most cost-effective, and least regulated entity.

If the business will be operated under a name other than the owner's name, a Fictitious Business Name Statement (DBA) must be filed with the County Clerk or Recorder where the principal place of business is located. If the principal place of business is located outside of California (CA), the statement must be filed with the Sacramento County Clerk-Recorder.

Although no documents are required to be filed with the Secretary of State (SOS) to establish a sole proprietorship, other state filings may be required depending on the type of business.

Partnership

Defined as an association of two or more individuals, a partnership may be created formally by written agreement or informally by mutual cooperation. In either case, the partners agree to furnish capital and/or labor in exchange for a negotiated share of the ensuing profits and losses. Each partner may independently hire employees, borrow money, and enter into contractual agreements, thereby binding all partners to these obligations.





Corporation


A corporation must seek approval of its charter from the Department of Corporations in the state in which it will be domiciled. Domestic corporations operate inside the state in which they are incorporated; while foreign corporations operate out-of-state. For example, Apple Computer is domiciled and incorporated in CA where it is considered to be a domestic corporation; but Apple also does business in 49 other states where it is considered to be a foreign corporation.


A corporation is owned by its stockholders who have contributed capital in exchange for pro-rata shares of the company and voting rights. Typically management is separate from ownership, although some shareholders may be appointed as directors or employed in administrative capacity. To minimize potential conflicts of interest, most publicly traded corporations are required to appoint outside directors who are unaffiliated with the company.

A closely-held corporation, on the other hand, is one in which ownership shares and voting rights are held by the same individual(s).

How does a corporation differ from other entities?

Created as a distinct legal entity, a corporation is taxed independently of its owners. Earned income is reported on a corporate tax return (Form 1120) and taxed under rules and rates different from those applied to individuals. Distributions to the shareholders in the form of dividends are later taxed to the recipients; thus, some corporate earnings are taxed twice—once at the corporate level and then again at the individual level.





Conversely, a partnership is considered to be a pass-through entity. Although a partnership tax return (Form 1065) must be filed annually, income and expenses are reported for informational purposes only and then “passed-through” to the partners using Schedule K-1s. The allocated amounts are reported on each individual’s personal tax return (Form 1040) and taxed according to the rules and rates applicable to single or married individuals.

Partnerships are but one type of pass-through entity; others include, but are not limited to Limited Liability Companies discussed later.


What are the legal distinctions between the various entities?


Generally, the owners of sole proprietorships and partnerships are fully liable for any acts connected to business operations. In many cases, liability may extend to an owner’s personal assets.

On the other hand, a corporate shareholder’s liability is usually limited to his investment in the company. However, if the shareholder participates in the control of the business, the corporate veil may be pierced and creditors may be allowed to seize personal property.

What are typical liability concerns?

An owner is always liable for his own wrongful acts. However, an owner may also be held strictly liable for product failures or be held accountable for the acts of a partner, an employee, or even an independent contractor engaged by the firm. Exposure may result from





many situations; for instance, if a hired individual is involved in a car accident or files suit for sexual harassment, personal injury, or wrongful discharge.


While many hazards may be insurable, others could expose the owner to financial loss. It is best to consult with a reputable insurance broker regarding available policies, coverage limitations, affordable premiums, and cost-saving deductibles.


Can insurance be used to minimize liability exposure?

In today's litigious society, it is not uncommon that an owner may be held legally responsible. Much will depend upon the probability that the inopportune will occur and whether insurance can mitigate the owner's financial exposure. If insufficiently protected, personal assets may be vulnerable. An owner with a relatively low personal net worth may have little at stake, while a wealthy individual may risk losing assets and future earnings.

Which type of business entity offers the best protection?

Generally, partners are jointly and severally liable for all obligations of a partnership and are individually and collectively responsible for the wrongful acts and omissions of their partners. However, liability may be limited when forming a **Limited Partnership**, wherein one individual is named as the General Partner (GP) and is exclusively responsible for management of the business. Although the GP retains full liability, the remaining partners enjoy limited liability in exchange for lim-






ited control and participation in the enterprise. Typically, these limited partners are investors who have helped to fund the venture, but who otherwise remain silent.


CA Limited Partnerships must file a registration statement with the SOS.

While corporate shareholders are shielded from personal liability, the corporation itself may be held accountable. Much like a natural person, a **C-Corporation** can hold property and commit crimes for which it may be fined or its directors imprisoned; whereas shareholders are protected from personal liability as long as they do not participate actively in the business.

Certain corporations may elect Subchapter S status and obtain the liability benefits of a C-Corporation, but the favorable tax treatment of a partnership. Presuming that the company has fewer than 75 shareholders and only one class of stock, it may make an affirmative election in a timely manner to become an **S-Corporation**. Form 2553 must be filed with the IRS no later than the 15th of the third month of the tax year to which the election is to apply. However, its status may be inadvertently terminated if the qualification criteria are not met on an ongoing basis. Effective January 2002, corporations which have received federal S-status are automatically considered S-Corporations in CA as well.

Similarly, members of a **Limited Liability Company (LLC)** enjoy limited exposure. Although treated as a pass-through entity for tax purposes, the LLC is a separate legal entity created upon filing of its Articles of





Organization with the SOS in the state of domicile. Additionally, an Operating Agreement between the members regarding the LLC's business affairs is required.

As a rule, an LLC must have more than two members, but CA has permitted the single-member LLC (SMLLC) since January 2000. This entity offers its owners limited liability, but is “disregarded” for tax purposes and is treated as a sole proprietorship.


Since the LLC is unavailable to professionals required to be licensed under the CA Business and Professions Code, the **Limited Liability Partnership (LLP)** may provide an attractive alternative. Here again, a separate entity is created to absorb most of the liability and shelter the personal assets of its partners. Available in CA to accountants, attorneys, and architects since 1995, the LLP is a pass-through entity which avoids the double taxation suffered by corporations.


Are there restrictions specifically applicable to licensed professionals?

Generally, licensed professionals cannot form partnerships with non-licensed individuals. Furthermore, many regulatory authorities and licensing boards may require minimum guarantees or insurance coverages against claims of patients and clients.

How may the corporate veil be pierced?

To avoid a potential loss of the limited liability afforded by corporations, shareholders must be careful to adhere to requisite procedures, including but not limited to the following:




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- Prepare formal minutes of regularly-held meetings (not required for an LLC if abolished by its Operating Agreement).
 - Sign all documents as “officers” or “members”, rather than as “owners” or “partners.”
 - Never commingle business and personal assets and carefully document all related party transactions.
 - Show the corporate name on all stationery, business cards, correspondence, and invoices.

Should I incorporate in Nevada or Delaware?

In the past, it may have been advantageous to incorporate in one of these tax-favored states. Today, however, it is usually best to incorporate in the state in which the company is operated or where the bulk of the business will be conducted, since this state will seek to collect taxes regardless of the company’s domicile.

Nevertheless, incorporating in either Delaware (DE) or Nevada (NV) may offer the following advantages:

- The cost of incorporation is extremely low and the process can be completed on the telephone in only five (5) minutes.
 - Directors are afforded complete anonymity in DE, while stockholders (including out-of-state residents) are not disclosed in NV.
 - There are no minimum capital requirements.
 - DE does not impose an income tax on corporations that operate out-of-state and NV does not assess a tax on corporate profits.
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What about non-profit organizations?

A non-profit corporation enjoys limited liability and continuity of life, unavailable to associations and trusts. To avoid the potential loss of its tax-exempt status, the non-profit entity should minimize activities that may generate substantial unrelated business income from activities that are not associated with the organization's charitable purpose. These activities should be isolated and conducted by a separate entity, if possible.

To obtain tax-exempt status in CA, the proposed Articles of Incorporation and a \$30 filing fee must be mailed to the SOS at 1500 11th Street, Sacramento, CA 95814.

All corporations and unincorporated associations, even if organized on a non-profit basis, are subject to CA franchise or income tax—the federal exemption does not automatically constitute an exemption from CA tax. To obtain tax-exempt status from CA, all of the following items must be sent to the Franchise Tax Board (FTB) at P.O. Box 942857, Sacramento, CA 94257:

- An Exemption Application (form FTB 3500).
 - The \$25 Exemption Application fee.
 - Copies of the Articles of Incorporation, the proposed bylaws, the proposed budget, and all supporting documentation.
 - A copy of the federal determination letter granting tax-exempt status, if available. For additional information, order IRS Publication 557: Tax-Exempt Status for Your Organization.
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Non-profit organizations with gross receipts in excess of \$25,000 must file an annual informational return (Form 990) with the IRS by the 15th of the fifth month after the close of the tax year.

What steps must be taken to incorporate in CA?

Entrepreneurs electing to incorporate may engage an attorney or a professional incorporation company, or file all requisite documents in person with the SOS. Domestic corporations must file a Statement of Information within 90 days after filing its Articles of Incorporation and annually thereafter. The cost is \$25 per year. The penalty for failure to file in a timely manner is \$250.


The bylaws of the corporation, as well as the minutes of directors' and shareholders' meetings must be kept in the principal business office.


How are corporations taxed?

The Internal Revenue Service (IRS) applies a graduated tax from 15 to 38% to corporate net income.

CA imposes a franchise (or income) tax on both domestic and foreign corporations for the privilege of doing business in the state. The rate for C-Corporations is 8.84%; the rate for S-Corporations is 1.5%.

CA also imposes a minimum franchise tax of \$800, which is due the first quarter of the tax year whether the corporation is active, operates at a loss, or does not do any business. New corporations that incorporate after January 2000 are exempt from the minimum tax and must merely pay a percentage of earned income;





in subsequent years, at least \$800 is due. S-Corporations, LLCs, LLPs, and LPs are also subject to the minimum tax.

How do I dissolve or withdraw my corporation?


Pursuant to a plan of liquidation adopted by the directors and shareholders, the corporation must notify the IRS of its intent to dissolve using Form 966. All final tax returns must be submitted within 2 months and 15 days after the end of the month in which the dissolution occurs. All outstanding stock certificates should be canceled.


Dissolution documents must also be filed with the SOS in compliance with the CA Corporations Code. A Tax Clearance Certificate must be obtained from the FTB by submitting form FTB 3555 and furnishing an individual, corporation, trust, LLC, or LLP to assume the tax liabilities of the corporation. A cash bond may be posted instead or certification may be requested on the basis that all requisite reporting forms have been filed and all taxes have been paid.

To surrender a foreign corporation's right to transact business in CA, the corporation must file a Certificate of Surrender with the SOS and satisfy the tax clearance requirements of the FTB.

Simplified Dissolution

Effective January 2003, the directors of a newly formed corporation that has not yet issued shares may dissolve by filing a Certificate of Dissolution and including a statement that:

- The Certificate is being filed within 12 months
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from the date of incorporation.

- The corporation has not issued any shares or has returned payment for previously issued shares to the investors.
- The corporation does not have any liabilities and that any tax liability has been paid or assumed.
- The corporation has filed its final tax return.
- The corporation has not conducted any business since its incorporation.
- The corporation's net assets have been distributed to the entitled persons.
- The dissolution is authorized by the directors of the corporation.
- The corporation is dissolved.

Upon receipt of this information, the SOS will file a Certificate of Dissolution without a Tax Clearance Certificate and will notify the FTB. The corporation may avoid any potential tax liability by electing a tax year that allows for the dissolution within the first year, rather than automatically assuming a calendar year.

Owners should consult with an insurance broker to cover potential claims for products liability, environmental hazards, errors and omissions which may be filed against the company after dissolution.

Additional References

- 1) IRS Publication 334: Tax Guide for Small Business
 - 2) IRS Publication 583: Starting a Business and Keeping Records
 - 3) FTB Publication 1060: Guide for Corporations Starting Business in CA
 - 4) FTB Publication 1083: Frequently Asked Questions
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5) Small Business Administration website at:
www.sbaonline.sba.gov

Abbreviations Used in this Text

Alternative Minimum Tax	AMT
CA	CA
Delaware	DE
Doing Business As (Fictitious Business Name)	DBA
Employment Development Department	EDD
Federal	F
Franchise Tax Board	FTB
General Partner	GP
Internal Revenue Service	IRS
Limited Liability Company	LLC
Limited Liability Partnership	LLP
Limited Partner	LP
Nevada	NV
Secretary of State	SOS
Single-Member Limited Liability Company	SMLLC
Social Security Number	SSN
Taxpayer Identification Number	TIN

	Sole Prop.	Partnership	C-Corp.	S-Corp.	LLC	LLP
Owner's Title	Owner	Partner	Shareholder	Shareholder	Member	Partner
Number of Participants	One	2 or more	1 or more	1 to 75	2 or more "Disregarded Entity" if only 1 member (taxed as sole prop.)	2 or more
Ownership Restrictions?	None	None	None	Yes (No affiliated corp. or non-res. aliens)	None	None
Available to licensed professionals?	Yes	GP—Yes LP—No	Yes	Yes	No	Yes
Cost & Difficulty to Form Entity	Low	Low	Moderate	High	High	Low
Easy to admit new owners?	N/A	Yes	Yes	No	Yes	Yes
Class of Stock	N/A	N/A	Multiple	Single	N/A	N/A
Convertible to another entity?	Yes	Convertible to all, but easiest to LLP	No	Convertible to C-Corp., but not LLC	Yes	Yes
Election req'd?	No	No	No	Yes	No	No

	Sole Prop.	Partnership	C-Corp.	S-Corp.	LLC	LLP
Taxpayer ID	SSN	TIN	TIN	TIN	TIN	TIN
Pass-through entity?	N/A	Yes	No	Yes	Yes	Yes
Fed. Tax Form CA Tax Form	1040 540	1065 565	1120 100	1120S 100S	1065 568	1065 565
Tax Year	Calendar	Calendar	Fiscal	Calendar Unless required for business purpose	Calendar	Calendar
Filing Deadline	April 15 th	April 15 th	15 th of 3 rd month	15 th of 3 rd month	April 15 th	April 15 th
Subj. to passive activity rules?	No	GP—No LP—Yes	No	Yes	Yes	Yes
Minimum Fran- chise Tax	None	GP—No LP—\$800	\$800	\$800	\$800	\$800
Gross Receipts Tax	No	No	No	No	Yes	No
Approx. Tax on \$5M earnings (2003 rates)	F: \$1.73M CA: \$463K	Taxed to Partner (see Sole Prop.)	F: \$1.7M CA: \$442K	F: Taxed to S/H CA: \$75K	F: Taxed to Member CA: \$11,790	Taxed to Partner (see Sole Prop.)
Self-emplmnt. Tax	Yes	GP—Yes LP—No	No	No if sufficient compensa- tion paid to owner	No Only if member is inactive	Yes

	Sole Prop.	Partnership	C-Corp.	S-Corp.	LLC	LLP
Subject to corp. AMT (20%)?	N/A	N/A	Yes	No	No	N/A
Cash method allowed?	Yes	Yes	No Unless personal service corp. or gross receipts < \$5M	Yes	Yes	Yes
Pro-rata distributions required?	N/A	No	Yes	Yes	Yes	No
ISOs allowed?	N/A	N/A	Yes	Yes	No	N/A
Limited liability?	No	GP—No LP—Yes	Yes	Yes	Yes	Yes
Most suitable for?	Consultant to another firm able to absorb liability Owner who is judgment-proof Entrepreneur seeking to establish cheaply	Real Estate LP Family LP	Most flexible entity Allows for eventual public offering	Use if losses are anticipated Use if future sale of corp. assets is expected	Any firm that seeks limited liability & favorable tax treatment	Licensed professionals

“Starting a Business” Checklist

*This list is provided to help you to start your business. Due to legislative changes that occur frequently, some of these steps may not apply to your business; while others that are required may not be covered here. **Please consult your attorney and accountant.***

- ☐ Develop a business concept, research the idea, and write a business plan.
- ☐ Select a business name and reserve it as a domain name, if available.
- ☐ Choose a location for the business and check local zoning laws with the city's planning commission.
- ☐ Contact the statewide **Chamber of Commerce** at (800) 331-8877 for local area information and referrals to other agencies.
- ☐ Check with the **Department of Consumer Affairs** at (800) 952-5210 to obtain required business licenses or permits.
- ☐ Publish required notices of business intent in the community.
- ☐ Identify the risks and liabilities that may be reasonably encountered and determine whether they may be affordably insured.
- ☐ File Partnership, Corporation, or LLC papers with the **Secretary of State** at (916) 653-6814.
- ☐ File Form SS-4 to obtain an Employer Identification Number from the **Internal Revenue Service (IRS)** at (800) 829-4933.
- ☐ Obtain an Employer Identification Number if you will have employees and discuss workers' compensation requirements with the **Employment Development Department (EDD)** at (888) 745-3886.
- ☐ Apply for a seller's permit with the **State Board of Equalization** at (800) 400-7115, if you plan to sell tangible personal property such as furniture, clothing, cars, etc. and see if you must pay any special taxes or fees.
- ☐ Register or reserve federal trademark, copyrights, and/or patents.
- ☐ Open a business bank account and arrange to accept credit card payments from customers.
- ☐ Prepare sales literature and place an advertisement in the local Yellow Pages. Distribute business cards at every opportunity.
- ☐ Establish an accurate recordkeeping system and do not commingle personal and business assets.
- ☐ File all required tax returns in a timely manner.



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