

## Choosing A Form Of Business Entity For Your New Company

When starting a new business, one of the first questions you, and your partners, will ask yourselves is the following: Given my business objectives what is the best form of business entity to create to operate my new venture? The key questions that must be asked by the attorney, and answered by the entrepreneur, are divided into tax and non-tax matters. This handout outlines the non-tax factors you should consider. A future handout will discuss the tax factors you should consider when establishing a new business entity.

### 1. Sole Proprietorship.

**A. Definition.** A natural person who directly owns the business and is directly responsible for all of the debts and liabilities. The simplest form of entity to conduct business accompanied by the greatest risks. Not a separate legal entity.

**B. Profits and Losses.** All the profits belong to the business owner and all the losses do too. An owner who uses this form puts his or her entire personal assets and wealth at risk in a proprietorship. If the owner is married, he or she puts the community property at risk as well.

**C. Management.** Owner has total management authority, but may act through agents. The actions of these agents can increase the risk of the owner incurring personal liability for those actions.

**D. Formalities.** No formalities are required to engage in business as a sole proprietor, other than complying with applicable licensing requirements.

**E. Duration.** The owner can sell the business as he or she chooses. Its duration is limited only by the owner's willingness or ability to stay in business.

### 2. General Partnership.

**A. Definition.** A general partnership is a form of business entity in which two or more co-owners engage in business for profit. Not a separate legal entity. No special formalities are required to form a general partnership and no written agreement is required. So long as two or more persons jointly agree to carry on a business for profit, they are general partners even if they have no intent to be general partners or have not reached agreement on how to share profits or losses or otherwise manage the business.

**B. Ownership.** A general partnership is a form of co-ownership by several persons which means the partners own the business assets and are personally liable for the debts. A partnership shares some of the attributes of a separate legal entity in that it: (1) can hold and convey legal title to real property in its own name, (2) sue and be sued in the partnership name; and (3) continue to exist despite dissociation of one or more partners.

**C. Sharing Profits.** In absence of an agreement, profits are shared equally among partners. A partnership agreement can allocate profits and losses disproportionately.

**D. Unlimited Personal Liability For Losses.** Each general partner puts his or her entire personal resources at risk for debts and obligations of the partnership business. Partners are jointly and severally liable to the partnership's creditors. The risk of personal liability is enhanced by the fact each general partner is deemed an agent of the partnership in dealing with third persons in the ordinary course of business. Each partner also is jointly and severally liable for tortious acts of co-partners in the ordinary course of business.

**E. Management and Control.** Each general partner has equal right to participate in management and control the business. Partnership agreements are useful to define roles. Disagreements in the ordinary course of business are decided by majority of partners; disagreements over extraordinary matters are decided by all partners. Agreements can modify these default rules. No partner has a right to compensation for services performed for the partnership unless the partners agree otherwise by writing or conduct.

**F. Transferability.** Unless a written agreement provides otherwise, no one can become a member of a partnership without the consent of all existing partners. A partner may assign his or her share of the profits and losses and right to receive distributions. A partner's judgment creditor may obtain an order to charge his or her distributions to satisfy a judgment.

**G. Duration and Dissolution.** A partnership at will is dissolved by the express will to dissolve of at least half the partners. A partnership for a definite term or particular undertaking (joint venture) is dissolved before expiration of the term or completion of the undertaking by (1) express will of all the partners, or (2) 90 days after a partner's death, bankruptcy or wrongful dissociation, unless within that time a majority in interest of the remaining partners agree to continue the partnership. For tax purposes, a partnership terminates (1) on the sale or exchange of a 50 percent or more partnership interest, or (2) if no part of the business or financial operation is carried on by any partner.

### **3. Limited Partnership.**

**A. Definition.** A limited partnership is comprised of (1) one or more general partners who manage the business and who are personally liable for partnership debts, and (2) one or more limited partners who contribute capital and share in the profits, but normally take no part in running the business and who incur no liability for partnership obligations beyond capital contributions. To form a limited partnership you must file a certificate of limited partnership with the Secretary of State.

**B. General Partners' Liability.** Except as otherwise provided by law or agreement, a general partner is subject to the same liabilities as a partner in a general partnership (i.e., joint and several liability for all debts and obligations of the partnership). A corporation can serve as a general partner. Shareholders of such corporation will not be

personally liable for partnership debts. Shareholders, directors and officers of a corporate general partner may also serve as limited partners without losing their limited liability.

**C. Limited Partners Are Passive Investors.** A limited partner is primarily a passive investor, not normally involved in day-to-day management and control of the business. Limited partners have a right to information, reports and accountings from the partnership, the right to inspect partnership records and attend partnership meetings. If a limited partner participates in control of the partnership business, she can be personally liable to creditors who reasonably believed the limited partner was a general partner.

**D. Division of Partnership Interests.** Limited and general partnership interests can be divided into classes that have different rights, powers and duties as set forth in a partnership agreement. The various partnership classes may be given the right to vote separately or together on any partnership matters.

**E. Economic Interest of Limited Partners.** General partners are co-owners of the partnership's assets. Limited partners have no direct ownership interest in those assets. Limited partners' sole rights are to a return of their capital and a share of the profits. Partnership profits, losses and distributions (including return on capital) are shared in proportion to the partners' contributions unless the partnership agreement states otherwise. A limited partner has the right to assign his or her interest, in whole or in part, to a third person. Such assignment transfers the right to receive distributions from the partnership, but does not entitle the assignee to become substituted as a limited partner.

**F. Duration.** The death, withdrawal, removal, incompetence, bankruptcy or dissolution of a general partner dissolves the partnership unless (1) the partnership agreement provides otherwise, (2) all remaining general partners continue the business, or (3) where no general partner remains, the limited partners holding a majority in interest in current profits agree to continue the business and admit one or more general partners. Death or incompetence of a limited partner has no effect on the partnership.

#### **4. Limited Liability Company.**

**A. Definition.** An LLC is a hybrid between a partnership and a corporation that combines the "pass through" tax treatment of a partnership with the limited liability protections of a corporation. An LLC is formed by filing articles of organization with the Secretary of State. The members must enter into an operating agreement before or after filing the articles, preferably in writing.

**B. Separate Legal Entity.** Like limited partnerships and corporations, an LLC is recognized as a legal entity separate and apart from its members (the owners).

**C. Limited Liability of Members.** LLC members are not personally liable for the entity's obligations and liabilities and thus enjoy the same limited liability status as corporate shareholders. Exceptions: (1) a member can be personally liable if he or she

personally guarantees an LLC obligation, or (2) suffers imposition of liability under the alter ego doctrine.

**D. Share of Profits, Losses, Distributions.** LLC profits and losses are distributed among the members in accordance with the operating agreement, or if silent, allocated in proportion to each member's capital contribution. Distribution of the LLC's cash or property are made as follows: (1) in accordance with the operating agreement, (2) if returns on capital, in proportion to contributions, and (3) if not returns on capital, in proportion to allocation of profits.

**E. Management and Control.** Under the statute, management of an LLC's business and affairs is vested in all its members (decentralized management like a partnership) unless the articles of organization state otherwise (centralized management like a corporation). Each member has the right to vote on the company's business matters in proportion to his or her interest in the current profits of the LLC unless the articles state otherwise. Where an LLC is managed by its members (like a partnership), each member is an agent of the LLC and can bind the company like a general partner. While this could result in personal liability for the member who binds the company, it would not result in personal liability for the other members (unlike general partnerships).

**F. Transfer of Interests.** Unless the LLC's articles or operating agreement state otherwise, no one can become a member of an LLC, either by issuance of a new membership interest or transfer of an existing one, without the consent of members having a majority in interest. A member can assign his or her rights to profits, losses or distributions in the LLC without causing dissolution of the company, unless otherwise provided in the articles or operating agreement.

**G. Duration.** An LLC is dissolved (1) at the time specified in the articles (if any), (2) upon an event specified in the articles or operating agreement (if any), or (3) by the vote of a majority in interest of its members (or some greater percentage provided in the articles or operating agreement). An LLC is more reliable than a partnership because the death, disability, withdrawal, resignation or bankruptcy of a member does not trigger a buy-out or dissolution of the LLC (unless articles or operating agreement provide for buy-out or dissolution upon one of these events) like a partnership.

## **5. Corporation.**

**A. Separate Legal Status.** A corporation is a separate legal entity existing under authority granted by state law. The corporation has its own identity, separate and apart from the persons who created it and from its shareholders. As a separate legal entity, a corporation has the power to act in any way permitted by state law or its own charter (i.e., contract, own and convey property, sue and be sued, commit torts or crimes, etc.). Formation of a corporation requires filing articles with the Secretary of State and payment of certain fees. Strongly recommended to prepare bylaws and appoint directors and officers.

**B. Liability for Corporate Debts.** As a separate legal entity, the corporation is responsible for its own debts. Shareholders, directors and officers are not legally responsible for corporate liabilities unless they personally guaranty the obligation or act in a manner that results in the imposition of alter ego liability. As a practical matter, limited liability is not always a crucial consideration, particularly in small closely-held corporation, for the following reasons: (1) banks and other persons extending credit to small corporations require personal guarantees from shareholders, (2) businesses carry liability insurance to cover claims for torts committed by their agents and employees, (3) under the alter ego liability, corporate form is pierced and shareholders are held personally liable for corporate debts.

**C. Management and Control.** Management and control is vested in the board of directors, elected by the shareholders. Directors make general policy decisions and major business decisions, and delegate responsibility for implementing those decisions and dealing with third parties (i.e., customers and vendors) to officers and employees. Some persons may be shareholders, directors and officers of the corporation and with a small entity usually are.

**D. Transferability of Shares.** Ownership interests in a corporation are freely transferable subject to certain limitations imposed by federal and state securities laws, agreements establishing rights of first refusal or co-sale rights, and thinly traded markets.

**E. Duration.** A corporation can continue indefinitely. Existence is not affected by death or disability of shareholders, officers or directors or the transfer of shares from one person to another.

If you are contemplating starting a new business and need advice and counsel to determine the form of business entity that best suits your business objectives, please call us at (925) 274-9600 or contact me at [lfinkel@finkellawgroup.com](mailto:lfinkel@finkellawgroup.com).