To Incorporate or Not to Incorporate?
That is the Question.
By Julia Sylva, Esq.

There are many avenues that a company, new or old, may take in the formation of a business. This paper will discuss the various types of entities available to businesses and the advantages and disadvantages of each of them. Of course, the selection of the type of business entity should be made in consultation with your accountant and your attorney.

Here are the most common types of business organizations:

Sole Proprietorships

A sole proprietorship is a business operated by an individual in his or her personal capacity rather than through a formal, separate entity. The term Asole@ may be a little confusing. A sole proprietorship can have an unlimited number of employees; the term Asole@ refers only to the fact that there is a single individual owner. The advantages of this format are simplicity (record-keeping is kept to a minimum) and ease of operation (business decisions can be made quickly).

There are, however, two very important disadvantages to this format. The first, and indeed huge, disadvantage is that sole proprietorship offers no protection from personal liability for any debts of, or other claims against, the business. For example, someone who is injured on the premises of a sole proprietorship can reach the business owner's personal assets (home, car, investments, etc.) in the event of a successful lawsuit. Thus, it is very dangerous to use this format in operating a business requiring substantial non-equity financing or involving uninsurable risk of liability to others.

A second disadvantage is that the sole proprietorship format cannot be used if it becomes necessary to raise additional equity capital in exchange for an interest in the business. As a business grows, it frequently becomes necessary to raise capital by taking in co-owners.

Partnerships

There are two basic types of partnership: general and limited[1]. In a general partnership, each partner is a general partner and is personally responsible for all of the

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[1/] A third type of partnership, a limited liability partnership (LLP), is used primarily in connection with the furnishing of licensed professional services and is beyond the scope of this paper.

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organization's actions, debts, liabilities and other obligations. In a limited partnership, there are two kinds of partners: the general partner[2], who manages the day-to-day operation of the business and is personally liable for its debts and other obligations, and the limited partners, who usually are the investors who provide the bulk of the initial financing for the business. The term "limited" refers to the fact that their personal liability for the partnership's debts is limited to their capital contributions. Limited partners do not participate in the management or operation of the partnership. Effectively, then, limited partners are essentially passive investors.

A general partnership is relatively simple to form; it does not require the filing of documentation such as a Certificate of Partnership. The partnership agreement may be very simple and may even be oral, although this is not a good idea. Even though all the partners are equally liable for the debts of the partnership, the partnership nevertheless has a separate legal existence so that it can own assets (including real property) and can sue or be sued in its own name. In the absence of an agreement to the contrary, each partner has an equal right to participate in and exert control over the business, but the partnership agreement may provide great flexibility in this regard. For tax purposes, profits and losses are passed through the partnership (untaxed) to the partners individually, so that the income is taxed only once and often at lower individual rates.

Because a general partnership provides the partners (general or limited) with no protection against the liabilities of the business, its use by individuals is greatly limited. General partnerships are most often used when the partners are either corporations or limited liability companies which themselves provide this protection (see below).

A limited partnership consists of at least one general partner and one or more limited partners. A limited partnership is formed by filing a Certificate of Limited Partnership with the California Secretary of State. Initial filing and annual maintenance fees must be paid. In general, limited partnership agreements are more complicated than general partnership agreements; and, although they may be oral, they are almost always in writing. Like a general partnership, a limited partnership enjoys the benefits of a high degree of flexibility and the tax advantages of single taxation of income often at lower individual rates. Although, as noted above, a limited partner is protected from liability in excess of his or her capital contributions, the general partner enjoys no such protection. Accordingly, in the context of a developing business adding new investors, the limited partnership format is commonly used after a corporation or limited liability company has been formed to protect the original owners from personal liability. The corporation or limited liability company becomes the general partner, and the new investors become limited partners thereby enjoying the benefits of single taxation of income combined with protection from liability.

[2/] There may be more than one general partner, but this is unusual.

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Corporations

A corporation is initially formed by filing Articles of Incorporation with the Secretary of State. Thereafter, bylaws to govern the operation of the corporation must be adopted and the directors have to hold an organizational meeting at which they elect corporate officers (president, secretary and chief financial officer), issue stock to the shareholders (*i.e.*, investors) and take the other steps necessary to complete the corporate formation.
Ongoing corporate formalities, such as meetings (held at least annually) of the board of directors and shareholders, must be observed and documented (via minutes of the meetings).

The great advantage of incorporation is that it provides the owners (shareholders) of the business protection from personal liability so long as the corporation is adequately capitalized and corporate formalities are observed.

A second advantage is that it provides an excellent framework for obtaining additional capital from newly-admitted owners without giving up control of the business.

The necessity of attending to and documenting ongoing formalities is a disadvantage of the corporate format, but the principal disadvantage to incorporating is that the net income of the business is taxed twice: once when earned by the corporation and again when distributed to shareholders in the form of dividends. However, there are two possible solutions to the problem of double taxation. The first is that in many cases in which the shareholders are actively engaged in the conduct of the business, the payment of reasonable salaries to those shareholders may eliminate profits at the corporate level.

A more common solution to the problem is for the corporation to make a timely election (known as an "S election") to be taxed under Subchapter S of the Internal Revenue Code. The income of a corporation (known as an "S corporation"[3]) making such an election is taxed to the shareholders in the ratio of their shareholdings and is not taxed to the corporation[4]. The S election is available only to relatively closely-held corporations. In order to make the election, the corporation must have no more than

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3/ Corporations not making this election are taxed under Subchapter C of the Internal Revenue Code and are referred to as "C corporations."

4/ There are some exception to this rule which might apply in the case of a corporation which has operated for some time as a regular, or C, corporation prior to making the S election.

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seventy-five shareholders and, with some exceptions, the shareholders must all be individuals.

It is often said that an S corporation is taxed as if it were a partnership, but this is not entirely accurate. A partnership agreement may provide for an allocation of partnership net income in a ratio different from the ratio of percentage ownership interests in the partnership, whereas the net income of an S corporation must always be allocated in the ratio of stockholdings. Furthermore, although California recognizes the S election, it imposes a tax at the rate of 1.5% (minimum of $800) on the S corporation's net income before it is passed through to shareholders.

Limited Liability Companies

A limited liability company ("LLC") is a relatively new kind of business entity that is treated like a corporation for liability purposes but is usually taxed as a partnership (*i.e.*, only one level of tax, at the owner level). As with a corporation, it is formed by filing a document (Articles of Organization) with the California Secretary of State's office. There are initial filing and annual fees, the latter being based on revenues, not net income[5]. The LLC is owned by one or more members, and its operations are governed by a written operating agreement. This structure allows for great flexibility of both management and profit allocation.

An LLC may have only one member, in which case it is taxed as a sole proprietorship. An LLC having two or more members may elect to be taxed either as a C corporation or as a partnership. Almost all such LLC's elect to be taxed as a partnership.

Essentially, an LLC can provide relief from double taxation and all the flexibility of a partnership or sole proprietorship while still providing protection from individual liability. In most cases, however, the operating agreement is a relatively complex document which should be prepared by an attorney. If, as is usually the case, the LLC elects to be taxed as a partnership, the returns can be complicated. In many cases the annual fee based on gross income may be a significant disadvantage.

Issuance of Securities

An important issue in connection with the formation of a business entity is the question of the necessity to comply with the somewhat complex federal and state laws

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[5/] These fees, which are adjustable from year to year, may currently be as high as $11,790 on income of over $5,000,000. They are not payable by an LLC which elects to be taxed as a corporation.

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involving the issuance of securities. In some cases involving only a few local investors, compliance with these laws may be a very simple matter. In other cases compliance may be more difficult. For example, if a California company sells, or offers to sell, interests in a California business to individuals in another state, the seller must comply with both California and the other state's laws respecting the issuance of securities. Failure to comply with these laws may result in civil, or even criminal, penalties and may give the purchaser of the business interest the right to rescind the transaction. It is therefore essential that anyone forming a new business entity obtain the advice of competent and experienced counsel.

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