

## Choice of Business Entity

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### I. Types of Entities

“Default Entities”:

Sole Proprietorship

General Partnership - Presumed if undertake a common endeavor. Can also be formed with a written agreement (generally preferable)

Entities requiring Formal Agreements:

Limited Partnership (“LP”)

C Corporation

S Corporation

Limited Liability Company (“LLC”)

### II. Purposes for Forming an Entity

Liability protection

- only available with LPs, Corporations and LLCs
- always should consider the costs, and consider whether insurance will provide adequate liability protection
- cannot avoid liability for personal actions by forming an entity

Tax savings

- always seek the advise of a tax professional in choosing business structure (difference between C and S Corporation is tax treatment alone)

Centralized Management/Structure for Multiple Owners

### III. Disadvantages of Incorporating

Expenses:

Formation

Annual Tax Returns

Annual \$800 Minimum Tax to Franchise Tax Board

Paperwork:

Corporations require specific documentation in order to protect tax status and liability protections

#### **IV. Considerations in Choosing an Entity**

Any limitations on what type of entity is available for your business?

- "professionals" as defined by the Business & Professions Code must use a "Professional Corporation"
- some boards (e.g. Contractor's Board) will not allow LLCs

Cost

- if incorporating for tax savings, what type of corporation would be best for your business
- if incorporating for liability reasons, is it worth it?

Ability to keep up with paperwork

	MANAGEMENT	TAXATION	PERSONAL LIABILITY	RECORD KEEPING
<b>SOLE PROPRIETORSHIP</b> (Not legally separate from the owner)	Owner managed.	Sole proprietor simply reports all business income or losses on their individual tax return.	Owner of the business can be held personally liable for business related obligations.	None.
<b>PARTNERSHIP</b> <b>-GENERAL</b> <b>-LIMITED</b> (At least one general partner and one limited partner are required)	GP: Any individual partner can bind the whole business to a contract. LP: GP controls the day-to-day operations. LP contributes financially but has minimal control.	Similar to a sole proprietorship the partnership itself does not pay any income taxes. Rather, income passes through the business and the partners reports their share of all business income or losses on their individual tax return. Partnership must also file an "informational return."	All GPs are personally liable for all business debts. In addition, each individual partner can be sued for the full amount of any business obligations. LP can loose their investment but are not personally liable for business obligations.	None.
<b>CORPORATION</b> (Considered a separate legal entity from its owners) <b>-C CORPORATION</b> <b>-S CORPORATION</b>	Governed by Bylaws.	<u>C Corporation</u> pays taxes on its own tax return for its profits and losses. The owner then gets paid a salary and pays income tax on that salary. "Double Taxation." Lower tax rates on the first \$75,000 of net income. <u>S Corporation</u> is similar to a sole proprietorship or a partnership in that the owners report all business income or losses on their individual return. Owners can take money from the corporation either through a salary or a draw.	Generally, owners of a corporation are not personally liable for corporate obligations. <b>EXCEPTIONS</b> Situations where owners can still face personal liability: 1) Personal guarantees 2) Taxes 3) Negligent or intentional acts 4) Breach of fiduciary duty 5) Blurring the boundaries between corporation and owner	1) Issue Stock 2) Hold regular board of director meetings and shareholder meetings 3) Keep corporate minutes 4) Maintain separate bank accounts and keep separate books
<b>LIMITED LIABILITY COMPANY (LLC)</b> (Combines pass through taxation with limited personal liability)	"Professional Services" cannot be an LLC Any member can bind the LLC unless you create a manager managed LLC.	LLC is similar to a sole proprietorship or a partnership in that the members report all business income or losses on their individual return. Gross Receipts Tax. LLC offers its members the flexibility of allowing the company to be taxed as a corporation.	Similar to a corporation, members are generally protected from business obligations. Same exceptions to this limited liability apply. See list of exceptions above.	1) Adequate capitalization 2) Maintain separate bank accounts and keep separate books.