

Types of Legal Organizations For Small Businesses

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I. Types of Business Entities.

A. Sole Proprietorship.

- This is not an entity, and there are no filing or other affirmative actions needed to become a sole proprietor. There is no liability protection or other flexibility in structuring your business if you operate as a sole proprietor. Due to the lack of liability protection, this is not a recommended way to operate a business.

B. General Partnership.

- Created under Chapter 178 of the Wisconsin Statutes, a general partnership is the association of two or more individuals or entities to operate as co-owners of a for-profit business. Like sole proprietorships, there is no filing requirement with the state. Again, like the sole proprietorships, there is a lack of liability protection so it is not a recommended entity choice.

C. Limited Liability Partnerships.

- Originally created under Chapter 178 of the Wisconsin Statutes to provide those operating as a general partnership with some liability protection in the area of torts and contracts. Otherwise, partners in a limited liability partnership are subject to liability issues like in general partnerships. Usually only recommended when already operating as a general partnership or for use by professional organizations such as attorneys or accountants (service orientated businesses).

D. Corporations.

- There are several different types of entities that all fall under the general category of corporation including:

- Service (regulated professional occupations). These corporations are for certain professions and are normally taxed at the highest corporate tax rates.
- Statutory Close. A corporation with a limited number of shareholders and fewer of the typical corporate formalities. These entities tend to be less flexible for future planning, and shareholders acting as managers are personally liable as managers.
- Not-for-profit. Used by community groups and other non-profit organizations. This is not available in the traditional business/entrepreneurial setting.
- Business. The typical business (for profit) corporation is created under Chapter 180 of the Wisconsin Statutes. One of the first decisions faced by most entrepreneurs who decide to incorporate is whether to be a C or an S corporation. The following section describes the differences between these two choices.

E. S Corporations. See Section II (What is an S Corporation?) for more information.

F. Limited Liability Companies. See Section III (What is a Limited Liability Company?) for more information.

II. What Is An S Corporation?

- A. Business Corporation that Elects S Corporation Status. An S corporation is a business corporation formed under state law whose shareholders have voluntarily elected to have the corporation classified as an S corporation for tax purposes.
- B. S Corporation/Subchapter S. S corporations used to be called “Subchapter S Corporations,” because the tax rules are located in Subchapter S (Sections 1361-1379) of the Internal Revenue Code.
- C. Contrast with C Corporation. A business corporation that has not elected S corporation status is referred to as a C corporation. Many of the rules that apply to regular business corporations are found in Subchapter C of the Internal Revenue Code.

- D. Why Switch from C Corporation to S Corporation? Normally, corporations are taxed on their income. A dividend is a corporation's distribution to its shareholders out of its earnings and profits, and the dividend is not deductible. In most cases the dividend is taxed to the shareholder. Therefore, a portion of the corporation's net income that is paid as a dividend is taxed twice – once when it is earned by the corporation and again when dividends are paid to shareholders.

To avoid double taxation, eligible corporations can elect to be taxed under Subchapter S of the Internal Revenue Code and become "S corporations." Generally, an S corporation does not pay any federal income tax itself. Instead, the S corporation passes through its income, loss, deductions and credits to its shareholders, and the items are then included on their separate tax returns. The S corporation is referred to as a pass-through entity, that passes the income, loss, deductions and credits to its shareholders to be reported on their tax returns.

- E. Special Requirements for S Corporations. Only corporations that meet certain requirements are eligible to elect S corporation status. Once the election is made, the corporation must continue to meet these requirements or the S corporation status will be lost.

- It must be a domestic corporation (organized in the United States or its territories).
- It may not have more than 100 shareholders. For purposes of counting the number of shareholders, a husband and wife are treated as one shareholder. It makes no difference if the stock is held separately or jointly. For other shareholders, each person who jointly owns stock is treated as a separate shareholder.
- Its shareholders must be limited to individuals (other than nonresident aliens), estates, certain exempt organizations or certain trusts.
- It may have only one class of stock, however, there may be differences in voting rights.
- It cannot be an "ineligible" corporation. Examples of ineligible corporations include: insurance companies and corporations that have made the special possessions tax credit election under Section 936 of the Code.

- F. Making the Election. The election of S corporation status must be made by a qualified corporation, with the unanimous consent of its shareholders. The election must be filed on or before the 15th day of the third month of its tax year in order for the election to be effective beginning with that year. To qualify, the eligibility requirements must be met at all times during the pre-election portion of the year. There are no grace periods for S corporation elections that are not made within the set deadline, unless the taxpayer can establish reasonable cause to the satisfaction of the IRS. Elections that are filed after the deadline will be treated as made for the following tax year.

The election of S corporation status is made on Form 2553.

The Subchapter S election is valid only if all the shareholders of the corporation on the date the election is made consent to the election and sign Form 2553 or an attachment to it. If the election is retroactive to the beginning of the tax year, any shareholders who disposed of their stock during the retroactive period must also consent to the election and must sign the form. If stock is held jointly, both persons must sign the consent.

- G. Fringe Benefits. Unlike a C corporation, an S corporation cannot provide its shareholder-employees with tax-favored fringe benefits. If such benefits are paid to shareholder-employees owning more than 2% of the stock, the benefits are not excludable from the employee's income. The corporation is treated like a partnership, and any more than 2% shareholder is treated like a partner. All other shareholders employed by the S corporation are treated like they were employees of a C corporation for fringe benefit purposes. For example, health and accident insurance premiums paid by an S corporation on behalf of a more than 2% shareholder-employee, his or her spouse and dependents are deductible by the corporation and includable in the shareholder-employee's gross income. The premiums are treated similar to a partner's guaranteed payments.

III. What Is a Limited Liability Company?

- A. Relatively New. The limited liability company (LLC) is a relatively new type of business entity. The LLC is neither a partnership nor a corporation, but it combines some of the major advantages of both forms of doing business.
- B. General. An LLC may be described as an unincorporated association of investors (called members) whose personal liability for obligations of the business are limited to the amount invested. It is intended to combine the best features of the partnership and corporate forms.

- From the partnership model, the LLC borrows informality and flexibility of organization and operation, direct participation by members in the business (if member managed), and no taxation at the entity level. The LLC abandons the partnership concept of investor personal liability to third parties.
- From the corporate model, the LLC permits investor-level liability protection for members and permits a corporate representative form of governance (for manager managed LLCs).

C. Key Legal Characteristics.

- It is formed by filing articles of organization with the Department of Financial Institutions.
- Generally, members do not have personal liability for liabilities of the LLC.
- The member's amount at risk for LLC obligations is generally limited to the amount invested or promised to be invested in the LLC.
- Single-member LLCs are permitted in most states (including Wisconsin).
- Few corporate-type formalities are required.
- The LLC may be member managed (similar to partners of a general partnership) or manager managed (similar to a board of directors).
- Any person or entity may be an owner (member) of an LLC.

D. Tax Classification. An LLC may elect to be taxed as:

- A sole proprietorship, if the LLC has one owner (member). In Wisconsin a married couple are considered one owner even though each spouse may have a 50% marital property ownership interest.
- A partnership, if the LLC has two or more owners.
- As an association taxed as a corporation (rarely selected).

E. Popular. In Wisconsin, its popularity is evidenced by the Department of Financial Institutions Annual Report on Filings for New Entities, which shows that the number of new LLCs organized in Wisconsin exceed the number of new corporations.

IV. Business Factors - Similarities and Differences.

BUSINESS FACTORS - SIMILARITIES

Factor	Limited Liability Company	S Corporation
Limited liability	Limited liability for members even if they participate in management	Limited liability for shareholders even if they participate in management
Management of company	By all members if member managed or by appointed managers if manager managed	By board of directors
Continuity of life	Permitted	Permitted
Transferability of ownership interests	Permitted, but unless otherwise provided in operating agreement, need members' unanimous consent	Permitted, but restrictions may be imposed in articles, bylaws or shareholders' agreement

BUSINESS FACTORS - DIFFERENCES

Factors	Limited Liability Company	S Corporation
Types of owners	No restrictions	Only individuals (other than non-resident aliens), estates, certain trusts, certain tax exempt organizations (including qualified plans), and another S corporation which owns 100% of the stock of an S corporation subsidiary and files a proper election
Number of owners	No maximum	Maximum of 100
Classes of ownership interests	Multiple classes permitted	Only one class of stock permitted, but there can be differences in voting rights
Qualification requirements	No restrictions	Various eligibility and ownership requirements, and must file timely election to be taxed as an S corporation

V. Tax Factors – Similarities and Differences.

TAX FACTORS - SIMILARITIES

Factor	Limited Liability Company	S Corporation
Company-level federal income tax	No tax at entity level (assuming it qualifies as sole proprietorship or non-publicly traded partnership, and no election to be taxed as corporation)	No tax at entity level (except if the company was previously a C corporation, there may be entity level tax on certain passive income, on built-in gains at time of conversion if recognized within 10 years and on inventory recapture)
Taxable year	Can elect fiscal year in very limited circumstances, otherwise calendar year	Can elect fiscal year in very limited circumstances, otherwise calendar year
Tax rates	Individual rates of owners	Individual rates of owners
Passive loss rules	Members must meet material participation rules	Shareholders must meet material participation rules

TAX FACTORS - DIFFERENCES

Factor	Limited Liability Company	S Corporation
Contribution of appreciated property - tax deferred?	Generally not taxable	Generally not taxable, but must satisfy requirements of Code Sections 351 and 357 (for example, liabilities cannot exceed adjusted basis of assets)
Special allocations of profit or loss among owners	Permitted, subject to Section 704(b) (the method of allocation to owners must have substantial economic effect)	Not permitted under one class of stock requirement
Tax deductibility of losses	Members may deduct their allocable share of LLC losses only to the extent of their tax basis in their LLC ownership interest, which includes their allocable share of LLC debt. At-risk and passive activity rules also apply.	Shareholders may deduct their allocable share of S corporation losses only to the extent of their <u>tax basis in the S corporation shares and loans they have made to the S corporation</u> (cannot count loans they have only guaranteed). At-risk and passive activity rules also apply.

TAX FACTORS - DIFFERENCES (continued)

Factor	Limited Liability Company	S Corporation
Basis adjustment available to entity assets	Upon death, liquidation and sale of interest of a member (Code Sections 734(b), 743(b) and 754)	Not available
Flexibility in structuring retirement payments (deductible v. nondeductible)	Yes (Code Section 736 considered a distributive share or guaranteed payment)	No
Taxation upon distribution of appreciated property	Generally no (exceptions see Section 704(c) if contributed property distributed within specified time, and Section 737)	Yes, subject to taxation
Social security/self-employment and Medicare taxes	Such taxes generally pass through to members on ordinary trade or business income. However, rental LLCs generally not subject to social security or self-employment and Medicare taxes. The law is not yet settled. Proposed regulations indicate that an owner of an LLC is not subject to social security/self-employment taxes if that owner is not personally liable for the debts of or claims against the LLC by reason of being a partner, does not have authority to contract on behalf of the LLC, and does not participate in the LLC's trade or business for more than 500 hours during the tax year.	Such taxes are paid on salaries and bonuses to shareholder-employees. Not applicable to dividends to shareholders above reasonable compensation.

VI. Pick the One that Best Fits Your Situation.

A. S Corporation. If:

- you find it is easy to satisfy the S corporation ownership and eligibility requirements,
- you are not transferring debt to the corporation or the amount of debt is less than the adjusted basis of the assets transferred,
- you do not expect losses to exceed your basis in the (i) corporation shares and (ii) loans that you make directly to the corporation,

- you are not planning to put real estate into the entity, and
- you want the ability to pay reasonable salaries and bonuses subject to social security taxes, while amounts paid to owners in excess of that will not be subject to social security taxes,

then:

Advantage S Corporation.

B. LLC. If:

- you want more flexibility of types of owners, numbers of owners, classes of ownership or qualification requirements than would be available with an S corporation,
- you may be transferring debt to the business that might exceed your adjusted basis of assets,
- your losses may exceed your basis in (i) shares and (ii) loans that you make directly to the S corporation,
- you want the ability to step up basis of the entity assets upon the death, liquidation or sale of an ownership interest,
- you want flexibility in structuring retirement payments as either deductible or non-deductible,
- you want the ability to dissolve the entity without substantial adverse tax consequences,
- the business generates passive income (not subject to social security taxes) or it is not important that you be able to make distributions to owners in excess of reasonable compensation that would not be subject to social security taxes,

then:

Advantage LLC.

It is not unusual to see the operating business as an S corporation and the land and buildings owned by a limited liability company that leases the real estate to the S corporation.

LLCs are well suited for real estate rental businesses.

VII. General Liability Issues.

- A. The “Corporate Veil.” The theory behind the “corporate veil” is that owners are not personally liable for the company debts just by being an owner. While this long-standing theory originally applied in the corporate context, it should also be applicable to LLC owners as well. When someone tries to “pierce” the corporate veil, they are arguing that the owners should be liable for what might otherwise be a company obligation. The most common piercing argument is that the company is really just the “alter ego” of the owner. The courts apply a multi-pronged test to determine whether the company really is its own separate entity or just the alter ego of its owners. Among the factors a court will consider are whether corporate formalities were followed and whether there was adequate capitalization at the time the business was formed. One common mistake that leads to piercing the corporate veil is commingling personal and company assets.
- B. Undisclosed Corporation Principle. To obtain the liability protections offered by a business entity, it is important that people dealing with the business know that they are working with an entity and not an individual. For example, companies should have their full legal name on the company website, checks, and other promotional materials. When entering into contracts, it is important that the business be the party to the agreement and not the individual owner. The owner may sign in their capacity as an officer or owner but should not sign individually.
- C. Statutory Violations. Certain statutes impose liability directly on owners and officers without having to pierce the corporate veil. Examples include certain consumer protection laws, employer tax withholding requirements, certain wage and retirement benefit funding and certain environmental liabilities. For example, the Wisconsin Department of Revenue may try to come after officers and owners for any sales taxes that were collected but not turned over to the state. This is why working with your professional advisors to set up internal controls is so important.
- D. One’s Own Tortious Conduct. None of the business entity forms will protect an individual from personal liability for their own negligent or intentional acts and conduct.

VIII. Other Issues to Consider.

- A. Operating Agreements/Bylaws and Buy Sell Agreements.
- B. Employee Handbooks - “At Will” Relationship.

- C. Non-Compete Agreements.
- D. Independent Contractor v. Employee.
- E. Insurance.
- F. Trust Fund Taxes.
- G. Business Contracts.
- H. Leases.
- I. Tax Identification Numbers and Applicable Permits.
- J. Federal Service Mark, Trademark or State Trade Name Protections.
- K. Business Succession Planning.



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