



ARNOLD & PORTER LLP

# Legal Perspectives on Small Business Entities

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# I. Introduction and Goals

- Understand the Difference Between “State Law Purposes” and “Federal Income Tax Purposes”
- Understand Key Aspects of the Most Prevalent Business Entities for State Law and Tax Purposes

## II. “Tax Purposes” vs. “State Law Purposes”

- Whenever you say what kind of entity something is, you have to know whether you mean under state law or under federal income tax law. Sometimes the same; sometimes different.
  - Most common example – a limited liability company (LLC) for state law purposes is usually a partnership for federal income tax purposes

## II. “Tax Purposes” vs. “State Law Purposes” (continued)

- There are other contexts that may introduce yet another type of entity (beyond scope for today)
  - Federal Income Tax vs. State Income Tax
  - Federal Income Tax vs. Other Federal Taxes
  - State/Local Income Tax vs. Other State/Local Taxes
  - Foreign Tax Characterization

## II. “Tax Purposes” vs. “State Law Purposes” (continued)

- Main Types of State Law Entities
  - Sole proprietorship
  - General partnership
  - Limited partnership
  - Corporation
  - Limited liability company
  - Others (LLP, LLLP, contractual relationship, tenancy in common, trust, estate)

## II. “Tax Purposes” vs. “State Law Purposes” (continued)

- Main Types of Entities for Tax Purposes
  - Partnership
  - C corporation
  - S corporation
  - Disregarded entity
  - Individual
  - Others (trust, REIT, REMIC, various other entities that have special tax treatment)

## II. “Tax Purposes” vs. “State Law Purposes” (continued)

- Vocabulary and concepts overlap; make sure that you know whether you are talking about tax or state law
  - Formation
  - Contributions/Distributions
  - Sales or other transfers of ownership interests
  - Liquidation/Dissolution/Termination
  - Merger/Conversion/Division/Spin-Off

## II. “Tax Purposes” vs. “State Law Purposes” (continued)

- Don’t judge book by its cover – a given state law entity can be treated various ways for tax purposes
  - State law general or limited partnership or LLC can be a partnership, C corporation, S corporation or disregarded entity for tax purposes
  - State law corporation can be a C corporation, S corporation or disregarded entity for tax purposes



# **III. Key Features of Selected Entities for State Law Purposes**

# Sole Proprietorship

- Also known as “sole trader” or “proprietorship”
- No legal distinction between an individual and his or her business
- Simple; no filings or agreements needed to form the “entity”
- Unlimited liability

# General Partnerships

- Preliminary Considerations
  - Default classification for a business association with two or more owners
  - A business association formed under another specific statute is not a general partnership
  - Generally an undesirable entity form

# General Partnerships (continued)

- Governing Law
  - Revised Uniform Partnership Act (“RUPA”)
  - For example, effective in D.C. for all general partnerships formed after January 1, 1998
  - Case law

# General Partnerships (continued)

- Formation
  - No public filing necessary
  - Association of two or more persons to carry on as co-owners a business for profit forms a partnership
    - Intent to form a partnership not relevant
    - Contribution of capital not relevant
    - Existence of written partnership agreement not relevant

# General Partnerships (continued)

## ■ Informal Partnerships

### – Receipt of a share of profits

- General presumption that a partnership exists, with enumerated exceptions (e.g. payments for services as an employee or independent contractor)
- Drafting point: use of “independent contractor” clauses

### – Defectively organized limited partnership, limited liability company or corporation (governing law may be unclear)

### – Partnership by estoppel

- Holding oneself out as, or allowing others to represent that one is, a partner

# General Partnerships (continued)

- Liability for Partnership Obligations
  - Unlimited joint and several personal liability for all obligations of the partnership incurred while a partner
  - Right of contribution
    - Credit risk
    - Generally, partnership itself has primary liability
  - No “corporate veil”

# General Partnerships (continued)

- Management and Control
  - Management decentralized
    - All partners entitled to participate in decisions
    - All partners have authority to bind the partnership
  - May be internally modified by agreement



# General Partnerships (continued)

- Fiduciary Relationships
  - Duty of loyalty
    - Refrain from competing with the partnership
  - Duty of care
    - Limited standard: gross negligence, willful misconduct or knowing violation of law

# General Partnerships (continued)

- Limited Liability Partnerships
  - Also governed by RUPA
  - Filing of Statement of Qualification
  - Similar to general partnerships in many respects (e.g., decentralized management, fiduciary duties)
  - No liability for obligations of LLP
    - Partner liable for own actions
  - Common uses
    - Law firms and accounting firms

# Limited Partnerships

- Preliminary Considerations
  - Purely a creature of statute
  - One or more general partners and one or more limited partners
  - Common uses
    - Hedge funds
    - Private equity, venture capital and real estate funds
    - Family limited partnerships

# Limited Partnerships (continued)

- Governing Law
  - Various versions of Uniform Limited Partnership Act (ULPA) or Revised Uniform Limited Partnership Act (RULPA)
  - Case law

## Limited Partnerships (continued)

- Formation of the Limited Partnership
  - Certificate of Limited Partnership (or equivalent)
    - Name (must include “Limited Partnership” or “L.P.”)
    - Name and address of registered agent for service of process
    - Name and address of each general partner
  - Partnership agreement often lengthy and complex
    - Generally written, not oral

# Limited Partnerships (continued)

## ■ Limited Liability

- General partners (unlimited liability)
- Limited partners (limited liability)
  - Investment in partnership at risk
  - Clawback of distribution if limited partner knew at the time that the partnership would be insolvent after distribution
  - Clawbacks may be contractually agreed to in partnership agreement
- Limited partners may forfeit limited liability protection
- Use of LLC or corporate general partner

# Limited Partnerships (continued)

- Management and Control
  - Vested in the general partner(s)
    - Day-to-day business and affairs
    - Broad authority (except as may be limited in the partnership agreement)
  - Certain fundamental actions generally require consent of limited partners
  - Voting rights of limited partners in partnership agreements

## Limited Partnerships (continued)

- Limited partners' right of reasonable access to partnership books and records (inspection rights)
  - Information regarding financial condition, tax returns
  - Name and address of each partner
  - Other information "as is just and reasonable"
  - Subject to nondisclosure of trade secrets and other confidential information



## Limited Partnerships (continued)

- Fiduciary Relationships
  - General Partners
    - To limited partners
    - To partnership
    - To other general partners
    - Can be limited or eliminated in agreement
  - Limited partners (none)

# Limited Partnerships (continued)

- Continuity of Existence
  - Term is perpetual unless otherwise stated in agreement
  - Death or withdrawal, etc. of limited partner (generally no effect)
  - Death or withdrawal, etc. of general partner without timely appointment of successor (generally triggers dissolution)
  - Events of dissolution specified in partnership agreements

## Limited Partnerships (continued)

- Transferability of Interests
  - Consent of the general partner(s) generally required for full transfer
  - Economic interests generally transferable without such consent

# Corporations

- Preliminary Considerations
  - Creature of statute (state law)
  - Governance of internal affairs and owners' liability
  - Legal entity separate from its owners

# Corporations (continued)

- Formation of a Corporation
  - Pre-incorporation stockholders and other agreements
  - File certificate/articles of incorporation with secretary of state / state corporation commission
  - Hold organizational meeting
  - Elect Directors
  - Adopt bylaws

# Corporations (continued)

- Governing Law
  - State corporation statutes
    - Mandatory rules
    - Default rules
    - Optional rules
  - Case law

# Corporations (continued)

- Limited Liability; Agency
  - Limited liability of stockholders
  - Authority: Corporations act through their agents
    - Actual authority
    - Apparent authority based on reasonable belief created by the corporation
    - Vicarious liability

# Corporations (continued)

- Piercing the Corporate Veil
  - Failure to observe corporate formalities
  - “Alter ego” common law doctrine
    - Disregard of “separateness”
    - Commingle assets
    - Use for personal purposes
  - Thin/inadequate capitalization
  - Formed or used to defraud creditors or other third parties



# Corporations (continued)

- Management and Control
  - Board of Directors
    - General rule: business and affairs of corporation are managed by or under the direction of the board of directors who are elected by the stockholders
    - Officers: agents; usual and regular decisions
  - Stockholders: limited control rights; elect directors and approval of certain extraordinary decisions and actions
  - Separation of ownership from management and control

# Corporations (continued)

- Fiduciary Duties
  - Board of Directors & Officers
    - Duty of care
    - Duty of loyalty (incl. good faith)
    - Business judgment rule
      - common law rule/presumption (often codified) that in making a business decision, directors acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the corporation, absent evidence of a violation of their fiduciary duties
      - precludes courts from second-guessing directors' decisions even if they ultimately prove to have been unwise
  - Controlling Stockholders
    - applicability of business judgment rule subject to limitations

# Corporations (continued)

- Continuity of Existence
  - Generally perpetual existence
  - Dissolution by voluntary action
  - Involuntary dissolution/suspension

# Corporations (continued)

- Transferability of Interests
  - Presumption: freely transferable
  - Transferability may be limited by circumstances
    - Statutes and Regulations
    - Contract
    - Illiquid securities / lack of markets

# Limited Liability Companies

- Certain Preliminary Considerations
  - Relatively new business form
  - Creature of statute (state law varies widely)
  - Characteristics of corporations and partnerships
  - Considerable organizational and operational flexibility

## Limited Liability Companies (continued)

- Formation of the Limited Liability Company
  - Filing of certificate of formation (or equivalent)
    - Name of limited liability company
    - Address of registered office
    - Name and address of registered agent for service of process
  - Perpetual existence is default unless otherwise specified or subsequently terminated
  - Limited liability company agreement (or operating agreement)
    - Not required
    - Functions as both charter and bylaws

## Limited Liability Companies (continued)

- Limited Liability
  - Owners are called members
  - Equity interests have various names, e.g. units, interests, percentage interests, membership interests, shares
  - Generally, members have limited liability
  - Analogous to corporations, in that only in exceptional circumstances will members be subject to personal liability
    - veil piercing
    - tortious or wrongful conduct
    - improper distributions
    - any contributions required by the LLC agreement

## Limited Liability Companies (continued)

- Management and Control
  - Considerable flexibility to structure management and control
    - Member-managed
    - Manager-managed
    - Board of managers
  - Contractually expand or restrict members' rights
    - Greater flexibility than with corporations
    - Limited statutorily mandated rights and restrictions
  - Corporate meeting, minutes and related formalities generally not required



## Limited Liability Companies (continued)

### ■ Fiduciary Duties

- Delaware LLC Act amended in 2013 to provide as default rule (i.e. baseline) that managers of LLC owe traditional fiduciary duties of loyalty and care to the LLC and its members, in the same manner as directors or officers of a corporation
- Delaware LLC Act does allow members and managers to alter or even eliminate any such fiduciary duties in the LLC agreement
- By contract, members and managers generally are not precluded from conducting business or competing with the LLC
- Nevertheless, there is an implied covenant of good faith and fair dealing that cannot be waived or bargained away

## Limited Liability Companies (continued)

- Transferability of Interests
  - Generally permissible, except as otherwise provided in the LLC agreement
    - Commonly restricted
  - Although a member's economic interest generally is transferable without member consent, the assignee acquires no management rights or to be admitted as a member
  - Consent of the members and/or compliance with other LLC agreement requirements generally required for admission as a member and management rights

## IV. Overview of Types of Entities for Federal Income Tax Purposes

- Partnerships
- C corporations
- S corporations
- Disregarded entities
- Election of tax characterization

# Partnerships (for *tax* purposes)

- 2 or more partners
- Pass through tax treatment – taxable income, gain, loss, deduction are allocated to partners via information return filed by partnership
- Flexibility of economic deal, matched by complexity in tax provisions
- Cannot use this form for a publicly traded entity

# C Corporations

- 1 or more shareholders
- Double taxation – treated as separate person for tax purposes
- Can be preferable or necessary for foreign or nonprofit owners (“blocker” corporation)
- Only choice for a publicly traded entity (with few exceptions)
- Consolidated group can aggregate income, losses etc. for income tax filing and payment

# S Corporations

- Similar to partnerships with several exceptions that generally make this form simpler but less flexible. Key differences:
  - Restrictions on ownership (1 to 100 shareholders; no p'ships, corps or foreign)
  - Single class of stock requirement (for economic rights; voting classes are OK)
  - No flexibility on allocations
  - No tax basis for corporate debt (limits ability to use tax losses)
  - Can convert from C to S corporation without triggering immediate tax
  - Losing S status tosses entity back under C corporation rules

# Disregarded Entities

- 1 owner
- Cannot be a state law corporation (exceptions: QSSS, QRS)
- Disregarded as entity separate from owner; results go on owner's tax return
- Usually "SMLLCs" because under state laws, LLCs can have 1 member
- But state law partnership can be disregarded entity if all of its partners are the same entity for tax purposes
- Entities can be formed and terminate for tax purposes without forming/terminating for state law purposes, or vice versa.

# Election of Tax Characterization

- “Check the box” regulations – Treas. Reg. Section 301.7701-3
  - “Per se corporation” treated as corporation
  - “Eligible entity” by default is treated as partnership or disregarded entity, depending on number of owners
  - Eligible entity may elect to be treated as corporation



# Election of Tax Characterization

- Subchapter S Election
  - Corporation is treated as C corporation unless S status is elected
  - Unanimous consent of shareholders is required
  - Timely filing is important

# Election of Tax Characterization

- Other Elections
  - Corporation may elect to be treated as a REIT
  - If REIT owns 100% of a corporation, it is treated as a QRS (disregarded entity) absent an election
  - REIT can elect to treat partially or wholly owned subsidiary as a TRS (C corporation)
  - If S corporation owns 100% of a corporation, it can elect to treat subsidiary as QSSS (disregarded entity)

# **V. Certain Choice of Entity Considerations in Structuring Business Ventures**

# Certain Choice of Entity Considerations in Structuring Business Ventures

- Choice of Structure Considerations
  - Tax treatment of the entity, its owners and its employees
  - Liability of the owners for the obligations of the entity, or limitations thereon
  - The extent to which the entity lends itself to centralization or decentralization of management

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Choice of Structure Considerations
  - The extent to which the entity lends itself to continuity of existence of the enterprise or limitations thereon
  - The legal requirement that the type of business must be conducted in a particular form
  - The number of co-owners of the entity
  - The extent to which the entity lends itself to a complex capital structure or the issuance of different kinds of securities

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Choice of Structure Considerations
  - The extent to which the entity facilitates various types of employee compensation
  - The nature of the duties of constituents to the entity, and to other constituents of the entity
  - The extent to which the entity is subject to record-keeping requirements and other formalities
  - The additional costs of tax filings and entity license fees
  - The extent to which the entity lends itself to anonymity of ownership

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Entity Comparisons
  - Limited Partnerships
    - Pass-through tax treatment
    - Limited liability for investors
    - Centralization of management

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Entity Comparisons

- Corporations

- Limited liability for investors
- Centralization of management and separation of management from ownership
- Shareholders control of management is limited and exercised through their election of the corporation's directors



## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Entity Comparisons

- Corporations

- Shareholders can participate in the business (absent circumstances invoking the doctrine of piercing the corporate veil).
    - Significant statutory rules and formalities for exercising internal management functions and owner control
    - Centralized control structure may not be the most suitable for development stage enterprise

# Certain Choice of Entity Considerations in Structuring Business Ventures

- Entity Considerations (Cont.)
  - LLCs
    - Limited liability
    - Pass-through tax treatment
    - Great flexibility in management structure
    - Members of an LLC may fully participate in management
    - Not restricted as to how many and what type of investors they may have

# Certain Choice of Entity Considerations in Structuring Business Ventures

- Entity Considerations (Cont.)
  - LLCs
    - Not obligated to adhere to many “corporate” formalities
    - Limitations on transferability of interests

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Example 1. New small business with single individual owner. Wants to minimize tax complexity/filings. Wants to limit personal liability.
  - Single member LLC with individual as owner may be best choice. Allows limited liability but is disregarded for federal income tax purposes, so individual reports the business' results on individual tax return.

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Example 2. Same facts as Example 1, except that there are 2 owners that are married and file joint federal tax return.
  - Single member LLC is unavailable unless couple is willing to have only 1 of them own the entire business. (In community property states, couple is allowed to jointly own LLC and still treat as a disregarded entity for tax purposes.)
  - Assuming 2 owners of LLC, it will be treated as a partnership for tax purposes and will file its own tax return.
  - Even though there is some expense for accountant preparing partnership returns, it is not much more complicated because 100% of the results from business will flow to the “married filing jointly” return

## Certain Choice of Entity Considerations in Structuring Business Ventures (continued)

- Conclusion
  - No “silver bullet”
  - Certain statutory default rules can be contractually altered
  - Entity choice and structure generally not irreversible or irrevocable

## VI. Conclusion; Q&A