Understanding Legal Organization Structures

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Legal Organization Structure

- Types of Legal Organization Structures
  - Sole Proprietor
  - Partnership
  - LLP/LLC
  - C-Corporation
  - S-Corporation
Sole Proprietor

Refers to an individual who owns, manages, assumes all the risk and derives all the profits/loss from a business.

Sole Proprietor Characteristics

- No special legal procedures, permits or licenses
- Business not limited by size; can be as large or small as owner desires
- Number of employees vary, additional management may be hired, and property may be co-owned with others
Sole Proprietor
Advantages

– Easiest to create.
– Owner has freedom in operating the business – i.e. is free to organize and operate business in any legal manner.
– Owner makes all management decisions.
– All business profits and losses belong to the owner/sole proprietor.
– Business is flexible – e.g. quick decision making regarding investments, purchases, sales, enterprise combinations, input levels, etc., based solely on owner’s best judgment.

Sole Proprietor
Disadvantages

• Owner is personally liable for legal difficulties and debts.
• Creditors have legal right to take business and personal assets of the owner in fulfillment of unpaid financial obligations.
• Size of business limited by capital available to single owner – e.g., if capital is small, business may be too small to realize economies of size, making it difficult to compete with larger/ more efficient ones.
• As business grows, management abilities and time of single owner may be insufficient, thus a large sole proprietorship may need to hire additional management expertise.
• Lack of business continuity – e.g. death of owner means business may have to be liquidated or reorganized under new ownership.
Sole Proprietor
Taxes

A sole proprietorship pays income taxes on profit at the tax rates for individual or joint returns. Business profits and capital gains are added to other taxable income earned to determine the individual total taxable income.

Partnership

- A voluntary association of two or more persons to carry on, as co-owners of a business for profit – i.e., the business must be owned by the partners.

- Partnerships are governed by Uniform Partnership Act, which assume an equal partnership in profit, management decisions, etc., unless a written record specifies a different arrangement.
**Partnership**

**Types of Partnerships**

1) Ordinary or General Partnership
2) Limited Partnership: where investors want to limit their financial liability and do not wish to be involved in management.

The differences between General and Limited are:

a. Limited partners cannot participate in management of business.
b. Financial liability of partnership debt and obligations is limited to actual investment of limited partner.

Liability of general partners can extend assets.

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**Partnership**

**Creating a Partnership**

- Can be created by oral or written agreement, but orally agreed partnership tend to have more problems than written partnership agreements.
- Most important problems to spell out before partnership can start, or the written agreement should cover the following points:
  - Management
  - Property Ownership and Contribution
  - Share of Profit and Losses
  - Records
  - Taxation
  - Termination or Dissolution
Partnership Characteristics

• Profit/Loss: The sharing of the business profit and loss.
• Property or Assets: Shared control of property.
• Management: Shared management of the business.

Partnership Advantages

• Capital & Management Pooling: Has advantage over a sole proprietorship in pooling capital of partners to allow a larger business, that can be more efficient than two or more smaller businesses. Total management and labor are increased by pooling expertise of all partners. Management efforts can be divided, with each partner specializing in one area of the business.
• Easier to Create: Its easier and cheaper to form than a corporation. It requires more records than sole proprietorship, but not more than a corporation.
• Flexibility of Inclusion: Many types of arrangements can be accommodated in agreement. It fits situations where parents want to bring children and spouses into business, e.g., agreement can be modified to allow for contributions of children management/capital.
• No Tax Payment: Pays no tax, as profits are distributed as income.
Partnership Disadvantages

• Unlimited liability for partners in general partnership: Each partner is held personally and individually responsible for any lawsuits and financial obligations arising from the operation of the partnership – i.e., a partner’s personal assets can be claimed by creditors to pay firm’s debts (only in ordinary or general partnership).

• Faith Trust for Success: Any partner, acting individually, can act for the partnership in legal and financial transactions. For this reason, the firm can succeed only if partners have faith and trust in other partners’ business abilities.

• Poor Business Continuity: Business ends with death, disagreement, bankruptcy or incapacity of a partner.

Partnership Taxes

• No Direct Income Tax Payment: A partnership does not pay any income taxes directly.

• Files Tax Info with IRS: It only files an info income tax return reporting the income and expenses for the partnership.

• Partners Income Taxed at Individual Rate: Income from the partnership is reported by individual partners on their tax returns, based on respective shares of partnership income. Partnership income is thus taxed at individual tax rates, with the exact rate depending on the amount of partnership income and other income earned by each partner/taxpayer.
Limited Liability Partnership Characteristics

- Separate legal entity from the members

- Benefit of limited liability - one partner is generally not responsible or liable for another partner’s misconduct or negligence.

- Taxed as a partnership

Limited Liability Partnership Advantages

- Profits pass through the LLP, and taxes are paid personally by the members of the company.

- An LLP does not expose its members to unlimited legal liability.

- An LLP offers protection to the members from being responsible for the wrongdoings of other members.

- Members are allowed to participate fully in management of the company.

- No limit on the number of members for a LLP.

- Offers a large amount of flexibility; members decide how to operate various business aspects through the partnership agreement.
**Limited Liability Partnership Disadvantages**

- Not every state is ready to accept LLP
- More complex formation documents
- Relative independence of members
- Cannot operate across state lines

**Limited Liability Company Taxes**

- No Direct Income Tax Payment: A partnership does not pay any income taxes directly.
- Files Tax Info with IRS: It only files an info income tax return reporting the income and expenses for the partnership.
- Partners Income Taxed at Individual Rate: Income from the partnership is reported by individual partners on their tax returns, based on respective shares of partnership income. Partnership income is thus taxed at individual tax rates, with the exact rate depending on the amount of partnership income and other income earned by each partner/taxpayer.
Limited Liability Company – LLC
Sole Proprietor or Partnership

Can be either a sole proprietorship or partnership

Limited Liability Company – LLC
Advantages

• Profits pass through the LLC, and taxes are paid personally by the members (owners) of the company.
• Liability of the members is limited to the amount of their investments. Caveat - PLLC
• Members are allowed to participate fully in management of the company.
• Corporations and partnerships can be LLC members.
• No limit on the number of members for a LLC.
• An LLC can have just one member.
• Offers a large amount of flexibility; members decide how to operate various business aspects through the operating agreement.
Limited Liability Company – LLC Disadvantages

- LLCs do not have a reliable body of legal precedent to guide owners and managers, although LLC law is becoming more reliable as time passes.
- An LLC is not an appropriate vehicle for businesses seeking to become public eventually, or to raise money in the capital markets.
- LLCs are more expensive to set up than partnerships.
- LLCs usually requires annual fees and periodic filings with the state.

Corporation

Created by state law and organized for the purpose of carrying on a business for profit. A corporation is a separate legal entity which must be formed and operated in accordance with the laws of the state in which it is organized.
Corporation
Legal Status

• A legal "person" separate and apart from its owners, managers, and employees. This separation of the business entity from its owners distinguishes a corporation from the other forms of business organization. As a separate business entity, a corporation can
  – own property,
  – own money,
  – enter into contracts, and
  – sue and be sued.

• Has most of the basic rights and duties of an individual.

Corporation
Organization

Laws affecting formation and operation of corporations vary from state to state – e.g., several states have laws preventing corporations from engaging in farming or ranching, or place special restrictions on farm and ranch corporations.
Corporation Characteristics

Organizing or Creating Corporations
Basic steps that apply to forming a corporation:

1. The incorporators file a preliminary application with the appropriate state official, including corporation name.
2. Incorporators draft a pre-incorporation agreement outlining the major rights and duties of parties after the corporation is formed.
3. The articles of incorporation are prepared and filed with the proper state office.
4. Incorporators turn property/cash over to the corporation in exchange for shares of stock representing their ownership share of the corporation.
5. Shareholders meet to organize the business and elect directors.
6. Directors meet to elect officers, adopt bylaws, and begin business in the name of the corporation.

Corporations
Individuals Involved

- Shareholders
- Directors
- Officers
Corporation Types

- C-Corporation – Regular
- S-Corporation – Tax Option

Corporation Differences between C and S

- Tax Differences
- Limitations on S Corp
Corporation

Advantages

• Personal Liability
• Continuity of Management
• Income Tax Minimization
• Specialization in Management Decision Making

Corporation

Disadvantages

• Difficult to Create
  – Legal
  – Financial
  – Filing Fees

• Double Taxation of Income
• Any questions?
Your opinion matters!

Please take a moment now to complete the evaluation.

Thank You!
## Chart of Entity Comparison

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietor</th>
<th>Partnership</th>
<th>C Corporation</th>
<th>S Corporation</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal Status</strong></td>
<td>Same entity as owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner</td>
</tr>
<tr>
<td><strong>Separate Taxable Entity from Owner</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Ease of Formation</strong></td>
<td>Very easy</td>
<td>Partnership agreement is helpful</td>
<td>Articles of incorporation generally required</td>
<td>Articles of incorporation generally required</td>
<td>Articles of organization generally required</td>
</tr>
<tr>
<td><strong>Management</strong></td>
<td>Owner</td>
<td>May be divided among partners</td>
<td>Board of Directors</td>
<td>Board of Directors</td>
<td>Per articles of organization</td>
</tr>
<tr>
<td><strong>Continuity of Life</strong></td>
<td>Terminates with death of owner</td>
<td>Cessation of business; ceasing to operate as a partnership; sale or exchange of 50% or more of the profits and capital within a 12-month period; may terminate with death of partner if agreement specifies.</td>
<td>Continuous</td>
<td>Continuous</td>
<td>Per articles of organization</td>
</tr>
<tr>
<td><strong>Number of Owners</strong></td>
<td>One</td>
<td>Unlimited</td>
<td>Unlimited</td>
<td>100</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Eligible Owners</strong></td>
<td>Individuals</td>
<td>Unlimited</td>
<td>Unlimited</td>
<td>Some limitations</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Owner Liability</strong></td>
<td>Unlimited exposure</td>
<td>Unlimited if general partner; limited to investment if limited partner</td>
<td>Limited to investment, except for personal services</td>
<td>Limited to investment, except for personal services</td>
<td>Limited to investment, except for personal services</td>
</tr>
<tr>
<td><strong>Transferability of Ownership</strong></td>
<td>Only by sale of entire business or creation of a different entity</td>
<td>Can sell all or a portion of partnership interest</td>
<td>Can sell all or a portion of stock</td>
<td>Can sell all or a portion of stock</td>
<td>Per articles of organization; commonly has some limitations</td>
</tr>
<tr>
<td><strong>Ability to Raise Capital</strong></td>
<td>Limited to owners assets and borrowing ability</td>
<td>Limited to owners assets and borrowing abilities; can sell interests to raise capital</td>
<td>Limited to owners’ contributions and corporation borrowing abilities; can sell interests to raise capital</td>
<td>Limited to owners’ contributions and corporation borrowing abilities; can sell interests to raise capital</td>
<td>Limited to owners’ contributions and LLC’s borrowing abilities; can sell interests to raise capital</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Ownership Rights</th>
<th>Sole Proprietor</th>
<th>Partnership</th>
<th>C Corporation</th>
<th>S Corporation</th>
<th>LLC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>Divided among partners</td>
<td>Divided among shareholders</td>
<td>Divided among shareholders</td>
<td>Divided among members</td>
<td></td>
</tr>
<tr>
<td>Tax Year</td>
<td>Same as owner</td>
<td>Majority interest rules; principal partner rules; or the least aggregate deferral of income rule; exceptions may be the business purpose of §444 election</td>
<td>Calendar or fiscal year</td>
<td>Calendar year; §444 election; or business purpose demonstrated</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Allocation of Income</td>
<td>100% to owner</td>
<td>Based on partnership agreement if it has substantial economic reality</td>
<td>100% to corporation</td>
<td>Normally pro-rata based on per share/per day rule</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Tax on Formation if in Control</td>
<td>No gain or loss</td>
<td>Gain to the extent debt relief exceed basis of property transferred</td>
<td>No gain if debt relief does not exceed basis of property transferred and no other assets received by transferee</td>
<td>No gain if debt relief does not exceed basis of property transferred and no other assets received by transferee</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Tax on Formation if Not in Control</td>
<td>Not applicable since always in control</td>
<td>Gain to the extent debt relief exceeds basis of property transferred</td>
<td>Gain or loss as if sold property transferred for the FMV of the stock received</td>
<td>Gain or loss as if sold property transferred for the FMV of the stock received</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Original Basis of Stock if Not in Control</td>
<td>Not applicable since always in control</td>
<td>Basis of property transferred less debt relief</td>
<td>FMV of stock received</td>
<td>FMV of stock received</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Basis Increases from Operations</td>
<td>Additional purchases or cash invested</td>
<td>Increased by profits, additional contributions, and increase in partner’s share of debts</td>
<td>Increased by additional investments</td>
<td>Increased by profits and additional contributions</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Basis Decreases from Operations</td>
<td>Normal basis adjustments; depreciation, amortization, etc.</td>
<td>Decreased by losses, deductions, distributions, and decreases in partner’s share of debts</td>
<td>Decreased by nontaxable return of capital, if any</td>
<td>Decreased by losses, deductions, and distributions</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Deductibility of Losses</td>
<td>Normal limitations, at-risk, passive</td>
<td>Passed through to partners, normal limitations apply, basis, at risk, passive</td>
<td>Stay at corporate level, not passed through to shareholders</td>
<td>Passed through to shareholders, normal limitations apply, basis, at risk, passive</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td>Nonliquidating Distributions</td>
<td>100% belongs to owner</td>
<td>Based on partnership agreement</td>
<td>Pro-rata among shares</td>
<td>Rights must be pro-rata among shares</td>
<td>Pro-rata among shares if a corporation; 100% if a sole proprietorship; or based on partnership agreement if a partnership</td>
</tr>
<tr>
<td><strong>Sole Proprietor</strong></td>
<td><strong>Partnership</strong></td>
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<td><strong>S Corporation</strong></td>
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<td>------------------</td>
<td>------------------</td>
<td>--------</td>
<td></td>
</tr>
<tr>
<td><strong>Liquidating Distributions - Owner Level</strong></td>
<td>Not a separate entity; therefore all reported as part of owner’s return</td>
<td>Gain if cash, debt forgiveness, and marketable securities exceed basis or if partner receives a disproportionate share of unrealized receivables</td>
<td>Sold stock for value of cash and property received</td>
<td>Sold stock for value of cash and property received</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Worthlessness of Investment</strong></td>
<td>Already has written off or capitalized all investments; loss sale of assets if sold</td>
<td>Capital loss of remainder of basis</td>
<td>Capital loss of remainder of basis; may qualify for §1244 ordinary loss treatment</td>
<td>Capital loss of remainder of basis; may qualify for §1244 ordinary loss treatment</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Charitable Contributions</strong></td>
<td>Generally 50% limitation</td>
<td>Generally 50% limitation at partner level</td>
<td>Generally 10% limitation</td>
<td>Generally 50% limitation at shareholder level</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Alternative Minimum Tax</strong></td>
<td>Applies at individual level</td>
<td>Applies at partner level</td>
<td>Applies at corporate level</td>
<td>Applies at shareholder level</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Death - Basis Adjustments</strong></td>
<td>Basis of assets is generally FMV on the date of death</td>
<td>Basis of partnership interest is generally FMV on the date of death; §754 election available at partnership level</td>
<td>Basis of stock is generally FMV on the date of death</td>
<td>Basis of stock is generally FMV on the date of death</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Self-employment Tax</strong></td>
<td>Yes</td>
<td>Yes if general partner, generally no if limited partner</td>
<td>No, since payment for services is in the form of wages</td>
<td>No, since payment for services is in the form of wages</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Salaries Paid to Family Members</strong></td>
<td>Exempt from FICA for wages paid to children of owner who are under the age of 18; spouse and parents exempt from FUTA</td>
<td>Exempt from FICA for wages paid to children of owner who are under the age of 18 only if all partners are parents of children</td>
<td>No exemption for any family member</td>
<td>No exemption for any family member</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Accounting Method</strong></td>
<td>Any method that clearly reflects income</td>
<td>Any applicable method; cannot use cash method of partnership is a tax shelter or has a corporation as a partner</td>
<td>Any applicable method; cannot use cash if it’s a tax shelter, required use inventories, or has annual gross receipts over certain limits</td>
<td>Any applicable method; cannot use cash if it’s a tax shelter, required use inventories, or has annual gross receipts over certain limits</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Fringe Benefits - Entity Level</strong></td>
<td>Most are nondeductible; may be able to deduct 100% of qualifying health insurance premiums</td>
<td>Most are nondeductible; partner may be able to deduct 100% of qualifying health insurance premiums</td>
<td>Most are deductible</td>
<td>Most are nondeductible; shareholder may be able to deduct 100% of qualifying health insurance premiums</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td></td>
<td>Sole Proprietor</td>
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<td>C Corporation</td>
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<td>---------------</td>
<td>---------------</td>
<td>-------------------------------------------</td>
</tr>
<tr>
<td><strong>Fringe Benefits - Owner Level</strong></td>
<td>See box above</td>
<td>See box above</td>
<td>Most are tax free</td>
<td>Most are taxable, although may be exempt from FICA if they are nondiscriminatory</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Capital Losses</strong></td>
<td>Deductible by the owner up to capital gains plus $3,000; excess is carried over until death</td>
<td>Passed through to partners with normal limitations applying at partner level</td>
<td>Allowed only to the extent of capital gains. Any net capital loss for the year is carried back three tax years as short-term capital loss then forward five years</td>
<td>Passed through to shareholders with normal limitations applying at shareholder level</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Income Characterization</strong></td>
<td>Treatment depends on income; ordinary income, capital gains/losses, investment income, passive, etc.</td>
<td>Passed through to partners; character is the same as if partner received it directly</td>
<td>Dividend income when reported to shareholder</td>
<td>Passed through to shareholders, character is the same as if shareholder received it directly</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Exempt Income (i.e., municipal bond interest)</strong></td>
<td>Exempt</td>
<td>Passed through to partners; retains character as exempt</td>
<td>Remains exempt for income tax, may be subject to AMT</td>
<td>Passed through to shareholders; retains character as exempt</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
<tr>
<td><strong>Retirement Plans</strong></td>
<td>Any retirement plan, including SEPs, SIMPLEs, Keoghs, solo-401(k)</td>
<td>Any retirement plan, including SEPs, SIMPLEs, Keoghs, 401(k); must be established at partnership level; contributions passed through to partner and deductible by partner</td>
<td>Any retirement plan except Keogh; deductible at corporate level</td>
<td>Any retirement plan except Keogh; deductible at corporate level; must be established at S corporation level</td>
<td>Depends on tax status as sole proprietorship, partnership, or corporation</td>
</tr>
</tbody>
</table>

**Note:** This chart is intended for informational purposes only and may not include all aspects of tax law. When choosing a business entity, extreme care must be taken to ensure all federal and state laws are being followed.