North Carolina Cooperative Extension Service

NC STATE UNIVERSITY

COLLEGE OF AGRICULTURE & LIFE SCIENCES

NC Cooperative Extension

NC State Economist

Agricultural and Resource Economics • September/October 2004

Deciding How to Structure Your Business

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Given the variety of organizational models currently available, prospective business owners should have no problem finding one to meet their needs. Factors to evaluate include tax consequences, costs of formation, complexity, limitations on liability, needs of outside investors, estate planning and transition issues, and any other goals of the owners. This article describes four common models: sole proprietorship, partnership, limited liability company and corporations.

Sole Proprietorship

In a ***sole proprietorship*** one person owns all of the assets and is responsible for all of the debts, unlike a partnership or corporation. Income is reported on the individual's Form 1040, Schedule C, C-EZ, or Schedule F.

Partnership

A ***partnership*** is an association of two or more persons to conduct a business for profit. The relationship is consensual and contractual. A partnership is treated as an entity for litigation, holding title to property and bankruptcy proceedings. North Carolina has adopted the Uniform Partnership Act (UPA). Under the UPA, the partners have equal management authority and share equally in profits and losses. They share an equal obligation to contribute time, energy and skill without compensation to the partnership business. Each partner has unlimited personal liability to the creditors of the partnership, and all partners are liable for wrongful acts and breaches of trust by any partner. The UPA provides these default provisions in the absence of a partnership agreement to the contrary. Most provisions of the UPA can be modified in a written partnership agreement (e.g., capital contributions, management, sharing of profits and losses, rights and obligations, terms of property ownership, termination and dissolution, and buy/sell agreements).

A partnership files a federal information tax return (Form 1065) annually. Each partner receives a Schedule K-1 form that provides information about their share of partnership income, credits, deductions, and other information. All income flows through and is taxed to the individual partners. A partnership interest is personal to the partner. The partnership is dissolved by the death of a partner or by the sale of a partnership share.

Limited partnerships have characteristics of both a partnership and a corporation. They are used when some partners want neither management responsibilities nor unlimited liability for the business venture. North Carolina has adopted the Revised Uniform Limited Partnership Act (RUPLA). Under this statute, a limited partnership is formed by at least one general partner and one or more limited partners. A general partner manages the partnership and has full personal liability for the debts of the partnership. A limited partner contributes cash or other property. Liability for partnership debts is limited to the amount of the investment in the partnership. Limited partners do not participate in the management of the partnership. A limited partnership also files an information tax return, but income is taxed to the individual partners.

Also based upon RUPLA are ***family limited partnerships***. They are usually restricted to individual and specific family members. These partnerships are used to keep business assets in the family; protect the business from the consequences of divorce, death, and disability; provide for better organization and management of the business; and reduce estate taxes through valuation discounts.

Limited Liability Company

The ***limited liability company*** (LLC) is a distinct entity that is a hybrid of a partnership and a corporation. An LLC offers more flexibility because of its hybrid nature It can be treated as a partnership for tax purposes. The IRS allows an LLC to choose whether to be taxed as a corporation or as a partnership. Like a corporation, the members have limited liability for debts of the LLC. The LLC is not allowed to have an unlimited life, as a corporation is, but it may have orderly transfer provisions. Membership interests are not freely transferable without consent of all other members. A member may assign economic rights but not voting rights. The statute has been amended to allow for a one member LLC. This business entity is often used in estate planning because it can be an efficient way to transfer assets over time to the next generation. It may also generate valuation discounts that can reduce the value of the business in the gross estate, with a concomitant reduction in estate taxes. Valuation discounts typically result from restrictions on sales placed upon owners of interests in the business, and the minority owner status of some or all owners.

The LLC has the same limitations on liability as a corporation. The owners, like shareholders of a corporation, are not liable for the debts, torts, or other civil liabilities of the LLC. However, the limitations on liability are largely illusory for owners in family-owned LLCs and shareholders in *close* corporations. Since the owners are also generally the operators of the business, the owners are likely to have personal liability in tort because it was their personal actions as operators or managers of the business that gave rise to the liability. Few lenders are willing to lend to LLCs and *close* corporations without the personal guarantees of the owners or shareholders.

Corporations

Corporations are formed under state statutes. A corporation is a separate legal person that has rights and liabilities separate from its shareholders. A shareholder of a corporation is only liable for the debts of the corporation to the extent of his investment in the corporation. Shareholders elect a board of directors who set policy and appoint officers to manage the company on a daily basis. Shareholders do not participate directly in management decisions (unless they are also directors or officers). A corporation has a potentially unlimited life, and it is not dissolved by the death of a shareholder, director or officer. As noted in the discussion of LLCs, the limitations on liability from civil actions and debts for *close* family corporations, however taxed, are largely illusory.

Corporations formed under Subchapter C of the Internal Revenue Code are subject to double taxation whether *close* or publicly traded. This means that profits are taxed as they are earned by the corporation. If those profits are distributed to the shareholders as dividends, they are taxed again to the individual. The Internal Revenue Code places some limitations upon the ability of the corporation to avoid paying dividends and accumulate earnings within the corporation.

A corporation formed under Subchapter S is a ***close corporation***that has elected to be taxed like a partnership. Shares in *close* corporations are not publicly traded and sale of such shares is usually restricted. Instead of being taxed at the corporate level, the income flows through to the shareholders and is only taxed once, at the individual level (whether the profits are distributed or not). As with a partnership and a LLC, the failure to distribute sufficient funds to the shareholders to allow them to pay taxes on their *pro rata* share of profits may result in hardship to those shareholders who lack another source of funds with which to pay the taxes.

Generally, shares of stock are freely transferable by the stockholder. However, North Carolina law permits the creation of restrictions on stock transfers by the articles of incorporation, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation. A restriction must be authorized by statute and must not be excessively one-sided under the circumstances. Additionally, there must be a conspicuous notice of the restriction on the certificate or in the information statement required by the statute. One type of restriction would be a buy-sell agreement between a stockholder and the corporation or other stockholders requiring the selling stockholder to offer the stock first to the other parties to the agreement. The agreement usually provides a means to price the shares.

Shares in a corporation can be defined as common or preferred (subchapter C only), based upon the rights and privileges that belong to the owner. Common stock represents a fractional proprietary interest in the property and assets of a corporation. Therefore, the common shareholder participates on a *pro rata* basis in the distribution of corporate assets upon dissolution, and participates in corporate profits (dividends) and management of corporate activities (right to vote). Traditionally, holders of preferred stock are not creditors of the corporation and therefore do not share in corporate assets upon dissolution. Instead, they have a right to a fixed dividend, due and payable before any dividends to common shareholders. However, the articles of incorporation can grant rights to preferred shareholders to receive preference over common shareholders with regard to distributions of dividends and corporate dissolution proceeds.

The shareholders are the actual owners of the corporation, and ultimately they choose the people who will manage the company. Under North Carolina law, the shareholders must elect a board of directors to whom they delegate the power of management. The board is responsible for all of the business affairs of the corporation, such as issuing shares of stock and the rights of the shares issued, the sale of corporate assets, mortgaging corporate assets, declaring dividends, and the election of corporate officers. The senior management of the company, represented by the chief executive officer (CEO) and the senior management team, are responsible for the day-to-day operations of the corporation. Their authority and duties are prescribed by the bylaws and the directors. Officers and directors owe a fiduciary duty to the corporation and the shareholders, and they must not engage in self-dealing. An officer or director cannot engage in a competing business without full disclosure and permission from the corporation.

There are two ways to terminate a corporation: voluntary dissolution and involuntary dissolution. The directors and shareholders may voluntarily dissolve a corporation by passage of a resolution of dissolution and filing of articles of dissolution with the secretary of state. In addition, a corporation may be dissolved without its consent by court action or administrative action of the secretary of state. If the directors are not acting in the best interest of the company, any shareholder may obtain judicial dissolution. If the corporation fails to file annual reports or pay franchise tax, for example, the secretary of state may administratively dissolve the corporation.

Formalities are very important if the corporate form is to be used effectively. Formalities include holding regular shareholder and directors meetings, keeping accurate records, including minutes of shareholder and directors meetings, and maintaining separation between the property and accounts of the corporation and its shareholders. Failure to observe these formalities may result in a court setting aside the corporate form. This will defeat any effort to use the corporate form to limit liability or protect the business from disruptions caused by the death or divorce of a shareholder.

It may also result in dire and unforeseen tax consequences.

Business Organization Choice

In general the simplest form of business organization that meets the needs of the owners should be selected. Choosing a form of business organization depends on the objectives of the owners. Selection is often dictated by the investors who are financing the business. Investors and lenders will generally insist on the type of ownership that best protects their investment. Tax issues, though important, should not necessarily be allowed to override other considerations. Estate planning issues and intra-family issues will also be very important. Where there are passive investors, the choice of a business form that limits their liability may be very important. The willingness and ability of the owners to meet the formal requirements of the form is also a critical factor in making the choice: it is futile to choose a form of business organization that a court is going to set aside because the owners failed to observe formalities. Startup costs, ongoing maintenance costs, and costs associated with taxes are further important considerations when making the choice.

An unabridged version of this article was published by the North Carolina Cooperative Extension Service (Publication AG-650). To download this article, visit http://www.ag-econ.ncsu.edu/faculty/feitshans/AG650_for%20web.pdf.

N.C. State Economist

Published bi-monthly by the Department of Agriculture and Resource Economics and the Cooperative Extension Service. Address correspondence to:

The Editor, N.C. State Economist
Box 8109, N.C. State University
http://www.ag-econ.ncsu.edu/extension/

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