

Most common types of business entities



Corporations



Limited Liability Companies (LLC)

Business entities and Tax Choices

Business Corporations

default tax status

“C” Corporation

optional tax status

“S” Corporation subject
to restrictions

All US corporations have to file at least a federal tax return each year. Many states also require an annual tax return as well. Business corporations are always a C corporation at the time of formation. If all the shareholders qualify, and all the shareholders want to, the corporation can elect to become an “S” corporation. There are certain benefits and costs for making this election.

Limited Liability Companies (LLC)

default tax status

One Member Sole Proprietorship
Two or More Members Partnership

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optional tax status

“C” Corporation

“S” Corporation subject to restrictions

Flexible & complicated. Under the default rules, an LLC with one member does not exist for federal tax purposes, and an LLC with more than one member is a partnership. If it files an IRS form, an LLC can become a corporation (S or C) for tax purposes. Some states follow the federal rules, and many do not.

LIABILITY PROTECTION

“Liability” just means that if there are unpaid bills or the company loses a court case, then you as a shareholder, member, partner or owner must pay up from your personal funds or assets – like your house.

Limited liability

Corporations

LLCs

The shareholders of a corporation are only liable for the amount of capital they have committed to invest in the company. If they have not paid in all their share capital and the corporation goes bankrupt, they may have to pay up the unpaid portion. The Members of an LLC are protected to the extent of their investment in the LLC, but if there are no managers of the LLC may bear legal responsibility for actions that the LLC has taken. Even if there are managers, the members may or may not have further liability for their actions or negligence.

Warning: A shareholder or member who agrees to personally guarantee an obligation of a corporation or LLC cannot then try to say they have no liability for that obligation. Further, sometimes an LLC operating agreement removes the limitation of liability for one or more members of that LLC.

Unlimited Liability

Sole Proprietorship

Partnership

A sole proprietorship does not exist as an entity that is separate from its owner. All it really is is a right to use a name that you weren't born with. This means that a sole proprietorship is just you, and if you are liable for any debts or damages, your personal assets are at stake. A partnership is even worse: each partner is fully liable for all partnership-related debts and obligations of every other partner. This means that if your partner did something wrong you can be required to satisfy the obligation, regardless of how much (or little) you invested in the partnership.



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LEGAL BASIS

Corporation Law

Corporation law is several hundred years old. It's based on the belief that the assets of the corporation are legally separated from the shareholders who own the corporation. The shareholders elect directors to represent their interests, and otherwise give up responsibility over the company.

Limited Liability Company Law

LLC Law is based on partnership law while allowing the limitation of liability common to corporations. This means that the separation of the owners from the company is less complete: in many states if a Member of an LLC leaves, dies, goes bankrupt or is no longer in the company, the company itself may automatically dissolve unless the remaining vote to continue the company.

Owning Real Estate

Corporation Ownership of Real Estate

Owning real estate through a corporation is rare, because of the tax consequences. Although the limited liability feature of a corporation is useful, even using an S corporation does not make owning real estate through a corporation attractive.

LLC Ownership of Real Estate

The pass-through taxation benefit combined with liability protection make LLCs the better entity to own real estate.

Ownership

Corporation Ownership

Corporations are owned by shareholders through their shares of stock. When the company is formed, the corporation tells the state government how many shares of stock it will be authorized to issue. This is the absolute maximum that can be sold to other people. However, the corporation does not have to issue all those shares, and if there is only one shareholder that shareholder owns 100% of the company whether one share was issued or 1,000. There can be more than one "class" of shares, so that the owners can better divide up how profits will be shared.

Limited Liability Company Ownership

LLCs are owned by Members. Since LLCs are based on partnership law, the owners are listed in the operating agreement that runs the company. Many LLCs like to give out Membership certificates to each member, but this



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is generally not required. Membership certificates designate how much “Membership interest” each member has but this is not as important as the operating agreement. Members can be divided up into different classes, each class having different rights and privileges. Members may also decide not to have any Managers, and thereby run the company by themselves.

Transferring Ownership

Transferring Corporation Ownership

Passing the shares of a corporation is a matter of cancelling an existing share certificate. If the corporation is redeeming the shares then the certificate is taken out of circulation. If the shares were sold to another person, then the corporation cancels the share certificate and issues a new certificate to the new owner.

Transferring LLC Ownership

It is can be more difficult to transfer the ownership of an LLC, and the operating agreement may prevent transfer of ownership.

When not to use

When to Avoid a Corporation

Don't use a corporation for holding real estate. Don't use a corporation if you hate formalities.

When to Avoid an LLC

Don't use an LLC when you plan to go public in the future. Don't use an LLC for starting an active trade or business in the US when you are a non-resident entrepreneur or company, unless you love international tax complexities.