THE BUSINESS ORGANIZATION
CHOOSING A BUSINESS ENTITY

The subject matter is divided into two sections:

1. **Section A shows direct comparison of different types of organizational structures.**
2. **Section B details advantages and disadvantages of different types of organizational structures.**

To use Section A and B in tandem will provide best reasoning when recommending a definite structure.

A note of caution: The counselor should not make his recommendations to appear to be the last word. There are tax and non-tax reasons. The client's accountant and/or lawyer may come to a different conclusion as to what structure is best suitable.

SOME SPECIFIC ATTRIBUTES COMPARED

Owner's Liability

Often a prime concern in selecting a business form is the owner's financial exposure. Unless the form selected provides limited liability, the owner's personal assets and holdings are exposed to the claims of creditors or claimants of the business. Although liability insurance is available to cover liability for tort claims, personal liability of the owner may be a significant concern, particularly if the business involves risk or if the owner has substantial personal assets.

Limited partnerships and corporations both provide limited liability and should be considered if liability exposure is a concern. A limited partnership has the disadvantages of requiring that at least one general partner be subject to the liabilities of the business.

Control

Control or management, when more than one person is involved in a business, is another major factor in selecting a form of business organization. Whether all owners can participate in control or management, and in what form, will depend upon the choice of business entity.

Transferability of Ownership Interests

Transferability of ownership interests permits the transfer of ownership of the business entity, during the owner's life and upon death, without disturbing the continuity of the business. All ownership interests are transferable, but the convenience or ease of transfer differs substantially among various forms of business entity.

Organization and Maintenance Costs

The costs of organizing a business entity, maintaining books and records, and complying with public reporting requirements can be substantial. These costs may be a factor in selecting a form of business entity.

Tax Attributes

The tax considerations relating to going into business for the first time or changing the form of a business are extensive and complex. The tax attributes of the various forms of business entities can be a significant consideration in selecting a form of business entity. In some cases, particularly with tax-motivated transactions, the tax attributes will be the primary consideration. Even if taxes are not a major consideration, the tax attributes of the chosen form need to be considered to avoid unintended negative consequences.

SECTION A

COMPARISON BETWEEN DIFFERENT TYPES OF ORGANIZATIONS

Attributes	Sole Proprietorship	Partnership	Corporation	S Corporation	Limited Liability Company
Entity Description	One individual who carries on an unincorporated trade or business. (A husband and wife who own a business jointly and contribute to the business as owners must file Form 1065 as a partnership.)	An association of two or more individuals who make a legal contract to carry on a trade or business. Each partner contributes cash, property, and/or services. A joint undertaking merely to share expenses or share ownership of property, does not necessarily constitute a partnership. A partnership has its own legal status.	A business entity that carries its own legal status, separate and distinct from its owners.	A corporation can elect to be taxed as an S corporation by filing Form 2553. Only domestic corporations with one class of stock are eligible. Limited to 75 shareholders, and may not have another corporation as a shareholder. (Exception for qualified subchapter S subsidiary.) Other restrictions apply.	A hybrid entity, generally formed under state law, that combines the pass-through attributes of a partnership with the limited liability of a corporation. The LLC can also elect to be taxed as a C corporation. For purposes of this chart, the LLC is assumed to have not made such an election.
Organization & Administration	Easiest business to organize. Allows complete intermingling of business and personal funds (although this is not recommended). Partnerships and corporations cannot intermingle business with personal funds. Business return is filed along with the owner's individual income tax return.	Easy to organize. A written partnership agreement is recommended, but not required. The partnership agreement determines how income and losses are allocated to the partners. If a partnership agreement does not exist, partnership items pass through based on the partners' ownership interest.	Difficult and expensive to organize. Must hold periodic board meetings and keep minutes. Must comply with federal and state regulations.	Set up as a regular corporation. Must make election to be treated as an S corporation. Certain events will cause automatic termination of S status.	An existing partnership can generally register for LLC status in the state in which it conducts business. Registration is generally less complicated than forming a corporation.
Bookkeeping & Accounting	Fewer requirements on what type of bookkeeping system or accounting method is used. The system must be consistent; clearly show income and expenses; and allow the taxpayer to file an accurate return. The sole proprietorship must follow the same tax year as the owner.	Depending on income and assets, the partnership may be required to include a balance sheet with its income tax return. Therefore, the partnership should use the double entry method for bookkeeping purposes. If a partner exchanges property other than cash in exchange for an interest in a partnership, special accounting rules must be applied.	The balance sheet on the corporation's tax return must agree with the corporate books. The corporation must use a double entry bookkeeping system. The corporation must file all necessary employment tax returns.	Must use double entry bookkeeping. Must file all required payroll tax and reporting forms.	Same as a partnership.
Owner Control & Flexibility	Owner is free to make all business decisions.	Control of the business operations is divided among partners.	Shareholders have control over the corporation to the extent that they own voting stock.	Shareholders have control over the corporation to the extent that they own voting stock.	Control is divided among members.
Transfer of Ownership	A sole proprietorship is not a separate entity from its owner. "Sale" of a sole proprietorship is actually a sale of assets.	The partnership agreement may restrict the sale of a partnership interest, and may control the terms of the sale.	Ownership is easily transferred by selling shares of stock. The corporate charter may place certain restrictions on the sale of stock by shareholders.	Ownership is transferred by sale of stock. The corporate charter may place certain restrictions on the sale of stock by shareholders.	The operating agreement may restrict transfer of ownership interest.
Transferability of Interests	Freely transferable.		Generally freely transferable. Can be restricted thru buy-sell agreements.		Generally subject to members approval.

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Taxation	Net profit is computed on Schedule C and is reported as income on the owner's Form 1040.	Partnership income and expenses flow through to the individual partners. Income is taxed to the partner whether or not it is actually distributed. Pass-through items retain the same character in the hands of the partner as they had in the hands of the partnership.	A C corporation pays tax on its profits. When the owners (shareholders) take profits from the corporation, the distributions take the form of taxable dividends (double taxation). "Personal Service Corporations" are taxed at a higher rate.	Taxed in the same manner as a partnership. Income and expenses flow through to shareholders. Pass-through items retain the same character in the hands of the shareholder as they had in the hands of the corporation.	Taxed as a partnership. Income and expenses flow through to members.
Tax Year	Must use tax year of proprietor	Generally must use fiscal year of majority interest partners or make IRC Sect. 444 election.	May select any fiscal year if not a personal service corp.	Generally must use calendar year or make IRC Sect. 444 election.	Generally must use fiscal year of majority interest partners or make IRC Sect. 444 election.
Maximum Tax Rate	Taxed at individual level.	Taxed at individual partner level.	35% with 3% increase for taxable income between $15-18.33 million.	Generally taxed at individual shareholder level.	Taxed at individual member level.
Taxability of Income	Proprietor pays.	Partner pays.	Corporation pays. Shareholders pay tax on dividends.	Shareholders pay.	Members pay.
Use of Tax Credits	Used to offset individual's taxes.	Passed thru to partners to be applied to their taxes.	Used to offset corp. taxes.	Passed thru to shareholders to be applied to their taxes.	Passed thru to members to be applied to their taxes.
Distribution To Owner	Nontaxable	Nontaxable to extent of basis in Ptp. Disproportionate of IRC Sect. 751 assets may trigger gain.	Not deductible by corp. Generally ordinary income to shareholder. Distribution of appreciated property results in gain recognition by corp.	Nontaxable to extent of basis in stock. Distribution of appreciated property results in gain recognition.	Nontaxable to extent of basis in Ptp. Disproportionate distribution of IRC Sect. 751 assets may trigger gain.
Wages & SE Tax	Owner is subject to self-employment tax of 15.3% of net earnings. Self-employment tax is computed on Schedule SE and is reported as "Other Taxes" on Form 1040.	A general partner's share of business income (including guaranteed payments) is subject to self-employment tax. A limited partner's share of business income is not subject to self-employment tax unless the partner performs services for the partnership. Other items, such as interest and dividends, retain their character and are passed through to the partner's individual income tax return.	Shareholders who perform services for a corporation, including officers, are treated as employees. Wages of corporate employees are subject to payroll tax and withholding. Wages paid to employee-shareholders must be "reasonable." Dividend distributions are not subject to SE tax.	An employee/shareholder of an S corporation receives wages for services rendered. Wages paid to employee/shareholders must be "reasonable." Additional profits are passed through to the shareholder and are taxable for income tax purposes but not for SE tax purposes. Double taxation of profits is avoided.	Profits are subject to income tax in the same way as a partnership. Members' business income (including guaranteed payments) is subject to self-employment tax.
Accumulation of Earnings	No restrictions.	No restrictions.	Corp. could be subject to accumulated earnings tax on unreasonable accumulation.	No restrictions.	No restrictions.

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Fringe Benefits	Only the amount paid on behalf of employees is deductible. Amounts paid on behalf of the sole proprietor are not deductible. Exception: A sole proprietor can deduct medical insurance premiums and medical reimbursement costs under an accident and health plan that covers all employees. If the sole proprietor's spouse is covered under a plan that also covers the owner as part of the family, the deduction is still allowed.	Generally not tax free to partner. Must be included in partner's income.	Owner/employees are entitled to the same tax-free fringe benefits as other employees (subject to discrimination rules).	Restricted for employee shareholders that own more than 2% of the corporation. Must generally be included in wages.	Subject to the same rules as a partnership.
Personal Liability	Sole proprietor is liable for all business debts and actions.	A general partner is personally liable for all partnership debt. A limited partner's liability is usually limited to the partner's investment in the partnership.	Shareholders are not liable for debts incurred by the corporation. Liability is generally limited to the amount invested.* *Caution: The courts may disregard the so-called "corporate liability shield" in the case of single shareholder corporations.	Shareholders have limited liability, just as with a C corporation.* *Caution: The courts may disregard the so-called "corporate liability shield" in the case of single shareholder corporations.	The degree of liability protection for LLC members varies from state to state.
Liability Of Owners	Unlimited	General Ptp. – unlimited. Limited Ptp.: general partner – unlimited; limited partners – limited to investment in Ptp.	Generally limited to assets in corporation.	Generally limited to assets in corporation.	Limited
Management	Centralized	General Ptp. not centralized. Limited Ptp. usually centralized.	Centralized. Board of Directors. Corporate officers.	Centralized. Board of Directors. Corporate officers.	May be either centralized or not.
Continuity of Life	Ends on death of proprietor.	Terminates if 50% of more of total interest in capital & profits is sold or exchanged within a 12-month period.	Indefinite	Indefinite	Generally no
Contribution Of Property	Nontaxable transaction.	Generally a nontaxable transaction. Assumption of liabilities by Ptp. may trigger gain recognition.	Nontaxable only if transaction meets Int. Rev. Code Sec. 351 requirements.	Nontaxable only if transaction meets Int. Rev. Code Sec. 351 requirements.	Generally a nontaxable transaction. Assumption of liabilities by LLC may trigger gain recognition.
Charitable Contributions	Deductible by individual subject to certain percentage limits.	Passed thru to partners. Limits apply at partner level.	Deductible by corp. subject to certain percentage limits.	Passed thru to shareholder. Limits apply at shareholder level.	Passed thru to members. Limits apply at member level.
At-Risk Rules	Limits apply at proprietorship level.	Limits apply at partner level.	Only applicable to certain closely held corp.	Limits apply at shareholder level.	Limits apply at member level.
Special Allocation of Income/Loss	Not permitted	Permitted as long as there is substantial economic effect.	Not applicable	Not permitted	Permitted as long as there is substantial economic effect.

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Losses	Business losses can offset other income such as interest, capital gains, or a spouse's wages if filing a joint return. Subject to "Hobby Loss" rules under IRC § 183.	Losses flow through to partners. Recognition of loss by a partner is limited by the partner's basis, at-risk rules, and passive activity rules. Subject to "Hobby Loss" rules under IRC § 183.	Capital losses are allowed only to the extent of capital gains. Net operating loss of a corporation may be carried over against corporate income, but is not directly passed through to shareholders.	Losses flow through to shareholders. Recognition of loss is limited by the partner's basis, at-risk rules, and passive activity rules. Subject to "Hobby Loss" rules under IRC § 183.	Losses flow through to members. Recognition of loss by members is limited by the member's basis, at-risk rules, and passive activity rules. Subject to "Hobby Loss" rules under IRC § 183.
Deductibility of Losses	Deductible by proprietor.	Generally deductible by partner to extent of basis. Liabilities may increase basis for deducting losses.	Deductible by corporation.	Generally deductible by shareholders. Liabilities do <u>not</u> increase basis for deducting losses except for direct loans from shareholder.	Generally deductible by member to extent of basis. Liabilities may increase basis for deducting losses.
Passive Losses	May not offset active or portfolio income.	Cannot offset active or portfolio income (limits apply at partner level).	May offset active income but not portfolio income of closely held corp. May not offset active or portfolio income of personal service corp.	May not offset active or portfolio income (limits apply at shareholder level).	Cannot offset active or portfolio income (limits apply at member level). *Unclear if members treated as limited partners*.
Use of Net Operating Losses	Used offset individual's income subject to certain limits.	Passed thru to partners. Limits apply at partner level.	Used to offset corp. income subject to certain limits.	Passed thru to shareholder. Limits apply at shareholder level.	Passed thru to members. Limits apply at member level.
Health Care for Employee-Owner	25% Deductible without regard to 7.5% floor. Remainder deductible as itemized deduction subject to 7.5% floor.	Typically deductible by Ptp. As guaranteed payment. Reported as income by partners. 25% Deductible by partners without regard to 7.5% floor. Remainder deductible as itemized deduction subject to 7.5% floor.	Payments are deductible.	Deductible by corp. as compensation. 25% Deductible by more than 2%-shareholder without regard to 7.5% floor. Remainder deductible as itemized deduction subject to 7.5% floor.	Typically deductible by Ptp. as guaranteed payment. Reported as income by partners. 25% Deductible by partners without regard to 7.5% floor. Reminder deductible as itemized deduction subject to 7.5% floor.
Qualified Retirement Plans for Employee-Owner	Payments to a Keogh or SEP are deductible.	Payments to a Keogh or SEP are deductible.	Payments are deductible if plan is nondiscriminatory.	Payments are deductible if plan is nondiscriminatory.	Payments to a Keogh or SEP are deductible.
Life Insurance for Employee-Owner	Premiums are not deductible.	Premiums are not deductible.	Premiums for first $50,000 group term life are deductible and not taxable to employee.	California statue unclear. Assume deductible as compensation.	Premiums are not deductible.
Gain on Sale of Interest	Capital and/or ordinary.	Capital (unless collapsible Ptp. rules apply).	Capital (unless collapsible corp. rules apply). Up to 50% of gain from qualified small business stock may be excluded.	Capital (unless collapsible corp. rules apply).	Capital (unless collapsible Ptp. rules apply).
Loss on Sale of Interest	Capital and/or ordinary.	Generally capital.	Ordinary to extent of IRC Sect. 1244 stock, otherwise loss is capital.	Ordinary to extent of IRC Sect. 1244 stock, otherwise loss is capital.	Capital.

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Liquidating Distribution	Nontaxable	Generally nontaxable. Cash distribution in excess of basis will trigger gain. Disproportionate distribution of IRC Sect. 751 assets may trigger gain.	At corp. level treated as sale of property. Gain to shareholders if fair market value exceeds stock basis.	At corp. level treated as sale of property. Gain passes thru and increases shareholder basis. Could trigger built-in tax gains.	Generally nontaxable. Cash distribution in excess of basis will trigger gain. Disproportionate distribution of IRC Sect. 751 assets may trigger gain.
Employee Benefits	Accident and health insurance is available to all entities, except only corporations are allowed a full deduction, all others may deduct only 25% of the premium on their personal income tax return, subject to the 7.5% floor.	Accident and health insurance is available to all entities, except only corporations are allowed a full deduction, all others may deduct only 25% of the premium on their personal income tax return, subject to the 7.5% floor.	Accident and health insurance is available to all entities, except only corporations are allowed a full deduction, all others may deduct only 25% of the premium on their personal income tax return, subject to the 7.5% floor. $50,000 group term insurance; Disability insurance; Medical expense reimbursement plans; Certain transportation, lodging and meal expenses; Deferred compensation plans, stock ownership plans; Certain types of deferred compensation plans; and Qualified Employee Stock Ownership Plans.	Accident and health insurance is available to all entities, except only corporations are allowed a full deduction, all others may deduct only 25% of the premium on their personal income tax return, subject to the 7.5% floor.	Accident and health insurance is available to all entities, except only corporations are allowed a full deduction, all others may deduct only 25% of the premium on their personal income tax return, subject to the 7.5% floor.
BUSINESS INSURANCE: The "limited liability" characteristics of certain business entities should not be considered a substitute for proper insurance coverage. The business owner should consider coverage to protect against: Fire and theft; Business interruption; Errors and omissions; Employment practices; Employee benefit plans; Employee Dishonesty. General liability coverage, including "umbrella" policies for personal injury and property damage, should also be considered.					

LATE BULLETIN – The $800 tax has been waived for the first two years of a corporation's existence. There will be only a $100 filing fee.

SECTION B

ADVANTAGES AND DISADVANTAGES OF DIFFERENT TYPES OF ORGANIZATION

1. SOLE PROPRIETORSHIP

Advantages:

- **Simple to start**
- **Nominal legal fee**
- **Low license fees**
- **Minimum Government interference**
- **Profits not shared**
- **Minimum legal restrictions**
- **Easy to discontinue**

a. Few formalities are required for organization and hence organizational costs are minimal.
b. Absence of statutory or other formalities required for decision-making and action.
c. Freedom to do business anywhere without elaborate formalities to qualify.
d. Minimal reporting requirements to government entities.
e. Control is centered in one person, thus avoiding the inconvenience of collective decision-making and the risks arising when broad powers to manage or obligate the business are granted to several persons.
f. Income is taxed at individual income tax rates, which are lower than corporate rates for income in excess of $75,000 per year.
g. Losses are available on the owner's personal income tax return and can offset other income.

Disadvantages:

- **Terminates with death**
- **Difficult to raise capital**
- **Needs diversified talent**
- **High failure rate**
- **May not bring in new owners**
- **Income tax cannot be deferred by retaining profits**

a. The owner is subject to unlimited liability for obligations and liabilities of the business.
b. The business is subject to termination upon the death or disability of the owner.
c. Transfer of the business through sale or otherwise requires transfer of the individual assets of the business.
d. Risk or equity capital is limited to resources of the individual owner, and borrowing capacity may be limited as well.
e. Business profits are taxed as income to the owner at individual income tax rates, which are higher than those of a corporation for income up to $75,000.

2. PARTNERSHIPS

Advantages:

- **Not very difficult to form**
- **A method of raising capital**
- **Partners are boss**
- **Abilities are complimented**

a. Minimal formalities are required for organization, and hence organizational costs are limited.

b. Since a partnership involves more than one person, it permits a combination of individual resources and talents, and authority to act is not limited to one person.
c. Law for decision-making and action requires few formalities.
d. The business may operate where it wishes without elaborate formalities to qualify.
e. Minimal reporting to governmental entities is required.
f. If the partnership agreement so provides, a partnership may continue in existence after the death or withdrawal of a partner.
g. Business profits are taxed to the partners, and if they are individuals, will be taxed at individual income tax rates, which are lower than corporate rates for income exceeding $75,000.
h. Business losses are available on partners' personal income tax returns and can offset other income.
i. Can be created by oral agreement.

Disadvantages:

- Finding suitable partners
- Disagreements
- Partnership agreement-Legal fees
- Authority of partners undefined
- Unlimited liability
- Difficult to dissolve
- Terminates with death
- Profits shared
- A partnership is often easier to get into than out of
- General partners are liable for actions of other partners

3. Limited Partnership

A limited partnership is a partnership formed under state limited partnership law. A limited partnership must have at least two partners, and must have at lease one general partner and one limited partner. A limited partnership may be formed only by filing a certificate of limited partnership with the Secretary of State of the state in which the limited partnership is to be organized.

The feature that distinguished a limited partnership from a general partnership is that limited partners' liability is restricted to their contribution. A limited partner is not responsible for the debts and liabilities of the partnership unless he or she takes part in the control of the business. Management of a limited partnership is vested exclusively in the general partner(s).

1. An artificial, intangible legal entity formed by two or more persons under California law with at least one general partner and one limited partner.
2. Control is centered with the General Partner, with few exceptions.

Advantages:

- The General Partner operates with a minimum of accountability to the limited partners

Disadvantages:

- The limited partner has no voting rights and no influence in the management of the business
- To invest in a limited partnership should depend on the track record of the general partner
- A $100 registration fee to the state
- No employee benefits are permitted for limited partners or shareholders who are not also employees

4. Corporations

Advantages:

- A way of raising capital
- Continues until terminated

a. Limited liability of the shareholders for debts and liabilities of the corporation.

b. Free and ready transferability of ownership by sale and transfer of stock, without affecting the continuing existence of the business or title to its assets.
c. Perpetual existence of the corporation unaffected by the death of shareholders or transfer of shares.
d. The ability to transact business without each shareholder participating in each decision.
e. Flexibility of financing through the sale of various securities to many investors.
f. The availability of tax-favored fringe benefits unavailable to other business entities.

    1. The first $50,000 earned are subject to a 15% tax; the next $25,000 to a 25% tax. These funds can be collected and returned up to $250,000 for the purpose of expansion or an investment in the business, a more worthwhile consideration in the business plan.
    2. Double taxation can be minimized or avoided by paying higher salaries, commission, or fringe benefits.

Disadvantages:

- Charter restrictions
- Legal requirements-Reports, records
- More government control
- Franchise tax

a. Relatively high costs of organization.
b. Burdensome requirements for reporting to governmental entities.
c. Statutory formalities must be adhered for decision-making and action.
d. Control is vested in a board of directors, not the individual owners.
e. Stock transfers are subject to securities law regulation.
f. Limited liability limits the assets available to establish credit. The result is that individual shareholders are often called upon to guarantee corporate indebtedness, which defeats the value of limited liability.
g. Must qualify to do business in states other than the state of incorporation.
h. Double taxation for federal income tax purposes of business income, which is taxable initially to the corporation and again upon distribution to the shareholders.
i. Individual shareholders may not deduct losses of corporations, unless the corporation elects to be taxed as an S Corporation.

    1. There is that double taxation one may not be able to avoid, if the firm grows and the investors want their share of the profit.

    2. Compare with tax savings of LLC example:

LLC taxable income		100,000
Tax to owner 30%		30,000
Balance to owner	70,000	
C Corporation taxable income	100,000	
Corporate tax 30%		30,000
Distribution to owner		70,000
Tax to owner 30%	21,000	
Balance to owner	49,000	

5. S-Corporations

Advantages:

- Eliminates corporate double taxing
- Keeps limited liability advantage of incorporation
- Tax is based on partnership returns
- Allows pass-through of losses to offset income from other sources
- Profits passed through are not subject to SE tax as in a partnership

a. Lower taxes.
b. No double taxation.
c. Loss deductions passed through to shareholders.
d. No accumulated earnings tax.
e. No personal holding company tax.
f. No alternative minimum tax.
g. Associations taxable as a corporation.
h. Family income splitting opportunities.
i. No unreasonable compensation concerns.

1. **Corporation profit passed through to shareholders who work for the corporation are not subject to self employment tax, as long as shareholder pays himself a reasonable salary, which is subject to this tax.**
2. **There is no dissolution tax on appreciated assets.**
3. **Losses are limited to each shareholder contribution.**
4. **Costs less to maintain than an LLC.**
5. **Satisfies the limited requirements of a small business.**
6. **There is no additional tax on revenue growth.**
7. **One person can form an S-Corporation.**
8. **Does not need the flexibility of an LLC in most cases.**

Disadvantages:

- **All profits must be distributed and taxed annually**
- **If in tax bracket exceeding corporate rate, an S-Corporation may not be desirable**
- **You must incorporate**
- **Not over 75 stockholders**
- **A single class of stock**
- **US citizen or resident**
- **Must incorporate and make S-Corp election by filing IRS Form 2553.**

a. Passive income restrictions.
b. Employee benefit restrictions for shareholders owning more than 2% of the stock.
c. Calendar year operation required (unless a valid business purpose.) (Proposal pending to permit fiscal years.)
d. Some less favorable deductions.
e. Carryovers from C-Corporation years.
f. Contribution limits to a qualified retirement plan are based on employee/shareholder's wages, not overall profits such as a sole proprietor.
g. Does not have flexibility of an LLC.

6. LIMITED LIABILITY COMPANIES

Advantages:

- **Similar to S-Corporations except that LLC's are subject to fewer restrictions**
- **An LLC is treated as a partnership for tax purposes instead of a corporation if it lacks a majority of the following corporation characteristics: limited liability, continuity of life, centralized management, free transfer of interest (ownership).**
- **Avoids double taxation of profits**

1. **Loan can be deducted, based on shareholders contribution plus borrowed funds.**
2. **Has choice: either pass-through entity like S-Corporation or treated and taxed like a C-Corporation.**
3. **Can allocate earnings/loss disproportionally.**
4. **Any accumulated earnings or personal holdings company tax problems will not exist for an LLC.**
5. **LLC members will not be at risk for unreasonable compensation.**

Disadvantages:

- **Annual fees are greater than for corporations**
- **A professional service company cannot be an LLC**
- **Restrictions on fringe benefits**
- **LLC's may face risks of higher taxes and liability for business done in other states**

1. **Besides paying a $100 registration fee, there is also a franchise tax of 1½% on net profit.**
2. **Extra profits, which cannot be reasonably paid as wages are subject to self-employment tax.**
3. **There is a dissolution tax on appreciated assets.**
4. **There are sliding taxes from $500 to $4500 (on 5M) on gross receipts.**
5. **Requires two people to form an LLC.**

LIMITED LIABILITY COMPANIES VS. OTHER TYPES OF ORGANIZATIONS

Advantages:

The LLC vs. the C Corporation

C corporations and their owners have always been subject to double taxation (once at the corporate level and once on the shareholders). Since 1986, this double tax has become particularly onerous upon liquidation of the corporation. An LLC, however, is subject to only one level of tax at the member level. Also, any accumulated earnings or personal holding company tax problems will not exist for an LLC, and LLC members will not be at risk for "unreasonable compensation."

The LLC vs. the Corporation

Although the pass-through concepts are similar, the LLC has some distinct advantages over the S corporation. First, where the S corporation rules restrict the number of shareholders and who they are, the LLC has no such restrictions. Corporations, nonresident aliens and trusts may be members and, unlike the S corporation, there can be multiple classes of members in the LLC. Second, where S corporations must allocate income or loss on a strict prorata basis to stock ownership, the LLC may specially allocate income or loss (subject to the confines of the economic effect rules). Third, the penalty taxes for built-in gains and excess passive income do not apply to an LLC. Fourth, unlike the S corporation, the LLC can elect to adjust the basis of its assets on the death of a member or on the sale of a membership interest. Fifth, it appears that an LLC member would be entitled to basis for the LLC's debt (unlike the S corporation shareholder for corporate debt).

The LLC vs. the General Partnership

The big difference: no member of an LLC is personally liable for the debts of the LLC. Again, bear in mind exceptions for professional liability and certain statutory liabilities, as well as any "piercing of the corporate veil."

Disadvantages:

Since money matters, let's start with the fees to the State of California. In addition to an annual minimum tax of $800, an LLC will pay annual fees on a sliding scale based on gross receipts.

Who Could Benefit from an LLC?

Any new business with more than one owner should consider operating as an LLC, especially if it is engaged in anything risky. Note that, unlike a C or S corporation, an LLC requires at least two members. An LLC might be a good choice to be the general partner in a limited partnership. And if you're considering a family limited partnership, an LLC might be a good alternative (but check those valuation discounts first).