

# Business Entities

## (And Other Cocktail Party Discussions)



I was recently at a cocktail party when I overheard the following discussion between two music store owners:

**Ed:** Hey Ralph, how's your business?

**Ralph:** Well, not bad, but I've been concerned about a few things lately. Do you mind if I ask what kind of business entity your store is? Is it a corporation, partnership or something else?

**Ed:** I'm a sole proprietorship. Why do you ask?

**Ralph:** Well, I'm incorporated, and I find it annoying. I pay taxes both corporately and personally. I have to conduct these ridiculous annual meetings. And my accountant costs a small fortune at the end of the year.

**Ed:** Gee Ralph, I was thinking about incorporating my music store because of some of the unique problems I've been having. I usually owe a ton of taxes on April 15th. Also, I want to give one of my key employees an ownership interest in the store, and I'm not sure how to do it. Plus, I'm a little nervous about a lawsuit that got filed against my store. I thought incorporating was the answer, but now I'm not sure. Any suggestions?

**Ralph:** Yeah, have another martini.

Whether or not Ralph and Ed are aware of it, they are discussing one of the most important issues in transacting business. Whether purchasing an existing business, starting one from scratch, adding a new owner

or addressing changing issues of liability and risk, every business owner must decide which form of organization (sometimes referred to as "business entity") is best for their company. The decision can often be difficult to make, as there are several choices and each has its advantages and disadvantages.

The following is some important information on the various types of business entities. This way you don't have to rely on cocktail party discussions for your primary source of critical business advice.

### The Big Four (or Five)

**Ed:** Hey Ralph, I heard some other music dealers talking about "C" Corps and an "S" Corps. What are they talking about with all these corps? Dead bodies or something? And pass me another beer.

**Ralph:** I think I'm an S Corp. I think it means I pay less taxes. Actually, I don't know what it means. It's something my overpaid accountant took care of. Pour me another scotch and we'll give him a call.

What Ed needs to know is that there are basically four different types of business entities a business owner can choose. They are: Sole proprietorship; General partnership; Corporation; and Limited Liability Company.

Now some of you may think there's another completely different entity type called an "S Corporation." You're half-correct. S Corporations, as their name implies, are still corporations. The only thing that makes S Corporations different than regular corporations (also known as "C Corporations") is simply the manner in which they're taxed. From a legal standpoint, there's no difference, as they're both corporations. But since the tax aspects of C Corporations and S Corporations do vary in significant ways, we'll treat the S Corporation

## BUSINESS ENTITY COMPARISON CHART

Characteristics	SOLE PROPRIETORSHIP	GENERAL PARTNERSHIP	LIMITED LIABILITY COMPANY (LLC)	"S" CORPORATION	"C" CORPORATION
Formation	No permission required	Agreement of parties involved; no permission required	File with state for permission	File with state for permission	File with state for permission
Duration	Dependent on sole proprietor	Dissolved by death of partner or bankruptcy	Typically limited to a fixed amount of time	Perpetual	Perpetual
Liability	Sole proprietor has unlimited liability	Partners have unlimited liability	Members not liable for the debts of the LLC	Shareholders are not personally liable for the debts of the corporation	Shareholders are not personally liable for the debts of the corporation
Simplicity of Operation	Relatively few legal requirements	Relatively few legal requirements	Some formal requirements but less formal than corporation	Formality of board of directors, officers, annual meetings and annual reporting	Formality of board of directors, officers, annual meetings and annual reporting
Management	Full control of management and operations	Typically each partner has an equal voice unless otherwise arranged	Members have operating agreement that outlines management	The corporation is managed by the board of directors who are elected by the shareholders	The corporation is managed by the board of directors who are elected by the shareholders
Taxation	Non-taxable entity; sole proprietor pays all taxes	No tax at the entity level. Income/loss is passed through to partners	No tax at the entity level. Income/loss is passed through to LLC members	No tax at the entity level. Income/loss is passed through to shareholders	Corporation taxed at entity level
Pass Through of Income/Loss	Yes	Yes	Yes	Yes	No; corporate losses can only be carried back/forward to offset corporate income
Double Taxation	No	No	No	No	Yes
Cost of Creation	None	None	Filing fee with the state	Filing fee with the state	Filing fee with the state
Raising Capital	Difficult, unless individual puts in money	Contributions from partners or an addition of more partners	Possible to sell ownership interest, but subject to operating agreement restrictions	Sell shares of stock to raise capital	Sell shares of stock to raise capital
Transferability of Interest	No	No	Possibly	Yes, subject to consent	Shares of stock in a corporation are easily transferable

as its own unique entity for this article. Now we have five different entities to choose from. Are you thoroughly confused? You should be. Just keep reading.

### Sole Proprietorships

**Ralph:** So Ed ('hiccup') you're a sole proprietor? Don't you feel all alone, being a sole proprietor? And does that mean you drink alone?

**Ed:** No, man. I'm not alone. I listen to Stevie Wonder, which makes me a "soul" proprietor. And here's some vodka. Pass me your glass, Ralph, and stop drooling on the rug.

Clearly, Ralph and Ed are moronic luses. They both should know the easiest and least expensive way to begin operating a business is as a sole proprietorship. Generally, there are no documents or forms needed to organize the business. If the business will operate under a name that is different from the owner's name, most localities will require the filing of specific documents that informs the local government and the

public that the business is operating under a "doing business as (or d/b/a)" name and indicates who the owner is.

However, as the owner of a sole proprietorship, you are personally liable for all obligations of the business. So creditors of the business can go after your personal assets if the business assets aren't sufficient to cover business debts. Since you're personally liable for obligations of the business, you should consider whether the business will be exposed to potential lawsuits. Although you can limit your exposure by purchasing adequate business insurance, a different business form (such as a corporation or LLC) may provide greater liability protection.

### Partnerships

**Ed:** Ralph, will you be my business partner?

**Ralph:** Only if I can wear a dress. Got any gin, Ed?

If Ralph wears that dress, the

business is going to be owned by more than one owner. And luckily for Ed and Ralph, the simplest business form to create and operate is a general partnership. Although a partnership is more complicated to form than a sole proprietorship, it's not as complicated as a corporation.

Forming a partnership entails an agreement between two or more partners. The agreement can be oral, but should be written and signed by all partners to avoid conflicts that may arise later during drunken stupors.

Virtually anyone can be a partner—as a partner can be an individual, a partnership, a limited liability company, a corporation or a trust. Additionally, the flexibility of a partnership allows profit sharing, loss sharing and ownership percentages to vary, making them far more flexible in financial structure than most other entities.

However, all partners are deemed "jointly and severally liable" for the obligations of the partnership. Joint and several liability means that each

individual partner can be held responsible for all obligations of the partnership.

## C Corporations

**Ralph:** Ed, I feel sick.

**Ed:** Is it due to the double taxation aspect of C Corporations?

**Ralph:** I think it's from the double bourbon aspect of that last drink. Where's the bathroom?

One of the best-known and most widely used business entity forms is the corporation. The primary advantage of a corporation is the liability protection it provides its owners. Liability is limited because the corporation is a legal entity that is separate from its shareholder owners. As a separate legal entity, the corporation is liable for its own debts and can only be held liable to the extent of its corporate assets.

Corporate creditors cannot take the personal assets of a shareholder, unless the 'veil' of corporate limited liability is "pierced." Beware: The corporate veil can be pierced when the required corporate formalities (such as having annual shareholder meetings, segregating corporate funds, using the corporate name in all business transactions, etc.) aren't followed.

Although not difficult, forming a corporation is more complicated and more expensive than forming a sole proprietorship or a simple partnership. To form a corporation, articles of incorporation must be filed with the Secretary of State's office in the state in which the corporation is being organized.

Corporations are owned by shareholders who, by nature, have no control over day-to-day operations. Shareholders are responsible for electing directors to make corporate decisions, including the appointment of corporate officers. Ultimately the officers are the ones responsible for day-to-day operations. Observing all these formalities provides evidence that the corporation is a separate legal entity, rather than an extension of its shareholders, thereby protecting its limited liability aspect.

In general, corporations are entities that are subject to federal and state taxation. When income is distributed to its shareholders, it is taxed again on the shareholder's individual tax return—hence the term "double taxation."

Given the complexity of tax laws governing C Corporations (especially in a liquidation), tax minimization strategies should be discussed with your accountant or your attorney—not Ed or Ralph.

## S Corporations

**Ed:** Ralph, what's an S Corporation again? And are you OK in there?

**Ralph:** Uuuhhhh—no. (Ed hears a flushing sound)

Had Ralph been sober, he would have told Ed that an S Corporation is not a separate type of corporation. The only difference between an S Corporation and a regular C Corporation is that the S Corporation has elected to be taxed similar to a partnership for federal (and most state) tax purposes. After making the S election with the IRS, income, losses, tax credits and other tax items of the corporation flow through the corporation to the shareholders. Thus, income is only taxed once, at the shareholder level.

At first look, it appears that every corporation should elect S Corporation status in order to eliminate the double taxation of income. However, there are disadvantages to making the election and restrictions on who is eligible to make it. Some of the disadvantages include limitations on who can be a shareholder, the number of shareholders, one class of stock and the taxation of certain fringe benefits.

## Limited Liability Company (LLC)

**Ed:** Ralph, you feel better now?

**Ralph:** Yeah. I think the coffee, aspirin, Pepto-Bismol, Mylanta, Tums and breath mints really helped.

**Ed:** Nah. I think it was your decision to become an LLC.

Of course it was the LLC, you big dopes. A limited liability company

(LLC) is a hybrid entity that combines the tax-friendly aspects of a partnership with the liability protection of a corporation.

The LLC is a relatively new type of entity that has only recently become available in all 50 states. To form an LLC, articles of organization must be filed with the secretary of state's office. Some jurisdictions also require that an operating agreement be filed in addition to the articles of organization. The articles of organization contain information about the LLC, such as its name, address, purpose, who organized it and who the registered agent is. The operating agreement is similar to a partnership agreement, its purpose to declare the conduct of the business.

## I Feel Sick Again

To help Ralph and Ed avoid getting sick again over this sore subject, I've included a comparison chart on page 29 that shows how the advantages and disadvantages of each business form compare.

## Some Final Thoughts

Although each business entity has its merits and its quirks, I am slightly partial to the LLC. They're easy to set up, easy to dissolve, easy to financially structure and there's no taxes to worry about at the entity level. Even if you're the sole owner of a music store, most states now allow a "single-owner" LLC (unlike a few years ago when most states required at least two owners).

But most importantly, don't rely on advice rendered at cocktail parties. The advice may sound great, but it's usually the combination of the single-malt scotch and peach schnapps that's doing the talking, followed by uncontrollable vomiting.



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