

# Selecting a Legal Entity for your Business

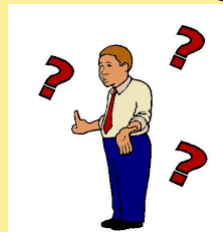
Corporation?

LLC?

S-Corporation?

Partnership?

Sole  
Proprietorship?



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## Organizational Forms

- Incorporated v. unincorporated
- Stock corporation
- Partnership, LLC (*limited liability company*)
- Benefit corporations
- For-profit v. non-profit/tax-exempt
- Publicly held, closely held, privately held
- Other

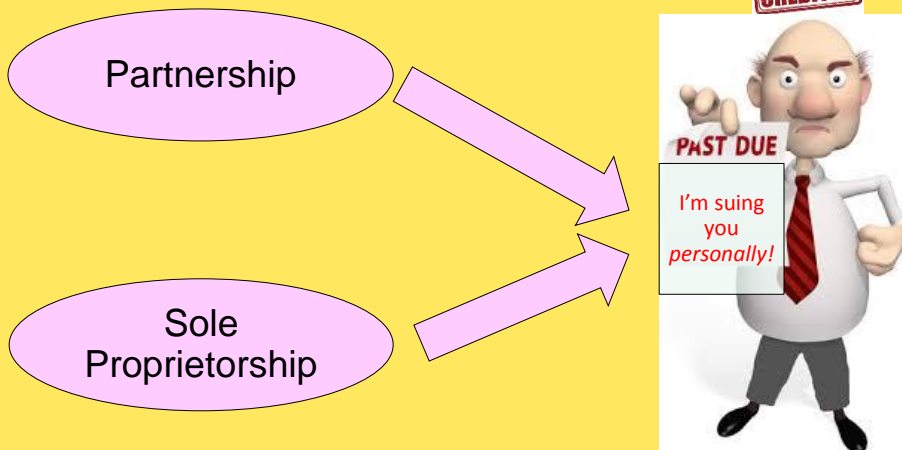


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## Risk of Personal Liability



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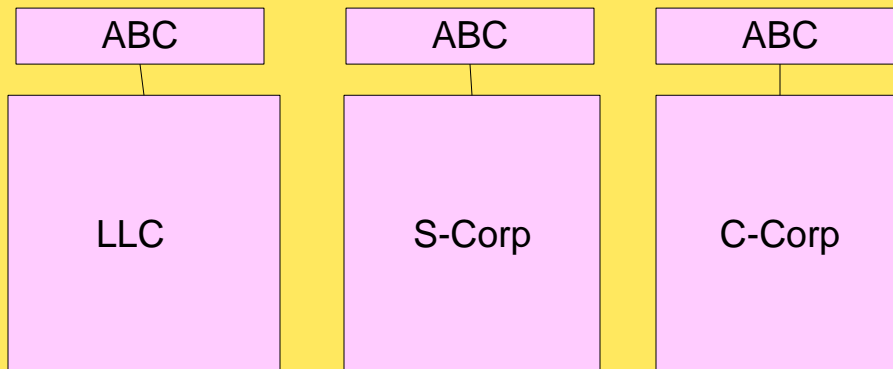
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# Limited Liability



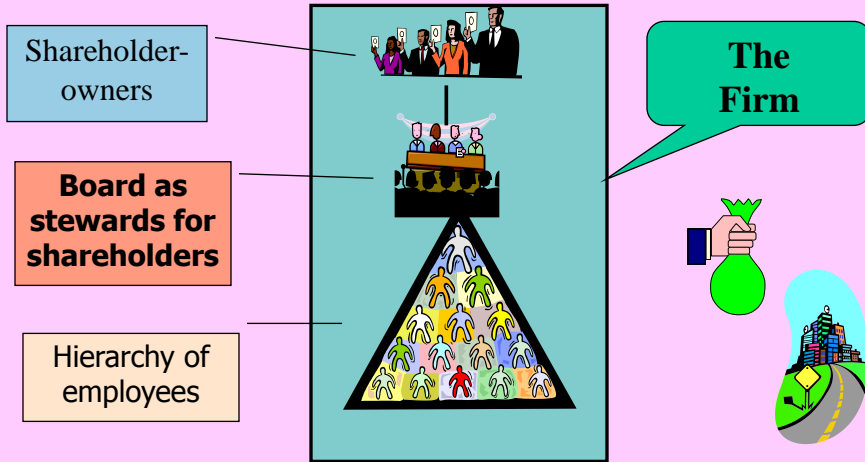
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# Small Business: Entity Choices



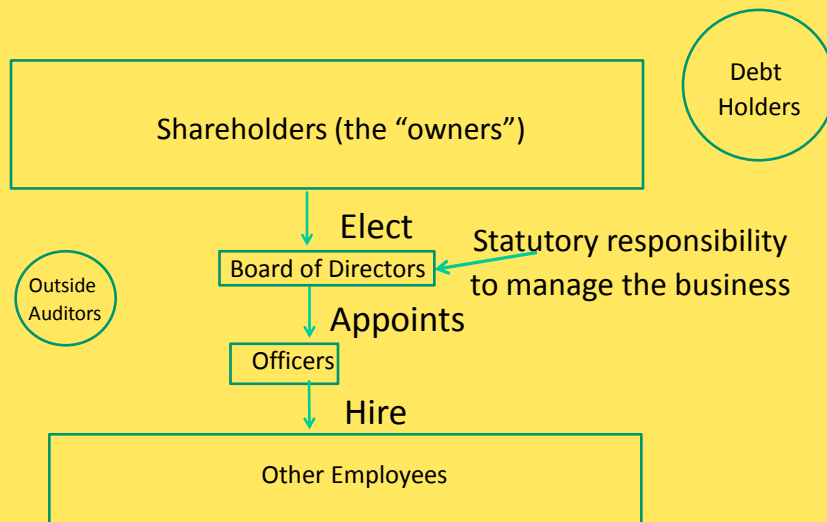
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# The traditional model of a Corporation



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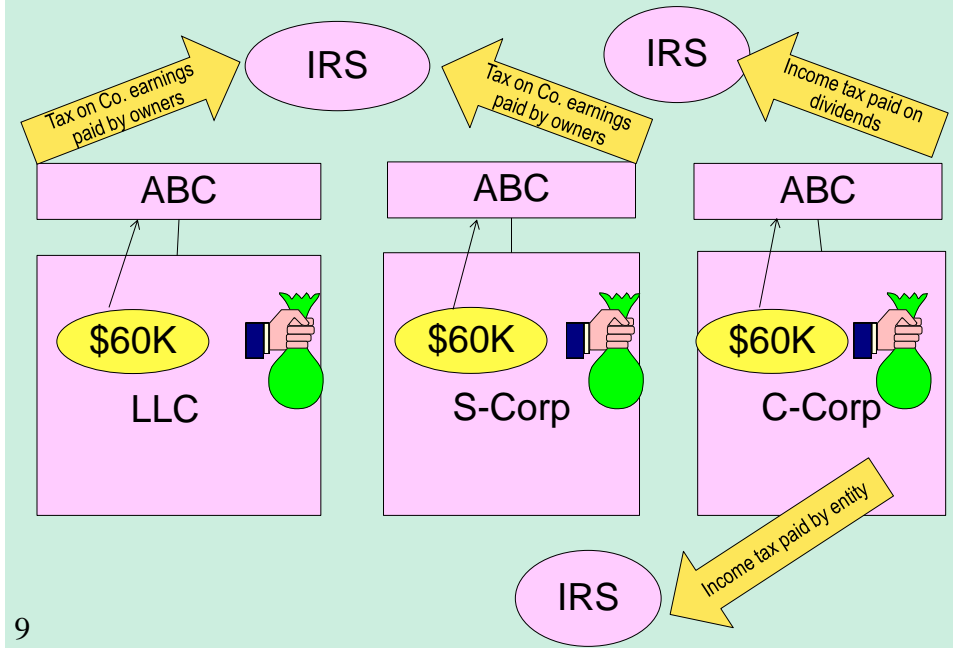
## Typical (simplified) Corporate Structure



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## Pass Through Taxation



## S Corporation

- Statutory creation of tax code.
  - Usually a “closely held” corporation
- Principal advantage:
  - Combines pass-through taxation with limited liability.
- Disadvantages:
  - Constraints on # of shareholders, types of shareholders, capital structure, deductions on pass-through losses.

## S Corporation Status

- S-CORP Not really a different type of corporation.
  - It is in actuality a **special tax designation** applied for and granted by the IRS to corporations [or LLCs] that have already been formed.
  - Lots of small business owners favor S Corporation because it combines many of the advantages of a sole proprietorship, partnership and the corporate forms of business structure.
- Advantages
- (1) Main advantage of S Corporation is special tax provisions.
  - S Corps get pass-through taxation, instead of double taxation\* (\*Note that the new Federal Corporate Tax rate is 21%).
- (2) S Corporation SHs retain limited liability for business debt.

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## S Corporation

- **ELIGIBILITY:** To elect S status, entity must meet specific requirements. A few of these requirements are:
  - Maximum number of shareholders/owners of 100.
  - All entities electing S Corporation status must have shareholders/owners who are citizens or residents of the United States. Nonresident aliens cannot be shareholders/owners.
  - S Corporations may only issue one class of stock.
  - No more than 25 percent of the gross corporate income may be derived from “passive” income. (Excessive passive income results in tax consequences and, ultimately loss of S Corporation status.)

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## S Corporation

- Not all domestic general business corporations are eligible for S Corporation status. These exclusions include:
  - A financial institution that is a bank;
  - An insurance company taxed under Subchapter L;
  - A Domestic International Sales corporation (DISC); or
  - Certain affiliated groups of corporations.
- How to File as an S Corporation
  - More detailed, BUT
  - First step is to form a corporation [or an LLC] in the state of your choice. You must also obtain the formal consent of the corporation's shareholders [LLC's members] (and their spouses if it's a community property state) and file form 2553 with the IRS.

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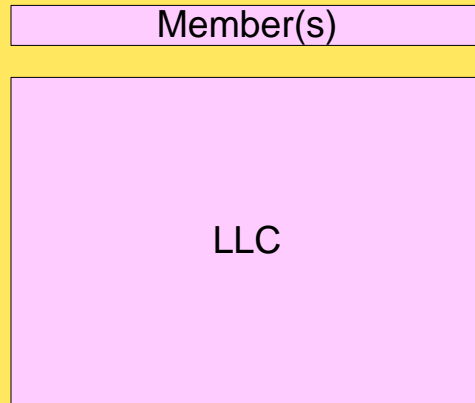
## S Corporation Status for LLCs?????

- Recently, it was determined that LLCs may elect S corporation status too.
  - This does not change the underlying entity – it is still an LLC for all purposes EXCEPT for how it pays taxes.
- Principal advantage:
  - Allows for the flexibility of an LLC structure with some of the tax benefits of S corporation status.
  - The CA minimum tax of \$800 (but not the 1.5% tax itself) is waived during the first year of existence.
- Disadvantages:
  - The LLC must comply with the S corporation rules.
  - No flexible distributions of funds or allocations of profits/losses.

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## Limited Liability Companies



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## Limited Liability Companies

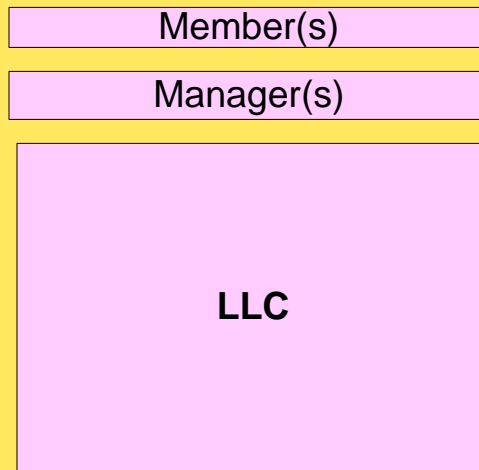
- A member managed LLC may provide significant flexibility in its management structure.
- Decisions may be structured to be decided by majority vote, super majority vote or unanimous vote.
- In addition, because an LLC may have multiple ownership interests, investors may be issued a class of ownership that has input (or even a veto) over only certain matters.
- These may be negotiated in the process of the investment.

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## Limited Liability Companies



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## Limited Liability Companies

- In a manager managed LLC (assuming that the entrepreneur serves as the manager) the manager may reserve significant power to him or herself.
- However, this is a more complex structure and the lack of control for the investor might impact potential investor interest.

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## California Taxation

- C-corporation 8.84% (for most non financial corps) (minimum \$800)
- S-Corporation (including LLCs that elect S-Corp. status) 1.5% of profit (minimum \$800)
- LLC: \$800 annual fee plus gross receipts tax on California revenue over \$250,000

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## California Taxation

LLC \$800 annually, plus a gross revenue tax:

- LLCs with annual gross revenues of:
  - less than \$250,000 = \$0;
  - at least \$250,000 but less than \$500,000 = \$900;
  - at least \$500,000 but less than \$1,000,000 = \$2,500;
  - at least \$1,000,000 but less than \$5,000,000 = \$6,000;
  - \$5,000,000 or more = \$11,790.

Note that this tax applies to foreign LLCs doing business in CA, even if they have not qualified to do business in CA

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## California vs. Delaware

- Where is the business located?
- Is the business a pass-through entity?
- Is the business about to go public?

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## Doing Business in California

- The taxpayer is organized or commercially domiciled in California.
- **Sales exceed** the lesser of \$500,000 or **25 percent of the taxpayer's total sales.**
- **Real and tangible personal property** of the taxpayer in California **exceed** the lesser of \$50,000 or **25 percent of the taxpayer's total** real and tangible personal property.
- The **amount paid in California by the taxpayer for compensation** exceeds the lesser of \$50,000 or **25 percent of the total compensation paid by the taxpayer.**
- For the conditions above, sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities.

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## *Some Other Issues*



- Who owns the entity?
- Who picks and removes directors, officers?
- What happens with the profits/surplus?
- What gets taxed?
- Who is liable for debts, other liabilities?