CHOICE OF BUSINESS ENTITY

Business, Legal and Tax Implications

A Primer

Presented for
BALTIMORE COUNTY SMALL
BUSINESS RESOURCE CENTER
Whiteford, Taylor & Preston L.L.P.

WhitefordTaylorPreston LLP

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A PRIMER

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TABLE OF CONTENTS

CHOICE OF BUSINESS ENTITY - BUSINESS, LEGAL AND TAX IMPLICATIONS.

I. INTRODUCTION

One of the first decisions an entrepreneur must make and about which his accountant or lawyer is asked is which business entity is best for him. To make that decision, the business owner must understand his choices. The guiding concerns in choosing the appropriate business entity are: (1) liability; (2) ease of formation and operation; (3) taxation; (4) suitability to a business purpose; (5) suitability for expansion, and (6) ease of sale, termination or dissolution.

The choices among business entities are numerous and have even grown wider in the last few years with the advent of the limited liability company and the limited liability partnership. Basic business entity choices are sole proprietorship, general partnership, limited partnership, limited liability partnership, corporation (which includes the subclasses of close corporation, professional corporation and S corporation), and limited liability company. The nuances of each require careful consideration and analysis when matched with a particular situation faced by or anticipated by the business person.

The purpose of these materials is to act as a general summary and guideline of some of the peculiarities of each type of entity to enhance the ability of the business person to select an appropriate business entity and ask pertinent questions, and to enhance the ability of the accountant or other advisor to consider all of the aspects necessary in making a choice of business entity.

II. BASIC ENTITY CHOICES

A. SOLE PROPRIETORSHIPS.

A sole proprietorship is the most basic form for doing business. It presumes one owner. All income and loss from the business flows directly to the owner. A sole proprietorship files no separate federal or state income tax return, but rather its income and expenses are reported on a Schedule C, which is a part of Form 1040 Individual Federal Income Tax Return of the owner. A sole proprietor should keep business records separate and apart from his personal records so that business expenses and income can be separately identified.

A sole proprietorship may be operated under any name, and it should register its trade name. It will have a Federal Identification Number, which may be, but is not required to be, the same as the sole proprietor's social security number. The duration of the sole proprietorship can be no longer than the life of the sole proprietor.

Just as all income and expenses from the sole proprietorship flow directly to the sole proprietor, so too does all liability. The sole proprietor is personally liable not only for his own intentional acts and negligence, but also the acts of each of his employees in the performance of their employee duties. All assets, business and personal, of the sole proprietor are subject to the claims of his creditors.

Because an individual cannot be insulated from his own negligence or intentional acts, no matter which entity is selected, sole proprietorships are often appropriate for an individual beginning a service type business without employees. The individual should secure adequate insurance to cover liabilities for negligence in performing the service. The sole proprietorship offers an opportunity for the individual to ease into the new business without significant initial expenses. Upon the hiring of employees, the decision to sell a product, or taking on contract liabilities, the analysis changes, and sole proprietorships are not recommended.

B. GENERAL PARTNERSHIPS.

A general partnership is defined as a voluntary contract (oral or written) between two or more legally competent persons to carry on a business for profit and to share profits and losses of the business. *§9A-101(i) of the Maryland Revised Uniform Partnership Act (1998).* Although recommended, a written partnership agreement is not required to form a partnership. For federal and state income tax purposes and for business law purposes, a partnership is a legal entity separate and apart from its owner/partners. A partnership may sue or be sued, buy, lease or sell property, sell and trade stocks and the like in its own name. A general partnership must also file federal and state income tax returns; however, it pays no federal or state income tax. The tax returns filed by a partnership are informational returns. The income and losses generated by a partnership are distributed or deemed to have been distributed to the general partners in accordance with the terms of the Partnership Agreement, which generally will provide for a distribution of profits and losses in accordance with the percentage of ownership interest of each owner/partner.

General partnerships exist under the law until there is only one remaining owner or until one or more of the partners has left the partnership, and the partnership and its partners do not elect to continue. *§9A-801 of the Maryland Revised Uniform Partnership Act (1998).* A general partnership does not provide any liability protection for its owner/partners. Each owner/partner is jointly and severally liable (that is each partner is individually liable to third parties for the entire liability of the partnership) to the extent of his or her personal assets for any liabilities of the partnership which cannot be satisfied by the assets of the partnership.

As referenced, Maryland has a new Revised Uniform Partnership Act. The Act is effective for all partnerships formed on or after July 1, 1998, and any partnership formed before July 1, 1998 that elect to be governed by the revised statute, and all partnerships after December 31, 2002. *§9A-1204 of the Maryland Revised Uniform Partnership Act (1998).* As originally drafted, the revised Act created a technical problem in the Statute. It replaced the existing partnership law statute, thereby eliminating any statutory governance for a partnership which did not elect to be under the revised statute but which was formed before July 1, 1998. A technical amendment was passed by the Maryland Legislature to renumber the Maryland Revised Uniform Partnership Act as Title 9A of the Corporations and Associations Article of the Maryland Annotated Code, leaving in place the original Section 9.

Practice Tip - Because of the joint and several liability of each owner/partner under the Maryland Revised Uniform Partnership Act, and even other prior existing law, a partnership between spouses increases their liability exposure by also subjecting their joint assets and those real estate assets owned as tenants by the entirety (often the home of the spouses) to the creditor's reach.

C. LIMITED PARTNERSHIPS.

A limited partnership is a statutory creation which requires the filing of a certificate pursuant to §10-201 of the Maryland Limited Partnership Act. Furthermore, the statute requires that the name of a limited partnership bear certain designations such as the words "limited partnership" or abbreviations thereof.

A limited partnership is composed of at least one general partner and other classifications referred to as limited partners. The general partner remains generally liable for all of the obligations of the partnership, thus, most limited partnerships have corporate or limited liability company general partners. Limited partners, however, have a shield against personal liability except to the extent of the investment which has been made in the partnership. A limited partnership is taxed under the same rules as that of a general partnership, that is the limited partnership files only an information return and pays no federal or state income tax. The income and loss as generated by the limited partnership are distributed or deemed to be distributed to the general partner and limited partners in accordance with the terms of the limited partnership agreement. Limited partnerships have a longer duration than that of general partnerships. Pursuant to §10-801 of the Maryland Limited Partnership Act, the limited partnership dissolves and is wound up upon the occurrence of certain events in the partnership agreement, which may be a termination date, a consent to dissolution by all partners, a decree of judicial dissolution or an event of withdrawal of a general partner, unless certain provisions are met. These termination provisions are more restrictive than those of a general partnership.

With the advent of the limited liability company, which will be discussed below, the utilization of the limited partnership has generally declined. The reason is that the limited liability company offers most of the same flexibility, tax treatment, and insures better liability protection because there is no need for a general partner.

D. LIMITED LIABILITY PARTNERSHIPS.

1. History. The first LLP statute was passed in 1991 in the State of Texas. The initial creation of LLP's was as a result of the desire of individual professional partners to limit their liability in malpractice actions. Actions taken by federal regulators regarding reviews of failed savings and loans created huge obligations for accounting and other firms and ultimately for their partners. Thus, professionals began to lobby for the creation of what appeared to be a perfect solution for these types of problems, i.e., an entity that shielded a partner from personal liability for the tortious acts of another partner; while at the same time retained favorable partnership tax treatment. The idea caught on very quickly.

2. Maryland Statute. Under general partnership law, each partner is jointly and severally liable for the actions of his or her partners, even if they had no involvement or even knowledge of the action. In Maryland's Revised Uniform Partnership Act, the Maryland Legislature modified this seemingly harsh rule.

a) Liability Relief. Under Maryland's LLP statute, any firm operating as a general or limited partnership in Maryland can register as a "Limited Liability Partnership" simply by filing a Certificate with the State Department of Assessments and Taxation. Being an LLP provides liability protection to individual partners in a partnership against malpractice claims or other tort lawsuits arising out of the activities of other partners, employees or agents of the partnership and also contractual claims. §9A-306(c) of the Maryland Revised Uniform Partnership Act provides that subject to specific limitations contained within the statute, "a partner of a limited liability partnership is not liable or accountable, directly or indirectly, including by way of indemnification, contribution, or otherwise, for any debts, obligations, or liabilities of or chargeable to the partnership or another partner whether arising in tort, contract, or otherwise, which are incurred, created, or assumed by the partnership, while the partnership is a limited liability partnership solely by reason of being a partner in the partnership or acting or omitting to act in such capacity or rendering professional services or otherwise participating, as an employee, consultant, contractor, or otherwise, in the conduct of the business or activities of the partnership."

The key elements of the liability protection are as follows:

(i) A partner is personally insulated from debts and obligations arising from wrongful acts or omissions chargeable to the partnership or another partner. Note, there is no change in the law with respect to an individual's responsibility for his or her own acts or omissions. Furthermore, the statute in §9A-306(d)(1) specifically states that a partner is not insulated from liability with respect to his or her own negligence in appointing, supervising or cooperating with another partner, employee or agent of the partnership.

(ii) Liability protection is available only for that period of time during which the partnership is an LLP. Thus, becoming an LLP does not expunge a partner's liability for claims (in tort or in contract) which occurs prior to the time that the entity becomes an LLP. *Note* - the key is the time of the occurrence and not the time that the claim is filed. In addition, nothing contained in the LLP statute expunges any liability of the partnership itself. Therefore, all of the assets of the partnership remain subject to any liabilities that exist.

(iii) The statute does not modify the authority of any regulatory body with regard to its ability to mandate licensing and liability requirements for various professions. For example, in the legal profession, the Maryland Court of Appeals has the authority to regulate the practice of law. Therefore, as the Court of Appeals has not addressed the issue, it remains unclear whether lawyers can rely on the liability shield intended by the LLP statute.

b) <u>Tax Implications</u>. Taxation of a limited liability partnership is the same as any general partnership as described in Section II B of these materials.

The tax issue of greater concern results when a general partnership or limited partnership converts to a limited liability partnership. The key tax issue is whether or not there will be any gain or loss recognized upon the "conversion" from a partnership to an LLP - that is, whether or not the original partnership will be treated as terminated and a new partnership formed for tax purposes. The Service has ruled generally that a conversion does not have any tax effect on the partners in a general partnership converting to a limited partnership as it does not relieve any partner's liability for the partnership's debts and the partnership will be generally considered to have continued for tax purposes.

c) <u>Formation</u>. In order to file as an LLP in the State of Maryland, the LLP must file a Certificate of Limited Liability Partnership with the State Department of Assessments and Taxation ("SDAT") and pay the appropriate filing fee. The LLP's name will be checked as would a corporate or LLC name for interference with the names of any other operating entities in Maryland. It should be noted, however, that this does not provide an absolute verification that there are not other entities operating within the State utilizing a similar name. It only is reliable as to those companies which have registered with the State Department of Assessments and Taxation.

A Certificate of Limited Liability Partnership must contain the name of the LLP; the purpose for which the LLP is formed; and the address of its principal office in the state and the name and address of its resident agent.

The name of the LLP must contain the words "Limited Liability Partnership" or either the abbreviation "L.L.P. " or "LLP," as the last words or letters of its name. *(§1-502 of Md Ann. Code Corp. & Assoc.)*

There are no limitations on purposes within the statute, except for the qualification that with respect to professional LLP's, the agency or entity which licenses that profession, shall have the right to place restrictions upon it.

E. CORPORATIONS.

A corporation is a statutorily created entity, which is considered under the law to be a person separate and apart from its owners. This concept is often misunderstood, but is very important. The duration of a corporation is generally perpetual unless otherwise restricted by its Articles of Incorporation.

1. Basic Structure. The corporation has a structure different from sole proprietorships and partnerships. A corporation is generally managed by a Board of Directors, which must consist of no less than the lesser of three persons or the number of stockholders.

The owners of the corporation are its stockholders. Stockholders of a corporation are those individuals who have invested cash or other assets in order to acquire an ownership interest (stock) in the corporation. As stockholders of the corporation, they are charged with the responsibility of electing a Board of Directors and for making decisions on certain major corporate actions. Stockholders do not (except in the case of a close corporation, which will be discussed below) manage the business. That job is left to the Board of Directors. No stockholder, individually, has the right to bind the corporation to agreements or commitments. The stockholders' power comes solely in official action taken in meetings and by stockholder votes.

Charged with the general responsibilities for keeping the corporation in operation on a daily basis are its corporate officers. The officers of a corporation are appointed by the Board of Directors. A corporation must have a president, secretary and treasurer but frequently corporations elect one or more vice presidents, assistant secretaries and assistant treasurers. Other elected officers can include a chairman of the board, chief executive officer, chief operating officer and/or chief financial officer.

2. Organization of a corporation.

a) Articles of Incorporation. In order to form a corporation "Articles of Incorporation" must be filed with an appropriate state agency. Any individual having legal capacity and of the age of majority can file Articles of Incorporation. There are a number of items which must be contained in the Articles of Incorporation including the principal address of the corporation, the number of shares of stock the corporation will have authority to issue, the powers of the Board of Directors and stockholders, the naming of a resident agent (i.e., the person who will accept service of process in the event of a law suit or other official notices sent to the corporation) and the possibility of requiring less than unanimous consent in written actions taken without a meeting.

b) Bylaws. The second step in the organizational ladder for a corporation is its Bylaws. Although often thought to be boiler plate and frequently unread until a crisis occurs, the Bylaws of the corporation are the governing document for the daily behavior of the corporation. Bylaws customarily provide the method by which meetings of stockholders and directors will be held, the general powers of the stockholders and directors, the method by which officers will be named for the corporation and the powers which those officers will have, the explanation of any indemnification which the corporation will provide for its officers, directors and employees and other such sundry matters as the parties wish to cover.

c) Corporate Minutes. Corporate minutes, or in the alternative informal actions and consents, record actual decisions of the directors and stockholders. Generally in order to pass any action of the corporation, it takes the vote of a majority of those in attendance at an authorized meeting of the directors or stockholders, whichever is appropriate. If the action is taken by an informal action and consent, the signature of all participants (directors or stockholders) will be required to pass the measure, unless otherwise provided by the Articles of Incorporation for the company.

d) Stock Certificate. In order to complete the organization of a corporation, the initial corporate meeting must be held and stock must be issued. Bostetter v. Freestate Land Corp., 41 Md 142 (1981), *modified,* 292 Md 570 (1982). Each stockholder of the corporation also receives a stock certificate. The certificate evidences the stockholder's ownership of shares in that corporation.

3. Limitation of Liability. A corporation offers as one of its primary advantages the limitation of liability to the stockholders of the corporation. Generally stockholders investing in a corporation put at risk only those assets which have been actually invested in the stock of the corporation. Also, in general, if the corporation suffers losses beyond its assets, the stockholders' personal assets are not subject to liability, so long as the corporation has properly maintained its independent status. Breaking through the corporate structure to attack its stockholders, whether they be individuals or other corporations or partnerships, is generally referred to as "piercing the corporate veil." Maryland courts generally protect the liability limitation which corporate stockholders seek. The only reported court decisions in Maryland that have allowed the "corporate veil" to be absolutely pierced have involved situations of fraud on the part of the stockholders against their creditors. Maryland Corporate Law does provide that stockholders who accept dividends or other distributions from a corporation having financial difficulty are subject to liability to the extent of such dividends or distributions.

4. Tax Considerations. Regular corporations (or C corporations, as they are referred to in the Internal Revenue Code) are considered for both federal and state taxing

purposes to be a taxpayer separate from its owners (stockholders). A corporation must file its own separate tax return and pay income tax on its earnings. Any losses generated by the corporation must be held for use against either past or future taxable income earned by the corporation.

Formation of a corporation can generally be accomplished in a tax-free manner. Assuming that the initial stockholders meet certain threshold tests, they may contribute cash and assets to a newly formed corporation without incurring any personal tax liability. The issue is somewhat more complicated with regard to the incorporation of an ongoing business. The general rule for the incorporation of an ongoing business is that if the debt assumed by the corporation exceeds the value of the assets transferred to the new corporation from the ongoing business, there may be tax implications to the individuals contributing the assets in exchange for stock in the new corporation.

5. Special Corporations. Maryland corporation law and federal tax law provide for certain special corporations. In order to qualify for such treatment, it is necessary to elect by a special form, or directly in the Articles of Incorporation, the privileges of these types of corporations.

a) Close Corporations. Title 4 of Maryland's General Corporation Law provides a special small corporation, called a "close" corporation. These corporations are generally used when there will only be one or very few stockholders. A "close" corporation gives certain advantages to its stockholders. Close corporations can elect not to have a Board of Directors, the officers of the corporation can elect not to be covered by Workmen's Compensation Insurance, and a single person can hold all officer positions, and sign any document in each of those positions, even to the extent of witnessing or attesting to his or her own signature.

"Close" corporations are not without their disadvantages. The election to be a "close" corporation cannot be revoked without the unanimous consent of the stockholders. In addition, unless otherwise unanimously agreed by the stockholders, most major actions of a "close" corporation require unanimous stockholder approval, e.g., no additional stock may be issued by the "close" corporation without the unanimous approval of stockholders.

Practice Tip - It is almost never advisable to use "close" corporations when multiple stockholders will own the corporation without a detailed Stockholders' Agreement covering rights of the parties.

b) Professional Corporations. Title 5 of Maryland's Corporation Law contains specific provisions on professional corporations. Professional corporations are those formed by certain licensed professions in the State of Maryland and only members of those professions may own stock in such corporations. There is an issue in Maryland as to the extent of the liability protection which is provided by professional corporations. It is generally clear that stockholders of professional corporations will not be shielded from personal liability for their own malpractice. With respect to certain professional corporations, it is unlikely that a court would hold that the corporation shields stockholders from liability with respect to malpractice of their fellow stockholders. The law is clear that the stockholders will be shielded from contractual and tort liabilities, separate and apart from professional malpractice. Except as provided, professional corporations generally operate the same as any other corporation. In addition, the benefits of professional and "close" corporations can be combined in the right situation.

c) S Corporations. Regular corporations, "close" corporations, and professional corporations can all qualify as S corporations. S Corporation status is a special federal taxing status given to those corporations electing to take advantage of its benefits. Those corporations electing to become S corporations, which requires the unanimous consent of its stockholders, must meet certain basic tests, such as no more than seventy-five (75) stockholders, no foreign aliens as stockholders, and only certain qualified trusts as stockholders. The advantage of an S corporation is that it allows the corporation to be taxed like a partnership. An S corporation, like a partnership, files an informational return and all the income and losses generated from the operation of the S corporation are passed through to the individual stockholders of the corporation. An S Corporation pays no federal income tax at the corporate level. This is advantageous under present tax law because (i) individual maximum tax rates are less than maximum corporate rates, (ii) in the event that the corporation is sold, the individual stockholders may receive more beneficial tax treatment, and (iii) losses incurred in the corporation will flow through to the individual advantage of the stockholders. The disadvantage of an S Corporation is that individual stockholders must pay tax on the profits of the S corporation even if those profits are not distributed to them by the corporation. Thus, an S Corporation may not be advantageous for a business that will require substantial reinvestment since the stockholders may be put in a position of having tax on earnings of the corporations without having actually received any dividends therefrom.

6. Operational Considerations. Corporations having multiple stockholders do pose operational considerations which are not unique nor are they uniquely cured by the corporate form. The designation of officers and the structure of the Board of Directors can be a very key element. Generally, upon the formation of the Corporation, the parties are trusting and encouraging to each other, however, there are frequently points in time when that is no longer the case. The individual controlling the Board of Directors or who is the president of the company may have significant control, at least in the short term, at the time of disharmony among owners.

Where there are multiple owners, a key consideration is also a Stockholders' Agreement. A full discussion of Stockholders' Agreement is beyond the scope of these materials; however, it is essential that at the time when all stockholders are cooperative and working together, decisions be made regarding the future of the company in the event of the death, disability, retirement or even bad acts of one of the principals of the company. Issues such as the description of events that may lead to the transfer of stock as well as setting the price and payment terms upon those events are critical to moving forward for the success of the corporation.

7. Termination and Dissolution. As noted earlier, the duration of a corporation is perpetual. For that reason, it is necessary to terminate the existence of the corporation at the appropriate time. The most complete way to terminate the existence of a corporation is to liquidate the assets of the company and to file Articles of Dissolution with the appropriate state office (in Maryland - the Maryland State Department of Assessments and Taxation). The benefit of doing Articles of Dissolution is to close down the corporation once and for all.

A second method commonly used for dissolution of the corporation is to forfeit the charter of the corporation. Forfeiture occurs after the corporation has not filed its Annual Report for two consecutive years. The problem with forfeiture is that there is a much longer time when not only does the state and federal taxing authorities, but also individual creditors, may believe that the corporation exists. It is less expensive than filing Articles of Dissolution, however, and is commonly used when the corporation's assets are depleted. It is important to note that forfeiture can occur at any time if the corporation fails to file its annual reports. Annual reports must be filed each year to keep the corporation in good standing.

F. LIMITED LIABILITY COMPANIES.

1. What is an LLC? A Limited Liability Company (LLC) is a hybrid entity combining some of the best aspects of corporations and partnerships. It is, essentially, a partnership with a limited liability shell. The LLC is intended to permit a business to accomplish directly what it has achieved indirectly -- and imperfectly -- through the use of entities such as S corporations and limited partnerships, i.e., limited liability for the owners of the business and a pass-through of the business's taxable income or losses to the owners. Limited partnerships with corporate general partners can be used to achieve results similar to those offered by an LLC, but such partnerships can be overly complex in structure and operation for the purposes of the business to be conducted. S corporation rules, in addition to restricting the type and number of stockholders, impose significant restrictions on the ability to allocate taxable income and losses among the owners often making the S corporation unattractive or unavailable as an operating entity. The LLC, however, (i) does not restrict ownership to certain individuals, (ii) is designed to allow pass-through taxation and special allocations among owners, and (iii) limits every owners' liability to the extent of their capital contributed to the business.

2. Formation. Limited Liability Companies can be formed with one or more individuals or entities. The LLC is created by having an individual, over the age of 18, file Articles of Organization with the State Department of Assessments and Taxation and pay the appropriate filing fee. Articles of Organization are an abbreviated disclosure statement resembling certificates of limited partnership. The only required information is: (a) the name of the LLC; (b) the purposes for which the LLC is formed; (c) the address of the principal

office of the LLC in the State of Maryland; and (d) the name and address of the resident agent. Generally, more specific information with respect to the organization and operation of the LLC appears in the Operating Agreement. With limited exceptions, the LLC may exercise any of the powers of the corporation for any lawful purpose. LLC in its name must include the words "Limited Liability Company" or "L.L.C.," or "LLC, " or "L.C.," or "LC. " The name, however, may not be identical to any other name which is currently in use by a corporation or registered partnership in the State of Maryland. Other aspects of reserving names, utilizing resident agents and the like are all similar to those requirements for corporations.

3. <u>Taxation</u>. With the advent of the "check the box" rules, an LLC may choose whether to be taxed as a partnership (that is, the income and loss of the LLC will not have an effect at the entity level but instead will be "passed through" to the LLC's members and reported on their individual tax returns) or otherwise. Single-member LLCs are disregarded for federal income tax purposes. This change in the tax rules has also eliminated operational restrictions on LLC's.

4. <u>Limited Liability</u>. Except in specific situations, a member in an LLC is "not personally liable for the obligations of a limited liability company. . . solely by reason of being a member." A member is still liable for his or her own negligent acts.

5. <u>Management and Operating Agreement</u>. Following the pattern of a partnership rather than a corporation, the operating rules of an LLC will generally be contained in a separate operating agreement. This agreement will govern the relationship between the members in a single document rather than in a corporation's charter, bylaws and stockholders agreement. It is permissible to have an oral operating agreement, but it is not recommended. An oral agreement presents additional difficulty in interpretation, especially when a dispute arises among the parties. The LLC statute is very flexible in allowing the drafting of these agreements. Without an agreement, the LLC statutory provisions will, by default, take precedence. It is generally advisable for the members to have comprehensive discussions about how they wish to handle management and operation of the LLC so that they can reach agreement early on about appropriate conduct of all parties.

As noted above, with the advent of the "check the box" rules, the possibilities for creating entities and organizations for LLC's are endless. There are no "standard" LLC agreements. Some are operated by managers and members which are similar to partners. Others have taken on the corporate form, creating Boards of Directors and officers having the more traditional titles of president, secretary, and treasurer. Although being able to make the choices allows the client to form an entity which is more suited to his or her exact desires, it also tends to make the process much more complicated and potentially more expensive by giving the clients so many choices of how to operate.

The other operational problem is that LLC's are relatively new and there is only an initial growing body of case law which interprets the LLC statutes as well as LLC operating agreements. As a result, when disputes arise with respect to the operating agreements or application of the LLC statute, there is less legal authority to rely upon in resolving the issues.

As is the case with a general partnership, members of an LLC are generally agents for the LLC unless: (a) the member has, in fact, no authority and the third-person knows that the member has no authority; or (b) the Articles of Organization expressly limit the members' powers.

6. Transferring Interest. Initial memberships in an LLC are effective upon formation and new members are admitted upon the unanimous consent of the then existing members, unless the operating agreement specifies otherwise. The operating agreement may also give individuals the right to assign all or part of their membership interests. The assignment of a member's interest does not dissolve the LLC, does not cause the assignee to become or obtain any rights of a member unless the operating agreement so provides; and does not release the assignor from any liability of capital contributions or for wrongful distributions.

7. Special Acts. Special acts with respect to a Limited Liability Company are similar to that of corporations. The limited liability company may be dissolved, merged and the like.

III. LIABILITY CONSIDERATIONS

A. GENERAL RULES.

With respect to all entities, whether a sole proprietorship, partnership, corporation, or limited liability company, an individual remains liable for his own intentional acts, negligence, malpractice, or other errors and omissions. No entity can protect the individual from those liabilities. Therefore, insurance should always be discussed and suggested to this person and should always be considered seriously by the business person.

B. COMPARISON OF ENTITIES.

When first created, the limited liability company and limited liability partnership had restrictions upon the types of liabilities against which they could protect either directly or by virtue of restricting their members. As the statutes have evolved, corporations, limited liability partnerships, and limited liability companies each offer comparable liability protection. The only inferior entities with respect to liability protection are sole proprietorships, general partnerships, and to a lesser extent, limited partnerships. Sole proprietors remain personally liable for the acts of their employees as they perform their employee duties. Partners remain jointly and severally liable for all of the obligations and acts of the partnership. Limited partnerships leave the general partner exposed to liability, although proper planning minimizes this risk. Generally through planning of the limited partnerships, the extent of this liability can be reduced (i.e., using a corporate general partner, for example) however, it still presents an additional hurdle to be sure that the appropriate liability protection is being granted.

IV. TAXATION

A. BASIC RULES.

Because of the "check the box" rules, many of the ongoing taxation issues have evaporated. With the exception of a C corporation, all of the other entities discussed can act as pass-through tax entities, passing to their owners directly tax benefits and burdens. There are some distinctions between entities as to the amount of losses which can be taken and how that is to be accomplished. When those particular issues are relevant, the applicable tax laws should be closely reviewed. In addition, there are some tax differences with respect to the formation of entities, however, in most cases, at the outset, an organization may be formed without tax impact.

Maryland tax rules should not be ignored in this regard. For example, when contributing property to an entity, you must closely review the Maryland statutes for transfer and recordation tax to determine when transfer may be tax-free and which may not. For example, Maryland has historically treated an estate planning transfer to general partnership as an exception for transfer and recording taxes. Maryland has also, by statute, created specific exemptions for transfer tax and recordation transfers to limited liability company. Transfers to corporations, however, are not tax exempt. These rules seem to be constantly changing and always need to be verified.

B. OTHER TAX ISSUES.

In certain circumstances, other considerations need to be reviewed in choosing an entity. For example, there are differences between entities and the types of pension benefits or medical benefits which may be deductible and available to owners of the company. Furthermore, if a company is repaying significant debt but will be making some profit, it may be advantageous to be a C corporation rather than an S corporation, for example, with smaller corporations which would pay lower marginal corporate income tax rates vs. individual income tax rates, principal debt repayment (which is not tax deductible) can be less burdensome. If the client's goal is purchasing and transferring real estate, then the options provided by limited liability companies are worth considering.

V. SUMMARY

In short, there are numerous choices of business entities. Although much of the current wisdom seems to indicate that limited liability companies are a correct move for all businesses, such a shortsighted review of the situation would be a disservice to the business owner or client. No entity is right for everyone. Each has its advantages and disadvantages, and only by reviewing the intention of the client, is it possible to assist in making the proper selection of a business entity.

There are a couple of practice tip reminders which should be considered:

1. An individual cannot escape liability for his intentional or negligent acts, but can be insulated with the proper entity for contractual claims;

2. Use written agreements. No partnership or limited liability company should rely on oral agreements or the statute;

3. Agree on ownership and transfer provisions at the outset when the parties are cooperating with each other;

4. Never create husband and wife partnerships because of the liability issues;

5. Consider the ease of allowing future growth in ownership with the selected entity. Frequently, investors do not want pass-through entities if looking for capital appreciation.

6. Consider the effect of self-employment income and options for reducing taxes beyond income tax.

NOTES