Russell N. Stein, Esq.
Ruberto, Israel & Weiner, P.C.
255 State Street, 7th Floor
Boston, Massachusetts 02109
Phone: (617) 742-4200
Facsimile: (617) 742-2355
email: rns@riw.com

**A. Sole Proprietorship**

The most commonly used form of business in the United States is the sole proprietorship. A sole proprietorship exists when one person owns a business and all the income and expenses of the activity belong to that person. This person has complete control over the business decisions and has unlimited (personal) liability with respect to the debts of the business. Income or loss of the entity accrues to the individual owner and, therefore, no tax is paid by the entity.

The gain of loss from each business the taxpayer operates as a sole proprietorship must be reported on a separate Schedule C to taxpayer's Form 1040. In addition, the sole proprietor's Schedule C income is subject to self employment tax and a sole proprietor will ordinarily make estimated tax payments.

The advantages of a sole proprietorship are the uncomplicated tax treatment involved (i.e., business profits reported on Schedule C to 1040) and that the business pays no tax. The disadvantage is that the sole proprietor has unlimited liability for the debts and obligations of the business thereby exposing his or her personal assets to the risks of the business.

**B. Partnerships (Limited and General)**

The non-tax considerations involved in deciding whether to operate as a partnership include the following:

i. Liability - The general partner(s) are liable for all partnership liabilities. In contrast, limited partners are not liable for partnership debts and have at risk only their capital contributions.

ii. Management - Partnership business operations are the responsibility of the general partner. Limited partners have no voice in management decisions (or could be deemed to be general partners).

iii. Formalities - Massachusetts state law requires a Certificate of Limited Partnership be filed with the Secretary of State. Otherwise, a partnership is consensual, and most matters can be made subject to terms and conditions of a partnership agreement.

iv. Capital Structure - The equivalent of "common" and 'preferred" interests can be created offering differing returns and incentives to partners.

With regard to tax considerations, as a result of the relatively new "check the box" regulations (i.e., for partnerships formed after January 1, 1997) an entity need only file a simple form to obtain partnership tax treatment. (Prior to January 1, 1997, to qualify for partnership tax treatment and not as an association taxable as a corporation, a partnership had to satisfy a set of complicated criteria designed to show it did not have too many corporate characteristics).

With regard to the formation of a partnership, generally there are no tax consequences to the partnership or the partners upon its formation. Furthermore, the partnership is a "pass-through" entity and as such bears no income tax liability. Items of income, loss, deduction and credit pass through to the partners and generally are reported in accordance with their percentage interests in the partnership. Accordingly, the character of items and impact on partner tax liability are determined at partner level. Partnerships also have the ability to specially allocate losses or specific deductions among partners regardless of their percentage interests in the partnership as long as the allocations have substantial economic effect.

### C. Corporations

A corporation is separate and distinct from its owners in both a legal and taxable sense. A corporation is established through the issuance of a corporate charter, usually by the state government. The corporation issues stock as a sign of ownership to its stockholders in exchange for contributions of money, property or services. Because these shares of stock are readily transferable, the duration of a corporation is indefinite.

The owners of the corporation are only liable for the business debts of the corporation to the extent of their investment in the corporation. Shareholders of corporations are not usually personally liable for the debts and obligations of the corporation or for claims against the corporation in excess of their capital contributions.

A state charter is required to form a corporation, as well as compliance with certain corporate formalities initially and on an ongoing basis. Formalities include filing articles of organization (the filing fee in Massachusetts for 200,000 shares of authorized capital stock is $200), adopting by-laws and electing officers and directors of the corporation. The Board of Directors and the officers appointed by the Board run and manage the corporation. Corporations continue to exist until dissolved and the shares of a corporation are freely transferable (subject to applicable securities laws) unless the articles or organization, by-laws or a shareholder's agreement impose certain restrictions on transfer.

Capital is provided to a corporation through the sale of stocks and bonds. Stock may also be issued for property and services, but transfers of property in exchange for stock are nontaxable only if, immediately after the exchange, the transferor(s) is "in control" (defined as ownership at least 80% of the corporation's stock) of the corporation. The Corporation can also borrow funds, on notes or an open account. The shareholders are not liable on the notes unless they personally guarantee them.

With regard to the taxability of the corporation and its owners, a distinction must be made as to whether the corporation is formed to qualify under Subchapter "C" or Subchapter "S" of the Internal Revenue Code. In order to qualify under Subchapter "S", a corporation must file Form 2553 with the Internal Revenue Service electing this tax treatment. Otherwise, a corporation will be taxed under Subchapter "C". The following illustrates their differences:

#### i. Taxation of Entity

The income of a Subchapter C corporation is taxed (after deducting ordinary and necessary expenses), to the corporation when it is earned pursuant to the corporation's method of accounting. Undistributed taxable income may be taxed a second time if it is also subject to personal holding company or accumulated earnings penalty tax. In addition, generally, a C corporation is not taxable on its distributions. However, if it distributes appreciated property, then it will have to recognize gain as if the property has been sold to the distributee at its fair market value.

In contrast, an S corporation pays no tax at the entity level.

#### ii. Taxation of Owner

Distributions from a C corporation are taxed as dividends to shareholders to the extent of current and accumulated earnings and profits. Dividends are allocated and distributed in proportion to shareholdings in common stock, after first paying off legal obligations to preferred shareholders. If a corporation does not distribute its income, the shareholders are not taxable on it.

An S corporation shareholder reports his or her allocable share (based on stockholdings) of the income or loss of the S corporation on his or her individual income tax return regardless of whether money is distributed to the stockholder. Distributions to the shareholder of an S corporation are tax free so long as the shareholder has basis in his/her stock.

The obvious drawback to the C corporation is that since C corporations are taxable entities, their taxable income is taxed twice: once to the corporation and once to the distributees. The advantage of a C corporation is that except for special types of corporations such as professional-service, not-for-profit, real estate investments trust (REIT), and foreign sales corporations, there are no restrictions on whom or what type of entity may be a shareholder in a C corporation. Additionally, no limitation exists as to the maximum number of shareholders allowed in a typical C corporation.

With an S corporation, however, there are certain prohibitions or restrictions which can limit their use. For example, an S corporation cannot have more than 75 shareholders and cannot have any nonresident shareholders. Furthermore, generally, only individuals can be shareholders (with some important exceptions such as certain types of trusts and estates). Finally, an S corporation cannot have more than one class of stock. (Under an important 1996 tax law change, S corporations can have subsidiaries (either S corporations or C corporations) but such subsidiaries must be 100% owned by the S corporation).

**D. Limited Liability Company (LLC)**

A limited liability company is a hybrid entity which has the limited liability of a corporation but the pass-through tax advantages of a partnership. In addition, the LLC does not have limitations on the type and number of owners; classes of stock; greater than 80% owned subsidiaries; participation of members (all of which must be considered when deciding on whether to use a partnership, C or S corporation).

Furthermore, the new "check the box" regulations does away with having to worry about the LLC having corporation features which could result in corporate as opposed to partnership tax treatment.

Although well suited for many types of businesses, LLC's seem particularly well suited for the following situations:

1. Start-up Businesses. A principal issue here may be the simplicity issue. The pass-through tax treatment, the limited liability and the flexibility in structuring compensation and other financial arrangements would seem to favor the LLC.

2. Family Businesses / Estate Planning. The LLC would afford all the advantages of the limited partnership for the estate planning of family business. In addition, this could be done without the need for two entities.

3. Real Estate. The LLC is particularly well suited for various types of real estate operations, and in fact experience to date in other states indicates that this has been in the most prevalent use of the LLC.

i.. Development. The LLC provides limitation of liability to developers while affording pass-through tax treatment similar to the S corporation, but permits significantly more flexibility in matters such as owners and compensation arrangements for employee/owners.

ii.. Ownership of Management. The LLC is a better alternative than the limited partnership for the ownership and management of real estate. It requires only one entity and minimizes uncertainties regarding limited liability and classification.

With all of the choices available when choosing a vehicle to operate your business, a person can both limit their liability and their tax burden. Readers of this article should understand that the above discussion presents the general rules and considerations and does not address specific situations. Therefore, a thorough analysis of these issues should be undertaken with an individual's legal and tax advisors before implementing any of these alternatives.