Morgan Stanley

Choosing a Business Entity

Estate Planning Strategies

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Family Office Resources

Starting a business can be exciting and confusing at the same time. One of the first issues with which an entrepreneur will be faced is how to legally organize the business. What are the benefits and drawbacks of each entity (or of no entity at all)? The decision can implicate issues involving tax, liability, retirement planning, business continuity, and estate planning to name just a few. This paper will review the primary choices available in the United States and, very generally, some of the main differences between them.

Sole Proprietorship*

By far, sole proprietorship is the easiest type of business to form, as it involves generally no organizational documents and few governmental filings. Since there is no difference between the owner and the business, there is only a single level of taxation – that of the owner. This ease of formation, however, comes at the price of the owner generally having 100% responsibility for any liability arising from the business and exposure of all personal assets (even those arguably not involved in the business) to such liability. No other investors or partners can become owners, no ownership shares can be issued or gifted to the next generation and the business simply ceases to exist on the death of the owner, with all assets of the business thus falling into the personal estate of the owner.

A sole proprietor may generally choose from a number of employer-sponsored retirement plans, such as a Simplified Employee Pension (SEP) Plan , Savings Incentive Match Plan for Employees (SIMPLE) 401(k) or IRA plan, and qualified retirement plans (also called Keogh plans when covering self-employed individuals), including 401(k) plans.

Partnerships*

A general partnership is formed when two or more people pool resources to operate a business. While formation documents are not required, generally, the parties will execute a partnership agreement that describes the rights and responsibilities of the partners. In a general partnership, each partner has unlimited liability to third parties with respect to the business operations. A partnership is a legal entity separate from its partners/owners. For income tax purposes, a partnership is a "pass through" entity, meaning that the income tax attributes, including profits and losses, of the partnership flow through to the partners. The partnership files a separate annual information return with the Internal Revenue Service to report the partnership's income, gains, losses, deductions, credits, etc. Additionally, the partnership files Schedule K-1 (Form 1065), which reports the amount of income, deductions, credits, etc. allocated to each partner. Each partner receives a copy of Schedule K-1 from the partnership.

A limited partnership provides a liability shield for the limited partners, whose liability is generally limited to their investment in the entity. The general partner manages day to day operations of the business, and generally has full personal liability for all debts and obligations of the partnership. Consequently, many general partners are entities formed as corporations or LLCs in order to provide the general partners with a liability shield. Limited Partnerships are formed by filing organizational documents with the Secretary of State in the state in which the partnership is organized. The governing instrument is a Limited Partnership agreement that includes rules regarding the operation of the partnership, the rights and responsibilities of the partners (general and limited), the allocation of income and losses among the partners and dissolution and liquidation of the partnership.

Partnership accounting can be complicated, as basis both inside the partnership (the tax basis of assets owned by the entity) and basis outside the partnership (the individual partners' bases in their partnership units) must be tracked using capital accounts in accordance with Treasury regulations. As stated earlier, partnership income flows through to the partners (whether or not distributed). Therefore, even if there are no distributions, partners may be required to pay tax on phantom income, in that their share of income is allocated to them, but not distributed.

Absent an agreement to the contrary, partnership units are transferable by the individual partners, during life or upon death. Similar to sole proprietorships, a partnership may choose from a number of employer-sponsored retirement plans. Employer contributions to the retirement plan accounts are generally deductible by the partners, but the amount of the deduction depends partly on the type of plan.

C Corporation

C corporations are separate, tax-paying entities. The corporation provides liability protection for its shareholders, whose liability is generally limited to their investment in the corporation. The shares (absent agreement to the contrary) are fully transferable during life or upon death. A C corporation may have multiple

classes of stock, each with different rights and/or economics. For instance, some shares may have voting rights while others may have limited or no voting rights. Other shares can be “preferred,” having an income preference or guaranteed dividend attached to them. Gain or loss by the shareholders is recognized when they sell their shares. In addition, the shareholder may receive a dividend from the company, which is taxable income. Under current law, if dividends are “qualified,” they will be taxed at long term capital gains tax rates at the federal level, regardless of how the revenue was generated inside the entity. If not qualified, they will be taxed at the federal ordinary income rate. A qualified dividend generally is any divided paid by a U.S. corporation or a qualifying foreign company. There also are holding period requirements of generally 61 to 91 days depending on the type of stock.

C corporations are taxed on their income at the corporate rate, currently 21% at the federal level. State level income taxes also may apply. Thus, corporate income is taxed at two levels: first at the corporate level and then again to the individual shareholder when paid as dividends. C corporations may also choose from a number of employer-sponsoredretirement plans are available except Keogh plans (which are limited to unincorporated businesses). Employer contributions are generally deductible by the C corporation, but the amount of the deductible depends, in part, on the type of plan.

C corporations are formed via state filings, usually with the Secretary of State of the particular state in which the company is organized. Filings via the state typically consist of Articles of Incorporation. In order to maintain the liability shield, the shareholders must respect the corporation as a separate and distinct entity. Such formalities include annual directors’ and shareholders’ meetings and maintenance of corporate books and records. Filing fees vary by state, and often fees must be paid annually to maintain corporate status. Typically, a legal representative must be identified for service of process against the corporation, and this information is included in the Articles of Incorporation.

S Corporation*

Similar to C corporations, S corporations are separate legal entities that generally provide a complete liability shield for their shareholders. However, an S corporation provides pass-through income tax treatment similar to a partnership. Thus, the S corporation generally is not subject tax at the entity level, unlike a C corporation. The income tax advantage comes with significant restrictions on ownership and the type of business in which the corporation may engage. For instance, including but not limited to, ownership is limited to 100 shareholders, and permissible shareholders must be one of the following: individuals, estates, certain qualifying trusts, certain 501(c)(3) organizations and employee stock ownership plans. One exception to this rule is that a single member LLC (see below) may be the sole shareholder of an S corporation if the single member of the LLC is a U.S. person. Note that only U.S. persons are eligible S corporation shareholders. Therefore, S corporation stock may not be held by an individual who is neither a U.S. resident nor a U.S. citizen.

S corporations have formation documents similar to C corporations, with attendant filing fees and the need to identify an agent for service of process. Corporate formalities must be observed in order to maintain the liability shield. S corporation shares, absent an agreement to the contrary, are freely transferable during life or at death, however the ownership rules must be maintained to avoid inadvertent

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termination of S corporation statusS corporations may choose any retirement plan except a Keogh plan, and the plan must be established at the corporation level.

S corporations may not have multiple classes of stock. However, this rule is ignored for purposes of voting rights. Thus, while S corporations may not have preferred and common shares, they can have voting and non-voting shares. This can create discounts in value in the non-voting shares for lack of control, which can be useful for estate planning purposes.

The shareholders of an S corporation receive a copy of Schedule K-1s (Form 1120S), which the S corporation uses to report each shareholder's share of the S corporation's income, deductions, credits, and other items, and the shareholders can have phantom income like partnerships. Company losses that pass through to the individual shareholders generally are limited to that particular shareholder's basis in their stock. S corporations were a very popular form of entity until the proliferation of state laws authorizing Limited Liability Companies, which allow similar liability protection and pass-through income tax treatment.

Limited Liability Company (LLC)*

Limited Liability Companies ("LLCs") began in 1977 in the state of Wyoming, but did not become widely accepted until the 1990s. Since then, all states have adopted legislation allowing the formation of LLCs with the filing of organizational documents with the Secretary of State in the state in which the LLC is organized. LLCs generally are more flexible than both state-law partnerships and corporations, while at the same time providing members with liability protection. Members' liability is generally limited to their investment in the LLC, just like with a corporation.

LLCs can have as few as one owner/member. There is no limitation on the total number of members. Single member LLCs can be disregarded for income tax purposes (unless the entity elects tax treatment as a C or S corporation). Thus, while providing a liability shield to the single member, all tax attritributes, income and losses, pass through directly to the member's individual Form 1040 and no separate tax identification number may be needed for the LLC.

A multiple member LLC is taxed as a partnership, unless an election is made to be taxed as an S corporation or C corporation. The vast majority of LLCs electto be taxed as partnerships. Consequently, the partnership tax rules noted above apply to LLCs electing to be treated as partnerships. Membership interests may have different voting rights and/or different economic rights. Absent an agreement to the contrary, membership interests are freely transferable during life or at death. It is common, however, for LLCs (like partnerships) to restrict transferability in some respect. Finally, LLCs may generally choose from a number of employer-sponsored retirement plans. LLCs may generally deduct employer contributions made to retirement plan accounts, but the amount of the deduction depends, in part, on the type of plan.

The Operating Agreement can appoint managers of the LLC, who may or may not be members managers Many states have special variations of LLCs depending on the type of underlying business such as LLPs (Limited Liability Partnerships, generally used by professionals such as lawyers and accountants) and LLLPs (Limited Liability Limited Partnerships, which allow for general partners and investor type limited partners who do not participate in the day-to-day operations of the business).

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***Note that with passage of the legislation "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (commonly known as "The Tax Cuts and Jobs Act"), effective for tax years beginning January 1, 2018, taxpayers may be entitled to a deduction of up to 20% of qualified pass-through entity income. For more information, see the whitepaper entitled "A (Very) General Overview of the Pass Through Rules of Section 199A".**

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