Chapter 1

CHOICE OF ENTITY

Allen E.F. Rozansky, Esq.
Solomon Pearl Blum Heymann & Stich LLP

SYNOPSIS

§ 1.1 INTRODUCTION

§ 1.2 ETHICS

§ 1.3 ENTITY TYPES IN COLORADO

§ 1.3.1—Corporations
§ 1.3.2—S Corporations
§ 1.3.3—General Partnerships
§ 1.3.4—Limited Liability Partnerships
§ 1.3.5—Limited Partnerships
§ 1.3.6—Limited Liability Limited Partnerships
§ 1.3.7—Limited Partnership Association
§ 1.3.8—Limited Liability Company

§ 1.4 LIMITATION OF LIABILITY

§ 1.5 DOUBLE TAXATION VERSUS PASS-THROUGH TAXATION

§ 1.6 SELF-EMPLOYMENT TAX

§ 1.7 FRANCHISE TAXES

§ 1.8 MANAGEMENT

§ 1.9 OWNERS' RIGHTS

§ 1.10 CONCLUSION

APPENDICES

Appendix 1A—Organizing The Colorado Business: A Glossary For The Frontline Soldiers
Appendix 1B—Choosing The Right Entity: A Taxing Decision

§ 1.1 • INTRODUCTION

When asked what entity is best, there are many factors that the attorney must consider. Although it is tempting to determine ahead of time what the answer will be for every situation, so that, when a client, or another attorney calls for advice, the attorney can look smart and whip out "the answer," it simply is not possible. Before a decision can be made, it is paramount to sit down with the client (or at least have the client on the other end of a telephone and e-mail conversation), not only to gather information about the client, but also to find out about all of the owners (and future owners) of the entity, the purpose for forming the entity, and the short-term and long-term goals for the owners and the entity. Until this conversation takes place, a decision that is in the best interest of the client cannot be made.

The sections in this Chapter outline the various types of entities available in Colorado and some of the more important factors that should be considered when choosing the "right" entity. The discussions in this Chapter are only short summaries of those factors and should not be relied upon by themselves. The chapters that follow provide the reader with a more in-depth look at each of these issues, as well as others that should be considered in choosing an entity.

§ 1.2 • ETHICS

The first paragraph of this Chapter should quickly raise two questions in every lawyer's mind. The first deals with conflicts of interest. As noted, it is important to have a conversation with the client to determine short-term and long-term goals. The question, however, is "Who is the client?" Although a seemingly basic question, if asked and answered at the beginning of every representation, all parties know to whom the lawyer owes duties and what those duties are.

In most instances, when forming a new entity, there will be more than one owner. It is possible that one or more of those owners will assume that the lawyer is representing him or her (or even, it). In addition, those owners will, most likely, assume that the lawyer represents the entity itself and will advise as to what is best for the entity. Furthermore, even if there is only one owner, it should still be made clear whether the attorney represents both the owner and the entity, and how potential conflicts of interest will be handled if they arise.

At the beginning of the attorney-client relationship the best course of action is for the attorney to specify to all parties whom the attorney represents and, if the attorney will be representing (and is able to represent) multiple parties, how conflicts will be handled when they arise. This should be done both in writing and, if possible, in a face-to-face discussion, so that everyone involved can ask questions. Also, if there are parties who are not yet represented by counsel, the attorney should recommend that they consult with an attorney and a tax adviser.

The second question that the first paragraph of this Chapter raises is "What if the client has already consulted with another professional (*e.g.*, an accountant or an attorney in another field) and has already decided what entity should be formed?" This situation often occurs and should not be taken lightly. If possible, the attorney should ask the client and/or the other professional how the decision on the chosen entity was made. Given that other professionals come from different backgrounds, the reasons for a certain choice may be valid but may not take into account other factors of which you are aware.

If, however, a discussion with the other professional cannot be had or the client insists that the type of entity already chosen is right and that no input from the lawyer is needed, the lawyer should include in the engagement letter, prior to beginning the representation, that the client has received advice from another source as to the chosen entity and that the lawyer is only drafting the documents requested, without giving advice as to the propriety of the choice made. It is better to have that statement made at the beginning of the representation, rather than when the client realizes that another entity may have been a better choice and starts looking for sacrificial goats on which to lay the blame.[1]

§ 1.3 • ENTITY TYPES IN COLORADO

When starting a discussion of what type of entity is best in any given situation, it helps to know the options. In Colorado, a cornucopia of choices exists for the business planning attorney. The differences between various choices sometimes seem minimal, but can be important in a particular situation. In addition to the discussion in this section, please see Appendix 1A to this Chapter for a graphical summary of the various entities types in Colorado.

§ 1.3.1—Corporations[2]

The corporation is a separate legal entity owned by one or more shareholders. However, the management of the corporation is entrusted to directors,[3] and some of the duties are delegated to officers.[4] In Colorado, it is possible (but not required) for all of these roles to be served by the same person or persons,[5] but each role imposes different rights and responsibilities. The Colorado corporation is formed by the filing of Articles of Incorporation with the Colorado Secretary of State[6] (which may be filed via the Internet[7] with a $0.99 filing fee) or by delivering a print copy to the Colorado Secretary of State's office with a $50.00 filing fee. The management of the corporation is governed by the bylaws of the corporation, if any.[8] In addition, if the shareholders so desire, the relationship between the shareholders may be governed by a shareholders' agreement.

§ 1.3.2—S Corporations

A Subchapter S Corporation (S Corp), deriving its name from its subchapter of the Internal Revenue Code, is a creature of tax innuendo and not a creation of the Colorado Revised Statutes. The main difference between a S Corp and a non-S Corporation (known as a Subchapter C Corporation, or C Corp) is that an S Corp itself is not taxed on its income.[9] Rather, it is a pass-through entity: the S Corp does not pay income tax on its income but, rather, the shareholders of

the S Corp are allocated a pro rata share of the corporation's net income that they, in turn, must report on their individual income tax returns.[10] For a Colorado corporation to become an S Corp, its shareholders must approve an election to be taxed as an S Corp[11] and must file a Form 2553 (by mail or facsimile) with the IRS within 75 days of incorporation.[12] Also, as of January 1, 2005, an S Corp may not have more than 100 shareholders,[13] none of whom can be non-U.S. citizens or nonresident aliens;[14] may not have more than one class of stock[15] (except that there may be both voting and non-voting stock[16]); and may not have any entities as shareholders (other than estates, certain trusts, and other S Corporations).[17]

§ 1.3.3—General Partnerships[18]

Other than a sole proprietorship, the general partnership is probably the easiest type of entity to form. There are no documents to file with the Secretary of State and no written agreement between the partners need exist. Rather, all that is necessary to form a general partnership is for more than one persons (and/or entities) to associate to carry on, as co-owners, a business for profit.[19] Given this broad definition, it is possible to be a general partnership without intending to be so.[20] This may not a desired result, as each partner in a general partnership has unlimited liability for the obligation of the partnership.[21] Thus, if unlimited liability is not desired, another type of entity may be more desirable. As for income tax purposes, the Colorado general partnership is a pass-through entity unless it elects otherwise,[22] as are limited partnerships, limited liability partnerships, limited liability limited partnerships, and limited partnership associations, each of which are discussed below.

§ 1.3.4—Limited Liability Partnership

A limited liability partnership (LLP) is a general partnership that has elected for all of the general partners to have their liability limited to the amount of property and money that they have agreed to contribute to the partnership. An LLP is formed by filing a Statement of Registration of a General Partnership as a Limited Liability Partnership either online or directly with the Secretary of State's office.[23]

§ 1.3.5—Limited Partnership

A Limited Partnership (LP) is a partnership in which at least one partner (the general partner) has unlimited liability for the obligations of the LP, and at least one partner (the limited partner) has liability limited to its contribution to the LP.[24] Management of the LP is vested in the general partner[25] and may be governed by a written Limited Partnership Agreement, although it is not required. The LP has had many traditional uses, such as for investment in real property, oil and gas interest, and cable deals, with the general partner usually being a corporation, so that the general partner's unlimited liability is cut off by the corporation's limited liability. To form a LP, a Certificate of Limited Partnership must be filed with the Secretary of State.[26]

§ 1.3.6—Limited Liability Limited Partnership

A limited liability limited partnership (LLLP) is formed by an LP filing a Statement of Registration of a Limited Liability Limited Partnership.[27] The effect of such a filing is that both the general and limited partners will have limited liability for the obligations of the partnership.[28]

§ 1.3.7—Limited Partnership Association

Although rarely used and somewhat unique to Colorado, a limited partnership association (LPA) is somewhat of an amalgamation of a partnership and a corporation. It is formed by filing Articles of Association with the Secretary of State.[29] Like a corporation, the LPA must have Bylaws,[30] the owners of the LPA (known as "members") subscribe to the capital of the LPA[31] and have limited liability for its obligations,[32] and distributions made to the members are "dividends" that are paid according to the relative interests of the members.[33] Furthermore, a short laundry list in the statute sets forth several actions that the LPA may or must take that are the same as that of a corporation.[34] Management of the LPA can be centralized in at least two of the members, with certain duties being delegated to officers.[35] As to the liability of the members of an LPA, the concepts of piercing the corporate veil are applied.[36] Despite looking much like a corporation, a LPA, as noted above, will be taxed like a partnership, as it is a domestic entity with two or more owners that is not a corporation *per se* under the Colorado statutes (unless the members of the LPA elect otherwise).[37]

§ 1.3.8—Limited Liability Company[38]

Limited liability companies (LLCs) have become quite popular in Colorado, being one of the first states to allow such an entity to be formed. Like a corporation, a LLC affords limited liability to its owners[39] (its "member" or "members" — it should be noted that, unlike a partnership, a LLC may have only one member[40]). However, like a partnership, it is a pass-through entity for federal income tax purposes, unless it elects otherwise[41] or has only one member, in which case it will be "disregarded" for federal tax purposes.[42] The business of a LLC is managed by the members themselves or is delegated to a "manager,"[43] the delegation of which must be indicated in the Articles of Organization filed with the Secretary of State when the LLC is formed.[44] Instead of bylaws or a partnership agreement, the relationship among the LLC members is set forth in an operating agreement, which need not, but should be, in writing.[45] In addition, the provisions of the operating agreement usually govern the way in which the LLC is managed, the rights of the members to distributions from the LLC, how the profits and losses of the LLC will be allocated among the members, the transferability of the members' ownership interest, and how the LLC may be dissolved. Thus, the operating agreement can be seen as a combination of the bylaws, a shareholder agreement, and a management agreement (which is why most operating agreements tend to be quite lengthy, expensive, and complex, much to the clients' chagrin).

§ 1.4 • LIMITATION OF LIABILITY

One of the first considerations when comparing the types of entities available is whether the owners of the entity will have liability for the obligations of the entity. Prior to making a decision that limited liability is important, discuss with the client the intended purpose of the entity. If the purpose of the entity does not involve a high level of risk, the formation of a limited liability entity such as a LLC or corporation may not be advisable, especially given the heightened level of administrative burden required to maintain such limited liability. Conversely, a client who is engaged in a business venture may not appreciate the advantages of forming a limited liability

entity or may be dissuaded from doing so due to the cost of forming a new entity. However, an assessment of the nature of the venture may cause the attorney to recommend such a step.

It should be noted that when it is said that an owner has limited liability, the owner's liability is limit to that which he or she promised to contribute to the capital of the entity.[46] Thus, it is very important to set forth in writing what the owner has promised to pay into the entity and that the entity has received such contribution. In addition, the limitation of liability afforded by the Colorado statutes does not extend to an individual owner's negligence. Thus, forming a corporation will not, by itself, protect a doctor or lawyer form his or her malpractice.

§ 1.5 • DOUBLE TAXATION VERSUS PASS-THROUGH TAXATION

In addition to limited liability, the manner of taxation of the entity's profits will be taxed is of great importance when determining the optimal type of entity. For income tax purposes, two basic tax structures exist: double taxation and pass-through taxation. Double taxation occurs when the entity itself pays income tax on its profits and then the entity owners also pay tax on distributions they receive from the entity. Under the Internal Revenue Code, such an entity is said to be taxed as a corporation. On the other hand, if the entity's profits are taxed at the owners', rather than the entity's, level (based on an agreement between them or upon their respective ownership interests in the entity), the entity is said to be taxed as a partnership.

Until 1997, a determination of how an entity was treated for income tax purposes was made by a multi-part test that looked at, among other things, the number of owners of the entity, whether any of the owners had unlimited liability for the obligations of the entity, whether management of the entity was centralized, and the transferability of the owners' interest in the entity. However, given that this test became more difficult to administer due to the advent of the limited liability company and its flexible nature, the IRS promulgated the "Check-the-Box" regulations, under which an entity had a certain default status unless a form was filed on which a box was checked to treat it otherwise.

With regard to domestic entities, the starting point for the Check-the-Box regulations is that a corporation, under state law, is taxed as a corporation.[47] Conversely, a domestic entity that has two or more owners and is not a corporation *per se* is taxed as a partnership.[48] On the other hand, a domestic entity that is not a corporation but only has one owner (*e.g.*, a single-member LLC) is "disregarded" for tax purposes[49] and any income thereof will be reported as income if its owner.

For a graphical discussion of the differences between entities taxed as corporations and as partnerships, *see* Appendix 1B to this Chapter.

§ 1.6 • SELF-EMPLOYMENT TAX

In addition to income taxes, the owners' liability for the federal self-employment tax may be a consideration when choosing the optimal entity for a particular situation. In general, the owners of a business will be liable for self-employment tax since the entity will not be withholding Social Security and Medicare taxes from the owners' pay. The rate for the self-employment tax is 15.3 percent (12.4 percent for Social Security and 2.9 percent for Medicare). The question, however, is "15.3 percent of what?" In the case of a partnership, general partners will be liable for self-employment tax on their entire share of the entities profits. Limited partners, on the other hand, will only be liable for self-employment tax on those amounts that are guaranteed payments (*e.g.*, salaries). Similarly, shareholders of an S Corp will only be liable for self-employment tax on their "reasonable" salaries. Any other amounts received as dividends are not subject to the self-employment tax. Of course, what is a "reasonable" salary is subject to IRS review.

The question then arises as to how amounts receive by members of an LLC will be treated. Although the IRS attempted to promulgate regulations that looked to the amount of time spent by the member in the LLC's business as determinative of whether the member should be treated like a general partner or a limited partner for self-employment tax purposes, Congress put a moratorium on the finalization of those regulations, mandating in the Taxpayer Relief Act of 1997 that regulations be proposed before July 1, 1998. Now, nearly a decade later, such regulations have still not been proposed. As a result, most accountants advise their clients that the member's entire share of the LLC profits will be included in his or her self-employment income. Thus, some accountants see an LLC as an inferior choice of entity over a S Corp, where the amount of self-employment tax can be limited.

§ 1.7 • FRANCHISE TAXES

In several states (such as Delaware), an annual franchise tax is charged to certain entities, based on the capital contributions of the entity owners or the entity's capital structure in general; in some cases, this franchise tax can be expensive. In most states that charge a franchise tax, it is only charged to corporations. However, there are still some states that treat LLCs as corporations, at least for franchise tax purposes.

In addition, although not technically a franchise tax, most jurisdictions charge an annual fee for entities whether foreign or domestic, which can also, in some cases, be quite expensive. When determining which type of entity should be chosen, an assessment should be made of where that entity will be formed and where it will do business; additionally, a review of those states' franchise tax and annual fees should be made, along with a review as to which entities those taxes and fees apply.

§ 1.8 • MANAGEMENT

Another important factor that may affect which entity should be chosen is how the entity is to be managed. If all of the owners of the entity will take an active role in the management of the entity, a general partnership may be sufficient. However, if some owners are to be "silent partners" while others will take over the active management of the business, a general partnership would not work. Rather, a corporation, LP or LLC may be more appropriate.

§ 1.9 • OWNERS' RIGHTS

One aspect of the entity that is often overlooked but which may be of significant import is the rights of the owners of the entity, especially minority owners to which management may have to answer. For example, under the provisions of several Colorado entities, including corporations and LLCs, the entity owners have a right to bring a derivative action on behalf of the entity if management refuses to bring such an action.[50] Furthermore, in the case of a merger of a corporation, shareholders who do not vote in favor of the merger have the right to exercise their dissenters' rights.[51] Also, the owners of Colorado entities have varying degrees of rights to review and copy certain records of the entity.[52] The amount of access to company records that the entity's management want the owners to have may determine what type of entity is chosen.

§ 1.10 • CONCLUSION

The foregoing discussion only touches on some of the factors to consider when choosing the right entity for a client. Other factors of equal import include the business for which the entity will be used, the types of investors the initial owners will be seeking, and what plans the owners have for giving up their ownership in the entity. A review of all of these factors, as well as the others discussed in more depth in the following chapters, must be done each time a client requests advice as to the "right entity." As no two situations will be alike, no one-size-fits-all approach should be taken.

NOTES

1. For an in-depth discussion, *see* Chapter 4.
2. For an in-depth discussion, *see* Chapter 8.
3. C.R.S. § 7-108-101(2).
4. C.R.S. § 7-108-302.
5. C.R.S. §§ 7-108-102 and -301(4).
6. C.R.S. § 7-102-103(1).

7. For a list of documents that may be filed online with the Colorado Secretary of State, visit www.sos.state.co.us/biz/FileDoc.do.
8. C.R.S. § 7-102-106.
9. I.R.C. § 1363(a).
10. I.R.C. § 1366(a)(1).
11. I.R.C. § 1362.
12. I.R.C. § 1362(b)(1).
13. I.R.C. § 1361(b)(1)(A) (note that special rules now exist for counting certain members of a family together as one shareholder of a S Corp. I.R.C. § 1361(c)(1)).
14. I.R.C. § 1361(b)(1)(C).
15. I.R.C. § 1361(b)(1)(D).
16. I.R.C. § 1361(c)(4).
17. I.R.C. § 1361(b)(1)(B).
18. For an in-depth discussion of all types of partnerships, *see* Chapter 9.
19. C.R.S. §§ 7-60-106 and 7-64-202(1).
20. *See* A. Rozansky, "Entity-Less Joint Ventures in the United States," *Lawyering in the International Market*, Campbell & Birkeland, eds. (Transnational Publishers, Inc., New York, 1999).
21. C.R.S. §§ 7-60-115(1) and 7-64-306(1).
22. Treas. Reg. § 301.7701-3(b)(1).
23. C.R.S. §§ 7-60-144 and 7-64-1002.
24. C.R.S. §§ 7-62-101(7), -303, and -403(2).
25. C.R.S. § 7-62-403.
26. C.R.S. § 7-62-201.
27. C.R.S. § 7-62-101(12).
28. C.R.S. §§ 7-60-115(2) and 7-64-306(4).
29. C.R.S. § 7-63-104.
30. C.R.S. § 7-63-109.
31. C.R.S. § 7-63-104.
32. C.R.S. § 7-63-107.
33. C.R.S. § 7-63-113.
34. C.R.S. § 7-63-108.
35. C.R.S. § 7-63-110.
36. C.R.S. § 7-63-108(1).
37. Treas. Regs. § 301.7701-3(b)(1).
38. For an in-depth discussion of LLCs, *see* Chapter 10.
39. C.R.S. § 7-80-705.
40. C.R.S. § 7-80-102(9).
41. Treas. Reg. § 301.7701-3(b)(1). Although most states now treat LLCs as pass-through entities, there are still a handful of states that tax LLCs as corporations. Furthermore, several countries, including Canada, Australia, and the UK, do not treat LLCs as pass-through entities; therefore, distributions made to members in those countries will be treated as dividends from a corporation and taxed accordingly.
42. Treas. Regs. § 301.7701-3(a).
43. C.R.S. § 7-80-401(1).
44. C.R.S. § 7-80-204(1)(e).
45. C.R.S. § 7-80-102(11).
46. *See, e.g.*, C.R.S. §§ 7-106-203(1) (with regard to shareholders of a corporation) and 7-80-502(1) (with regard to members of a LLC).
47. Treas. Reg. § 301.7701-2(b)(1).
48. Treas. Regs. § 301.7701-3(b)(1).
49. Treas. Reg. § 301.7701-3(a).
50. C.R.S. § 7-107-402 and §§ 7-80-713 through -719, respectively.

51. *See* C.R.S. §§ 7-113-101, *et seq.*

52. *See, e.g.*, C.R.S. §§ 7-80-408 (with regard to LLCs) and 7-116-102 (with regard to corporations).