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Protecting Your Business

How do you protect yourself, your business, yourself from your business, and protect your clients all at the same time?

If you are serious about your consultancy, then you will want to build a practice of value, and that value should be protected, separate from your personal assets, and managed as the business it is.

Why do people incorporate? Is it really necessary? What does it mean to my clients? Can I do business without incorporation? How do I go about incorporating if that's what I decide to do? Do I have to have an attorney?

In this session, learn how to:

Evaluate the risks you need to take and what you might do to mitigate them.

Decide what form your business will take (partnership, sole proprietor, corporation, limited liability company),

What are the advantages and disadvantages of each?

Take the next steps in formalizing a business entity.

Keep from piercing the corporate shield"and putting your personal assets at risk.

I. Business Risks

Errors and Omissions

Liability for Employees' Actions

Worker's Compensation Liability

Payroll Tax Liability

Liability for Co-owner's Actions

Disputes between Owners

Client Lawsuits for Breach of Contract

Not Getting Paid for Work Performed

Liability for Leases and other Long-term Obligations

Embezzlement

II. Mitigating Business Risks

Errors and Omissions.

E&O Insurance
Retainer Agreements Clarifying Responsibilities
Put Business in a Limited Liability Entity such as Corporation or LLC
Associate with Other Experts when necessary.

Liability for Employees' Actions

Owner is liable when employee injures someone while on company business.
Insurance: Auto, Umbrella
Put Business in a Limited Liability Entity such as Corporation or LLC

Worker's Compensation Liability

Workers Compensation overrides normal laws of liability between employer and employee. Carry workers' compensation insurance to limit liability.

Payroll Tax Liability

A "responsible person" may be personally liable for withheld payroll taxes which are not paid over to the IRS (Personal Income Tax and Employee's half of FICA & Medicare).

If you mis-categorize an employee as an independent contractor, you may still be liable for unpaid payroll taxes. Payroll taxes are not dischargeable in bankruptcy.

Liability for Co-owner's Actions

A partnership is an association of two or more persons to carry on as co-owners a business for profit [Calif. Corp. Code. Sec.15006(1)].

All Partners are liable jointly and severally for everything chargeable to the partnership under Sections 15013 [wrongful act or omission of any partner acting in the ordinary course of the business of the partnership] and 15014 [partnership bound by partner's breach of trust] and jointly for all other debts and obligations of the partnership [Corp. Code Sec. 15015].

Any partner with apparent authority can obligate the partnership.

Put Business in a Limited Liability Entity such as Corporation or LLC. Clear Standards of Conduct. Arthur Andersen & Co.

Disputes between Owners

What constitutes profits? How are they to be shared? What are the duties of each owner?

Specify clearly in written agreements: Such as LLC Operating Agreements, Board of Director Minutes, Shareholder agreements, Buy-Sell Agreements.

Client Lawsuits for Breach of Contract

Clear written agreements with clients. Not saying yes to every prospective client.

Not Getting Paid for Work Performed

Up front fees. Progress payments. Clear Billing Statements. Written Agreements.

Liability for Leases and other Long-term Obligations

Putting Business in a Limited Liability Entity such as a Corporation or LLC may avoid some liability. Often, Lenders or Lessors will require the owner's personal guaranty.

Embezzlement

Install proper accounting controls. Separation of functions. Person receiving and depositing money doesn't also write checks. Review and sign all checks. Be careful about delegating check signing authority. Review credit card bills.

Put Business in a Limited Liability Entity such as a Corporation or LLC. I've seen where a simple corporation would have avoided personal bankruptcy for the business owner as a result of embezzlement by a trusted employee.

III. Decide what form your business will take (partnership, sole proprietorship, corporation, limited liability company). What are the advantages and disadvantages of each?

HIGHLIGHTS OF S AND C CORPORATIONS AND LLCs

A. Deciding whether to form a limited liability entity such as a corporation or LLC.

Raising Capital from a Broad Base. If one is seeking to raise large amounts of capital from numerous equity holders, the corporation is probably the best vehicle. The free transferability of shares and the established stock markets are tremendous assets in raising capital.

Ease of Formation; Transaction Costs. The size and complexity of a proposed business venture has more effect on the ease and cost of forming the appropriate business structure, than the particular form of entity used.

A **sole proprietorship** is the simplest form of business organization. No filings, fees, or minimum annual taxes are necessary to form and use a sole proprietorship. Income is reported on Schedule C of Form 1040.

Liability Protection. For a business which plans to remain closely-held for some time to come, the analysis is different. Usually, the reason for incorporating is to limit liability. For purposes of this liability protection discussion, “incorporation” also refers to forming an LLC, if it is more appropriate. The liability of some businesses is obvious due to the nature of their product or services. These will explore forming a limited liability entity such as a corporation or LLC sooner. Other businesses have less exposure. Nevertheless, given an employer’s liability for the acts of its employees while carrying out their business duties, even a small business with employees may wish to incorporate. As soon as a business has employees driving errands for the business, incorporation starts looking attractive to most owners.

Incorporation should not replace insurance. That is usually the first line of defense against liability. However, incorporating provides a valuable supplement. Clients should compare the cost of incorporating versus the type and amount of insurance protection they can obtain for the same price.

For most small corporations, the **cost of incorporating** is probably about $2,000 up front plus $2,000 per year. The annual costs consist of the $800 California minimum tax, the accountant’s fees for preparing the corporation’s tax returns, and the legal fees for preparing the annual minutes.

Since insurance policies often exclude many things from coverage, and because insurance companies sometimes go out of business, **corporations can provide a broad safety net of liability protection** underneath the business’s insurance policies. To keep this protection

in place, it is important to observe the corporate formalities, such as annual actions and not having the corporation pay for personal expense items of the owners, unless they are properly reflected as compensation to the owner. Otherwise, the corporate veil could be pierced under an "alter ego" theory. That is where the owners have not respected the corporation as a separate entity. As a result, the courts won't recognize it either, as a barrier as against creditor's claims.

Another asset protection advantage is that a corporate-sponsored retirement plan has greater protection from creditors than a self-employed person's retirement plan.

Tax Advantages. A sole proprietor with high medical expenses and few employees may find a C corporation attractive because it can have a medical reimbursement plan. Under the reimbursement plan, the corporation can reimburse the employees for many medical expenses that would not be covered by their medical insurance, in addition to the cost of the insurance itself. These benefits are then deductible to the corporation, but not taxable to the employees. A C corporation can also provide other tax-free benefits that other entities cannot, such as disability insurance and group-term life insurance (up to $50,000), but medical insurance is usually where the biggest tax savings are.

An S corporation has an advantage in the self-employment tax area. An S corporation's distributions of profit to owners that work in the business are not subject to self-employment taxes. However, all of a sole proprietor's profits, and a general partner's share of the partnership's profits are subject to self employment taxes. Therefore, if an sole proprietor can justify paying himself or herself a reasonable salary that is less than the maximum self-employment tax limits, then the profits in excess of the owner's salary can escape self-employment tax if they are paid out as S corporation profits, instead of partnership or sole proprietorship profits. For many small businesses, these tax savings can easily cover the costs of being a corporation.

B. Comparing Other Advantages of S and C corporations With LLCs.

C Corporation Advantages

Compared with an S corporation:

The corporation's shareholders are not limited to 75 shareholders, which must generally be US resident/citizen individuals. Except in special cases, shareholders may not be corporations or partnerships or nonresident aliens.

The C corporation is not limited to one class of stock, and therefore, strictly pro rata allocation of profits between shareholders. A C corporation and have various classes of preferred stock, so that preferred returns can be offered to different investors at different levels.

Compared with an LLC:

C corporation stock may be acquired under the tax-free reorganization provisions of IRC § 368. Those reorganizations include statutory mergers, stock-for-stock acquisitions, and stock-for-assets acquisitions.

C corporations can offer incentive stock options to their employees.

They are not subject to the LLC's fee on total income.

If the corporation has adopted and issued stock under IRC §1244, then a loss on that stock would be an ordinary loss, rather than a capital loss.

C corporations do not need to amend their governing documents, each time an ownership interest is transferred.

Some third parties may be more comfortable dealing with corporations, which are more familiar to them than LLCs, which are relatively new.

Compared with both S corporations and LLCs:

Small business stock benefits: investors who have held qualified small business stock for more than 5 years may be able to exclude 50% of the gain on its sale or be able to roll over the gain into other qualified small business stock.

C corporations have their own graduated tax rates, which may be lower than the owners' individual tax rates. Therefore, a growing business, which is investing profits back into the business, may wish to take advantage of the lower tax rates on retained profits. The tradeoff may be double taxation on those profits if they are paid out to the shareholders in the future. However, if the shareholders have a different exit strategy, such as a tax free stock-for-stock swap when their company is acquired by a public company, then the double taxation may be a smaller issue. Care must be given to the accumulated earnings tax and personal holding tax rules when following this strategy.

Certain tax advantaged fringe benefits can be offered by a C corporation that may not be offered tax-free by a partnership, LLC or S corporation, such as health benefits. This difference is reduced by the deduction for self-employed health insurance premiums that is offered to most sole proprietors, partners and 2% S corporation shareholders.

Where the company conducts business in states other than where the owner resides, the flow-through nature of partnerships and S corporations will require the owners to file state tax returns in those states. This is unnecessary with a C corporation.

Taxable year - Unless it is a professional corporation, a C corporation is generally free to pick any fiscal year for its tax year. A partnership (including LLCs, LLPs, Limited Partnerships)

must use the tax year of its principal partners, or the calendar year, if the partners have different tax years. It is difficult for an S corporation to use other than a calendar year.

C Corporation Disadvantages

Compared with LLCs:

Shareholders meet IRC § 351 80% control group requirements in order to avoid taxation on contributions of appreciated property to the corporation.

Generally, distributions of appreciated property to shareholders will be double-taxed.

Compared with both S corporations and LLCs:

If the corporation's tax cannot be "zeroed out" by paying increased compensation to the owners, then double taxation may occur. Levels of salary, rent and royalties paid to the corporation's owners are all subject to reasonableness requirements. If they are unreasonable, they can be recharacterized as nondeductible dividends. This can trigger large amounts of corporate tax and penalties during an audit.

Losses and credits cannot be passed-through to the owners to shelter other income.

A partial redemption of a shareholder's stock could be treated as dividend (ordinary) income, rather than capital gain income.

Method of Accounting - A C corporation with average annual gross receipts of more than $ 5 million dollars for any prior period of 3 tax years (or the period of its existence if the corporation is less than three years old), cannot use the cash method of accounting. The cash method is generally simpler and more tax advantageous.

S Corporation Advantages

Compared with a C corporation:

S corporation's losses, deductions and credits can pass through to the owners to shelter other income, subject to the basis, at-risk, and passive loss limitation rules.

Income is only subject to one level of tax, except for California's 1.5% S corporation income tax.

Appreciated property may be distributed with only one level of gain recognition, except for California 1.5% tax.

Partial redemptions are not subject to possible taxable dividend treatment.

Compared with LLCs:

Not subject to California LLC total income fees (just the 1.5% income tax)

Profit distributions to owners who are also active in the business are not subject to self-employment tax.

S Corporation Disadvantages

Compared with an LLC:

Owner's basis does not include share of entity's debt. This restricts the ability to pass-through losses, or to take out depreciation-sheltered income without triggering capital gain.

Distributions of appreciated property will trigger a single-level of tax (plus the California 1.5% S corporation income tax).

Minority shareholders may need to be protected through supra-majority vote requirements and peripheral agreements such as shareholder agreements, buy-sell agreements and employment agreements. With an LLC, these issues may be addressed permanently in the operating agreement itself, in a simpler, more-binding agreement.

Similarly, profits must generally be allocated according to share ownership alone, whereas with an LLC, profit and cash flow allocations can be made according to complex and creative formulas that can be spelled out in a single-operating agreement, as opposed to numerous peripheral agreements.

Compared with both C corporations and LLCs:

S corporations may not have more than 75 shareholders, who are typically individuals and not non-resident aliens.

S corporations may only have one class of stock. This limits their ability to offer preferred returns to investors or quasi-equity returns to lenders. However, voting rights of S corporation common stock can vary without creating more than one class of stock.

State Taxation.

In California, C corporations, S corporations, limited partnerships, LLCs and LLPs must all pay at least an annual minimum tax of $800.

C corporations are subject to a franchise tax which is similar to the federal corporate income tax. The maximum tax rate is 8.84%. Rev & T C §23151(d).

S corporations' net income is taxed at 1.5%. Rev & T C §23151(d).

The $800 minimum tax does not currently apply to corporations during the first year.

LLCs are subject to an additional fee based on total income (which is essentially equivalent to gross revenues) as follows (Rev & T C §17942):

Total Income	Fee Amount
Less than $250,000	0
$250,000 to $499,999	$900
$500,000 to $999,999	$2,500
$1,000,000 to $4,999,999	$6,000
$5,000,000 or more	$11,790

Since this fee is based on gross revenues, rather than net income, the California tax on LLCs can differ drastically from that tax the same business would pay if it were an S corporation. Since limited partnerships are not subject to this fee, it often makes sense to put a real estate investment into a limited partnership, with an LLC or an S corporation owning a small portion as the general partner, rather than just using an LLC.

More About LLCs and Limited Partnerships.

1. Limited Liability Company (LLC). LLCs were created to fill the gap in between limited partnerships and corporations. Like a limited partnership, the LLC is generally not subject to federal income tax. However, like a corporation, the members of an LLC do not have personal liability for the debts of the LLC.

The federal "check-the-box' tax regulations make it much simpler for the LLC to achieve its desired tax status classification. Unless a contrary election is made, a single-member LLC will be a disregarded entity for federal tax purposes, and LLCs with more than one member will be taxed as partnerships.

In addition to the "tax shelter" applications discussed below, LLCs can have a definite advantage over S corporations where some of the proposed investors may not meet the S

corporation shareholder requirements. That would include corporations, partnerships and foreign investors. In addition, if special allocations of taxable income, losses or credits is desired, then an LLC would need to be used, instead of an S corporation. An LLC can also be useful to protect a minority investor's rights, where there is a danger that the other investors might constantly have opposing interests.

2. Limited Partnership. Like a general partnership, a limited partnership has one or more "general partners" who actively engage in the management and control of the business and who are personally liable for the partnership's obligations. However, a limited partnership also has one or more "limited partners". Limited partners do not participate in the control of the partnership's business and they are not personally liable for its obligations.

Like general partnerships and LLCs, a limited partnership is generally not subject to federal income tax. As with LLCs, this issue has been greatly simplified and much uncertainty has been removed by the adoption of the "check-the-box" regulations. Like LLCs, limited partnerships are subject to California's $800 annual franchise tax. However, they are not subject to an additional fee based on total income, as LLCs are.

Limited Partnerships were previously the vehicle of choice for most tax shelters. Partnership losses could flow through to the partners to shelter other income. Partners can be treated as having contributed amounts which a partnership borrows directly. This increases the partners' tax basis and allows them to deduct more in losses than they have invested in or loaned to the partnership. Promoters could retain full control over the business as the general partners. As limited partners, passive investors bore no fiduciary responsibility for the operation of the partnerships' business.

LLCs can offer all of these advantages, without requiring general partners to bear personal liability for the LLC's debts. Therefore, LLCs appear to be a better choice in most areas where a limited partnership would previously have been used. The 1986 tax act drastically reduced tax shelters outside of the oil and gas industry. However, real estate investments can still shelter their income with non-cash depreciation deductions. This allows an investor to receive cash distributions without receiving any corresponding taxable income. In order for these distributions to avoid taxation, they must not exceed a partner's basis. Since they are taxed as partnerships, LLCs and limited partnership can allow a partner to include a portion of the partnership's debt in their basis. This allows the partner to take more cash out of a partnership than they have invested, without being subject to taxes in the short-run.

A limited partnership still appears to have a valuable use in conjunction with an LLC, to reduce California taxes. Both LLCs and limited partnerships must pay an $800 annual franchise tax. However, LLCs with revenues over $250,000 are also subject additional fees in excess of $800. For LLCs with revenues in excess of $5,000,000, the extra fees are $11,890. If an investment with expected revenues over $250,000 is structured as a limited partnership with an LLC owning a small interest as the general partner, these fees can be reduced or eliminated. Since only a small portion of the investments revenues are allocated to the LLC, the LLC may

not have sufficient income to trigger the additional California fees. These fee savings could easily outweigh the cost of the extra $800 franchise tax and preparing an additional tax return.

Limited Partnerships and LLCs are also used in asset protection and estate planning. A detailed discussion of those uses is beyond the scope of this course. However, the following are some of the highlights. The creditor of a partner cannot levy on a debtor partner's share of a partnership or LLC's assets. They can only get a "charging order", which entitles the creditor to any distributions from the partnership (or LLC). It also appears to make the creditor liable for the income taxes related to the seized partnership interest. Asset protection limited partnerships often give the general partners extra powers to accumulate income for future investments and specify a long partnership term. As a result, a partnership can distribute taxable income to a creditor, but no cash, for a number of years. This makes it easier to negotiate with the creditor.

Family limited partnerships and LLCs are also used to reduce the value of property for estate and gift tax purposes. Courts have held that a minority partner in a limited partnership (or member of an LLC) may discount the value of their partnership interest as a result of their lack of control over the partnership and their interest's lack of marketability. Therefore, by putting assets into a limited partnership or LLC and using the resulting discounts in value, more assets can be transferred by gift or from an estate than would otherwise be possible without incurring addtional taxes.

Formation

Limited Liability Company. An LLC is formed by filing Secretary of State Form LLC-1 (the Articles of Organization) with the Secretary of State. The Articles may be signed by an organizer of the LLC, who need not be a member or manager of the LLC. The filing fee is $70. All members of the LLC must also enter into an operating agreement. This may occur either before or after the Articles are filed, and it may be either written or oral. Obviously, written is preferred. It should address all material issues among the members. The agreement's complexity and cost will depend on the particular agreement between the members and the business' complexity.

The operating agreements usually take one of two basic forms: member managed or manager managed. The member-managed form is similar to that of a general partnership, where all of the members participate in the management of the LLC. The manager-managed form is similar to a limited partnership, where only the managers control the LLC, and the members are mere passive investors.

Within 90 days after the Articles are filed, the LLC must file a Statement of Information with the Secretary of State, providing the names and addresses of the LLC's managers (if manager-managed) or its members (if member-managed). It must also provide and agent for service of process, the address of its principal business office, and its principal business activity.

The LLC must pay an $800 franchise tax by the 15th day of the fourth month of its taxable year.

Federal Income Tax Considerations. Due to the new check-the-box regulations, limited partnerships, LLPs and LLCs with more than one member should all be taxed as partnerships. References to partnerships in this federal income tax discussion will include limited partnerships, LLPs and LLCs. LLCs with one member are disregarded for tax purposes, so that their income and expenses are included directly in the member's tax return. Accordingly, single member LLCs will not be included in this discussion of partnership taxation.

A. Tax Consequences of Formation. Generally, partnerships are not taxed on the receipt of capital contributions of cash, property, or services by partners (including members in an LLC). IRC §§ 721, 1032). There is no "control" requirement as there is for corporations under IRC § 351.

Exceptions for Contributions of Property. If contributed property is subject to a liability, the contributing partner may recognize gain equal to the amount by which the liability exceeds the partner's basis in the property plus the partner's basis in his partnership interest prior to the contribution.

Contributions of Services. If a partner contributes services to a partnership and receives a **capital interest** in exchange, the partner has taxable income. Treas. Reg. § 721-1(b)(1). If a partner contributes services to a partnership and receives a **profits interest** in exchange, but no interest in the underlying capital, then in most situations, the Internal Revenue Service will not tax the partner on the receipt of the profits interest. Rev Proc 93-27, 1993-2 Cum Bull 343.

B. Taxation of Partnership and Partners.

(1) Pass-Through Entity. Partnerships are not subject to federal or California income tax. (As discussed above, California does levy an $800 annual franchise tax and an LLC fee based on revenues in excess of $250,000). Instead, the partnership's income and losses flow through to its partners. The partnerships generally reports these tax items to the partners and the Internal Revenue Service on form 1065 "k-1" (and 565 k-1 for California). Partners then include these items of income and deductions, etc., on their own tax returns. As a result, there is only one level of tax. Items of Income, Deductions, Gains, Losses, Preference Items, etc. generally retain the character they had in the partnership. IRC § 702. In order to deduct losses, a partner must have sufficient basis in his or her partnership interest (IRC § 704(d)). The losses will also be subject to the at-risk and passive loss rules (IRC § 465, 469).

Generally, this pass-through treatment is advantageous because it eliminates the threat of double taxation and may allow partners to offset partnership losses against other income, resulting in tax savings. However, if a partnership is reinvesting its profits in a growing business, then partners may have to pay taxes on income which they have not received, because the

partnership reinvested it. An asset protection partnership may purposely follow this strategy in order to discourage creditors who have obtained charging orders against the partnership.

(2) Distributions. A partner does not generally recognize taxable income when the partnership distributes cash or property to the partner. IRC § 731. The distributions do reduce the partner's basis in his or her partnership interest (IRC § 705(a)(2)) and the partner's new basis in the property is generally carried over from the partnership, unless the partner's interest is being liquidated (IRC § 732). If the amount of cash distributed exceeds the partner's basis in his or her partnership interest, then the excess is recognized as capital gain. IRC § 731(a)(1). Since a reduction in the partner's share of the partnership's indebtedness is deemed to be a distribution of cash, principal payments of the partnership debt can create capital gain for the partner, if the partner's partnership basis has already been reduced to zero.

(3) Special Allocations. Normally, items of income, loss, deductions, and credits are distributed among the partners according to their profit and loss sharing ratios. However, the partners can agree to make different "special allocations" of such tax items, provided they have "substantial economic effect." IRC § 704(b)(2); Treas. Reg. § 1.752-3. Treasury Regulations §§ 1.704-1 et seq. Set forth detailed rules for determining whether a special allocation has substantial economic effect. Although these regulations are very complex, they are based on a simple economic principle. If an item of partnership income or gain benefits a partner economically, the corresponding tax item must be allocated to that partner so that he bears the related tax burden. Similarly, if a partner will suffer the economic burden of an item of partnership deduction or loss, the corresponding tax benefit must be allocated to that partner burden.

Generally, allocations will have an **economic effect** if:

Capital Accounts are maintained according to the rules in the Regulations;

Liquidation Distributions are made according to positive capital account balances; and

A Partner with a Capital Account Deficit Following Liquidation, must restore the negative balance to the partnership by the end of the partnership's taxable year in which the liquidation occurred (or 90 days after liquidation, if that is later), to be paid to the partnership's creditors or to the other partners in accordance with their positive capital account balances.

An allocation's economic effect will be **substantial** if it is reasonably possible that it will substantially affect the amounts the partners will receive, independent of tax consequences. Treas. Regs. §§ 1.704-1(b)(2).

Corporations are unable to make such special allocations.

(4) Partnership Debt Increases Partners' Basis. Shareholder in C and S corporations receive no basis from corporate borrowings, except that an S corporation shareholder gets credit for amounts that the shareholder directly lends to the S corporation. Partnerships are very different. Under IRC § 752(a), a partner's "share" of partnership debt is deemed equivalent to a contribution of money by the partner to the partnership. That deemed contribution increases the partner's basis in this partnership interest under IRC § 705. This is a significant advantage over S corporations, because the higher a partner's basis in his partnership interest, the more deductions the partner can take, or alternatively, the more distributions can be made to the partner without triggering capital gain.

The rules for determining what a partner's share of partnership debt is differ between recourse and nonrecourse debt. Recourse debt is allocated between the partners based on how they share the "economic risk of loss" with regard to the debt. Treas. Regs. §§ 1.752-2. Therefore, in a limited partnership, all of the recourse debt basis is typically allocated to the general partners, unless a limited partner has personally guaranteed some of that debt. Nonrecourse debt is shared under a complex stacking rule. However, generally, that results in nonrecourse liabilities being shared according to how the partners share profits. Treas. Regs. §§ 1.752-3.

The application of these allocation rules to LLCs is complicated by the fact that all of an LLC's members lack personal liability for the LLC's debts. Normally, the determination as to whether a debt is recourse or nonrecourse is based on the provisions of the debt instrument. However, all debts of an LLC, whether recourse or nonrecourse as to the LLC, are effectively nonrecourse to the members.

(5) Section 754 Election. If a shareholder of an S or C corporation dies or sells his or her stock, it has no effect on the corporation's tax basis in its assets. The same is true for partnerships, unless they make an election under IRC § 754. If a partnership makes a section 754 election, the when a partner dies or sells his interest, the partnership increases or decreases the "inside" basis of the new partner's share of the partnership assets to equal the new partner's "outside" basis.

In other words, if a new partner purchases 10% of a partnership for $100,000, and a 754 election is in place, then the partnership will treat 10% of its assets as if it just purchased them for $100,000. All of the depreciation on these assets, or gains from their sale, are tracked separately and allocated to the new partner to whom they pertain. If a partner dies, then the partner's heirs are treated as having paid an amount equal to the date of death value of the partner's interest for that partner's interest. The partnership then increases (or decreases) the inside basis of the heirs' share of the partnership assets to equal that amount. If the partnership then sells those assets, the new partner's share of the gain on the sale will be reduced by the amount of the 754 "step-up" on that partner's share of the assets.

Once the 754 election is made, it is permanent. Although the 754 election is very advantageous for tax purposes, if the partnership has many partners or there are frequent

transfers of partnership interests, tracking each new partners new basis in each of the partnership assets can be burdensome. A new depreciation schedule must be kept for all of the partnership's assets, for each new partner. For a closely-held partnership, the (typical) advantages of increased depreciation and reduced gains on sale are worth the record-keeping requirements.

(6) Passive Loss Rules. Another major hurdle that must be crossed for a partner to deduct a los from a partnership is the passive loss rules. If a partner (or S corporation shareholder) does not materially participate in a partnership activity, then the partnership's losses are passive to that partner. Passive losses can only be offset against passive income from another passive activity. IRC § 469. They can't be deducted against portfolio income such as dividends, interest, and most gains from sales of stock. They cannot be deducted against income from an activity in which the partner materially participates, such as salary. There is an exception for when the partner's interest in the passive activity is ended, such as from a sale. The passive loss rules are very detailed and thorough.

They further narrow the difference between partnerships, S corporations and C corporations with respect to the ability to use losses from an entity to shelter other income. C corporations are useless in that area because no losses flow from a C corporation to its shareholders. Losses flow from both S corporations and partnerships, but an S corporation shareholder generally has less basis to claim them, since the shareholder can't include corporation debt in the shareholder's basis. This advantage is limited by the at-risk rules, except in the case of real estate. The passive loss rules further limit this advantage, even in the area of real estate, unless the partner is materially participating in the activity. However, they do still allow an investor to take depreciation-sheltered income out of an investment without taxable gain as a result of receiving basis from partnership debt, since losses are not an issue.

(7) Taxable Year. A partnership must use the same taxable year as the majority of its partners or its principal partners. IRC § 706(b). If the majority or principal partners do not all have the same fiscal year, then the partnership must generally use the calendar year.

Taxation on Liquidation or Disposition of Interests.

A corporate shareholder who sells his shares generally recognizes a capital gain (or loss) to the extent that the amount the shareholder receives for his or her stock exceeds (or is less than) the shareholder's basis. If appreciated property is distributed to a shareholder upon liquidation, the corporation (whether C or S) recognizes gain, as if it had sold the property. The shareholder also recognizes gain as if he had sold his stock to the corporation in exchange for the assets distributed. This generally results in double taxation for a C corporation, but not for an S corporation, unless the S corporation has "built-in" gains from converting from an S corporation to a C corporation within the last 10 years.

A partner generally has capital gain or loss when the partner sells his or her partnership interest. IRC §741. As with a corporation, the gain (or loss) is equal to the amount by which the

amount the partner receives for the partner's interest exceeds (or is less than) the partner's (outside) basis in their partnership interest. A major distinction is that to the extent the assets received by a partner are attributable to IRC § 751 "hot assets", such as unrealized receivables, substantially appreciated inventory or depreciation recapture, the partner will have ordinary income, instead of capital gain. IRC §741, 751(a).

Unlike a corporation, when a partnership is liquidated and the assets are distributed to the partners, the partnership generally has no taxable event. The partners also generally do not recognize gain or loss except to the extent that they receive cash in excess of their basis. However, recall that being relieved of a share of the partnership's debt is deemed to be a cash distribution. An exception is when the partnership makes disproportionate distributions of unrealized receivables or subustantially appreciated property to the partners. IRC §731, 751. Consequently, a partnership not only avoids double taxation upon liquidation, but its partners may avoid taxation as well, if the assets distributed are primarily property (whether appreciated or not) and there is little debt relief.

Other Tax Considerations.

Self-Employment Income.

Distributions of profit from a corporation are not self-employment income to a shareholder and are not subject to the self-employment tax. However, a general partner's share of partnership income is typically self-employment income. IRC §§ 1401-1402. A limited partner's share of partnership income is not self-employment income, unless it is in the form of "guaranteed payments" for services rendered to the partnership by the partner. IRC §1402(a)(13).

The members of an LLC have limited liability like limited partners. They can also participate in management and operation of the partnership, whereas limited partners cannot without jeopardizing their limited partner status under state law. Therefore, LLC members fall somewhere between general partners and limited partners with respect to self-employment income.

The IRS has proposed regulations addressing how an LLC member's share of the LLC's income will be treated for self employment tax purposes. Prop Reg § 1.1402.(a)-2(h). Generally, an LLC member will be treated as a limited partner for self-employment tax purposes, unless:

- Personal liability;
- Authority to contract for the LLC under the laws of the state where the LLC was organized;
- More than 500 hours in a taxable year of participation in the LLC's trade or business.

Management and Control.

Corporations. Ownership of a corporation is often separated from management. The shareholders of a corporation elect a board of directors to manage the corporation. The directors set corporate policy and authorize corporate actions that are outside the normal course of business. The directors elect officers to manage the day-to-day affairs of the corporation. Shareholders have no authority to contract for the corporation or to participate in its day-to-day management.

Certain protections, such as supra-majority vote requirements can be put in place to protect minority shareholders.

By electing to be a statutory close corporation, a corporation may avoid corporate formalities and vest management in the shareholders. Corp C §158. In a "close" corporation, the shareholders may adopt a shareholders' agreement that will allow them to manage the corporation in a manner similar to a partnership. Corp C §§ 158, 186, 300(b).

General Partnership. Management of a general partnership is very dependent on each partnership agreement. If the agreement does not provide otherwise, then each partner has an equal right to manage and conduct partnership business. Corp C §§ 15018(e), 16401(f). Sometimes the partnership agreement provides a formula by which partners can resolve differences by voting their respective interests. Sometimes the partners will appoint a managing partner or a management committee to manage the ordinary affairs of the partnership.

In California, each partner is an agent of the partnership and has the ability to bind the partnership contractually, if they are apparently carrying on the partnership's business. The partnership agreement may place limits on a partner's authority, but it will not be binding upon third parties who have no knowledge of its provisions. Therefore, a partner who is acting within his or her apparent authority may obligate the partnership contractually, even though the partner has no right to do so under the partnership agreement. Since each of the general partners is liable for all of the partnership's debts, and since each partner has the ability to incur tremendous debt on behalf of the partnership, partners should have tremendous trust in each other. The role of general partner carries tremendous liability with it.

Limited Partnerships. Control over a limited partnership is exercised by the general partners. Limited partners may not participate in the management of the partnership. If they do, they risk losing their limited liability. Corp C § 15632. California law does allow limited partnerships to permit the limited partners to vote on certain extraordinary partnership actions without jeopardizing their limited liability status.

If there is more than one general partner, then they may have some of the same control difficulties that a general partnership has. However, since a limited partnership is created

through a more formal process, there is a greater likelihood that the partnership agreement will provide more detail on how conflict between the partners is to be resolved.

Unlike corporate directors, who must generally be reelected by the corporation's owners regularly, the general partners in a limited partnership are often not subject to removal by the limited partners. Therefore, even though the limited partners may own 99% of the limited partnership, they may have no substantial control over the general partners. Therefore, limited partnerships often have more centralized and powerful management than general partnerships or corporations.

D. Limited Liability Companies. LLCs may follow either the general partnership or the limited partnership forms of management and control. They may be "member managed." That is where each of the members is involved in managing and controlling the LLCs. Typically, the LLC agreement would give each member a vote that is weighted based on the members percentage ownership of the LLC.

Alternatively, the LLC may be "manager managed." This format is modeled after limited partnerships. Control and management is placed in the hands of designated managers. The members have limited control, similar to limited partners.

IV. Avoid Piercing the Corporate Shield putting your personal assets at risk.

One of the main reasons that individuals form corporations is to shield themselves and their personal assets from individual liability for corporate acts. Courts allow this benefit only if the corporation remains properly organized, adequately capitalized, and completely separate as a legal entity. If a court finds that the corporate privilege has been abused, the court may disregard the corporate entity, exposing the corporation's shareholders to liability for the corporation's acts relating to that abuse.

Alter-Ego Doctrine

The legal theory on which shareholder liability is based is generally called the "alter-ego doctrine." A plaintiff attempting to create shareholder liability will try to "pierce the corporate veil" by proving that the corporation is merely an agent (or the "alter-ego") of the individuals behind it. Plaintiffs attempting to pierce the corporate veil and assert the alter-ego doctrine must generally prove two things:

(i) That there is a unity of interest and ownership between the corporation and the shareholders, such that the corporation and the shareholders are no longer separate or individual; and

(ii) That an injustice or fraud will occur if the corporation's actions are treated solely as the acts of the corporation.

Observing Corporate Formalities

One of the most overlooked areas in separating the interests of a corporation from that of its shareholders is the documentation of the corporation's actions. **Good corporate maintenance means keeping minutes of shareholders' and directors' meetings and documenting the authority for major corporate actions**. It is usually the duty of the Corporate Secretary to make sure all meetings are properly noticed and minutes of meetings are prepared and distributed.

The business and affairs of the corporation are handled by the Board of Directors, and all corporate powers must be exercised by or under the Board's direction. The officers of the corporation carry out the day-to-day functions of the corporation pursuant to the direction and policies established by the Board. The Board should make decisions as a group; the individual directors should not act alone. The Board should make decisions involving corporate policy, election of officers and determination of the officers' duties and compensation, issuance of securities, adoption, amendment or repeal of the Bylaws, participation in various business transactions, execution of material leases and contracts, declaration of dividends or redemption of shares, determination of the corporation's budget, corporate borrowings, and other major corporate transactions.

Various actions of the corporation also require shareholder approval. Some of these actions include: the election of directors, the merger, consolidation, reorganization, or dissolution of the corporation; the sale or transfer of all or substantially all the corporation's assets; and amendments to the Articles of Incorporation and, in some cases, the By-laws.

Annual Meetings Required

A corporation is required under California law to hold an annual shareholders' meeting. The date, place and time for the meeting is usually designated in the Bylaws, or the Bylaws may specify a procedure for fixing such information. The first annual meeting must be held within 15 months of incorporation and future annual meetings must be held within 15 months of the previous meeting. If a meeting is not timely held, a shareholder may apply to the superior court for an order demanding that the meeting be held.

Notice of Meetings

Both directors' and shareholders' meetings require "notice." The corporation's By-laws state how notice must be sent, and how much time before the meeting notice must be received by each shareholder and/or director. Notice is not required when:

100% of all voting shareholders/directors are present at the meeting and do not object to the lack of notice; or

All voting shareholders/directors sign a "Waiver of Notice"; or

Directors/shareholders are acting "by consent."

Actions by Unanimous Consent

The shareholders may act "by consent" when more than 50% of those shareholders entitled to vote on an issue agree to take the action without a meeting by signing a written

consent that documents the action agreed upon. (Note that the corporation's Articles or By-laws may specify a higher or lower percentage.) The consenting shareholders are required to send a notice to all of the other shareholders of the action taken within a reasonable time after they take action by consent.

The directors may act "by consent" only when 100% of the directors agree in writing that an action should be taken without a meeting. When directors act by consent, the Corporate Secretary is responsible for sending a copy of the minutes to all directors for their signature.

Any actions requiring the approval of the directors and/or shareholders should be documented in writing — either in the form of "minutes" of meetings actually held, or in the form of a "written consent" signed by all directors and, where shareholder approval is necessary, at least a majority of the shareholders. These minutes and written consents provide proof of the corporation's separate legal entity apart from that of the shareholders. They are an important tool in keeping the "corporate veil" that shields shareholders — and their assets — from liability for corporate action.

Payment of Personal Expenses By Corporation

If shareholder treats corporation's assets as his own and corporation, why shouldn't creditors be able to treat shareholder's assets as one also?

Thin Capitalization

Insufficient assets for a normal business to conduct its chosen activity.