I. THE FUNDAMENTALS OF LIMITED LIABILITY COMPANIES, LIMITED LIABILITY PARTNERSHIPS AND LIMITED PARTNERSHIPS

A. Overview of Relevant Statutes.

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. In California, LLCs are authorized and governed by the Beverly-Killea Limited Liability Company Act (Corp C §§ 17000-17705).

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.

All LLCs doing business in California must pay an annual franchise tax of $800. In addition, additional statutory fees are charged for any years in which an LLC's total income is $250,000 or more. These fees are based on the level of the LLC's total income. Total income is defined as essentially gross revenues, rather than something akin to net income. Rev & T C § 17942 (a).

2. Limited Liability Partnership (LLP). Professionals are generally prohibited from organizing as LLCs. However, California has relatively recently authorized attorneys, accountants, architects, and certain affiliates to organize themselves in LLPs. (Corp C §§ 16101(5)-(6), (12), (17)). An LLP is a form a general partnership that allows each partner’s liability for the debts of the partnership to be limited. Partners are still liable for their own negligence and misconduct. However, under most LLP statutes, a partner will not be liable for the negligence, wrongful acts, and misconduct of another partner and of employees and agents of the LLP.

In many other states, Partners are still liable for the negligent or wrongful acts or misconduct of any person acting under their direct supervision and control, as well as for the contractual obligations of the partnership. California’s LLP law is rare in that partners may avoid liability for contractual liability and also because partners are not liable for the tort of another merely as a result of their supervision or control over the wrongdoer. (Corp C §16306(b)).

An LLPs’ partners may agree by majority vote (or a different vote if specified in the partnership agreement) to be personally liable for specific obligations. (Corp C §16306(d)). Partners may also personally guarantee or supply collateral for their LLPs’ obligations. (Corp C §16306(h)).

For an LLP engaged in the practice of law, the protection against liability does not apply to claims based on acts, errors, or omissions derived from rendering legal services unless the LLP has a currently effective certificate of registration issued by the State Bar (Corp C §16306(f)).

3. 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. (Corp C §§ 15611(r)).

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. (Rev & T C §§ 17935, 23153). However, they are not subject to an additional fee based on total income, as LLCs are.

The California Revised Limited Partnership Act (CRLPA) governs limited partnership formed in California on and after July 1, 1984 (Corp C §§ 15611-15723. Unless they have elected to be governed by the CRLPA, limited partnerships formed in California before July 1, 1984 are governed by the California Uniform Limited Partnership Act, which is found in Corp C §§ 15501-15533. (Corp C §§ 15710-15714).

B. Advantageous Uses.

1. Limited Liability Partnership. The exposure the previously well-respected firm of Arthur Andersen currently faces as a result of the actions of some of its partners and employees in the case of its Enron audit demonstrates the advantages of the LLP form of doing business. Partners in law, accounting and architectural firms can continue to enjoy the management and income-sharing flexibility of general partnerships, while limiting the partners' liability for the negligence and misconduct of their other partners. It appears that many clients are abandoning Arthur Andersen following its criminal indictment. Many employees have been laid off. In addition, Arthur Andersen presumably has a

number of long-term leases on expensive commercial property. In California, the LLP statutes would protect the individual partners from personal liability for such leases, unless they have otherwise personally guaranteed them or voted to be personally liable for them.

2. Limited Partnerships. 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 $11,790. 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 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's assets. They can only get a "charging order", which entitles the creditor to any distributions from the partnership 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 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 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 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 additional taxes.

3. Limited Liability Company. In addition to the "tax shelter" applications discussed above, 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.

A creditor's remedy against an LLC member is a charging order, just as with limited partnerships. Therefore, LLCs could be drafted so as to increase their asset protection abilities, in the same manner as limited partnerships. Similarly, LLC interests should be able to show discounts in the value of minority interests due to lack of control and lack of marketability, just as limited partnerships do. That should allow them to be used for estate and gift tax planning as well.

C. Comparison of LLCs, LLPs and LPs.

1. 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.

A. Limited Partnership. A limited partnership is formed when a Certificate of Limited Partnership (Secretary of State Form LP-1), executed by all of the general partners, is filed with the Secretary of State. (Corp C §§ 15621(a), 15624(a)(1)). The filing fee is $70. (Govt C § 12213). In addition, all of the partners must enter into a limited partnership agreement. This may be done either before or after the Certificate is filed. (Corp C § 15621(a)). The CRLPA permits the agreement to be oral. (Corp C §15611(y)). Nevertheless, it is much better if the agreement is in writing and if it addresses all material issues between the partners.

Limited partnerships must pay an $800 annual franchise tax. It is due on the due date of the limited partnership's tax return.

B. Limited Liability Partnership. A general partnership may be formed as an LLP by filing Secretary of State Form LLP-1 with the Secretary of State. It must be signed by one or more partners authorized to do so. A $70 filing fee is also required. (Corp C §§ 16953(a)-(b)). A partnership agreement is required. In addition to general partnerships engaged in the practice of law, accountancy and architecture, those providing services or facilities related or complementary to those provided by such firms may also form LLPs. This is to accommodate the consulting businesses of accounting firms, which are often organized as separate partnerships, since not all of the partners may be CPAs.

The name of the LLP must contain the words “Registered Limited Liability Partnership” or “Limited Liability Partnership” or one of the abbreviations “L.L.P.,” “LLP,” R.L.L.P.,” or “RLLP” as the last words or letters of its name. (Corp C §16952). Whereas, the Secretary of State may refuse to register the name of a corporation, partnership or LLC because it is substantially similar organization, the same is not true for LLPs. Unlike other general partnerships, an LLP does not need to file a fictitious business name statement.

The partners of a preexisting general partnership may convert it to an LLP by a majority vote of the interests of its partners in the current profits of the partnership, or by a different vote if so specified in the partnership agreement, and by registering with the Secretary of State as discussed above. The converted general partnership is considered to be the same entity still has all the assets and liabilities of the converting partnership.

At the time of registration as an LLP, and at all times thereafter during which it conducts business in California, the LLP must provide security for claims against it based on acts, errors, or omissions arising out of its professional practice. Law and accounting firm LLPs may meet the security requirements by maintaining insurance policies or a trust or bank escrow account of cash, bank certificates of deposits, U.S. Treasury obligations, bank letters of credit, or bonds of insurance companies. Alternatively, accounting LLPs may confirm that the firm’s net worth exceeds $10,000,000. Law firm

LLP partners are deemed to have guaranteed any shortfall between the amount of security required and what the firm actually has. For a law firm, these security requirements are different from those required of a professional corporation.

An LLP must also comply with all the registration requirements of the state board, commission, or other agency that prescribes the rules governing its particular profession. The State Bar requires the execution and filing of an Application for Issuance of Certificate of Registration as a Limited Liability Partnership. The State Board of Accountancy also has prescribed forms for the licensure of an accountancy LLP. A law firm's liability shield is conditioned on the firm's maintenance of an effective Certificate of Registration issued by the State Bar.

C. 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.

2. 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.

In certain situations, a contribution of property followed by a distribution may be taxed as a disguised sale. If the combined effect of the contribution and subsequent distribution is to allow the contributing partner to withdraw all or part of the partner’s equity in the transferred property, then the two transfers may be viewed as related components of a disguised sale. IRC § 707(a)(2)(A) and (B).

A contribution of marketable securities to a partnership may also result in recognition of gain if diversification results. IRC § 721(b).

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 a fee based on revenues in excess of $250,000). Instead, the partnership’s income and losses flow through to its partners. The partnerships generally report 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.

Gain may also be recognized on distribution of marketable securities or certain unrealized receivables or appreciated inventory, if the distribution results in a shift of the partners' interests. IRC §§ 731(c), 751.

Another anti-abuse rule may cause a partner who contributed appreciated property to recognize all or a part of that gain if, within seven years, the partnership distributes either (1) the contributed property to another partner (IRC § 704(c)) or (2) different property to the contributing partner (IRC § 737).

(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) At-Risk Rules. Congress made several attempts to limit tax shelters prior to the 1986 tax act, which added the passive loss rules. These prior laws include the investment interest limitation rules and the "At-Risk" rules. As a result, in order for a partner to use a loss flowing from a partnership, the partner must get over several hurdles. The first hurdle is that a partner may not claim losses in excess of the partner's basis in the partnership. IRC § 704(d). A second hurdle is the at-risk rules. They generally provide that a partner may only use losses to the extent of the amount that they have "at-risk" with respect to the partnership

The amount a partner has at risk is generally the partner's capital investment in the partnership plus his share of the partnership debt for which he is personally liable. That would prevent limited partners from using their basis from nonrecourse debt to claim losses. Therefore, even though a limited partner has basis under IRC § 704(d) from nonrecourse debt, the partner cannot generally use that basis to claim a loss, because the partner is not at risk. An exception is made for "qualified nonrecourse financing." Generally, that is nonrecourse debt secured by real property. IRC § 465(b)(6).

The at-risk rules eliminate much of the difference between S corporation shareholders and limited partners, members of and LLC or partners in an LLP, with respect to their ability to use a partner's share of partnership debt to allow them to deduct partnership losses. The exception is in the area of real estate, where qualified nonrecourse financing is available. General partners also maintain their advantage in this area, since they are personally liable for the partnership debt.

(7) Passive Loss Rules. Another major hurdle that must be crossed for a partner to deduct a loss 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.

(8) Termination of Partnership for Tax Purposes. Transfers of shareholder interests have no effect on a C corporation's tax year. They have little effect on an S corporation, other than the allocation of items of income and loss for the year. However, if 50% for more of the interests in a partnership are sold or exchanged within 12 months, then for tax purposes, the partnership is deemed to have terminated. IRC § 708. The result is the partnership is deemed to have distributed its assets proportionately to the partners and then to have received them back from the partners. If the amount of the deemed distribution to a partner exceeds the partner's "outside" basis in their partnership interest, then the partner will recognize gain in the amount of the excess. IRC § 731(a)(1).

(9) Method of Accounting. Like individuals, a partnership may generally use the cash method of accounting. However, partnerships that are "tax shelters" must use the accrual method of accounting. IRC § 448(a)(3) A limited partnership that allocates over 35% of the partnership's losses to limited partners is a tax shelter. IRC § 448(d)(3), § 461(i)(3), § 1256(e)(3). If a partnership has a C corporation as a partner and average annual gross receipts in excess of $5 million over the past three years, then it must also use the accrual method of accounting. IRC § 448(a)(2). A California LLP should be able to use the cash method, since it is restricted to performing professional services,

(10) 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.

3. 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 substantially 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.

4. 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

This fee was constantly rising from year to year, but. the legislature recently indicated it would remain at these levels under the current law. 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.

5. Other Tax Considerations.

A. 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.

Because a partner in a California LLP will generally only be rendering professional services, the partner's share of income should be self employment income, except for certain payments to retired partners. IRC §1402(a)(10).

B. Fringe Benefits.

A C corporation can deduct the cost of health insurance and certain other benefits such as group health, medical reimbursement plans, disability and accident insurance, that it provides to its employees. The employees do not have to report these benefits as income. The same is true for S corporations, except that a shareholder who owns more than 2% of the corporation's stock must include the cost of the medical insurance provided to them in their taxable income.

A partnership can deduct the cost of the health insurance it provides to its partners as "guaranteed payments." The partners must then report these payments as income to them. Alternatively, the partnership can choose not to deduct the payments, but treat them instead as cash distributions to its partners. In that case, the partners will not have gain, unless the distribution exceeds their basis. Rev. Rul 91-26, 1991-1 Cum Bull 184.

S corporation shareholders, partners, and sole proprietors can deduct some of the cost of their health insurance on their personal tax returns.

6. Management and Control.

A. 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).

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 §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.

C. 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.

I would like to acknowledge that in drafting these materials, relied heavily on the works of John R. Bonn and Robert C. Trask who authored Chapter 2 “Evaluating Entity Choices” from “Selecting and Forming Business Entities”, California Business Start-Up Series (Cal. CEB 1996).

II. HIGHLIGHTS OF S AND C CORPORATIONS

A. Deciding whether to incorporate.

1. 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.

2. 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. The liability of some businesses is obvious due to the nature of their product or services. These will explore incorporating 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.

3. 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.

4. 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. Other Advantages of S and C corporations.

1. 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 reduce by 70% deduction for self-employed health insurance premiums that is offered to most sole proprietors, partners and 2% S corporation shareholders. It increases to 100% in 2003.

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.

2. 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.

3. 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.

4. 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 S 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.

I would like to acknowledge that in drafting these materials, I relied heavily on an outline titled "Choice of Entity Consideration" by Kimberly Stanely, Esq. of GRAY, CARY WARE & FREIDENRICH LLP.