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## SOLE PROPRIETORSHIP, C-CORPORATION, S-CORPORATION, OR LIMITED LIABILITY COMPANY (LLC)... THINGS TO CONSIDER WHEN STARTING A BUSINESS

### INTRODUCTION

Many of the business owners that I speak with at initial business formation consultations have the following threshold questions:

1. What are the advantages and disadvantages of running my business as a sole-proprietorship?
2. If I want to avoid the risks involved with a sole proprietorship, what are my business entity choices, and which should I choose for my business?

Searching the Internet for answers to these questions is a bit overwhelming. There is a lot of information available, but much of it is confusing, misleading, contradictory, or flat-out inaccurate. This is a complicated area of law, and it is difficult to get clear answers to these questions.

The goal of this article, therefore, is to discuss these questions in as straight-forward a way as possible, and to give California business owners a good idea of the things they should consider when choosing from among the following popular kinds of business entities - Sole Proprietorship, California C-Corporation, S-

Corporation, and Limited Liability Company (LLC).

### SOLE PROPRIETORSHIP

There isn't a whole lot of magic to a "sole proprietorship." A sole proprietorship is a business run by one person that has not been organized as a partnership, corporation, limited liability company (LLC) or other legal tax entity. There is no distinction for tax purposes between the owner of the sole proprietorship and the business itself. They are, effectively, one and the same. The business profits are reported and taxed on the owner's personal tax returns. The business itself does not file tax returns.

A major disadvantage of doing business as a sole proprietorship is that the owner risks all of his or her personal property (cash, assets, etc.) if the business suffers losses, is sued, or otherwise incurs debt. For example, if the business becomes liable for a debt, the creditor can pursue the owner's personal property for payment. If the owner is married, the creditor can pursue assets held as community property in the marriage. The potential for this kind of personal liability is one of the primary reasons business owners choose to form a limited liability entity instead, such as a corporation or

limited liability company (LLC). When properly formed, a corporation or LLC offers its owners limited liability protection that is not available to sole proprietors. With some exceptions, this protection shields the owners from business debts and obligations.

An advantage of doing business as a sole proprietorship is that, other than any applicable licensing requirements, sole proprietors do not have to comply with any of the formalities that apply to limited liability entities like corporations and LLCs. There are no bylaws, articles of incorporation, operating agreements, directors, officers, members, LLC managers, etc. The owner makes all decisions as s/he sees fit. However, given the potential for unlimited personal liability of a sole proprietorship, a business owner with assets they wish to protect should consider running their business as some form of limited liability entity such as an LLC, Corporation, Limited Liability Partnership (LLP), or Limited Partnership (LP).

### CORPORATION (AKA C-CORPORATION)

Corporations, like the other limited liability entities discussed here, offer business owners limited liability protection that is not available to

business owners doing business as a sole proprietorship or general partnership. The corporation and the individual owner(s) are considered different “people” and the business owner (with some exceptions) will only stand to lose what s/he invested in the business if the business is ever sued or otherwise incurs debt.

**Ownership/Management:** The owners of a corporation are its shareholders. There is no limit on the number of owners a corporation can have, and it can have as few as one. The corporate form, therefore, is a popular option for business operations of all sizes – like a sole proprietorship, it can have only one owner, or, as is the case with large publicly traded companies, it can have thousands. An S-Corporation, on the other hand (discussed below) can have only a limited number of shareholders. Also unlike an S-Corporation, there no restrictions on who can be a shareholder. An S-Corporation, for example, cannot have foreign shareholders.

The ability to have an unlimited number and type of shareholders makes the corporate form a viable option for businesses that plan to raise capital through the sale of stock to a potentially large number of shareholders, so-called crowdfunding options which are becoming more and more popular, and/or with investors who are not United States citizens or resident aliens.

As discussed above, a disadvantage of doing business as a corporation is that it must follow certain management formalities required by law. For example, the shareholders elect a board of directors, who in turn elect officers. The number of board members the corporation must have depends on the number of shareholders. Generally, a corporation must

have at least three directors. However, a corporation with one shareholder can have one or more directors (the shareholder can elect him/herself as the only director and officer of the corporation). A corporation with two shareholders can have two or more directors. The board of directors and officers govern the day-to-day activities of the corporation as outlined in the company’s bylaws and articles of incorporation. The corporation must also hold annual shareholder and board meetings and keep minutes of those meetings. Corporations that do not follow these formalities jeopardize losing the limited liability protection of their shareholders.

Another disadvantage for general corporations is double taxation. Corporate profits that are distributed to shareholders in the form of dividends are effectively taxed twice. The corporation pays taxes first on the profits earned. The shareholders then pay taxes individually for the dividends received. Dividends are currently taxed at capital gains rates which, for some taxpayers, could be 0%. Dividend payments are not deductible by the corporation. On the other hand, various other payments to shareholders may be deducted by the corporation. These include reasonable salaries, rent for property leased by a shareholder to the corporation, and interest on loans by shareholders to the corporation.

**Tax considerations:** California corporations pay federal taxes at graduated rates which depend on the corporation’s income in any given taxable year and an \$800 minimum annual California franchise tax.

**Other considerations:** ownership of California corporations is generally easy to

transfer through stock sales; unlike an S-Corporation, a C-Corporation can have different classes of stock; professional corporations are allowed; owner/shareholders can remain anonymous; corporate losses cannot be claimed by shareholders.

#### CORPORATION WITH S ELECTION (AKA S-CORPORATION)

A California S-Corporation is formed the same way as a C-Corporation, except that it makes a special election to be taxed under Subchapter S of the Internal Revenue Code.

In order to make this election, the corporation must meet certain requirement. For example, an S-Corporation must have 100 shareholders or less. Shareholders are limited to people who are United States citizens or resident aliens, estates, certain kinds of trusts, an S Corporation if it is the sole shareholder, a partnership under certain circumstances, and charitable organizations. These restrictions may not concern a small closely-held company. They may be very important, however, to companies planning to solicit a large number of investors and/or investors outside the United States.

Management and other operational formalities are generally the same as in C-corporations – shareholders elect a board of directors who elect officers. Annual shareholder and board meetings must be held and minutes kept.

**Tax considerations:** An S-Corporation is taxed like a sole proprietorship or partnership. Income and expenses are “passed through” to its shareholders in the same way partners in a

partnership and members of a limited liability company (LLC) are treated for tax purposes, so there is no federal double-taxation as in a C-Corporation. An S corporation, therefore, benefits from the advantages of a general corporation and the flow- or pass-through benefits of an LLC or partnership. California, however, imposes a 1.5% franchise tax on an S corporation's net taxable income or \$800, whichever is greater. NOTE: an LLC (discussed below) can also make an S election and be taxed in the same way as an S-Corporation.

Other considerations: An S-Corporation's shareholder-employee's salary is subject to self-employment tax; Shareholder-employee salaries must be paid if services are rendered, and the amount must be reasonable; like C-Corporations, ownership is generally easy to transfer through stock sales; professional corporations are allowed; shareholders/owners can remain anonymous; loss write-offs cannot exceed the amount of a shareholder's actual investment (including loans) to the company.

#### LIMITED LIABILITY COMPANY (LLC)

A limited liability company has characteristics of a corporation and sole proprietorship or partnership. Like corporations, owners of an LLC enjoy limited liability protection. Like a sole proprietorship or partnership, LLC owners enjoy relaxed formality requirements and, unless they choose otherwise (discussed below), they also enjoy pass-through income taxation.

An LLC can be formed for any lawful business purpose with the following exceptions: a) the business of banking; b) the issuance of insurance policies; c) the assumption of

insurance risks; d) the operation of a trust company; or (e) the rendering of (most) professional services.

Tax considerations: For California income tax purposes, a limited liability company is by default treated as a sole proprietorship (a "disregarded" entity) if it has one member and as a partnership if it has more than one member. As such, LLC income and expenses pass or flow through to its members/owners. LLCs have the option, however, to be taxed as C-Corporations, in which case income would not pass through to the members. LLCs also have the option to be taxed under Subchapter S of the Internal Revenue Code like an S-Corporation. The same ownership and other restrictions applicable to S-Corporations would apply to LLCs making the S Election.

Unless the LLC makes an S Election, the members must pay self-employment tax on all LLC income. If the S Election is made, the members will only pay self-employment tax on their salary (which must be reasonable).

Limited Liability Companies are subject to a minimum \$800 California franchise tax. A California franchise fee also applies to an LLC that has a total income of \$250,000 or more. Corporations, by contrast, are not subject to this fee.

Ownership/Management: LLCs that do not elect to be taxed under Subchapter S can have an unlimited number and type of members/owners. LLCs can choose to be managed collectively by all members or can appoint or elect one or more managers to run the company who do not necessarily need to be members. But LLCs were created as a flexible

alternative to corporations, so they can have a board of directors and officers if the members choose to be managed that way.

Other considerations: unless otherwise agreed to by the members, transfer of membership requires unanimous member approval; members may remain anonymous if the company is run by managers; manager identities are public record; loss write-offs are allowed up to amount of investment.

We hope you find this article helpful and that it answers some of your more general questions regarding business entity formation. Do not hesitate to contact the Tagre Law Office if you have questions regarding anything discussed above or questions about your business in general. We can be reached at <http://www.tagrelaw.com> or toll free at 888.597.9685.



*Pablo A. Tagre, Esq. is Principal/Owner of the Tagre Law Office with convenient locations in Modesto and Santa Clara, California. Mr. Tagre has extensive experience helping small, medium, and*

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