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## CORPORATIONS - CONSIDERATIONS IN CHOOSING THE FORM OF A BUSINESS ENTITY

This memorandum reviews factors that may influence a business decision to operate as a corporation rather than another legal entity. Volumes have been written on this topic. An infinite range of considerations exists and the objective of this memorandum is to point out the major factors that are generally involved in decisions on the form of doing business.

### AVAILABLE FORMS

An individual or group of individuals in a business venture may choose from a wide range of forms of doing business. The following are general descriptions of the available forms:

1. **Sole proprietorship** is operated by a single individual who owns the business assets, is liable for any business debts, and receives any business profits. Sole proprietorships usually are small businesses.
2. **Partnership** is an agreement of two or more individuals to carry on a business under terms of a partnership agreement. Each partner is individually liable for the debts of the partnership.
3. **Limited partnership** is a partnership in which general partners run the business and are fully liable for partnership debts and limited partners provide capital and are liable only to the extent of their investments.
4. **Limited liability partnership** is a general partnership with a partial liability shield.
5. **Limited liability limited partnership** is the same as a limited partnership except that all partners, including general partners, have limited liability.
6. **Limited liability company** is a hybrid between a corporation and a partnership. Members are not personally liable for debts. Members manage the business according to their agreement, and their interests are not freely transferable.
7. **Corporation** is formed by the sale of ownership interests to shareholders. The shareholders elect directors and officers to manage the business affairs of the corporation. Unless there is fraud or inequity, corporate participants are not personally liable for corporate debts. The corporate form can take many shapes, including for-profit, nonprofit, and Subchapter S corporations and may even

include a single person doing business as an incorporated proprietorship.

8. **Other forms** of doing business may be created by combining any of the other forms or creating layers within the structure of a business entity. A joint venture is one optional form, which functions as a partnership with a stated objective. A joint venture may involve individuals, partnerships, corporations, or any combination of entities working together for a stated objective. A business trust is another form of business in which investors transfer property to a trustee who manages the property for their benefit.

### FACTORS INFLUENCING DECISIONS ON FORM OF DOING BUSINESS

#### Duration

The length of time a legal entity may exist can be an important factor in choosing the form of doing business. The death or withdrawal of a person from the business can result in liquidation of the business, which can obviously be an undesirable result for some of the participants. For example:

1. **Partnership** dissolves upon death, bankruptcy, or withdrawal of any partner (NDCC Sections 45-18-01 and 45-20-01). Without planning, there is no assurance that a partner will not withdraw and exercise his right to demand liquidation of the business.
2. **Limited partnership** dissolves upon the death or withdrawal of a general partner unless there is a remaining general partner and the partnership agreement allows continuation (NDCC Section 45-10.1-47).
3. **Limited liability company** may dissolve upon the death or withdrawal of any member or upon occurrence of an event described in the articles of organization (NDCC Section 10-32-109).
4. **Corporation** existence is perpetual unless the corporation is dissolved by reason of misconduct or by agreement of a majority of the incorporators or shareholders (NDCC Section 10-19.1-105).

#### Management

Desire to control management of a business may dictate the form the business must take. Some forms

of business are better suited to management control than others. For example:

1. **Partnership** can be bound by the action of any partner. This may occur by transacting business as agreed by the partners or by appearing in the eyes of outside parties to have apparent authority to carry on partnership business (NDCC Section 45-15-01).
2. **Limited partnership** general partners have authority to bind the partnership, but limited partners generally only have voting authority over specified matters (NDCC Section 45-10.1-22).
3. **Limited liability company** management action is decided in proportion to capital contributions of members, unless the members agree to centralize decisionmaking by electing managers.
4. **Corporation** is under the management of the board of directors (NDCC Section 10-19.1-32). Corporate officers carry out policies determined by the board of directors. Shareholders elect the board of directors and govern the adoption and amendment of the articles of incorporation and bylaws of the corporation but have no authority to manage or bind the corporation.

### Transferability

Whether ownership interests in a business may be sold or otherwise transferred may dictate the form of doing business. For example:

1. **Partnership** interests cannot be sold or transferred unless all partners agree or the partnership agreement permits the transfer (NDCC Section 45-16-01).
2. **Limited partnership** limited partner interests are freely transferable, but a general partner cannot transfer its interest unless all the other general and limited partners agree or the partnership agreement allows the transfer.
3. **Limited liability company** interests cannot be transferred unless all members consent (NDCC Section 10-32-32).
4. **Corporation** shares are freely transferable unless restrictions have been created by the corporation (NDCC Section 10-19.1-70). Because of transferability considerations, a business seeking public investment by listing on a stock market must choose to do business as a corporation, with very few exceptions.

### Liability

Liability that may exist for participants in a business may dictate the form of doing business. Lenders will sometimes demand that corporate or limited liability

company participants personally guarantee corporate obligations to reduce the significance of limited liability. Liability may exist for contractual business obligations or because of misconduct (torts) of the business. For example:

1. **Partnership** imposes unlimited personal liability on partners. Their personal assets are at risk for all partnership obligations (NDCC Section 45-15-06).
2. **Limited partnership** requires at least one person to be a general partner with unlimited liability. Limited partners are liable only to the extent of their investments if they do not participate in the control of the partnership (NDCC Section 45-10.1-22).
3. **Limited liability company** obligations are not personal obligations of members, except to the extent of their investments (NDCC Section 10-32-29).
4. **Corporation** shareholders, directors, and officers have limited liability for corporate obligations.

### Taxation

Taxation issues may dictate the form of doing business. For example:

1. **Partnership** is not a taxable entity for federal and state income tax purposes. The partnership is a "flowthrough" entity for tax purposes. Its positive or negative income, deductions, and credits flow through to partners who must pay income tax accordingly.
2. **Limited partnership** is treated as a partnership for income tax purposes, unless the limited partnership is structured like a corporation. Federal law applies a four-factor "association" test to determine when an entity is an association subject to corporate tax treatment, regardless of its nominal form. The four factors are duration, centralized management, liability limited to corporate property for business debts, and free transferability of ownership interests.
3. **Limited liability company** is treated as a "flowthrough" entity like a partnership for tax purposes if the entity avoids at least two of the "association" factors listed above. A limited liability company usually avoids corporate tax treatment because a limited liability company does not have the corporate attributes of perpetual duration or free transferability of ownership interests.
4. **Corporation** income tax is perceived by most observers as a "double tax" because dividends are not deductible by the corporation. Therefore, corporate earnings are subject to corporate income tax before they are distributed to

shareholders as dividends and then are treated as taxable income to shareholders for individual or corporation income tax purposes. When one considers that a corporation may be a shareholder of another corporation and may itself have shares owned by yet another corporation, it becomes apparent that infinite levels of taxation could exist and at each level dividends would be subject to double tax. Noteworthy among the many varieties of corporations are:

- a. **S corporation** (so called because its tax treatment is provided under Subchapter S of the Internal Revenue Code) status allows avoidance of the "double tax" problem of a C corporation because shareholders may elect flowthrough tax treatment similar to a partnership. To qualify, the entity must be a domestic corporation with no more than 35 individual shareholders and a single class of stock.
- b. **Nonprofit corporation** may be a tax-exempt organization if it meets specific requirements. These organizations are generally excused from paying income taxes on money they earn and spend on functions in furtherance of their exempt purposes. However, they are subject to taxes on unrelated business income, which may be generally defined as gross income derived by an organization from a trade or business regularly carried on by the organization which is not substantially related to the organization's exempt purpose or function. There are many kinds of nonprofit corporations, some of which are tax-exempt organizations.
- c. **Farmers' cooperative** is a nonprofit corporation established as an agricultural association organized and operated on a cooperative basis to turn back to members or producers on a proportionate basis the proceeds of the venture minus operating expenses. Cooperatives operate under special rules and the general principle that they act on behalf of their patrons and not on the organization's own behalf. An organization taxed as a cooperative is allowed to deduct from its income any amounts paid as patronage dividends.

### Other Considerations

There may be miscellaneous factors that influence the decision of whether or not to form a corporation for business purposes. For example:

1. **Professional organizations**, such as those consisting entirely of medical or legal

professionals, may be limited by law in some jurisdictions to certain business forms.

2. **Hybrid organizations** are often created as a way to avoid some of the considerations that exist with certain legal entities. For example, common practice is to create limited partnerships with a corporate general partner. This approach combines flowthrough tax treatment of partnerships with limited liability of corporations.
3. **State laws** may dictate the form of a business entity. For example, a state law may require a business to be a corporation to qualify for a property tax credit. A business operating in several states may be forced to be a corporation because of differences in state laws on other business forms.

### AVOIDING DOUBLE TAXATION

Attorneys and accountants have spent a great deal of time devising methods to conduct business and avoid the double tax layers that may apply to corporate earnings. Among the most common approaches are the following:

1. **Subchapter S status** retains the corporate attributes, including limited liability, without application of corporate income tax. All corporate income, losses, deductions, and credits of a Subchapter S corporation flow through to the shareholders. Application is limited to a domestic corporation with 35 or fewer shareholders.
2. **Limited partnership** with a corporate general partner provides corporate limited liability for the general partner and flowthrough tax treatment through the partnership.
3. **Limited liability company** is a relatively recent legal development in most states. This entity combines corporate limited liability and partnership tax treatment.
4. **Compensation to shareholders** is deductible from corporate gross income under federal law. Because dividends are not deductible, it is apparent that there is a substantial advantage in characterizing payments to shareholders as compensation rather than dividends. However, compensation exceeding the value of the services rendered may be subject to treatment as "constructive dividends," so the Internal Revenue Service has a weapon to combat abuses.
5. **Interest paid to shareholders** can be a deductible corporate expense, which would be more advantageous than payment of nondeductible dividends. This would require characterizing capital contributions of investors as debt rather than equity. The Internal Revenue

Service will recharacterize debt as equity if it appears the amounts were at risk in the business.

6. **Reinvesting earnings in the corporation** (or retaining earnings) allows the corporation to delay imposition of the corporate income tax. Before the Tax Reform Act of 1986, it was common to reinvest earnings until a major capital transaction (such as liquidation) distributed the assets among shareholders without corporation income tax liability. This approach is no longer available, but delaying application

of corporate income taxes is still a significant tax planning tool for corporations.

## **CONCLUSION**

An enormous range of factors may influence the decision of what form a legal entity chosen for doing business will take. In a given business situation, any combination of the factors reviewed in this memorandum may determine the legal form for conducting business. The area is so complex that many lawyers and accountants specialize solely in analyzing and advising business clients on these decisions.