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About the Business Advisor

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CHOOSING AN ENTITY FOR BUSINESS OR REAL ESTATE OWNERSHIP

by Mary Hanson

In today's litigious world, business owners and real property owners seek protection from personal liability by using some type of entity as insulation from the liabilities arising from the business or ownership of property.

While the use of entities for personal protection is widespread, a thorough understanding of the strengths and weaknesses of that protection is less common.

All entities – corporations, limited partnerships, limited liability companies, and limited liability partnerships – offer protection from personal liability. It's important to understand what is an entity and what isn't – and what the "protection from personal liability" really means.

Existence of an Entity

Some articles on "choice of entity" list "sole proprietorship" and "general partnership" as choices. This can be misleading. There is no entity and no insulation of the individual owners from the business liabilities for either a sole proprietorship or a general partnership. They aren't entities. Even the registration of a general partnership with the Secretary of State – as can be done in California – doesn't make it an entity.

A general partnership is a particularly risky way to hold a business. Where there are two or more owners, each owner can be sued and required to pay for liabilities of the business – including liabilities resulting from

actions of the other partner – even if the partner held liable did not know of the actions or approve of the actions.

The personal liability associated with the sole proprietorship or general partnership means that an individual owner's entire net worth is exposed to the liabilities arising from the business. It's one thing to lose your entire investment in a business; it's quite another to risk losing everything over some claim arising from the business.

Another similar misconception is that a trust protects the creator of the trust or the trustee from liability. It doesn't. A trust isn't an entity and it does not provide protection from personal liability.

Similarly, the different forms of ownership of real estate, such as tenancy in common, joint tenancy, and community property – are completely different legal concepts than the concept of ownership through an entity. These forms of holding title to real estate are not types of entities. They do not provide protection from personal liability and they expose owners to undesirable joint and several liability.

Entities vs. Insurance

Another misunderstanding regarding the use of an entity is that it is a substitute for insurance. Certainly, if you can't get insurance for some business activity, having the business held in an entity would be more important. But insurance and the

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protection from an entity are two different things.

Insurance provides protection from certain risks that are identified in the insurance policy. The insured party can be one or more individuals or entities that are identified as the insureds. The protection only goes to the coverage limit (e.g., \$1,000,000) and is subject to exclusions listed and a deductible (e.g., \$1,000). This does not support a conclusion that insurance is less important than holding business or real property assets in an entity. Since most liabilities are small in comparison with the value of a business or of real estate, it is important to have insurance. Insurance provides coverage for the protection of business owners, the business, and injured parties (whether the insurance claim is based on product liability, an auto accident, slip and fall, professional negligence, or anything else covered by insurance). Insurance typically provides for defense and there is value in having the insurance company and its attorneys handle claims that are insured.

The protection offered by an entity can be described as broader than insurance. It changes the responsible party (the owner of the business or property) from the individual owner of the business to the business entity. The individual owner is potentially protected from every type of liability to an unlimited level.

The use of an entity provides a level and type of personal protection that is not offered by insurance. On the other hand, it is misguided to think of the use of an entity as a substitute for insurance. Is a business owner going to walk away from a valuable business because claims come in and he or she doesn’t want to pay them?

Weak Links

Although the use of an entity for operation of a business provides protection from personal liability, there are “weak links” in the protection when the owners are employees or managers of the business or are otherwise involved in business activities. If the owners are not involved in business operations, the protection can be most meaningful. When a business is incorporated, the entity is the EMPLOYER of the employees, the OPERATOR of the business, and the SELLER of the business products. The party responsible for operation of the business, compliance with laws, and payment of bills is the entity.

When a business owner is involved in the operation of the business, he or she must recognize limitations on the protection from personal liability. Individuals are responsible for the consequences of their own actions, and if the individual is involved in hiring, firing, supervising, driving, dumping refuse, or anything else, liability resulting from the individual’s actions are a potential source of personal liability. A business owner may be liable for accidents, errors made, poor supervision of employees, misrepresentations, harassment, professional negligence, and a broad range of other liabilities arising from his or her actions.

Since there is no automatic protection from all liabilities, it is important to note the key types of liability arising from a particular business. Consider the involvement of the owners, and make a determination of the importance and effectiveness of the protection offered by an entity. For example, the key liability for attorneys, medical doctors, and other professionals is professional liability, which can’t be shifted to an entity. A

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professional, especially one with no employees or no partners to increase risks, may rightly question the value of an entity.

Real estate is often held in an entity because many of the liabilities that might arise are based on ownership of the property, and because the individual owners or investors are often uninvolved in the management of the property. By holding the real property in an entity, the many potential liabilities arising from ownership of the property usually will stop at the entity level. The OWNER of the property is the entity.

Another weakness in the protection offered by an entity is that the entity must be properly set up and maintained. If the business owner is not prepared to properly establish the entity and to operate a business as an entity, the entity may not provide the desired protection from personal liability. There may be a “figurehead” or “smokescreen” corporation or other entity, but that entity may not withstand a challenge by a motivated claimant seeking to “pierce the corporate veil” and hold the individual owners personally liable.

Choice of Entity

The entity choices for a business or investment are a C corporation, an S corporation, an LLC or a limited partnership. Another alternative, the limited liability partnership, is only available for certain professions.

Although charts on choice of entity typically compare numerous features, the key determinant is the tax treatment of the entity. Because taxes are typically quite high, other concerns often fail to outweigh the significant tax differences between alternative entities.

Flow through Tax Treatment

A key tax concern that drives the choice of entity is “double taxation” versus the flow through of tax consequences to the individuals to be taxed just once. The C corporation (a corporation that has not elected to be treated as an S corporation) subjects its shareholders to two levels of tax. Income, gains, and any other taxable event is taxed at the corporate level. In addition, any distributions of dividends to the shareholders over time or upon liquidation are taxed again. The double taxation is often of greatest concern when the corporation sells its assets and liquidates.

To avoid double taxation, the individuals elect S corporation status or form an LLC, limited partnership, or limited liability partnership, in which the tax treatment is flowed through to the individuals. An individual wanting to avoid taxes at the individual level (for example, a foreign national not otherwise subject to U.S. tax) will have to choose the C corporation despite disadvantages.

Among the “flow through” entities of the S corporation, LLC, limited partnership, and limited liability partnership, making a choice is not rocket science or a dart throw. There are clear differences in both taxes and features that should guide owners to a firm preference.

A key distinction is that the S corporation is NOT a true partnership for tax purposes while the LLC, limited partnership, and limited liability partnership are true partnerships (except where different tax treatment is elected). In addition, the S corporation has a number of limitations, violation of which can lead to an automatic termination of the S election (causing the S corporation to revert to the dreaded C corporation



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Publisher's Note

There are many different entity features that can be listed for comparison purposes. But most entity decisions turn on a few key tax features. Other features, such as management structure, control, convertability, ease of setting up, protection from partners' creditors, etc., often are greatly outweighed by tax benefits. Often one type of tax benefit outweighs another.

Don't select an entity because someone said the entity provides benefits. If it doesn't provide benefits to YOU, in YOUR situation, such a label is meaningless. Every situation will differ, depending upon the number of owners, the circumstances of the owners, the amount of money involved, whether estate planning and gifting will be involved, whether large changes of ownership are anticipated, and other factors involved in the particular situation.

Starting with the most likely best fit and seeing if it fits is as appropriate for choice of entity as it is in shopping for a new suit.

Your tax professional should play a key role in making sure the entity fits the particular situation.

If you find that you made the wrong decision when you formed an entity, be advised that there can be undesirable tax consequences from a switch to another entity – or from making an S election. Don't change your type of entity without reviewing all the tax consequences of the proposed change with your tax professional!

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status). Key limitations are the prohibition against different classes of stock (including allocating tax consequences differently among shareholders) and the prohibition on ownership by corporations or non-resident aliens.

The LLC provides liability protection to all members, including managers, while offering partnership tax treatment, flexibility in allocating some distributions and tax treatment to different members, and flexibility in determining the type of management structure. When these features are desired, as is often the case with real estate investments, the LLC is the first choice, eliminated only if some other feature of the LLC does not work with the proposed ownership, operations, or life cycle of the investment.

The owner of an active operating business (such as manufacturing, retail, professional services,

construction, or consulting) may not see benefits from partnership taxation, and is likely to be disadvantaged by certain aspects of partnership tax treatment, such as exposure to self-employment tax.

The first choice for an active operating business (operated by shareholders) will be the S corporation. The S corporation is typically only rejected if one or more of the S corporation limitations make it unavailable or problematic now or in the future.

Start with the most likely entity choice. Determine whether you want the tax treatment offered by that entity or if you need to look for different tax treatment. If the tax treatment is desirable, and you would be eligible for that treatment, look at the other pros and cons in both tax treatment and entity structure to make sure other features are not unacceptable for your situation. **BA**

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