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Closely Held Business Organization Entity Choices

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I. SOLE PROPRIETORSHIPS.

- A. **Structure/Governance.** A sole proprietorship is a commonly used business organization, whether by design or default. It is used where an individual (or a married couple) operate a business. The sole proprietorship is often treated as the alter-ego of the owner. If there are two or more owners, the business is a partnership by default, unless another entity was created.
- B. **Transferability.** The sole proprietorship dies with the owner. The owner can sell the business, in whole or in part, in a purchase-sale agreement. If only a portion of the business is sold or transferred to a third-party, the business becomes a partnership by default. The sole proprietorship “entity” is not flexible for business succession, even though it is simple to manage.
- C. **Liability.** All personal assets of the sole proprietor are at risk for any business debts or tort liability.
- D. **Tax Issues.** Tax issues are simple as all income and expenses are reported on the owner’s personal tax return (Schedule C).

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II. CORPORATIONS (“C” AND “S” CORPORATIONS).

A. Structure/Governance.

1. Ownership in a corporation is evidenced by shares of company stock. The corporation is a legal entity separate from its shareholders. The corporation is governed by state law and by the corporation’s articles of incorporation and adopted bylaws.
2. Corporate management is vested in one or more directors who may entrust operational management in one or more officers. Directors and officers owe the corporation and shareholders certain fiduciary duties.
3. Shareholders share in profits and losses in proportion to the number of shares owned.

B. Transferability.

1. Subject to securities restrictions, corporate shares are transferable. NOTE: “S” corporations may have no more than 35 shareholders, who must be U.S. citizens or permanent residents.
2. Transferring shares of a closely held corporation may have estate planning advantages, but there may be a loss of control.
3. Many closely held corporations with a small number of shareholders may have agreed to share transfer restrictions and be subject to a Shareholder Buy-Sell Agreement.

C. Liability.

1. A shareholder is generally not personally responsible for the debts of the corporation or torts committed by the corporation’s other directors, officers or employees.
2. Exceptions: A creditor can “pierce the limited liability veil” of the corporation if the corporation was not adequately capitalized, the shareholders do not observe corporate formalities, the shareholders treat the corporation as their alter ego, the directors or officers breach their fiduciary duties, or if shareholders personally guarantee any corporate debts.



D. **Tax Issues.**

1. “C” Corporations are taxed both at the corporate entity level and when retained profits are distributed to shareholders in the form of dividends. Although corporate profits are taxed on two events, corporations may provide tax advantages in certain situations where the corporation offers insurance or other benefit plans. Shareholders can act as corporate directors, officers and/or employees and can obtain salaries or other compensation. The salary or compensation is taxed at the individual level and may be deducted by the corporation as an expense.
2. “S” Corporations are pass-through entities. Unlike the “C” corporation, the corporate entity is not taxed. All corporate income and expenses are “passed through” to the shareholders in proportion to their shareholdings. The resulting profit is individually taxed as dividend income. A shareholder who works in the corporation must take a reasonable salary, which is an expense to the corporation.
3. Tax issues may arise when converting assets from a sole proprietorship to a corporation.

III. LIMITED LIABILITY COMPANIES (LLCs).

A. **Structure/Governance.**

1. The owners are called members; there may be one or more members. A LLC is a legal entity separate from its members. Whereas a corporation is structured and operated largely based upon state corporate statutes, a LLC is structured and operated in accordance with an Operating Agreement.
2. The Operating Agreement is drafted with the unique needs of the objectives of the LLC members and there are few mandatory statutory provisions (or prohibitions). In the absence of provision in the Operating Agreement, statutory default rules may apply.
3. The LLC member has LLC allocations in (i) profits, (ii) losses, (iii) capital, and (iv) distributions. Each of these interests may be independently allocated to a member. Allocation depends upon the terms of the Operating Agreement and may have tax consequences.

4. **Management.**

- a. Member managed by default. Most closely held businesses are actively managed by members.
- b. Option to elect one or more managers in Articles of Formation – the public document filed with the State of Washington.
- c. LLCs are generally not required to observe formalities required for corporations (e.g., regular documented Board of Directors meetings and special meetings to approve of corporate activities). Good or “best” business practices, however, include memorializing important LLC business transactions.

B. **Transferability.**

1. Generally, LLC interests are not freely transferable.
 - a. No securities laws registration.
 - b. By default, a LLC may not admit a new member without the unanimous consent of all LLC members. An Operating Agreement, however, may define whether a member may transfer his or her interests and under what circumstances.
2. The LLC member may generally transfer interests, but not management rights in a closely held LLC and there may be certain estate planning advantages while maintaining control.

C. **Liability.**

1. Liability generally limited to the amount invested. A LLC member is generally not personally responsible for the debts of the LLC or torts committed by other members or employees.
2. Exceptions: A creditor can “pierce the limited liability veil” of member managed LLC if the LLC was not adequately capitalized, the members treat the LLC as their alter ego, the members breach their fiduciary duties, or if members personally guarantee any LLC debts.



3. Unlike a corporation, a LLC is not required to observe corporate formalities to maintain limited liability.

D. **Tax Issues.**

1. From a tax perspective, a LLC is either a disregarded entity or a pass-through entity. By default, a single member (or married couple) LLC is a disregarded entity and treated as a sole proprietorship. The single member reports LLC income and expenses on their personal tax return and no LLC tax accounting is required. By default, a multiple member LLC is taxed by the IRS as a partnership. The LLC prepares a partnership tax return that allocates each member's share of income, deductions, depreciation and credits to be reported on each member's personal tax return.
2. Real estate and other business assets can generally be contributed and retitled into a LLC without tax on unrealized gains when changing form of ownership.
3. Although profits, losses, capital and distribution rights may be independently allocated to members, there may be additional tax issues unique to each LLC.