**SONKIN & SCHREMPP**, PLLC
***Attorneys At Law***

*From the desk of:*
**Irving A. Sonkin**

*12715 NE Bel-Red Road Ste150*
*Bellevue, WA 98005*
*T 425-289-3443*
*F 425-289-3005*
*Email irvs@lawyerseattle.com*

# MEMO RE CHOICE OF BUSINESS ENTITY

1. ***INTRODUCTION***.

1.1. ***Purpose***. Maybe you own an ongoing business, professional practice or passive asset, such as real estate. Maybe you are considering starting a business or acquiring an investment asset. In all of these cases, an important consideration is how you hold and manage the business and/or investment. This Memo is a brief introduction to your options.

1.2. ***Disclaimer***. This Memo is not a substitute for a deeper understanding of the various issues. Each situation is unique and requires specific planning. Use of professionals, such as accountants and attorneys is required. You may refer to this Memo from time to time as a review.

2. ***DEFINED TERMS***. Defined terms (capitalized and/or in bold) have the following meanings:

2.1. ***Administration***. The clerical tasks of operating a **Business Entity**, including filing all necessary applications and licenses with the government, filing all tax returns and properly documenting operations.

2.2. ***Business Entity***. An entity for holding an investment and/or operating a business, including **Corporations**, **LLCs**, **Partnerships**, **Sole Proprietorships** and **Tenancies In Common**.

2.3. ***Corporation***. A corporation, established according to State law.

2.4. *E**ntity Agreements***. An agreement by the owners of a **Business Entity** that cover the relationship between and amongst **Owners** and **Governance** issues.

2.5. ***Governance***. The management and control of a **Business Entity**.

2.6. ***Legal Entity***. An entity that is a fictitious person, established pursuant to statute, including **Corporations** and **LLCs**.

2.7. ***LLC***. A limited liability company established according to State law.

2.8. ***Operating Business***. The active participation in an ongoing business or the development of real property. The ownership of real property or other assets for rent or other income.

2.9. ***Owner***. The equity owner of personal property, real property and/or a **Business Entity**.

2.10. ***Partnership***. 2 or more persons engaged in a business or investment for profit. A partnership can be general (all partners involved in decision making and bearing full personal liability) or limited (the general partner[s] being able to make decisions but having full personal liability and the limited partners having limited or no decision making authority but not having personal liability).

2.11. ***Sole Proprietorship***. An individual operating a business without a **Legal Entity**, or holding an investment in his/her own name.

2.12. ***Tenancy In Common***. Each **Owner** of an asset, usually real property, owns an undivided interest in such asset.

2.13. ***Transferability***. The ability to sell, convey, encumber or otherwise transfer an ownership interest in an **Investment**.

3. ***ENTITIES***. The following is a list of the most common **Business Entities** to consider for your **Investment**, and major Advantages and Disadvantages for each (Another resource is a State of Washington website, *http://business.wa.gov*):

3.1. ***Sole Proprietorship (for one owner, including a marital community)***. There is no definite structure for **Administration** or **Governance**. The **Owner** has full personal liability for all acts and omissions. The **Owner** is taxed directly.

3.1.1. ***Advantages***. Ease of **Administration**.

3.1.2. ***Disadvantages***. Unlimited personal liability; no tax benefits; and difficulty of **Transferability** (assets owned are not easily defined or segregated from other assets).

3.2. ***Tenancy In Common (for Real Property only)***. Similar to a **Sole Proprietorship** where there are multiple **Owners**. Agreements require, prevent and/or limit certain actions by each **Owner**.

3.2.1. ***Advantages***. Inertia and not having to pay to establish an entity.

3.2.2. ***Disadvantages***. Unlimited personal liability; difficulty of **Transferability**; and difficulty in making and implementing decisions.

3.3. ***Partnership***. **Partnerships** can be created by actions or by written agreement. Each **Owner** (partner) reports tax impacts on a personal basis, with options selected at the **Partnership** level. There is little reason to be a **Partnership** form. The advantages of a **Partnership** are available to an **LLC**.

3.3.1. ***Advantages***. Centralized **Governance**; ease of **Administration**; limited liability for Limited Partners; full flexibility for profit and loss allocation amongst **Owners** (partners); **Transferability** easier in that assets are usually defined.

3.3.2. ***Disadvantages***. Unlimited personal liability for general partners; difficulty of **Transferability**; and inability of Limited Partners to make decisions.

3.4. ***Corporation***. A **Corporation** is a **Legal Entity**. Ownership of the **Corporation** is evidenced by ownership of "**Shares**" of "**Stock**." **Owners** ("**Shareholders**)" select a "**Board of Directors**." A **Corporation** can have one or more **Shareholders**. The **Board of Directors** controls and manages the **Corporation**, sometimes by delegation to "**Officers**."

3.4.1. ***Advantages***. Defined **Governance**; limited personal liability; some opportunity for tax and/or estate planning; and streamlined **Transferability** (subject to contractual limitations).

3.4.2. ***Disadvantages***. Potential negative tax impacts; **Administrative** requirements; and limited flexibility of income division amongst "**Shareholders**."

3.5. ***Limited Liability Company***. An **LLC** is a fictitious person created under State law. From the outside it looks like a **Corporation**. Internally, it is taxed as a **Sole Proprietorship** or a **Partnership**. **Governance** and income splitting is infinitely flexible. Ownership of the **LLC** may be evidenced by ownership of "**Units**." Owners are called "**Unitholders**." Unitholders who can make decisions are called "**Members**." LLC's are managed by the **Members** and/or by a "Manager."

3.5.1. ***Advantages***. Centralized and flexible **Governance**; ease of **Administration**; limited personal liability; unlimited flexibility for profit and loss distributions; and **Transferability** is easy (but may be limited by agreement).

3.5.2. ***Disadvantages***. Potential negative tax impacts. All income, unless the **LLC** only owns "passive" assets, is subject to self-employment tax. **Administration** required.

4. ***MISCELLANEOUS***.

4.1. ***Considerations***. The focus of business planning takes numerous matters into account. A qualified team can maximize your efficiency and minimize your liability. Your other professionals can assist you with financing, taxation issues, business plans, **Operations** and funding. My primary focus, in choosing the **Business Entity** that is best for you, is analyzing:

- **Administration** requirements.
- **Governance** options and requirements.
- Decision making, including the avoidance and/or resolution of **Owner** disagreements or disputes.
- Allocating profit, loss and other revenues and liabilities.
- Minimizing liability to third parties.
- Tax implications.
- **Transferability**.

4.2. ***Entity Agreements***. Agreements are used for **Governance** issues and to establish the relationship between and amongst **Owners**.

4.2.1. ***Partnerships***. **Partnerships** have an agreement set forth by statute, which the partners may change. Oral agreement are hard to prove and lead to disputes. You may enter into a written agreement, which would be your best option.

4.2.2. ***Corporations***. **Corporations** have Shareholder Agreements (under various names, including buy-sells).

4.2.3. ***LLC's***. **LLC's** utilize Operation Agreements (sometimes with other names).

4.3. ***Taxation***.

4.3.1. ***Non-Corporations***. Essentially, all aspects of income and loss are paid for at the owner lever. Earned income (wages) are also subject to self-employment (social security) tax. Any earned income means that all profits are earned income.

4.3.2. ***Corporations***. A **Corporation** may be taxed as a separate entity (a 'C' corporation) or as a pass through entity (an 'S' corporation). A 'C' corporation pays income tax on its income. For **Owners**, earned income is paid as wages. Any other return to an owner on his/her investment is paid as a dividend, which are taxable to the recipient. An 'S' corporation is taxed directly to the **Owners**. An S corporation may be able to differentiate, in a tax sense, between wages (subject to social security and Medicare tax) from return on investment (called S dividends). This is subject to change by the IRS or by congress.

4.4. ***Key Persons***. Substantial value of your **Investment** may be tied to people involved in its day to day operations and/or other **Owners**. Tying key employees to the **Business Entity** helps preserve that value.

4.4.1. ***Non-compete Agreement***. Non-compete provisions prevent key people from competing with the **Business Entity**. Such provisions are in Employment Agreements or **Entity Agreements**.

4.4.2. ***Non-Disclosure***. If your business has a special product or service it offers, or if there are customer lists or suppliers you need to preserve, your key employees and owners should be prevented, by contract, from using this information against the business.

4.5. ***Buy-Sell***. If you have a co-owner, the buy/sell provisions should be part of an **Entity Agreement**. The buy/sell is a blueprint of how you would resolve conflict over future ownership of the business. There can be provisions providing for buyouts if a co-owner dies, divorces, becomes disabled, wants to retire or no longer wants to be involved in the business/investment.

4.6. ***Insurance***. Continuity of the business (by the remaining/surviving owner or his/her estate) can be funded by life insurance. Disability insurance is a key to maintaining cash flow for business operations and personal expenses in the event of disability. Estate and retirement planning benefit from insurance funding.

4.7. ***Estate And Marriage Planning***. If the **Investment** is **Stock** in a **Corporation** or **Units** in an **LLC**, **Transferability** is easier.

4.7.1. ***Estate Or Gift***. It is easier to pass your investment to heirs or as gifts. They would receive a single asset (the **Stock** or **Units**) rather than a part ownership in individual assets. You may avoid ancillary (separate) probate for the asset (e.g., real estate must be probated in the jurisdiction in which it is located).

4.7.2. ***Marriage***. If there is a gift or inheritance, the **Investment** remains the separate property of your heir (or donee), until and unless consciously converted to community property.

5. ***CONCLUSION***. There are numerous types of **Business Entities** because each one has advantages and disadvantages. The majority of investors benefit from using a **Corporation** or an **LLC**. Any solution needs to be tailored to your unique situation.

The matters raised in this Memo should be analyzed in depth. Please contact me with you questions and comments.

IAS