

Know the Advantages, Disadvantages of C-Corporations, S-Corporations and Limited Liability Companies

Q: What is a C-corporation and what are the principal advantages and disadvantages of using one?

A: A C-corporation is typically a business organized as a corporation under state law, and is subject to federal income tax under sub-chapter C of the *Internal Revenue Code*. A C-corporation is subject to federal corporate income tax on its taxable income, and its shareholders are subject to federal income tax on any dividends at a maximum 15 percent federal income tax rate (as of December 2008) if certain requirements are met. Otherwise, dividends are subject to federal income tax at the shareholder's ordinary income tax rate. These two layers of tax are sometimes referred to as double taxation. If the federal corporate income tax imposed on business profits is less than the individual income tax on those same profits, then a C-corporation may provide a modest federal income tax advantage. Currently, the first \$75,000 of taxable income of a C-corporation is subject to a maximum federal income tax rate of 25 percent. If earnings of the business will be retained in the corporation and reinvested in the business, then using a C-corporation takes advantage of these lower federal tax rates. This advantage will be lost if the earnings are distributed by the C-corporation to shareholders as dividends to be taxed again at the shareholder level.

The principal non-tax advantage of any corporation is that the corporate form of doing business is familiar. Many statutes and administrative rules anticipate corporate structures, and there is a developed body of case law that helps set parameters for appropriate conduct for shareholders and directors.

State corporate law lets a corporation have different classes of stock with varied distribution and voting rights, such as preferred stock or classes of stock with special rights and preferences. A C-corporation can generally use this flexibility without affecting its tax treatment.

Another disadvantage, aside from the double taxation that applies to C-corporations, is the "trapping" of losses in the corporation. C-corporation net operating losses are generally carried forward or back to offset income of the C-corporation; they cannot be used by shareholders to offset personal income.

Finally, in many states, and in Ohio through 2009, the C-corporation is subject to a separate state franchise tax that does not apply to S-corporations or limited liability

companies (LLCs). For tax year 2010 and later, Ohio's franchise tax will remain in place only for financial institutions and certain holding corporations.

Q: What are the principal advantages and disadvantages of using an S-corporation?

A: An S-corporation is generally treated as a *flow-through* entity for federal income tax purposes; that is, income and losses of the S-corporation are reported on the shareholders' personal income tax returns. Thus, the chief advantage of an S-corporation is the ability to generally eliminate the federal entity-level income tax while using the corporate form of organization under state law that is generally familiar to business people and fits well with most statutes and regulations. Also, subject to applicable limitations, shareholders can use their pro rata share of an S-corporation's losses to offset other personal income. A major disadvantage of an S-corporation is its rigid requirements to qualify for and retain its S-corporation status. If any requirement is not satisfied, then the corporation will lose its status as an S-corporation and be subject to federal income tax as a C-corporation. For example, one requirement mandates that the S-corporation have only one class of stock, which generally means that all outstanding shares of stock must confer identical rights to distribution and liquidation proceeds. Also, the number of shareholders is generally limited to 100, and there are restrictions on who can be a shareholder. Only individuals who are not non-resident aliens for federal income tax purposes, estates, and certain trusts and tax-exempt entities can be S-corporation shareholders. Corporations and other entities, such as partnerships, cannot own S-corporation stock.

Q: What are the principal advantages and disadvantages of using a limited liability company?

A: The limited liability company, like a corporation, generally provides its owners with limited liability. Except in special circumstances, only the company, not its owners, is liable for the debts and obligations of the business. The limited liability company, like the S-corporation, has *flow-through* taxation unless an election is made to treat the LLC as a C-corporation for federal income tax purposes. This means that the income and losses of the business are reported on the owners' personal income tax returns, and the LLC does not have any federal income tax liability. Unlike the S-corporation, the LLC can create different classes of interests, such as interests having a preference on liquidation and/or dividends, or with varied distribution rights. Also, LLC interests, unlike S-corporation stock, can be owned by any individual or entity without affecting the LLC's flow-through tax treatment.

The limited liability company is more flexible than a corporation and allows the members to be creative in developing a management structure. The LLC can be managed by a manager, its members, a board, or a combination of these elements. As a result, the LLC structure, as described in its operating agreement, can resemble the structure of a

corporation, a partnership or something in between.

A disadvantage of the LLC is that it is a relatively new form of entity. Ohio's LLC statute is just 15 years old, whereas Ohio's corporation law predates the codification of the *Ohio Revised Code* in 1955. There is less case law interpreting the LLC form of organization, and not all state statutes and regulations explain how an LLC should fit into their schemes.

Another disadvantage of the LLC is that self-employment taxes generally apply to a member's distributive share of trade or business income of the LLC, subject to certain exceptions.

Caution: This discussion assumes that the LLC is treated as a partnership for applicable income tax purposes or, if there is only one owner, it is being disregarded (ignored) for applicable income tax purposes.

Q: How do business owners choose from among these options?

A: Most owners desire the protection of limited liability, and all of these options afford their owners limited liability from obligations and liabilities of the company. In choosing among the three entities, the facts and circumstances of each business must be considered. For many businesses that wish to avoid the double taxation of a Ccorporation, but want flexibility in management and distributions, the LLC is an increasingly popular choice. Owners may also want to consider how to pass a business on to the next generation or the potential effect of a sale or other disposition of all or part of the business.

—by Cleveland-area attorneys Jack Kurant and Michele R. Yeh. Updated by Jeanne M. Rickert and Wade Wagatsuma, attorneys in Jones Day's Cleveland office. The views set forth herein are

the personal views of the authors and do not necessarily reflect those of the law firm with which

they are associated.

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C-Corporations, S-Corporations and Limited Liability Companies Are Taxed Differently

Q: How are C-corporations, S-corporations, and Limited Liability Companies (LLCs) different for income tax purposes?

A: The taxable income of C-corporations is subject to a corporate level federal income tax, and a shareholder-level tax is imposed on cash or other property that is distributed to shareholders as a dividend. Thus, the earnings of a C-corporation are potentially subject

to two layers of federal income tax (*i.e.*, double taxation).

Both S-corporations and LLCs (taxed as partnerships for federal income tax purposes) generally are pass-through entities for federal income tax purposes. Income and deductions attributable to business operations of the entity are passed through to the owners in accordance with applicable law. The results of the entity's operations are reported on the owners' individual income tax returns, and also reported on the entity's federal information tax return. The entity generally does not pay federal income taxes. However, even if the entity does not make any cash distributions to the owners, the owners still must pay federal income tax on the earnings of the business.

Caution: Certain publicly traded limited liability companies and LLCs that specifically elect to be taxed as corporations will be taxed as C-corporations. For purposes of the following discussion, LLCs will be assumed to be taxed as partnerships for federal income tax purposes.

Q: Does the choice of entity affect how owner-employees are treated for payroll tax purposes?

A: Yes. With either a C-corporation or S-corporation, only the amounts paid to the shareholder-employee as compensation are subject to payroll taxes. The compensation must be "reasonable," or the IRS may treat the excess compensation as a non-deductible dividend or distribution.

The different tax rules for C-corporations and S-corporations create different incentives in determining the amount of compensation paid to owner-employees. In a C-corporation, the tendency is to set salary/compensation at the higher end of the reasonable compensation range so that the corporation can deduct such payments to the shareholder and reduce the amount paid out dividends, which are subject to double taxation. (Dividends are not deductible by the C-corporation.) Conversely, salary paid to an S-corporation shareholder-employee would more likely be set at the lower end of the reasonable compensation range and provide for a larger dividend distribution, which would mitigate payroll taxes on such distribution.

By comparison, an LLC owner-member does not receive a salary. All amounts reflected on the tax return of the owner-member who performs services for the business are generally subject to self-employment taxes.

Q: Can losses incurred by the entity be used to offset the owners' personal income?

A: In a C-corporation, the answer is no. Losses of the C-corporation can only be used by the corporation and, generally, are carried forward or back to offset corporate income.

Losses generally do pass through to shareholders of S-corporations and members of LLCs to offset their other personal income. The amount of losses the S-corporation shareholder/LLC member can use, however, depends upon applicable tax rules and regulations, which depend, among other things, on the owner's tax "basis" in his or her stock or LLC interest, and in the case of S-corporations, certain debt instruments. Whether the losses can offset other income of the owner, such as wages or interest, depends again on applicable rules, notably whether the S-corporation shareholder/LLC member is regularly active in the operation of the business.

In an LLC, a member's tax basis in the member's LLC interest will be increased in accordance with applicable law if the LLC borrows money, which will then generally provide the member with increased capacity to take additional losses on his or her tax returns.

A shareholder's basis in any indebtedness of the S-corporation to the shareholder increases the shareholder's capacity to report loss deductions. After the shareholder's stock basis has been reduced to zero, the basis in such indebtedness may be reduced (though not below zero) by deductions passed through to the shareholder-creditor.

—by Cleveland-area attorneys Jack Kurant and Michele R. Yeh. Updated by Jeanne M. Rickert and Wade Wagatsuma, attorneys in Jones Day's Cleveland office. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the law firm with which they are associated.

The LLC: A Useful Business Entity

Since the 1994 enactment of legislation in Ohio that gave us the limited liability company (LLC),

this new form of business entity has become immensely popular. And for good reason. The LLC

is a flexible and valuable tool for business owners. In this brief article, I will talk about what an LLC is and how you might make use of it.

The LLC is an entirely separate type of business entity. Although it is not a corporation or a partnership, it can share attributes of each. Like a corporation, the LLC will generally shield its owners (called “members”) from the company’s creditors. The LLC is similar to a partnership in that it can choose to be taxed as a partnership or, in the case of a single-member LLC, as a sole proprietorship. In either case, the LLC will not be a tax-paying entity. Instead, its net income and other tax items will flow through to the members and will be reported on their income tax returns.

In this way, the LLC is similar to the Subchapter S-corporation (S-corp).

Although the LLC is similar to the S-corp, the LLC is more flexible. With the LLC, there are no restrictions on the number or type of owners, and the LLC can have more than one class of ownership (similar to common and preferred stock). For employment tax reasons, however, the S-corp is sometimes a preferable choice to an LLC.

If you currently own a business, you might consider forming an LLC, perhaps with your business

partners or family members, to hold newly acquired real estate, equipment, or other assets that

can then be leased by the LLC to the main business entity. This approach protects the main corporation from liabilities associated with the assets. To the extent that family members are involved, this approach might also have income and estate tax-planning benefits.

—by Michael J. Stegman, an attorney with the Cincinnati firm of Kohnen & Patton LLP.

Essential Elements for Operating Agreements of Limited Liability Companies

The limited liability company (LLC) is quickly becoming the business organization of choice for many small business owners. The growing popularity of LLCs is the result of their simplicity and

flexibility. Limited liability companies are separate legal entities, like corporations, but are treated as pass-through entities for tax purposes, provided they have not elected with the IRS to

be treated as taxable entities. The members are protected from personal liability for the company’s debts. Profits and losses are passed directly through to the members, which avoids double taxation because the LLC does not pay income taxes itself.

An essential element to the efficient operation and governance of an LLC is the operating agreement. An Ohio LLC can be organized without a written operating agreement. However, if there is no written operating agreement, the provisions of Chapter 1705 of the *Ohio Revised Code* govern the relationship of the members and the operation of the LLC, and many of the statutory default rules leave open important issues.

An operating agreement should provide sufficient detail to serve as a road map for the members with respect to LLC governance and operation. This is all the more important since LLCs are a relatively new form of entity in Ohio and the parties involved and the public at large likely will have very little experience in dealing with LLCs than with other forms of business entities. The initial drafting of the operating agreement is very important because a well-drafted agreement will reduce the potential for disputes between the LLC members and managers in the future. Every LLC operating agreement should address these essential elements:

Contributions of the members.

Many statutory rights of the members are based on the value of their capital contributions, so it is vitally important that this information is recorded in the operating agreement. If contributions will be in a form other than cash (such as services), it is important that the members explain the form and value of such non-cash capital contributions.

Transferability of membership interests and admission of new members.

The operating agreement should describe the restrictions on the transferability of membership interests and explain the rules governing transfers and the admission of new members.

Withdrawal rights.

If the members want a right to withdraw from the LLC, the terms and conditions governing withdrawal must be addressed in the operating agreement.

Death, bankruptcy or divorce of a member.

It is important that the members specify what will

happen to their membership interests in the event of a death, bankruptcy or divorce of a member.

Otherwise, there may be a number of undesirable possible outcomes. For example, an heir of a deceased member, a divorced member's ex-wife, or a creditor of a member may become a member of the LLC.

Allocation of profits, losses and distributions.

It is often desirable to allocate profits, losses and distributions in a manner other than based on the value of the capital contributions of each member. By addressing these issues in the operating agreement, the members can ensure fair allocations to the members.

Management.

It is important to indicate whether the LLC will be managed by its members or by elected managers. If managers are elected, the operating agreement should specify which actions managers may take on behalf of the LLC (such as day-to-day business activities) and which actions require the approval of the members (such as material financing or business acquisition transactions). The operating agreement also should specify whether the members' voting rights are per capita, pro-rata based on capital contributions, or determined in some other manner.

Indemnification.

The operating agreement should outline the terms and conditions regarding indemnification by the LLC of the members and managers.

Confidentiality.

The operating agreement should address restrictions on a member's rights to use or disclose the LLC's confidential information.

Covenants not to compete.

The operating agreement should address any restrictions on a member's right to compete with the LLC's business or pursue opportunities that should first be made available to the LLC. Ohio case law involving LLCs, although still limited, has

established

that the common law fiduciary duties of the members can be modified or eliminated by the terms of the operating agreement.

—by D. David Carroll and Adam J. Biehl of the Columbus law firm, Bailey Cavalieri, LLC.

Letters of Intent: To Do or Not To Do

Business people involved in mergers, acquisitions and divestitures love them; their lawyers dislike and fear them. What are they? They are letters of intent.

The legal issue with a letter of intent has to do with whether the letter is a legally binding document or just an expression of the parties' intent to try to make a deal. When drafted by the inexperienced, a letter of intent that was only meant to be an expression of ideas about a possible

future agreement can produce costly litigation. Further, a court may decide that the seemingly nonbinding letter of intent is a wholly or partially legally binding contract.

Business people are often drawn to letters of intent because they feel that putting something on paper makes a deal more likely to happen. A party may erroneously believe that the letter of intent morally commits the other side, while counting on the “nonbinding” nature of the letter to avoid making its own firm commitment.

Over the years, a lot of litigation has involved the binding effect of letters of intent. Even some letters of intent that specifically say they are not binding are held by a court to be binding in whole or in part for a variety of reasons. Lawyers tend to dislike letters of intent because they understand the litigation risks and the uncertainty even when the letter says, “This is not a legally binding document.”

Nevertheless, a properly written letter of intent dealing with the merger acquisition or divestiture of a business sometimes serves a useful purpose. Such a letter is usually partially binding and partially non-binding. The usual binding provisions concern the preservation of confidentiality, exclusivity of negotiations, expense allocation and due diligence procedures. During a buyer's due diligence, the parties negotiate the definitive purchase/sale agreement containing details of

the transaction, such as the exact purchase price, price adjustments, and payment terms, representations and warranties, closing contingencies and a host of other matters that need to be covered as facts become known through due diligence.

The bottom line is this: If you decide to use a letter of intent for any transaction, use it carefully and with help from experienced counsel.

—by Charles R. Schaefer, an attorney with the Cleveland firm of Walter & Haverfield

Shareholders Can Be Personally Liable for Corporate Obligations

Q: Businesses incorporate to protect their owners from liability for corporate obligations. Are there any statutory provisions imposing personal liability on shareholders?

A: Yes. Ohio statutes impose personal liability on shareholders in the following situations:

- 1) When a person subscribes for shares in a corporation, there is a personal obligation to pay the corporation for those shares.
- 2) Any shareholder who knowingly receives any dividend, distribution, or payment made contrary to law or the corporate articles is personally liable to the corporation for the amount received in excess of the amount that would have been paid or distributed without violation of law or the articles.
- 3) A shareholder may be personally liable for the purchase price of corporate shares and punitive damages if the shareholder sells such corporate shares in violation of the Ohio Securities Act.
- 4) Any shareholder selling shares in an insolvent corporation without disclosing the financial situation of the corporation is personally responsible for the purchase price to the purchaser.
- 5) Any shareholder exercising corporate rights, privileges and authority after the corporate Articles of Incorporation have been canceled or after the corporation has been dissolved are subject to the obligations resulting from the shareholder's

actions.

6) A shareholder having control of more than one-third of the shares of a corporation may be held personally responsible if the corporation fails to report and remit Ohio sales and use taxes.

Q: Are there federal statutes that impose personal liability on a shareholder for the shareholder's conduct?

A: Yes. In addition to the federal liabilities on shareholders who are also officers and directors of corporations, there are several statutes that impose liability on shareholders simply for being shareholders.

1) To prevent 10-percent shareholders of a publicly held corporations from using inside information, these shareholders must return to the corporation any profits resulting from the shareholders' purchase and subsequent sale of the corporation's equity securities within a six-month period.

2) The Comprehensive Environmental Response Compensation and Liability Act (CERCLA) imposes a liability on *owners and operators* for the costs associated with the clean-up of any spills, discharges or releases of hazardous substances. The Environmental Protection Agency considers shareholders to be owners, but normally has confined its imposition of liability to those shareholders who are active in the business. The courts have generally limited shareholder liability to those situations in which the corporation entity can be disregarded under state law.

3) A shareholder in "control" of a publicly held corporation is liable personally for the acts and omissions of that corporation in violation of the federal securities laws.

Q: What is meant by the phrase, "piercing of the corporate veil?"

A: In addition to the statutory liabilities, courts have imposed liability for corporate obligations on a shareholder when the corporate form is used to perpetrate a fraud or an illegal act. Normally, this *piercing of the corporate veil* is applied against a shareholder who dominates the corporation so that the corporation is considered to be an extension or "alter ego" of the shareholder and that the corporation has no separate mind or will of its own. Courts have not established a precise test for determining when corporate domination by a shareholder occurs to the extent that the existence of the corporation is disregarded. Each case is decided on its own facts. The shareholder's domination and control of the corporation must be used to commit fraud or an illegal act. The injury or loss must directly and foreseeably result from both the shareholder's control and the fraud, illegal act or unjust conduct.

Q: What can be done by shareholders to prevent a court from piercing the corporate veil?

A: Observe the formalities of the corporate organization. Hold meetings of the directors and the shareholders. Authorize actions such as loans, purchases of property and leases of real estate by written action or at a meeting following these steps:

- 1) Keep separate financial records for the corporation.
- 2) Keep the corporate record book up to date and record all corporate actions by the shareholders and directors.
- 3) Do not commingle the assets of the corporation with the assets of the shareholder or any affiliated entity.
- 4) Provide the corporation with adequate capital to start its operation.
- 5) Never mislead a creditor as to the financial condition of the corporation.
- 6) Use the formal corporate name on all purchase orders, invoices and communications with customers and third parties.
- 7) The corporate bank account should be set up in the name of the corporation and with the name of the corporation on all checks.

It is possible that a shareholder, by his or her conduct, may assume a personal liability. To avoid this, all corporate contracts, agreements, notes, documents and checks should be signed in the individual's corporate capacity, as in the following example: "Smith Corporation by John Smith, its president."

Q: Is there any duty of a shareholder to the other shareholders?

A: Yes. The courts have imposed upon a dominant or majority shareholder a fiduciary obligation when dealing with the other shareholders. The dominant or majority shareholder must take actions for the benefit of the corporation and all of the shareholders. The dominant or majority shareholder must act in good faith when dealing with other shareholders. For example, in a corporation where there are two shareholders—both of whom work for the corporation—one owning 60 percent of the shares and the other owning 40 percent of the shares, a fiduciary duty could be breached if the majority shareholder fires the minority shareholder without good reason and for the purpose of increasing the majority shareholder's salary.

—by Jason C. Blackford, an attorney with the Cleveland firm, Weston Hurd LLP.

Understanding Personal Liability for Corporate Obligations

A major benefit of incorporation is to protect shareholders' personal assets from corporate liabilities. The general rule is that shareholders are *not* liable for the debts or obligations of a corporation; however, if a corporation cannot pay its debts, there are circumstances where courts

sometimes disregard the general rule and attempt to impose personal liability for the corporate debt on the shareholders by *piercing the corporate veil*. When this so-called piercing the corporate veil is successful, a claimant against the corporation may be able to collect from a shareholder's personal assets.

In Ohio, a claimant against a corporation must satisfy three elements to successfully pierce the corporate veil and collect from shareholders' personal assets. The claimant must be able to demonstrate that:

- 1) the corporation is completely controlled and dominated by its shareholders;
- 2) the corporation was used to commit fraud or an illegal act; and
- 3) the fraud or illegal act resulted in an injury or unjust loss.

Adherence to the following principles and compliance with state laws reduces the risk that a court will pierce the corporate veil.

1) Keep the corporation completely separate from its shareholders. Observe corporate formalities and respect the legal separateness of the corporation.

Issue stock in compliance with the law. Hold regular shareholder and director meetings when required and ask shareholders or directors, as appropriate, to approve actions outside the ordinary course of business. Officers and directors should exercise independent judgment that is in the best interest of the corporation. Shareholder votes must be based on the number of shares held. In some instances, a close corporation agreement may serve to reduce the need for certain of the required formalities mentioned above.

Maintain adequate corporate and financial records.

Adequate records are especially

important when shareholders and directors approve significant corporate activities (*e.g.*, borrowing, compensation and purchase decisions).

Use corporate funds and property only for corporate purposes.

Never use corporate funds for personal use. Pay dividends only when appropriate.

Conduct business in the corporate name.

Use corporate letterhead and the full corporate name in estimates, quotes, bids, invoices, purchase orders, contracts, etc. Have corporate officers sign their names and official capacity on all contracts and other corporate documents.

Keep corporate assets separate from shareholders' assets.

When starting a corporation, conduct due diligence to ensure there is enough capital to fund the type and size of the business and to cover accompanying risks. Avoid regular shareholder loans or contributions.

Make sure shareholders do not commit fraud or illegal conduct. Shareholders should not siphon funds to try to protect the corporation from judgments or other debts.

Shareholders must not mislead third parties by suggesting they will fulfill corporate obligations or that the corporation has assets that are really owned by shareholders.

Do not permit the corporation to incur additional debts or liabilities if it is insolvent or in financial distress.

In summary, in order to pierce the corporate veil and collect from shareholders' personal assets, a claimant must demonstrate that the corporation's shareholders reaped corporate benefits and profits at the claimant's expense. The mere fact that the corporation ceases operation without being able to pay all of its debts is not enough to cause shareholders to be personally liable for the corporation's obligations. But in today's economic climate, even the most basic corporate transactions are scrutinized to the highest degree when a corporation becomes insolvent. Compliance with the above principles will undoubtedly help shield shareholders from being liable for corporate obligations. Nevertheless, corporate officers and shareholders must remain vigilant and alert in their objective to operate their corporation within the boundaries of law—separately, independently, and free from fraud or illegality.

—by attorney D. David Carroll of Bailey Cavalieri LLC in Columbus and Hollie K. Foust, formerly of the same firm. Updated by D. David Carroll and Jameel S. Turner, both of Bailey Cavalieri LLC.

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