

NEXSEN PRUET JACOBS & POLLARD, LLC

LEGAL STRUCTURE OF BUSINESSES A Comparison

1. Corporations.

1.1 "C" Corporations.

1.1.1 Legal Characteristics.

a. Organization.

1. Articles of Incorporation.
2. Bylaws.
3. Organizational Minutes.
4. Name:
 - a) Must contain word "corporation", "incorporated", "company" or "limited", or the abbreviation "corp.", "inc.", "co.", or "ltd".
 - b) Must not be deceptively similar to the name of an existing corporation, limited partnership, limited liability company, etc.

b. Upkeep.

1. Annual shareholder meetings.
2. Amendments to Articles.
3. Annual Reports.
4. Annual Fees.
5. Dissolution formalities and technicalities as defined and provided by statute.

c. Management.

1. Tripartite System (i.e. shareholders, directors, officers).
2. Can be cumbersome in small corporations.
3. Individual officer's duties and authority may be defined in a shareholder management agreement.

d. Liability.

1. Limited Liability for shareholders.
2. Piercing the corporate veil.
3. Officer and director liability.
 - a) Statutory indemnification.
 - b) Statutory immunity.

e. Securities compliance.

1. All stock is subject to compliance.

f. Control.

May opt into:

1. Cumulative voting.
2. Supermajority quorum and voting.
3. Preemptive rights.
4. Staggered board.
5. Voting agreements and voting trusts.
6. Share transfer restrictions.
7. Right of first refusal.

8. S.C. anti-takeover statute.
9. S.C. business combination statute.

g. Liquidity.

1. Free transferability of shares.
2. Stock transfer restrictions.
3. Buy-sell agreements useful at death, disability, or employment termination of a shareholder.
4. Mergers and other business combinations and reorganizations are possible by statute.

1.1.2 Tax Characteristics.

- a. Double taxation.
 1. Corporation pays tax on its net taxable income.
 2. Shareholders pay tax on dividends, i.e., corporation's net earnings that are distributed.
 3. Accumulated Earnings Tax on retained earnings over \$250,000 (\$150,000 in the case of corporations whose principal business is rendering professional services) that are not necessary for the capital needs of the Corporation.
- b. Minimize the Corporation's income by paying shareholder-employees large salaries, but must be reasonable.
- c. Employee benefits.
 1. Shareholders who are employed by the corporation are eligible for special insurance programs and other fringe benefits not available to sole proprietors, partners, limited liability company members, or shareholders of S corporations owning 2% or more of the corporation's stock.

2. These include:
 - a) Group term life insurance.
 - b) Disability insurance and medical expense reimbursement plans.
 - c) Certain transportation, lodging and meal expenses.
 - d) Fringe benefits (no additional services, qualified employee discounts, working condition fringes such as free parking, de minimis benefits such as free coffee and donuts, on-site athletic facilities.
 - e) Certain types of deferred compensation plans; and
 - f) Qualified Employee Stock Ownership Plans (ESOPs).
3. Fringe benefits must not discriminate in favor of highest paid corporate executive and therefore involve significant costs to the business.
- d. 1993 Tax Act created special exclusion of gain for sale of qualifying small businesses owned as "C" corporations.

1.1.3 Other Factors.

- a. Perpetual existence.
- b. Ability to be sued in corporate name.
- c. Ability to own property.
- d. Ability to bring suit.
- e. Easier to raise capital than other forms.

1.2 "S" Corporations.

1.2.1 Legal Characteristics.

a. Organization.

1. Must file Form 2553 with IRS to be S corporation - timing issues.

2. Eligibility requirements.
 - a) No more than one class of stock (beware of non-safe harbor debt).
 - b) No more than 75 shareholders.
 - c) Shareholders must be individuals or "Qualified Subchapter S Subsidiary" (some trusts and estates can qualify however).
 - d) Wholly-owned "C" corporations may not file consolidated returns.

b. Upkeep.

1. Same as "C" corporations.

c. Management.

1. Same as "C" corporations.

d. Liability.

1. Same as "C" corporations.

e. Securities compliance.

1. Same as "C" corporations.

f. Control.

1. Same as "C" corporations.

1.2.2 Tax Characteristics.

- a. Conduit principle.
 1. Pass through of losses.
 2. Pass through of benefits.
 3. Pass through of income - "phantom gain or income" problem.
 - a) Need for mandatory dividend requirement.

- b. Must balance individual tax rates against corporate tax rates to aid in election decision.
 - 1. Not as attractive since 1993 Tax Act made individual tax rates higher than corporate tax rates.
- c. Employee benefits.
 - 1. Fringe benefits only available to shareholder-employees owning less than 2% of the corporation's stock.
- d. Avoidance of "double tax" problem especially significant upon the sale of the business.

1.2.3 Other Factors.

- a. Perpetual existence.
- b. Ability to be sued in corporate name.
- c. Ability to own property.
- d. Ability to bring suit.
- e. Easy to raise capital.

1.3 Statutory "Close" Corporations.

1.3.1 Legal Characteristics.

a. Organization.

- 1. Special articles and specially legended stock.
- 2. Advantages.
 - a) Usually all or most of the shareholders are actively involved in managing the business.
 - b) Statutory rights automatically granted to shareholders.
 - i) "Put" at death of shareholder.
 - ii) Right of first refusal.
 - c) Greater degree of operating informality.

- i) No bylaws.
 - ii) No annual meetings.
 - iii) No directors.
 - d) Eligibility requirements.
 - i) Differ among states.
 - ii) Requirements:
 - (a) 2.Unanimous consent of all shareholders.
 - (a) Notice of special arrangements given to third parties.
 - (i) designate in Articles of Incorporation.
 - (ii) notice on stock certificate.
- a. **Upkeep.**
 - 1. Less formal than regular corporations.
- b. **Management.**
 - 1. Tripartite system.
 - 2. Shareholder management agreements often used.
 - 3. Board of Directors can be eliminated.
- c. **Liability.**
 - 1. Limited liability for all shareholders.
 - 2. Special statutory protections against piercing actions for lack of formalities.
- d. **Control.**
 - 1. Same as "C" corporations.
 - 2. Buy-sell agreements and shareholder agreements are more pervasive in corporations with few shareholders.
- e. **Securities compliance.**
 - 1. Same as "C" corporations.
- f. **Liquidity.**
 - 1. Not a ready market.
 - 2. Statutory transfer restrictions.

- a) "Put" at death.
 - b) Right of first refusal.
3. Mergers and other business combinations and reorganizations are possible by statute.

2.0.1 Tax Characteristics.

- a. May be taxed as either "C" or "S" corporation.
- b. Employee benefits available.

2.0.2 Other Characteristics.

- a. Same as "C" Corporation.

2.1 Professional Corporations.

2.1.1 Legal Characteristics.

a. Organization.

1. Eligibility requirements:
 - a) Limited to single profession or two or more professions if the professions are authorized by the licensing law to be operated in combination.
 - b) Licensed professionals as stockholders.
 - c) Include in corporate name:
 - i) "professional corporation".
 - ii) "professional association", or
 - iii) their abbreviations.

b. Upkeep.

c. Management.

1. Must be by licensed professionals.

d. Liability.

1. Individually liable for own malpractice and those you supervise.
2. Not liable for malpractice of other professionals in the professional corporation.

e. Securities compliance.

1. Technically required, but lesser issues.

f. Liquidity.

1. No market except to other licensed professionals.
2. Recommended buy-sell agreement for time when shareholder dies to establish price for compulsory buy-out.
3. Mergers and other business combinations and reorganizations are possible by statute.
4. Thirty day option to purchase shares of terminated shareholder.

2.1.2 Tax Characteristics.

- a. May be taxed either as a "C" or "S" corporation.
- b. Qualified retirement plan parity rules deleted an attractive advantage of using a professional corporation over a partnership form.

2.1.3 Other Characteristics.

- a. Perpetual existence, but recommended buy-sell agreement for time of death of a shareholder to establish price for compulsory buy-out.
- b. Ability to be sued in corporate name.
- c. Ability to bring suit.
- d. Ability to own property.
- e. Easy to raise capital.

2.2 Non-Profit Corporations.

- a. South Carolina Non profit Corporation Act of 1994.

3. Partnerships.

3.1 General Partnerships.

3.1.1 Legal Characteristics.

a. Organization.

1. Formed by:
 - a) Written agreement.
 - b) Oral agreement.
 - c) Partnership by estoppel.
2. Partnership Agreement - allows flexibility.
3. Governed by Uniform Partnership Act (UPA).
4. Not necessary to have ownership interest in capital and profits proportionate to the investment made, and losses need not follow profits.
5. Need clear obligation to pay in initial and additional capital and mechanism to enforce or reduce interests.
6. Mercantile or industrial partnerships must register names of partners with clerk of court in county where partnership conducts business - seldom done.

b. Upkeep.

1. Less burdensome than corporations.
2. Dissolution formalities and technicalities are defined and provided by statute, but agreement needed.

c. Management.

1. Essentially all partners have equal management authority, but can and should be defined in agreement.

d. Liability.

1. Not separate legal entity in many respects.
2. General partners are personally liable for all debts and other liabilities of the partnership.

e. Securities Compliance.

1. None, so long as all partners are involved in management and none are "passive".

f. Control.

1. Easier to achieve than in corporation, but agreement needed.

g. Liquidity.

1. Less liquid than shares in a "C" corporation.
2. Can and typically should be restricted by agreement.
3. Mergers and other business combinations and reorganizations are not possible, but agreement amendments can achieve same results.

3.1.2 Tax Characteristics.

a. Conduit Principle.

1. Partners deduct losses on personal tax returns.
2. Partners report income on personal tax returns.
3. "Phantom income" problem.
 - a) Need mandatory disbursement requirement.

- b.** Subject to substantial economic effect test, may make special allocations of income, deductions, and credits.

- c.** No fringe benefits.

- d.** "Constructive Termination" - change of 50% ownership.

3.1.3 Other Characteristics.

- a.** Partnership technically legally dissolved at the time a general partner dies. Can result in liquidation of the business.

- b.** Status as separate entity allows partnership to own and dispose of property in name of the partnership.

- c.** Also, in most states, can sue partnership in its own name without naming all the owners. Also, partnerships, in most states, can bring suit in its business name. In South Carolina, this is the case by legislation.

- d. Ability to raise capital in a partnership is greater than in a proprietorship, but in many cases less than in a corporation because of the greater variation in ownership or capital interests available in the corporate form.

3.2 Limited Liability Partnerships.

3.2.1 Legal Characteristics.

a. Organization.

1. Formation and organization is identical in every way to general partnerships except that a limited liability partnership must also file a registration form with the Secretary of State and pay a \$100.00 registration fee on an annual basis.
2. Name:
 - a) Must contain the words "Limited Liability Partnership" or the abbreviation "L.L.P." Anticipated that the omission of the abbreviation "LLP" is unintentional and not substantive.

b. Upkeep.

1. Identical to general partnerships except for the annual renewal of the registration.

c. Management.

1. Identical to general partnerships.

d. Liability.

1. Identical to general partnerships except that the partners are not liable for the business-related torts of other partners unless they participate in the wrong or have supervisory responsibility for the tortfeasor.

e. Securities Compliance.

1. Same as general partnerships.

f. Control.

1. Same as general partnerships.

g. Liquidity.

1. Same as general partnerships.

3.2.2 Tax Characteristics.

a. Conduit Principle.

1. Same as general partnerships.

3.2.3 Other Characteristics.

- a.** Same as general partnerships.

3.3 Limited Partnerships.

3.3.1 Legal Characteristics.

a. Organization.

1. Must have at least one general partner and one limited partner.
 - a) Can have corporate general partner and corporate limited partners (unlike "S" corporation), but tax problems if corporate general partners without substantial net worth.
2. Must file limited partnership certificate in one or more places and keep them up to date.
3. Governed by ULPA and RULPA; in South Carolina by RULPA.
4. Agreement recommended because many provisions of RULPA anticipate an agreement (implied statute of frauds on many issues, making certain oral agreements unenforceable, i.e. oral agreement to pay in capital).
5. Name:
 - a) Must contain words "limited partnership" or abbreviation "LP" or "L.P."
 - b) Must not be deceptively similar to the name of any corporation or limited partnership whose name was previously filed or is doing business in that state.

b. Management.

1. General partner has control of business.

c. Liability.

1. Limited partners have liability to the extent of investment obligations and wrongfully distributed assets.
2. Limited partners can lose their limited liability if they take part in control of the business.
3. General partner liability the same as in general partnership.

d. Securities Compliance.

1. Required of all limited partnership interests, just like stock in a corporation.
2. Need restrictions on transfer for tax and securities law reasons.

e. Control.

General partner has control of most transactions.

f. Liquidity.

1. Limited partners may freely transfer their interests, but there may be a limited market and tax problems.
2. Mergers and other business combinations and reorganizations are possible by statute in South Carolina and a few other states.

g. Upkeep.

1. Greater amount than general partnerships.
2. Dissolution formalities and technicalities defined by statute, but agreement needed.

3.3.2 Tax Characteristics.

- a0 Same as general partnership, but passive activity loss limitations of the Internal Revenue Code prohibit individuals from deducting losses or tax credits generated by passive investment activities in excess of income generated by such activities.

- b0 Limited partners can increase basis by pro rata amount of non-recourse debt.
- c0 "Check the Box"
- d0 "Constructive termination" same as general partnerships.

3.3.3 Other Factors.

- a0 A change in the number or composition of limited partners is not potentially as disruptive as the retirement, death, or disability in a general partnership.
- b0 When general partner withdraws, the partnership is legally dissolved unless a substitute general partner is elected within 90 days, and agreement so provides.
- c0 ULPA and RULPA allow partnership to be sued in its business name without naming the partners individually.

40 Limited Liability Companies.

4.1 Legal Characteristics.

a0 Organization.

- 1 One or more members which can be corporations, partnerships, LLCs, or individuals.
- 2 Must file Articles of Organization with the Secretary of State and keep it up-to-date. File Annual Report each year.
- 3 Governed by the LLC Act in South Carolina.
- 4 Operating Agreement may be oral or written but written is prudent to cover a number of items addressed by the LLC Act and business practice.
 - a Default Provisions: The South Carolina LLC Act contains many default provisions which require particular results on various issues unless otherwise provided in the Operating Agreement, where permitted.
- 5 Name:

- a Must contain the words "Limited Liability Company" or abbreviation "LLC" or "L.L.C."
- b Must not be deceptively similar to the name of any corporation, limited partnership, or LLC whose name was previously filed or is doing business in that state.

b0 Management.

- 1 Management of the LLC can be virtually identical to a general partnership by having member-management, in which case each member participates in control of the business.
- 2 Management of the LLC can be virtually identical to a corporation or limited partnership if the LLC elects to have manager-management, in which case certain designated managers control the business of the LLC as the Board of Directors of a corporation or the general partner of a limited partnership would do.

c0 Liability.

- 1 Members have liability to the extent of their investment obligations and wrongfully distributed assets.
- 2 Members will not lose their limited liability if they take part in control of the business.
- 3 There is no member or manager with statutory liabilities such as a general partner in a general or limited partnership.

d0 Securities Compliance.

- 1 Whether membership interests in an LLC are "securities" is a developing area of law. The South Carolina Securities Commission has issued a statement policy setting forth the following presumption:
 - a Membership interests in a manager-managed LLC are presumed to be securities.
 - b Membership interest in a small, member-managed LLC are presumed not to be securities so long as all the members have meaningful participation and control.

The South Carolina statement policy sets forth a safe harbor for member-managed LLC's which will be deemed not securities.

e0 Control.

- 1 Control decisions in the LLC is vested either in all the members (resembling a general partnership) or in the managers (resembling a limited partnership or a corporation).

f0 Upkeep.

Similar to limited partnerships.

4.2 Tax Characteristics.

- a0 Same as limited partnership, including passive activity loss limitations, etc.
- b0 Members can increase basis by pro rata amount of non-recourse debt.
- c0 "Check the Box" permits great flexibility
- d0 "Constructive Termination" same as general and limited partnerships.

50 Sole Proprietorships.

5.1 Legal Characteristics.

a0 Organization.

- 1 No formalities - No statute similar to those in corporation or partnership govern their organization or operation.
- 2 No expense in forming such as filing fees.
- 3 Mercantile or industrial proprietorships must file trade names and names of the owners with the clerk of the court of the county in which the principal place of business is located, and a sign, placed near the entrance of each place of business, must state the name of the owner or proprietor.

b0 Upkeep.

None.

c0 Management.

- 1 No sharing of control of the business with others as is true in partnership or corporation with more than one shareholder.

do Liability.

- 1 Proprietor fully liable for the debts and other liabilities of the proprietorship.

e0 Securities Compliance.

None.

fo Liquidity.

- 1 May sell assets of entire business if there is a willing buyer. Difficult to transfer liabilities with the business.
- 2 Beware of non-transferable assets such as contracts, franchises, and beware of due-on-sale clauses in debt instruments.
- 3 Mergers and other business combinations are not possible.

5.2 Tax Characteristics.

- a0 Income, credits and deductions of the business must be reported by the proprietor on his individual income tax return.
- b0 Not eligible for fringe benefits.

5.3 Other Characteristics.

- a0 Problems associated with no separation of business and personal affairs.
- b0 Least flexibility of all forms with respect to raising capital.
 - 1 No ownership interest can be sold to other persons.
 - 2 Ability to borrow money for the business is dependent on the net assets of the sole proprietor.
- c0 At death of proprietor, proprietorship ceases to exist and the business must be liquidated with the loss of the going concern value unless:

- 1 Estate is authorized to continue business during administration of the estate.
 - 2 A new owner is found.
 - 3 Becomes incorporated.
- d0 Cannot sue or be sued in business name.

60 Other Business Forms.

6.1 Joint Ventures.

6.1.1 Incorporated Joint Ventures.

- a0 For a specific business activity, therefore terminates when venture is completed.
- b0 Taxed and regulated as corporations.
- c0 Limited liability.

6.1.2 Unincorporated Joint Venture.

- a0 For a specific business activity, therefore terminates when venture is completed.
- b0 In absence of a written agreement, courts usually apply partnership principles:
 - 1 Personally liable.
 - 2 Taxed as a partnership.

6.2 Business Trusts.

- a0 Assets of business trust are held by trustee under terms of written trust for benefit of beneficiaries who hold transferable interests in the trust estate.
- b0 Usually taxed as corporations.
- c0 Limited liability.

6.3 Cooperatives.

- a0 Formed not so much to make an entrepreneurial profit, but to provide a benefit for its members. Example - Credit union.
- b0 Governed by state statute.
- c0 Generally given limited liability.
- d0 Usually taxed as partnership or "S" corporation.

6.4 Real Estate Management Investment Conduit (REMIC).

- a0 Created by Tax Reform Act of 1986.
- b0 Designed to facilitate the secondary mortgage market by allowing entities that hold large pools of real estate mortgages to sell mortgage-backed pass through securities to investors on a tax conduit basis.
- c0 Can be a partnership, corporation or trust.
- d0 Taxed as a partnership regardless of form.

6.5 Franchise.

- a0 Not a distinct business entity, but a method of marketing and merchandising.
- b0 Can function as a proprietorship, partnership or corporation.
- c0 Subject to both state and federal franchise laws.

6.6 Publicly Traded Partnership.

- a0 Created by the Revenue Act of 1987.
- b0 Can either be a general or limited partnership, an LLP, or an LLC.

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June 2001