GUEST COLUMN By John M. Cunningham

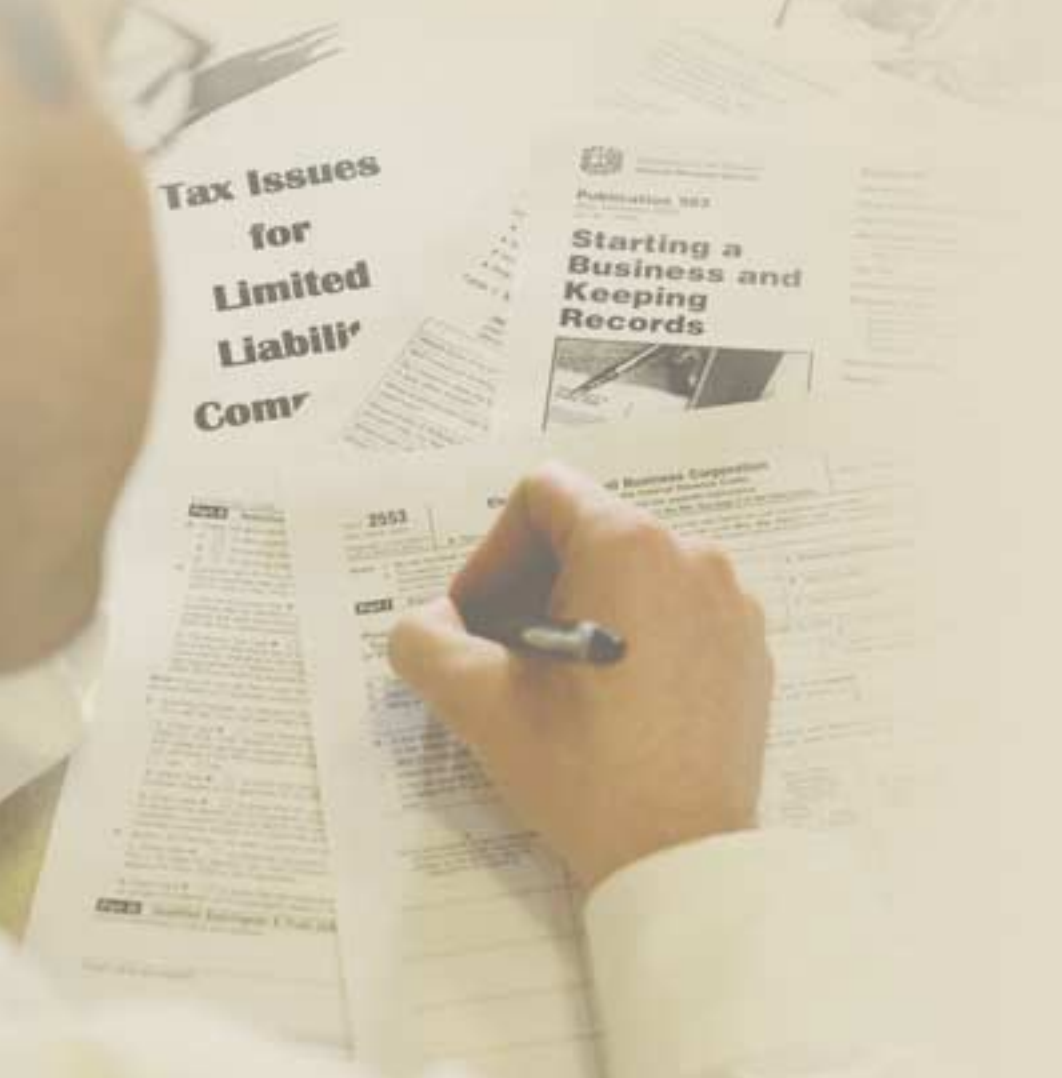
Updating Your Legal and T

Ten Questions Worth Asking

A sound legal and tax infrastructure can play a key role in the success of many privately held businesses. However, if my 30 years of experience as a corporate and tax lawyer are any guide, at least half of all U.S. companies—including many successful ones—have an infrastructure that badly needs fixing. Many of these companies have had the wrong infrastructure right from the start. For others, their infrastructure has become wrong precisely because of their success. This is true, for example, for companies that have accumulated valuable business assets but have never adopted legal structures that maximize business asset protection. With a nod to David Letterman, here is my list of the top 10 questions, starting with the most important, that business owners of privately held companies should be asking about their company's legal and tax infrastructure.

1 If for state law purposes your company is a sole proprietorship, should you convert it to a state-law business corporation or to an LLC?

A sole proprietorship is simply a business that operates without having made an official filing to adopt a state business form—e.g., the corporate or LLC form. There are roughly 15 million active sole proprietorships in the United States. Some have large numbers of employees, substantial business assets, and revenue in the millions. But the sole proprietorship business organization form provides no liability shield and no business asset protection. Further, sole proprietorships provide their owners with a federal tax regimen that, for many of them, is the worst possible regimen because it needlessly maximizes Social Security taxation. Anyone who operates a business as a sole proprietorship should seriously consider converting it to a corporation or to an LLC.



2 If for federal tax purposes your company is a C corporation, should you convert it to an S corporation?

There are presently about 5.2 million active U.S. business corporations, of which about 3.2 million are subject to federal income taxation as S corporations and 2 million as C corporations. If your company is subject to the federal double-tax regimen imposed on C corporations, this means, among other things, that if you sell the assets of your company, you will realize after federal and state taxes as much as 40% less than if your company is an S corporation. All businesses that are taxable as C corporations should seriously consider converting to S corporations.

3 If your company is a state-law business corporation, are your corporate minute books in good order?

If your company is a state-law business corporation, the statutory and case law of most states effectively provide that if you want to protect your personal assets from suits against your business, your corporation must comply with myriad statutory formalities. These include the adoption of organizational resolutions, the issuance of stock certificates, the adoption of bylaws, and the holding of annual shareholder and director meetings. Furthermore, the only way your corporation can prove this compliance in a lawsuit is by keeping a comprehensive and up-to-date minute book. My experience is that a good two-thirds of private U.S. corporations flunk this minute book requirement—and thus are open to "veil piercing" lawsuits that could destroy their business.

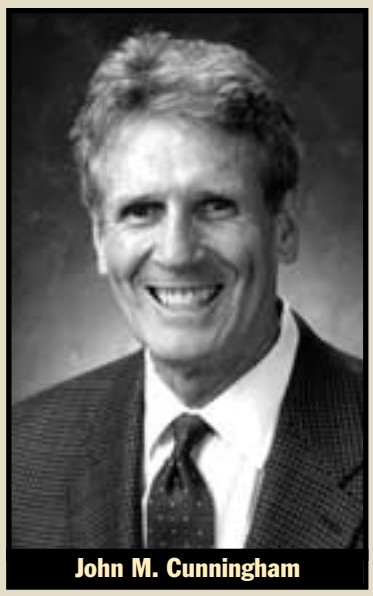
4 If your company owns valuable business assets and you conduct your business through a single entity, should you adopt, instead, a "holding company/operating company" structure?

If, like millions of other U.S. businesses, you hold your business assets in the same entity that conducts your business operations, then all of your business assets are at risk in the event that you are sued. There is a very simple solution to this risk:

- Turn your operating company into a holding company.
- Create a new company (which should often be a single-member LLC) to conduct your operations.
- Have your old company lease its assets to your operating company.

If you use this holding company/operating company structure, your holding company, as a mere passive lessor, should be safe from any claim affecting your operating company—and this means that your business assets will also be safe from the claim.

Tax Infrastructure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5 If you've already got a holding company/operating company structure, are you implementing this structure properly?

The holding company/operating company structure—used by practically all publicly held companies but, unfortunately, by relatively few private companies—can provide you with a powerful source of business asset protection, but only if, in the event of a lawsuit, you can prove the separateness of the two companies. The best way to do this is to set up written intercompany agreements between your two companies that contain arm's-length terms governing their relationship. These intercompany agreements often include personal property lease agreements. They may also include real property lease agreements, license agreements covering trademarks, trade names and other intellectual property, and intercompany promissory notes and security agreements.

6 If your company has two or more owners, does it have an adequate inter-owner agreement?

Roughly half of all U.S. private companies have two or more owners. As I often tell my clients, two-owner companies are not twice as complex as companies with a single owner; they're 20 times as complicated. The best way for you to avoid the problems that arise with multiple ownership is to have a carefully drafted agreement with your co-owners about your business. This agreement should address owner buyouts, expulsions for owner misconduct, and a host of other critical issues, including, above all, methods of resolving serious inter-owner disputes.

7 If you conduct your business as a state-law business corporation, is it time for you to consider converting it to an LLC?

For most private companies, LLC federal and state taxation are at least as good as corporate tax and often much better, and LLC statutory and case law are almost always better than corporate law. For example, LLCs offer a stronger liability shield than corporations, and they provide business asset protection that no corporation can provide. Despite what your lawyer or accountant may tell you, LLCs are not "experimental" any more; there are now approximately 3.5 million active LLCs. If your corporation owns valuable business assets, you should seriously consider converting it to an LLC. The laws of many states make these conversions relatively quick, cheap, and easy.

8 If you conduct your business through a single-member LLC, should you convert it to a two-member LLC?

As I've indicated, LLCs offer their members uniquely powerful statutory business asset protection. However, the purpose of this protection is to protect innocent *non*-debtor LLC members from the risk that LLC assets will be sold in satisfaction of the debts of *debtor*-members. Thus, if you own a single-member LLC that, in turn, owns valuable business assets that you want to protect, you should ask your spouse or another trusted person to become a second member. Transferring a portion of your LLC membership rights to your spouse will be tax free. Although for various tax and legal reasons there should be a written "operating agreement" (effectively, an LLC partnership agreement) between spouses, these agreements will obviously be friendly ones and won't be costly to plan, negotiate, and draft.

9 If your LLC is taxable as a sole proprietorship or as a partnership, should you convert it to an S corporation to avoid Social Security taxes?

From a federal income tax viewpoint, sole proprietorship and partnership taxation are, for many businesses, as good as federal tax can get; but these federal tax regimens can also result in maximum Social Security taxes. To avoid Social Security taxes, businesses that are taxable as sole proprietorships or partnerships should seriously consider making S elections. The Social Security tax savings that result from such an election can amount to thousands of dollars a year.

10 If you conduct your business as a multimember LLC that is taxable as a partnership and your LLC is "member-managed," should you restructure it as a "manager-managed" LLC to reduce your self-employment tax burden?

Under all U.S. LLC acts, LLC members have to choose whether their LLCs will be member-managed or manager-managed. Member-managed LLCs are those in which every member is also a manager. Manager-managed LLCs are those in which the only members with management rights are those specifically appointed as managers. However, under IRS regulations, every member of a member-managed multimember LLC must pay Social Security taxes on his or her entire share of the LLC income, even if the member is a mere passive investor in the LLC.

To avoid this tax, the members may switch their LLC management structure to manager management; and often they must also restructure their LLCs to meet other special IRS regulatory requirements. There are probably hundreds of thousands of multimember LLCs that are unaware of these regulations. The members of countless thousands of these LLCs are paying Social Security taxes that they could easily avoid.

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