

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND LEGAL PROFESSIONALS

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HAVE LLCs MADE CORPORATIONS OBSOLETE FOR NEW HAMPSHIRE BUSINESS START-UPS?

EXECUTIVE SUMMARY. With the advent of LLCs, it is almost always a mistake for people starting new businesses in New Hampshire to form their businesses as corporations. Instead, both for legal reasons and for federal and New Hampshire tax reasons, these businesses should almost always be LLCs. However, this general rule has three exceptions that, for a few clients, may be important.

DISCUSSION. Thus far in 2006, New Hampshire business people have formed no less than 1,515 LLCs under RSA 304-C (New Hampshire's limited liability company statute) but only about 346 business corporations (which I'll refer to here simply as "corporations") under RSA 293-A (the state's for-profit corporation statute) —a ratio of almost five to one. As of March 7, 2006, there are roughly 32,000 New Hampshire LLCs in good standing but only about 22,000 corporations—even though the LLC form has been available in New Hampshire for less than 13 years and the corporate form for well over a hundred.

There are three main legal reasons and two main tax reason why clients should almost always form New Hampshire businesses as LLCs rather than as corporations:

- 1) Charging order protections. LLCs provide business owners with statutory business asset protection and other statutory protections that corporations do not provide. (Lawyers often refer collectively to these protections as "charging order protections." For a detailed discussion of charging order protections, visit www.llcformations.com and click on Newsletter No. 7 (February 1, 2004) in the newsletter archive in that website.)
- 2) Liability shield. From a technical viewpoint, the limited liability shield provided by LLCs and the shield provided by corporations are the same. However, the LLC liability shield is harder for plaintiffs to pierce than the corporate shield. This is because, in order to maintain their corporate liability shield, shareholders have to comply with numerous corporate statutory formalities. LLC statutes don't impose these formalities.
- 3) Management structure. The management structure of LLCs is far more user-friendly than the corporate management structure. Corporations have a complex quadripartite management structure consisting of shareholders, directors, officers and employees. The management structure of most LLCs is either a one-level structure called a "member management" structure or a two-level structure called a "manager management" structure. Both of these structures are simple and intuitive.

- 4) Federal income taxation under the Check-the-Box Regulations. Under U.S. Treasury Department entity classification rules known as the “Check-the-Box Regulations,” the only federal tax regimens available to corporations are Internal Revenue Code Subchapter C and Subchapter S. By contrast, the Check-the-Box rules permit individuals who own single-member LLCs to choose among sole proprietorship taxation, Subchapter C and Subchapter S; and they permit owners of multi-member LLCs to choose among Subchapter C, Subchapter K and (with certain limitations) Subchapter S.
- 5) Interest and Dividends Tax avoidance. Under RSA 77:4, III, New Hampshire residents who are members of LLCs with “nontransferable shares” are not liable for the New Hampshire Interest and Dividends Tax on distributions from these LLCs. With very few exceptions, New Hampshire residents who hold shares of corporations are always liable for this tax even if these shares are nontransferable.

Is there ever a situation where a corporation will be a better choice for a New Hampshire business start-up than an LLC? I can think of only three such situations. All of them are rare.

- The business will soon go public. The first situation is when, even when the business in question is formed, it is clear that it will soon go public. Since Wall Street is willing to invest in highly promising corporations but generally not in LLCs, this business should be formed as a corporation.

EXAMPLE. XYZ Company has breakthrough technology in a potentially very lucrative line of business and it has a management team with a superb track record. In addition, XYZ will clearly need access to public investment in order to realize its full potential. For these reasons, there is a serious possibility that XYZ will be able to make a successful public offering of its stock soon after it is formed. (For 99.999% of all start-ups, the chance that they will ever make a successful public offering—or any public offering at all—is zero.)

- The customers of the business deal only with corporations. The second situation is when, because of industry conservatism or otherwise, the customers with whom the business will be dealing are willing to do business only with corporations and not with LLCs.

EXAMPLE. Engineers Jones and Smith are specialists in upgrading anti-pollution equipment in the smokestacks of energy utilities. They want to form a joint business to provide their services to these utilities. Some of these utilities are highly conservative and will only do business with entities that are corporations.

- The client insists. The third situation is when, even though you explain to your clients with total clarity the above five reasons why LLCs are superior to corporations for almost all New Hampshire business start-ups, the clients nevertheless insist that their business should be formed as a corporation. (Obviously, the client is king even when wrong.)