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NON-TAX CHOICE OF ENTITY

EXECUTIVE SUMMARY

Non-tax choice of entity is the process by which a lawyer chooses the best type of entity for a client's business on business law grounds rather than tax grounds. As discussed below, the process usually involves just three steps, and each of these steps is usually simple to perform. This newsletter explains the process under New Hampshire law, but the process is essentially the same under the law of Massachusetts and other states.

The bottom line in the process is this: Your clients should almost always form their businesses as single-member or multi-member LLCs.

DISCUSSION

Every business lawyer should be skilled in non-tax choice of entity, and accountants should at least have a basic understanding of the process. The following is a very succinct and schematic outline of the process, but this outline is all you'll need to know in the vast majority of non-tax choice of entity engagements.

- 1) The stakes in non-tax choice of entity. The stakes in non-tax choice of entity can be high, so these choices have to be made correctly. For example, if (i) a lawyer advises a client to form her business as a corporation; (ii) the business owns valuable business assets; and (iii) there is a major claim against the client for actions unrelated to her business, she may lose these assets, since corporations don't provide a special type of statutory business asset protections called "charging order protections." However, she stands a good chance of keeping them if her business is conducted as a two-member LLC, since two-member LLCs do provide these protections.
- 2) What types of business entities are available under New Hampshire law? The starting point in non-tax choice of entity is to know the types of available entities in the relevant jurisdiction. In New Hampshire and most other U.S. jurisdictions, there are eight main types of entities:
 - a) Sole proprietorships;
 - b) Divisions (i.e., administrative units of entities);
 - c) "Traditional" general partnerships (i.e., general partnerships that do not register with the New Hampshire Secretary of State as limited liability partnerships ("LLPs"));
 - d) LLPs;

- e) “Traditional” limited partnerships (i.e., limited partnerships that do not register with the New Hampshire Secretary of State as limited liability limited partnerships (“LLLPs”));
 - f) LLLPs;
 - g) LLCs; and
 - h) Business corporations.
- 3) Main legal features of New Hampshire business entities for non-tax choice of entity purposes. The main legal features of each of the above types of entities that are likely to be relevant for non-tax choice of entity purposes are the following:
- a) Sole proprietorships. Sole proprietorships are very simple and user-friendly, but they don’t provide their owners with limited liability or with charging order protections. With rare exceptions, they should only be used by individuals who own single-owner businesses but have no employees.
 - b) Divisions. Divisions are very simple and user-friendly but they don’t provide the entities that operate them with either limited liability or charging order protections.
 - c) Traditional general partnerships. Traditional general partnerships are also a simple and convenient business organization form, but they don’t provide their partners with limited liability.
 - d) LLPs. LLPs are also simple and convenient, but the limited liability they provide to their partners protects the partners only from claims of negligence and willful misconduct and not from any other types of claims, such as contract and statutory claims.
 - e) Traditional limited partnerships. Traditional limited partnerships provide statutory charging order protections and they provide limited liability to their limited partners, but they do not provide limited liability to their general partners.
 - f) LLLPs. LLLPs provide statutory charging order protections and they provide both their limited partners and their general partners with limited liability. However, they are somewhat less flexible than LLCs; they must have at least one general partner and one limited partner in order to exist; and the limited liability they provide to their general partners, like the limited liability provided by LLPs, is only a partial limited liability.
 - g) LLCs. LLCs provide their members with strong limited liability and with statutory charging order protections; they are the most flexible of New Hampshire business organization forms; their management structure is generally simple and intuitive; they provide strong limited liability; and they can exist with only one member.
 - h) Corporations. Corporations provide all of their shareholders with limited liability, but not with statutory charging order protections; and their management structure is cumbersome for smaller businesses and can facilitate veil-piercing (i.e.,

- plaintiffs' piercing their limited liability and holding shareholders personally liable for corporate debts).
- 4) The three steps in the non-tax choice of entity process. The three steps in the non-tax choice of entity are these:
 - a) Determine the ownership structure of the business in question. Is the owner one individual; one entity; or two or more persons (whether individuals or entities)?
 - b) Determine the types of entities available to businesses with that ownership structure.
 - c) Determine which of those entities is best for the business in question. The determining factors will almost always be limited liability; charging order protections; and management structure.
 - 5) Types of entities available to single-owner businesses owned by individuals. There are three types of business entities available to single-owner businesses owned by individuals:
 - a) A sole proprietorship;
 - b) A single-member LLC; and
 - c) A single-shareholder corporation.
 - 6) Non-tax choice of entity guidelines for individuals forming single-owner businesses. Individuals who are forming single-owner businesses should never use sole proprietorships unless they have no need either for limited liability or for charging order protections. They should never use corporations if they have a need for charging order protections or a simple management structure. In practice, this means they should almost always form their businesses as LLCs. However, if the owners in question have valuable business assets, they should form their businesses as *two*-member LLCs (ideally, with their spouses as second members), since, for various important legal reasons, multi-member LLCs are much more likely to provide charging order protections than single-member LLCs.
 - 7) Types of entities available to single-owner businesses owned by entities. There are three types of business entities available to single-owner businesses owned by entities:
 - a) A division;
 - b) A single-member LLC; and
 - c) A single-shareholder corporation.
 - 8) Non-tax choice of entity guidelines for entities forming subsidiaries. Entities should not use divisions to conduct any of their lines of business if there is a significant risk that third parties will make claims against any of their lines of business. Because single-member LLCs provide a much simpler management structure than single-shareholder corporations, entities that operate wholly owned businesses should almost always use single-member LLCs, not single-shareholder corporations, to operate each of their lines of business and also to hold valuable business assets.

- 9) Types of entities available to multi-owner businesses. Multi-owner businesses should never operate as traditional general partnerships because general partnerships provide no limited liability to any of their partners. They should never use traditional limited partnerships because these limited partnerships provide no limited liability to their general partners. They should almost never use LLPs or LLLPs because under New Hampshire law, LLPs and LLLPs provide general partners with only partial limited liability.

Thus, as a practical matter, there are only two types of business entities available to multi-owner businesses:

- a) A multi-member LLC; and
- b) A multi-shareholder corporation.

- 10) Non-tax choice of entity guidelines for multi-owner businesses. Multi-member LLCs provide at least as strong limited liability protection as corporations but are also much more flexible and have much simpler management structures. In addition, multi-member LLCs provide charging order protections, which corporations do not provide, and multi-member LLCs have a simpler management structure and provide greater legal flexibility than corporations. For all these reasons, persons forming multi-owner businesses should almost always conduct their businesses as multi-member LLCs rather than as multi-shareholder corporations.

If you have comments on this column or wish to contact me for any other reason, please send me an e-mail at lawjmc@comcast.net or give me a call at (603) 228-0125. If you'd like to visit my website, the link is www.llcformations.com.