

CHAPTER 2

COMPARISON OF BUSINESS ENTITIES

2.1 INTRODUCTION

Over the years, the distinctions among business entities have become increasingly blurred by the frequent modifications of federal income tax laws and revenue rulings and the adoption and revisions of state statutes that define the various types of entities and their characteristics. There are now fewer bright-line choices. Ongoing efforts of the National Conference of Commissioners on Uniform State Laws regarding partnerships and limited liability companies and the evolution of state entity legislation will continue to modify some of the defining rules. Vigilance by practitioners in advising clients will help them to choose the type of business entity that best suits their needs. This chapter focuses on the contrasts among entities organized under Virginia law: sole proprietorships, corporations (both C corporations and S corporations), general partnerships, registered limited liability partnerships, limited liability companies, and business trusts.¹ Income tax considerations are covered in detail in Chapter 3 of this handbook.

Since the last edition of this publication (which reported 2014 statistics) and the prior edition (which reported 2007 statistics), the limited liability company maintained and substantially extended its preferred status over the corporation as the entity of choice in Virginia. As of December 31, 2018, there were more than 170,000 active Virginia corporations (down about 3% since 2014, and down about 13% since 2007); over 40,000 active foreign corporations (up about 2% since 2014 and up about 7% since 2007); over 268,000 active domestic limited liability companies (up about 33% since 2014 and up over 210% since 2007); and 31,436 foreign limited liability companies (up about 31% since 2014 and up about 100% since 2007). There were 5,929 active domestic and foreign limited partnerships (down about 11% more since 2014 and down about 25% since 2007); 1289 active domestic and foreign limited liability partnerships (almost level from 2007 to 2014, but down about

¹ A comprehensive chart follows Chapter 3 and compares the limited liability company, the partnership (including the general partnership, the limited partnership, and the registered limited liability partnership), the corporation (both the C corporation and the S corporation), and the Virginia business trust.

5% since 2014); 673 general partnerships on record (down about 23% since 2014 and down about 38% since 2007), and 326 active Virginia business trusts (up about 14% since 2014, and up about 200% since 2007).² The absolute rate of formation of corporations has declined since 2007, and the rate of formation of new limited liability companies has steadily and substantially increased since 2007. In 2007, the number of new limited liability companies exceeded the number of new corporations by a factor of two-to-one, with 35,820 new limited liability companies formed compared to 17,721 new corporations, while in 2014 new limited liability companies exceeded the number of new corporations by a factor of over four-to-one, with 53,281 new limited liability companies formed, compared to 13,052 new corporations. In 2018, new limited liability companies exceeded the number of new corporations by a factor of almost six-to-one, with 72,305 new limited liability companies formed, compared to 12,703 new corporations.

The growth of the limited liability company likely reflects the continuing recognition that it offers the best characteristics of both the limited partnership and the corporation. The limited liability company can select partnership or corporate taxation under the IRS's "check-the-box" regulations, offers limited liability to its owners, and allows broad flexibility in structuring governance procedures. As a result, the limited liability company appears to have become the preferred entity for most privately held business ventures.

With the advent of new choices of entities that protect owners from personal liability, the scope of active operations is important to evaluate in choosing an entity. In addition, current uses may be different from those that can reasonably be anticipated in the future. For example, a business venture might reasonably be expected to produce losses in its initial years, become highly profitable for several more, and then ultimately be sold, perhaps through a public offering of ownership interests in the venture. The type of entity best suited for each of these distinct phases, particularly from an income tax perspective, may be very different. Accurately predicting the outcome of the anticipated operations may be difficult, and choosing an appropriate entity often becomes a selection of the most flexible form of entity that can most easily accommodate business changes or be changed itself as needs dictate.

² Provided by the Clerk of the State Corporation Commission (SCC) in its Annual Report.

A comparison of business entities requires examination of both general business considerations and federal income tax considerations to determine which form of entity best serves the client's needs. There is unlikely to be a perfect choice, and often more than one choice of entity will fit the needs of the client. The practitioner must consider the evolution of the business cycle of the client's business, which may mandate conversion of the business form from one type of entity to another, perhaps more than once, to best meet the requirements of the business and its owners.

The business needs of the client should include an examination of issues such as business purpose, ownership structure, management, control, duration of the business, liabilities inherent to the business, capital and debt needs of the business, preferential treatment of different owners and investors, liquidity and ease of transferability of ownership interests, transferability of business assets, administrative and reporting burdens, and cost of the business.

The federal income tax considerations typically involve a comparison of the desirability of passing through items of income, gain, loss, deduction, and credit from the business entity to its owners with the burdens and benefits that affect only the income tax returns of the owners and not both the business entity and the owners. The issues to be examined, in addition to that of income taxation at the entity and owner levels, include comparative tax rates, desired allocation of the income tax attributes to owners, desired distributions to owners, comparative income tax accounting methods, whether the business is a passive activity for the owners, employee benefits, self-employment tax, and other tax burdens unique to corporations. These issues are discussed fully in Chapter 3.

2.2 SOLE PROPRIETORSHIPS

2.201 Purpose. A sole proprietorship is a business owned and operated by one person. The proprietor may or may not employ others. Generally speaking, sole proprietorships are small businesses or solo professional practices having the rights and obligations of any individual person.

2.202 Organization. There are no formal organizational requirements to establish a sole proprietorship in Virginia. However, if business is to be conducted under a fictitious name that does not include the name of the proprietor, the proprietor must file a fictitious name certificate with the clerk of the circuit court in the jurisdiction where the business is to

be conducted, setting forth the name under which the business is to be conducted and the name of the person owning the business, along with his or her mailing address.³ The proprietor must also obtain applicable state and local business licenses and comply with any local zoning ordinance requirements.

2.203 Permitted Ownership. The proprietor is the sole owner of the business.

2.204 Control. The proprietor has absolute control over the affairs of the business, subject to the requirements of local, state, and federal laws.

2.205 Duration. A proprietorship terminates upon the death or bankruptcy of the proprietor, or the disposition of the business by sale, succession, transfer, or otherwise. Although the business does not legally terminate upon the disability of the proprietor, it may be terminated by the proprietor or by the proprietor's family or legal representative.

2.206 Owner Liability. The proprietor has no insulation from liability and is personally liable for all of the obligations of the business. Not only the assets of the business, but also the proprietor's other personal assets, are available to satisfy creditors of the business or of the sole proprietor.

2.207 Classes of Ownership Interest. A proprietorship consists of only one type of interest; the business and the individual owner of the business are one and the same.

2.208 Transfer of Interests and Assets. All assets and interests of the proprietor in the business are freely transferable at any time. Depending on the nature of the business, state and local licensing laws and permit requirements may impose restrictions on transferability.

2.209 Income Tax Treatment. A proprietor and the proprietor's business are one and the same for income tax purposes, and the profits and losses of the proprietorship are reflected on the proprietor's personal federal income tax return by attaching Schedule C. A proprietor must also pay self-

³ Va. Code § 59.1-69. Fictitious name certificate filing requirements are applicable to all entities transacting business under a fictitious name.

employment taxes on his or her taxable income and withholding and Social Security taxes for any employees.⁴

2.210 Advantages. A proprietorship requires only one owner and is inexpensive to establish and simple to operate. There are few formalities that need to be observed other than state and local license, permit, and zoning compliance.

2.211 Disadvantages. Proprietorships lack the structure for accommodating additional equity holders. Additionally, a loan to the business is a personal loan to the proprietor and, subject to the Equal Credit Opportunity Act,⁵ often requires the personal endorsement of the proprietor's spouse. In a proprietorship, because no separate business identity exists, the proprietor faces the potential for unlimited liability. The proprietor must include all items of income, gain, loss, deduction, and credit from the business in his or her individual income tax reporting.

2.3 CORPORATIONS⁶

2.301 Purpose.

A. Stock Corporations. Stock corporations are business entities authorized by law to issue shares of equity and may conduct any lawful business.⁷ There are also nonstock corporations, which generally are used for clubs, charities, trade associations, and other entities that are not operated as a trade or business for a profit.⁸

B. Professional Corporations. Professional corporations are stock corporations that are organized for the sole purpose of rendering those professional services enumerated in section 13.1-543 of the Virginia Code and whose shareholders are generally individuals who are licensed or otherwise authorized to render the professional service for which the corporation was

⁴ See I.R.C. §§ 1401, 3101, 3111, 3402.

⁵ 15 U.S.C. § 1691d.

⁶ See Appendix 2-1 to this chapter for sample articles of incorporation. See *Corporations and Partnerships in Virginia* (Virginia Law Foundation 2016) for a comprehensive discussion of formation issues and a forms disc that includes articles of incorporation, bylaws, and other corporate documents.

⁷ See Virginia Stock Corporation Act, Va. Code §§ 13.1-601 *et seq.*, 13.1-626, 13.1-627.

⁸ See Virginia Nonstock Corporation Act, Va. Code § 13.1-801 *et seq.*

organized. At least one of the shareholders must be licensed in Virginia.⁹ Notwithstanding the limited liability of corporate shareholders in general, shareholders of a professional corporation are personally liable for their own negligence in rendering or overseeing professional services.¹⁰ A shareholder of a professional corporation, however, is not liable for the negligence of any other shareholder, officer, or employee of the corporation who is not under his or her supervision.¹¹ Unless otherwise prohibited by law or regulation governing a profession, professional services may also be rendered by a general business stock corporation.¹²

2.302 Organization. Corporations are formed by filing articles of incorporation with the SCC containing the information specified in section 13.1-619 of the Virginia Code. The corporation must have a board of directors, unless all of the shareholders agree to eliminate the board,¹³ and must have such officers as are necessary to enable the corporation to meet statutory filing requirements and otherwise as may be necessary to conduct business.¹⁴ Additionally, there are statutorily mandated meeting and recordkeeping formalities that must be observed.¹⁵

The corporation's name must be distinguishable in the records of the SCC clerk's office from the registered or reserved name of any other corporation, limited liability company, business trust, or partnership.¹⁶ A corporate name must also contain the word "corporation," "incorporated," "company," or "limited" or the abbreviation "corp.," "inc.," "co.," or "ltd."¹⁷

⁹ Va. Code §§ 13.1-543(A), 13.1-544.

¹⁰ Va. Code § 13.1-547.

¹¹ See Laura R. Brown, Comment, *Limited Liability for Shareholders in Virginia Professional Corporations: Fact or Fiction?*, 21 U. Rich. L. Rev. 571 (1987).

¹² Va. Code § 13.1-542.1.

¹³ Va. Code §§ 13.1-671.1, 13.1-673.

¹⁴ Va. Code § 13.1-693.

¹⁵ See Va. Code §§ 13.1-654, 13.1-684, 13.1-770, 13.1-774, 13.1-775.

¹⁶ Va. Code § 13.1-630(C).

¹⁷ Va. Code § 13.1-630(A).