

Business Entity Options

This paper is intended to provide a brief overview of the various types of business entities available in North Carolina and some of the advantages and disadvantages of each one. This paper may at times refer to the various tax consequences associated with specific types of business entities but in no way intended to fully address the subject and scope of the federal and state tax laws that apply to a business and should not be considered legal advice. It is highly recommended that the advice of a tax professional, such as a tax attorney or certified public accountant, be obtained for this important topic.

Preliminary Considerations

Prior to the actual formation of a business entity, the individual or individuals involved should give extensive thought to their goals and what they are attempting to achieve with their business, whether it is a start up business or an existing business to which a change in entity formation is contemplated.

Although not intended to be all-inclusive, some of the important factors to consider in forming and operating a business are as follows:

- The cost of formation and annual reporting;
- The tax consequences of the various business entities;
- Personal and business asset protection;
- Government regulation over the type of business contemplated;
- Dispute resolution among partners or shareholders;
- Continuance of business upon an individual's death;
- Record keeping requirements;
- Estate planning considerations;
- Management and control issues;
- Requirements for dissolution or termination of business;
- Public filing requirements.

As can be seen from this limited checklist, careful thought is one of the keys in choosing a business entity that best suits your needs and information gathering is an important component of this process. It is also important to understand that there is probably no perfect business entity choice in that each separate type involves differing advantages and disadvantages. Your task, with the help of your advisors and consultants, such as lawyers and tax professionals, is to choose the business entity that best suits your needs.

Entity Types

Sole Proprietor

A common and the oldest type of business entity that we are aware of is the sole proprietorship. An individual who operates a business without any government filings is operating as a sole proprietorship. The only filing requirement imposed in North Carolina upon a sole proprietor is registering the true name of the owner with the office of the Secretary of State if the owner is operating his business under a trade name or assumed name. Under a sole proprietorship, the individual is responsible for all aspects of the business and is personally liable for any of the debts incurred by the business. In other words, his or her individual assets of whatever nature, business or personal, are subject to the payment of business debts. A sole proprietor who ceases to operate or dissolves his business can be held liable for debts incurred by the business.

The principal advantage of operating as a sole proprietorship is the streamlined procedure in making all business decisions without the consent of others and the lack of formalities in formation and its continued operation. The sole proprietor, however, will still be subject to the general laws applicable to everyone. The income generated by the business is attributed to the owner as personal income and he or she is taxed on this income at the personal tax level applicable to the income. A sole proprietorship has only one owner and the death of the individual owner ends the business. If the sole proprietor brings in a co-owner who shares in the profits and losses of the business, North Carolina law considers a partnership to have been formed, even in the absence of a formal agreement.

General Partnership

A general partnership is an association of two or more persons to carry on as co-owners a business for profit. N.C.G.S. § 59-36(a). The definition of a “person” includes individuals, corporations, partnerships and other associations, making it possible to form a partnership between individuals, corporations, partnerships, etc. Similar to a sole proprietorship, there are no statutory requirements involved in the formation or operation of the entity, except for the registration or filing of a trade or assumed name. This does not mean that the partnership and partners are not subject to laws effecting their conduct and responsibilities in the operation of the partnership business. An agreement to form a partnership can be written or oral and can be inferred from the conduct of the parties.

Every partner is an agent of the partnership for the purpose of its business. N.C. G.S. § 59-39. A partnership is bound by a partner’s wrongful act committed in the ordinary course of business of the partnership or with the authority of the co-partners. N.C.G.S. § 59-43. In an ordinary partnership, as distinguished from a limited liability partnership, all partners are jointly and severally liable for the acts and obligations of the partnership. N.C.G.S. § 59-45. A person admitted to an existing partnership is liable for all the obligations of the partnership arising before his admission, except that his liability can be satisfied only out of partnership property. N.C.G.S. § 59-47. A partner can assign his interest in the partnership to an outsider without dissolving the partnership, but the

assignee is only entitled to the profits of his assignor and is not entitled to take part in the running of the business.

Each partner has a fiduciary duty to the other partners with respect to all matters affecting the partnership. N.C.G.S. § 59-51. Despite this duty, one of the keys to having a successful partnership is to have a carefully drafted partnership agreement that defines the rights and obligations of the partners. As the number of partners increases, the possibility of disagreement among the partners also increases. Although there is no specific requirement for a written partnership agreement, a well drafted and comprehensive agreement can minimize the occurrences of dispute and can provide the framework for an orderly distribution of assets after a dissolution. N.C.G.S § 59-70.

A general partnership can be dissolved at the end of a set term stated in a partnership agreement. N.C.G.S. § 59-61(1). In the absence of a contrary provision in a partnership agreement, the death of a partner will result in the dissolution of the partnership. N.C.G.S. § 59-61(4) and the bankruptcy of an individual partner will also result in dissolution. N.C.G.S. § 59-61(5). The dissolution of a partnership does not terminate the partnership as it continues until the winding up of the partnership's affairs is completed. N.C.G.S. § 59-60.

For income tax purposes, the partnership, as an entity, does not pay income taxes, but instead, the taxes are attributed to each partner based on his share of the partnership's profits.

Limited Partnership

In North Carolina, a limited partnership is a partnership formed by two or more persons under the laws of this state and having one or more general partners and one or more limited partners. N.C.G.S. § 59-102(8). It can be formed to carry on any lawful business. N.C. G. S. § 59-105.

In order to form a limited partnership, a certificate of limited partnership must be executed and filed in the office of the North Carolina Secretary of State listing, among other information, the name of the limited partnership, the address of the registered office and registered agent, and the name and address of each general partner. N.C.G.S. § 59-201(a). If the limited partnership is to dissolve by a specific date, the latest date upon which the limited partnership is to dissolve must appear in the filed certificate of partnership, but if no date is specified, the limited partnership has no limit on its duration. N.C.G.S. § 59-201(a)(3).

One of the advantages of a limited partnership is that a limited partner is liable for debts or claims against the limited partnership only to the extent of his capital contribution to the limited partnership and since 1999, this is true even if the limited partner participates in the management or control of the business of the limited partnership. N.C.G.S. § 59-303. Additionally, with new legislation taking effect in 2002, a limited partnership may elect to file an application with the North Carolina Secretary of State to become a limited liability limited partnership. N.C.G.S. § 59-210. Additionally, by virtue of N.C.G.S. § 59-45(a1), a general partner in a registered limited liability partnership is not individually liable for debts and obligations of the partnership incurred while it is a registered limited liability partnership solely by reason of being a partner and does not become liable by participating in the management or control of the partnership.

The death or withdrawal of a limited partner or the assignment of a limited partner's interest to a third party does not dissolve the limited partnership. However, the death of a partner can act to dissolve the limited partnership unless there is a written partnership agreement to the contrary or the remaining partners agree in writing to continue the business and to appoint one or more additional partners. N.C.G.S. § 59-801.

A limited partnership can elect to be taxed as corporation or as a partnership if it has two or more members and the Internal Revenue Code and treasury regulations should be consulted along with seeking the advice of a tax professional. The principal advantage over a general partnership is the limited liability for investors.

Corporations

Under N.C.G.S. § 55-1-40(4), a "corporation" is defined as a corporation for profit or a corporation having capital stock that is incorporated under or subject to the provisions of North Carolina Business Corporations Act that is found in Chapter 55 of the North Carolina General Statutes.

One or more persons may act as the incorporator or incorporators of the corporation by delivering articles of incorporation to the Secretary of State for filing. N.C.G.S. § 55-2-01. The information contained in the articles of incorporation includes the name of the corporation, the number of shares the corporation is authorized to issue, the street and mailing address of the initial registered office, the name and address of registered agent, the address of the principal office and the name and address of each incorporator. N.C.G.S. § 55-2-02. Corporate existence begins when the articles of incorporation become effective. N.C.G.S. § 52-2-03.

After the corporation is formed, a majority of the directors named in the articles of incorporation should hold an organizational meeting to appoint officers, adopt bylaws and conduct any other business brought before the meeting. N.C.G.S. § 55-2-05(a)(1). If the articles of incorporations did not name the initial directors, then the incorporator or a majority of the incorporators should hold a meeting to elect directors to complete the organization of the corporation or elect a board of directors to complete the organization of the corporation. N.C.G.S. § 55-2-05(a)(2). At or shortly after this initial meeting, the incorporators or board of directors should adopt the initial bylaws of the corporation that can contain any provisions for managing and operating the business that are not in violation of the law or inconsistent with the terms of the articles of incorporation. N.C.G.S. § 5502-06.

Generally, and absent a limiting term in its articles of incorporation, a corporation has perpetual duration and has the same powers as an individual to do all things necessary and convenient to carry out its business. N.C.G.S. § 55-3-02(a). Some of the statutorily enumerated powers of a corporation include the power to sue and be sued; to make and amend bylaws not inconsistent with its articles of incorporation; to purchase, receive and lease property; to sell, convey, mortgage, pledge and exchange property; and to make contracts, guarantees, incur debt, borrow money, establish pension plans and make charitable donations. N.C. G. S. §53-3-02.

One of the main advantages of a corporation is that a shareholder is not personally liable for the debts of the corporation, unless the shareholder engages in conduct that would allow a creditor to "pierce the corporate veil." A court could make such a finding

in situations where a shareholder engages in such conduct as to fail to observe corporate formalities, exercises control over the corporation and undercapitalizes the corporation. This subject requires a more thorough treatment than will be found in this particular article.

A director of a corporation is required to operate under a duty of good faith. N.C.G.S. § 55-8-30. An officer of a corporation has the authority and duties as set forth in the bylaws and has a duty to act in good faith when exercising discretionary authority. N.C. G. S. §55-8-41 and §55-8-42.

Tax considerations for a corporation can vary depending on the classification of the entity. Under a “C” corporation classification, a corporation is taxed as a separate entity. This can result in taxes being paid on the corporate level plus individual shareholders also being taxed on their distributions from the entity, resulting in double taxation. If all the shareholders consent, a corporation can file with the IRS an application to be classified as a “S” corporation, the result being that the corporation will not pay federal income tax at the entity level and all of the corporate income will “pass through” directly to the shareholders, who will be liable for the tax on the individual level. This election is limited to corporations with no more than 100 shareholders. For a more detailed explanation of the tax treatment for corporation, the advice of a tax attorney or certified public accountant should be sought together with a reading of the appropriate sections of the Internal Revenue Code and related rulings.

Limited Liability Company

A limited liability company is formed in North Carolina under the laws contained in the North Carolina Limited Company Act as found in Chapter 57C of the North Carolina General Statutes.

One or more persons may form a limited liability company by filing articles of organization with the Secretary of State. N.C.G.S. §57C-2-20(a). Some of the information required in the articles of organization include: the name; a date of dissolution if one is decided upon; the name and address of each person executing the articles of organization, the address of the organizations initial registered agent, and the street and mailing address of the principal office. N.C.G.S. §57C-2-21. If no date of dissolution is stated in the articles of organization, there shall be no limit on its duration. N.C.G.S. §57C-2-21(a)(2). Each domestic limited liability company, other than a professional limited liability company, is required to file an annual report with the Secretary of State. N.C.G.S. § 57C-2-23(a).

Although not mandated by law, it is highly recommended that a limited liability company have a written operating agreement in order to prevent potential disputes and to overcome statutory principals that will be imposed on the entity in the absence of such an agreement.

One of the main advantages of a limited liability company is the limitation of liability of its members. A person who is a member, director, executive, or any combination if these, is not liable for the obligations of the limited liability company solely be reason of this status. N.C.G.S. § 57C-3-30. Similar to corporations, a member, director, or executive may be held personally liable for the liabilities of a limited liability

company by reason of his or her actions or conduct. N.C.G.S. § 57C-3-30; however, this subject is beyond the scope of this summary article.

Absent contrary provisions in the articles of organization, all members of the limited liability company shall be managers. If the articles of organization provide that all members are not necessarily managers by virtue of their status as members, then those persons designated as managers in the articles of organization or a written operating agreement, shall be managers. N.C.G.S. § 57C-3-20.

A manager of a limited liability company has the duty to discharge his duties as manager in good faith, with the care an ordinary prudent person in a like position would exercise and in the manner the manager reasonably believes to be in the best interest of the limited liability company. N.C.G.S. § 57C-3-22. Every manager is an agent of the limited liability company for the purpose of its business. N.C.G.S. § 57C-3-23. The authority of a manager may be delegated to persons other than the manager or managers if and to the extent that a written operating agreement allows. N.C.G.S. § 57C-3-24. Any person dealing with a limited liability company may rely conclusively upon its most recent annual report and amendments as to the identity of the managers unless that person has actual knowledge to the contrary. N.C.G.S. § 57C-3-25.

Unless otherwise stated in the articles of organization or operating agreement, the unanimous consent of all the members is required to adopt or amend the operating agreement; admit any new members; or sell, transfer, or dispose of the assets of the limited liability company. N.C.G.S. § 57C-3-03.

A limited liability company is dissolved and its affairs wound up upon the occurrence of any of the following: the time specified or the occurrence of a specified event in the articles of organization or written operating agreement; the written consent of all members; the limited liability company has no members, unless the assignee or fiduciary of the last remaining member agrees in writing to continue the business; or the entry of a judicial dissolution. N.C.G.S. § 57C-6-01.