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The ABC's of Entity Choice

Although many assume that the limited liability company is the best choice for all clients, there are a number of important factors which should be considered, including personal liability protection, management rights, rights to distributions, transferability of interests, flexibility, annual maintenance obligations and tax issues. The purpose of this article is to highlight the basic characteristics of the various for-profit business vehicles available in South Carolina and identify issues that should be considered in the selection of an entity.

Sole Proprietorship

A sole proprietorship is an enterprise which is owned by a single person and which is not incorporated or otherwise formally organized as an entity under state law. The proprietorship is not a legal entity separate from the owner, and there are no filings or filing fees (or attorneys' fees) required to form the proprietorship. The owner has full control over the management of the business and has the right to receive all of the cash flow from operations and all proceeds from liquidation. However, the owner also has unlimited personal liability for the debts and obligations of the business, including all tax liabilities. There are no annual filings or corporate formalities required to maintain a sole proprietorship except as may be required for business licenses and similar items.

Although this form of business is simple and inexpensive to start and maintain, the potential exposure to personal liability is significant, and it would be prudent generally to advise clients to choose a form of business which provides limitations on such liability.

Partnership

General Partnership

A general partnership is an association of two or more co-owners which come together to operate a business for profit. S.C. CODE ANN. § 33-41-210 (West Supp. 2004). There are no filings or filing fees required to form a general partnership, and a general partnership may be formed without the partners expressly organizing or even realizing that a partnership was created. The existence of a general partnership is a question of fact, and certain statutory rules apply to determine whether a partnership exists. *See* S.C. CODE ANN. § 33-41-220 (Law Co-op. 1990). For example, the sharing among persons of the profits of a business is prima facie evidence that a general partnership exists. S.C. CODE ANN. § 33-41-220(4) (Law Co-op. 1990). Thus, if a group of clients begins to conduct business before coming to your office for choice of entity advice, the clients may have already formed a general partnership. Any

conversion from a general partnership to another type of entity may raise significant tax issues that should be considered before advising clients to move forward with such a conversion.

General partnerships are governed by the South Carolina Uniform Partnership Act (the "UPA"), S.C. CODE ANN. §§ 33-41-10 to -1330 (Law Co-op. 1990 & West Supp. 2004). Certain provisions of the UPA may be modified by an agreement among the partners. For example, the partnership agreement may vary the default rules of the UPA regarding management rights, transfer of interests and allocations of profits and losses and liquidation proceeds. S.C. CODE ANN. § 33-41-510(1), (5) (Law Co-op. 1990 & West Supp. 2004). This gives general partnerships flexibility to customize the partnership agreement in order to fit the unique needs of its owners. However, unlike limited liability company operating agreements (as discussed below), partnership agreements may amend only those provisions of the UPA which expressly permit such modification. The discussion below is based on the UPA default rules and assumes the absence of a partnership agreement to the contrary.

All partners have equal rights in the management of the partnership and share equally in the profits and losses of the business. S.C. CODE ANN. § 33-41-510(1), (5) (Law Co-op. 1990 & West Supp. 2004). Each partner is an agent of the partnership for purposes of conducting its business and generally can bind the partnership when apparently carrying on in the usual way the business of the partnership. S.C. CODE ANN. § 33-41-310(1) (Law Co-op. 1990). Each partner is taxed at the individual level on the profits of the partnership, and there is no entity level tax imposed on the partnership itself (thus avoiding the "double taxation" of corporations as discussed below, and potentially resulting in lower tax rates and other tax advantages for partners). As with sole proprietors, partners have no statutory limits on their personal liability—all partners are jointly and severally liable for the debts and obligations of the partnership. S.C. CODE ANN. § 33-41-370(A) (West Supp. 2004). A partner may transfer its partnership interest, but such a transfer entitles the transferee only to receive the distributions to which the transferor would otherwise be entitled and not to any management or other rights. S.C. CODE ANN. §§ 33-41-740(1) (Law Co-op. 1990).

There are no annual filings or other maintenance obligations required of a general partnership except with respect to business licenses and similar items. However, the duration of a partnership is not perpetual. A partnership dissolves upon any change in partners or upon other events described in the UPA or the partnership agreement. *See* S.C. CODE ANN. §§ 33-41-910 to 940 (Law Co-op. 1990). After dissolution, any assets remaining after the payment of other partnership liabilities are first applied to repay the capital contributions of the partners and then distributed equally to the partners. *See* S.C. CODE ANN. §§ 33-41-510(1), -1060 (Law Co-op. 1990).

The general partnership provides advantages in terms of flexibility and (possibly) taxation. However, the potential liability exposure to partners is significant, and in light of other available options which combine the advantages of a partnership with limited liability, there are limited circumstances in which a general partnership would be advisable. Two of these other available options include the limited partnership and the limited liability partnership as discussed below.

Limited Partnership

A limited partnership is a form of partnership in which at least one partner (a "general partner") is personally liable for all of the debts and obligations of the partnership. A limited partnership is an entity separate from its partners formed by filing a certificate of limited partnership with the South Carolina Secretary of State (the "Secretary of State") and paying a $10 filing fee. *See* S.C. CODE ANN. § 33-42-210 (Law Co-op. 1990).

Limited partnerships are governed by the South Carolina Uniform Limited Partnership Act (the "LPA"), S.C. CODE ANN. §§ 33-42-10 to -2140 (Law Co-op. 1990 & West Supp. 2004), and, to the extent not inconsistent with the LPA, the UPA. S.C. CODE ANN. § 33-41-210, -42-2020 (Law Co-op. 1990 & West Supp. 2004). Like general partnerships, limited partnerships typically have partnership agreements which modify the provisions of the LPA to the extent permitted by the LPA. For example, a partnership agreement may be used to modify the rights and obligations of the general partners with respect to management or to limit the liability of the general partners to the limited partnership and its other partners. S.C. CODE ANN. § 33-42-630 (Law Co-op. 1990). The discussion below is based on the LPA and UPA default rules and assumes the absence of a limited partnership agreement to the contrary.

Under the LPA, each limited partnership must have at least one general partner. *See* S.C. CODE ANN. § 33-42-1410(4) (Law Co-op. 1990). The general partners are responsible for the management of the business and generally have such rights, powers and liabilities with respect to the limited partnership as are provided by the UPA. *See* S.C. CODE ANN. § 33-42-630(a) (Law Co-op. 1990). The general partners must be named in the certificate of limited partnership. S.C. CODE ANN. §§ 33-42-210(a)(3), -220(b) (Law Co-op. 1990). Any partner which is not a general partner (a "limited partner") is not personally liable for the debts and obligations of the partnership unless the limited partner: (i) is also a general partner; (ii) subject to certain exceptions, permits its name to be used in the name of the limited partnership; (iii) knowingly executes a false certificate of limited partnership or certificate of amendment; or (iv) takes part in the control of the partnership's business. *See* S.C. CODE ANN. §§ 33-42-270(1), -430(a), (d) (Law Co-op. 1990). The LPA provides a safe-harbor for limited partners by listing activities which do not constitute taking part in the partnership's business, including being a contractor for or agent or employee of the limited partnership. *See* S.C. CODE ANN. § 33-42-430(b) (Law Co-op. 1990). Subject to certain exceptions, general partners and limited partners may withdraw from the limited partnership at any time without causing dissolution of the limited partnership. *See* S.C. CODE ANN. §§ 33-42-1020, -1030, -1410(4) (Law Co-op. 1990 & West Supp. 2004). This means that a limited partnership may have perpetual duration. In addition, partners may assign their partnership interests in whole or in part. However, the transferee is only entitled to receive the distributions to which the transferor would otherwise be entitled and not to any management or other rights in the limited partnership. S.C. CODE ANN. § 33-42-1220 (Law Co-op. 1990).

The profits and losses of, and distributions made by, a limited partnership are allocated based on the value of the contributions made by the partners or as otherwise provided in the partnership agreement. S.C. CODE ANN. §§ 33-42-830, -840 (Law Co-op. 1990). In general, a limited partnership is taxed like a general partnership.

There are no annual filings or other maintenance obligations required of a limited partnership except with respect to business licenses and similar items.

Limited Liability Partnership

A limited liability partnership ("LLP") is a partnership which registers with the Secretary of State as an LLP and pays a $100 filing fee. LLPs are governed by the UPA.

The primary advantage for a partnership to register as an LLP is to limit the liability of its partners. A partner in an LLP is not liable for torts committed in the course of the LLP's business by its other partners or its employees, agents or representatives (unless the LLP provides professional services and the partner is at fault in appointing, supervising or cooperating with the tortfeasor). S.C. CODE ANN. §§ 33-41-370(B), (D) (West Supp. 2004). However, LLP partners only receive protection from tort liability and, unlike limited partners in an LP, remain jointly and severally liable for the LLP's contractual liabilities. *See* S.C. CODE ANN. § 33-41-370(A) (West Supp. 2004).

An LLP must renew its registration each year within sixty days prior to the expiration of its then-current registration and pay a $100 renewal fee in order to maintain its status as an LLP. S.C. CODE ANN. § 33-41-1110(E) (West Supp. 2004). If an LLP fails to renew its registration, the LLP becomes a general partnership, and the partners lose their limited liability protection. In addition, each LLP must carry a certain amount of liability insurance (or its equivalent) in order to maintain its status as an LLP, and if the LLP is providing professional services, the LLP must maintain such insurance as may be required by the applicable licensing authority. *See* S.C. CODE ANN. § 33-41-1130 (West Supp. 2004).

Business Corporation

A corporation is a legal entity separate and distinct from its owners which is formed by filing Articles of Incorporation with the Secretary of State and paying a $135 filing fee (which includes a $25 filing fee for the corporation's initial annual report to the South Carolina Department of Revenue, which must be filed with the Secretary of State along with the Articles of Incorporation). Articles of Incorporation must be signed by an attorney licensed to practice in South Carolina. S.C. CODE ANN. § 33-2-102(a)(6) (West Supp. 2004). Thus, a client must involve an attorney in order to form a corporation.

Corporations are governed by the South Carolina Business Corporation Act of 1988, as amended, S.C. CODE ANN. § 33-1-101 to -20-105 (Law Co-op. 1990 & West Supp. 2004) (the "Corporate Code"). The governing documents of a corporation are its Articles of Incorporation and its Bylaws. There is not as much flexibility with these corporate governance documents as compared LLC operating agreements and partnership agreements to modify or supersede applicable statutes. However, they can be used to customize the rights, duties and obligations of a corporation and its shareholders, directors and officers so long as such customization is consistent with the Corporate Code. *See* S.C. CODE ANN. §§ 33-2-102(b)(2),

-106(b) (Law Co-op. 1990). In addition, the shareholders of a corporation may enter into agreements which further regulate the rights, duties and obligations of shareholders. For example, such shareholders' agreements commonly impose transfer restrictions, buy-out mechanisms and other regulations with respect to a corporation's stock.

The equity holders of a corporation are its shareholders, who the Corporate Code assumes are passive investors with little interest in participating in corporate management. Unlike partners and members in a member-managed LLC, shareholders have no agency authority to act for or bind the corporation and very few rights to participate in management other than the right to elect directors and the right to vote on certain extraordinary actions, such as amendments to the Articles of Incorporation, mergers, sales of corporate assets outside of the ordinary course of business and dissolution. *See* S.C. CODE ANN. §§ 33-8-103(d), -10-103(b)(2), -11-103(b)(2), -12-102(b)(2), -14-102(b)(2) (Law Co-op. 1990). The shareholders elect directors to manage the corporation, and the directors in turn appoint officers to serve as agents of the corporation and handle its day-to-day operations. *See* S.C. CODE ANN. §§ 33-8-101(c), -400(a) (Law Co-op. 1990).

The equity of a corporation is represented by shares of stock held by its shareholders. Unless otherwise provided by the Articles of Incorporation, each shareholder is entitled to one vote per share of stock on each matter submitted to a shareholder vote, to receive dividends and other distributions if and when made by the corporation, and to receive a portion of the net proceeds of the corporation's liquidation. *See* S.C. CODE ANN. §§ 33-6-101(b), -6-400(a), -7-210 (Law Co-op. 1990). The Articles of Incorporation may create different classes and series of shares of stock with different rights. S.C. CODE ANN. § 33-6-101 (Law Co-op. 1990). This gives a corporation some flexibility to create rights and obligations which may be attractive to investors, who may insist on certain preferential stock rights such as dividend and liquidation preferences, board rights, redemption rights and anti-dilution protections. However, a corporation must at all times have one or more classes of shares that together have unlimited voting rights and one or more classes that together are entitled to receive the net assets of the corporation upon dissolution. S.C. CODE ANN. § 33-6-101(b) (Law Co-op. 1990).

Shareholders generally are not personally liable for the debts and obligations of a corporation. S.C. CODE ANN. § 33-6-220 (Law Co-op. 1990). However, South Carolina courts have recognized that this limitation is not absolute and that creditors of a corporation may pierce this "veil" of limited liability if its shareholders fail to treat the corporation as a truly separate entity (as evidenced, for example, by a failure to keep minutes and obey other corporate formalities) and if there is an element of injustice or unfairness to protecting the shareholders. *See*, *e.g.*, Sturkie v. Sifly, 313 S.E.2d 316 (S.C. Ct. App. 1984). One way to possibly obtain more protection against veil piercing is to incorporate as a statutory close corporation. A statutory close corporation is a corporation to which certain special provisions apply as set forth in Article 18 of the Corporate Code, such as statutory rights of first refusal and restrictions on the transfer of stock. *See* S.C. CODE ANN. §§ 33-18-110, -120 (Law Co-op. 1990). A corporation can become a statutory close corporation by stating its election to be a statutory close corporation in its Articles of Incorporation. S.C. CODE ANN. § 33-18-103 (Law Co-op. 1990). The Corporate Code provides that a statutory close corporation's failure

to observe corporate formalities is not a ground for imposing personal liability on its shareholders. S.C. CODE ANN. § 33-18-250 (Law Co-op. 1990). Thus, close corporations in theory protect against veil piercing. However, at least one South Carolina case indicates that this statute does not fully protect against the failure to observe corporate formalities in a veil piercing analysis. *See* Hunting v. Elders, 597 S.E.2d 803, 807 (S.C. Ct. App. 2004).

Shares of stock in a corporation are transferable subject to restrictions imposed by applicable securities laws or otherwise imposed by the corporation.

As legally recognized entities, corporations pay taxes at the corporate level, and shareholders do not pay any taxes with respect to the profits of a corporation unless the corporation makes a distribution to the shareholders (at which time shareholders are taxed on their respective distributions). This results in double taxation. However, corporations may avoid this double tax by electing to be taxed as an S corporation pursuant to subchapter "S" of the Internal Revenue Code of 1986, as amended. S corporations are not taxed at the entity level. Instead, the profits and losses of the corporation pass through to the individual shareholders, who pay taxes on their respective allocated shares of profit at the personal level. A corporation must meet certain criteria before being eligible to become an S corporation (including limitations on who can be an owner of the S corporation), and a tax professional should be consulted to determine whether such an election would be beneficial to a client.

The Corporate Code imposes certain annual maintenance requirements on corporations. For example, corporations must hold annual shareholders' meetings each year and must provide their shareholders with certain financial reports. S.C. CODE ANN. §§ 33-7-101, -16-200 (Law Co-op. 1990). In addition, corporations must file an annual report (as part of their state tax filings) each year with the South Carolina Department of Revenue each year. S.C. CODE ANN. § 33-16-220 (Law Co-op. 1990). Failure to comply with these requirements may evidence grounds to pierce the corporate veil or result in administrative dissolution.

Limited Liability Company

A limited liability company ("LLC") is a legal entity separate and distinct from its owners which is formed by filing Articles of Organization with the Secretary of State and paying a $110 filing fee. Unlike corporations, no attorney's signature is required on the Articles of Organization in order to form an LLC. LLCs have become one of the most popular choices of entity in South Carolina, and more LLCs have been formed in South Carolina during the past few years than any other type of entity which files with the Secretary of State.

LLCs are governed by the South Carolina Uniform Limited Liability Company Act of 1996, as amended, S.C. CODE ANN. §§ 33-44-101 to -1208 (West Supp. 2004) (the "LLC Act"). The governing documents of an LLC are its Articles of Organization and any operating agreement executed by its members. An LLC is not required to have an operating agreement. However, one of the biggest advantages to the LLC form is the considerable flexibility of the operating agreement. An LLC has wide latitude through the terms of the operating agreement to vary most provisions of the LLC Act, even provisions which would otherwise appear to be

mandatory. *See* S.C. CODE ANN. § 33-44-103 (West Supp. 2004). This contractual authority is significantly broader than the authority granted by the UPA to the partnership agreement or the Corporate Code to the Articles of Incorporation and Bylaws. As a result, the LLC can be customized to a greater degree than can partnerships and corporations. For purposes of this article, I will discuss the default provisions of the LLC Act and assume the absence of an operating agreement to the contrary.

The equity holders of an LLC are its members. The management rights of a member depend upon whether the LLC elects in its Articles of Incorporation to be manager-managed. *See* S.C. CODE ANN. § 33-44-203(a)(6) (West Supp. 2004). If no such election is made, the LLC is member-managed. If an LLC is member-managed, the LLC operates like a partnership—each member has equal rights in management and is an agent of the LLC with binding authority when apparently carrying on in the ordinary course the LLC's business or business of the kind carried on by the LLC. S.C. CODE ANN. §§ 33-44-404(a), -301(a)(1) (West Supp. 2004). If an LLC is manager-managed, the LLC operates like a corporation—the members have few rights in management other than the election of managers, each of which has equal rights in management and has agency authority to bind the LLC when apparently carrying on in the ordinary course the LLC's business or business of the kind carried on by the LLC. S.C. CODE ANN. §§ 33-44-301(b), -404 (West Supp. 2004). LLC members share any distributions made prior to dissolution in equal shares. S.C. CODE ANN. § 33-44-405(a) (West Supp. 2004).

As a default, the existence of an LLC is perpetual ("at-will LLC"). However, an LLC may elect in its Articles of Organization to exist only for a specified term ("term LLC"). *See* S.C. CODE ANN. § 33-44-203(a)(5) (West Supp. 2004). The practical difference between an at-will LLC and a term LLC relates to the obligation of an LLC to purchase the interests of its members who withdraw from the LLC, which is referred to as "dissociation" under the LLC Act. The LLC Act contains a laundry list of events which result in dissociation, including a member's right to dissociate at any time upon notice. *See* S.C. CODE ANN. §§ 33-44-601, -602 (West Supp. 2004). In the event of a member's dissociation, the member loses all rights to participate in management, and the LLC is required to purchase the interest of such member for its fair value. S.C. CODE ANN. § 33-44-701 (West Supp. 2004). If the LLC is at-will, the purchase price is determined as of the date of dissociation, and the LLC must commence a statutory buy-out process within thirty days after determining the price. S.C. CODE ANN. §§ 33-44-603(1), -701 (West Supp. 2004). However, if the LLC is a term LLC, the purchase price is determined as of the expiration of the LLC's term that existed on the date of dissociation, and assuming the LLC does not dissolve at or prior to such date, the LLC has no obligation to purchase the interest until such date. S.C. CODE ANN. §§ 33-44-603(2), -701(a)(2) (West Supp. 2004). As a result, a term LLC has an advantageous ability to delay the purchase of a dissociated member's interest, especially when the LLC has a lengthy term.

Members and managers generally are not personally liable for the obligations of the LLC. S.C. CODE ANN. § 33-44-303 (West Supp. 2004). As with statutory close corporations, the LLC Act provides that an LLC's failure to observe usual company formalities is not a ground for imposing personal liability on its members or manages. S.C. CODE ANN. § 33-18-250 (Law Co-op. 1990). Thus, LLCs in theory are protected against liability theories

analogous to veil piercing in the corporate context. However, as noted above, at least one South Carolina case in the corporate context indicates that this type of statute does not fully protect against the failure to observe formalities in a veil piercing analysis. *See* Hunting v. Elders, 597 S.E.2d 803, 807 (S.C. Ct. App. 2004). Thus, even though the LLC Act does not require formalities like the Corporate Code, it may be advisable to have your clients hold regular meetings, keep minutes and observe other traditional corporate formalities.

A member may transfer its interest in distributions made by the LLC, but has no right to transfer any other membership rights. S.C. CODE ANN. §§33-44-501(b), -502 (West Supp. 2004). In the event of such a transfer, the transferee only obtains the right to receive distributions and does not receive any rights to vote or otherwise participate in any management unless the other members agree to admit the transferee as a member. *See* S.C. CODE ANN. §§ 33-44-502, -503 (West Supp. 2004).

As a default, single-member LLCs are disregarded for tax purposes, and the member reports and pays taxes at the individual level on the profits of the LLC. LLCs with multiple members are taxed like a general partnership. An LLC can elect to be taxed as a corporation. A tax professional should be consulted to determine what form of taxation would be most advantageous for each client.

There are no annual filings or other maintenance obligations required of an LLC except with respect to business licenses and similar items.

Conclusion

There are many for-profit business options available in South Carolina, each with its own advantages and disadvantages. None of the options described above will be the right choice for every client. As a result, understanding at least the basics of choice of entity is important to help you guide each client to its best option.

	Sole Proprietorship	**General Partnership**	**Limited Partnership**	**Limited Liability Partnership**	**Business Corporation**	**Limited Liability Company**
Filings to Create	None	None	Certificate of Limited Partnership	Application for Registration	Articles of Incorporation	Articles of Organization
Limited Liability	No	No	Only for limited partners	Only for tort liabilities	Yes	Yes
Term of Existence	Not perpetual	Not perpetual	May be perpetual	Not perpetual	Perpetual	Perpetual, unless otherwise provided in Articles of Organization
Management Rights	Proprietor has sole right to manage business	Partners have equal rights unless modified by agreement	General partner manages business; limited partners have limited control	Partners have equal rights unless modified by agreement	Directors and officers manage business	Members have equal rights if member-managed, unless modified by agreement; managers manage business if manager-managed
Rights to Profits and Losses	Proprietor has sole right to profits and losses	Partners share equally unless modified by agreement	Partners share in proportion to value of contributions unless modified by agreement	Partners share equally unless modified by agreement	Shareholders have rights to distribution of profits if and when made by corporation	Members share equally unless modified by agreement
Taxation on Profits	Proprietor pays all taxes	No entity level tax; each partner taxed at individual level	No entity level tax; each partner taxed at individual level	No entity level tax; each partner taxed at individual level	Corporation pays tax (unless S-Corporation); shareholders pay taxes on distributions	As a default, no level entity tax—each member taxed at individual level; can elect to be taxed at entity level
Transferability of Interests	Not transferable	May transfer only rights to distributions unless modified by agreement	May transfer only rights to distributions unless modified by agreement	May transfer only rights to distributions unless modified by agreement	Transferable (although corporations generally impose restrictions)	May transfer only rights to distributions unless modified by agreement
Annual Corporate Filings	None	None	None	Annual registration with SC Secretary of State	Annual report to SC Department of Revenue	None
Governing Statutes	None	S.C. CODE ANN. §33-41-10 et seq.	S.C. CODE ANN. §33-42-10 et seq.	S.C. CODE ANN. §33-41-10 et seq.	S.C. CODE ANN. §33-1-101 et seq.	S.C. CODE ANN. §33-44-101 et seq.