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Understanding Alaska Business Entities

The organizer of a new business has a wide variety of legal forms to choose from in implementing the new venture. A similar choice must often be made when organizing a vehicle to be used for investment (i.e., a passive activity rather than an operating business). The organizer must carefully analyze the available options and determine which business form is the most appropriate for the new (or restructured) enterprise.

The basic forms of business entities include the following:

(1) a sole proprietorship;
(2) a joint venture;
(3) a general partnership;
(4) a limited partnership (or "LLP");
(5) a limited liability partnership;
(6) a limited liability limited partnership;
(7) a limited liability company (or "LLC");
(8) a regular (or "C") corporation; and
(9) a tax option (or "S") corporation.

Sole Proprietorship

A sole proprietorship is a business conducted in one owner's individual capacity without the organization of a separate legal entity for holding and conducting the business. The business owner merely utilizes a certain portion of his or her directly owned assets for business purposes.

Since no separate entity exists, no separate income tax return is required for a sole proprietorship. Rather, the owner of the sole proprietorship reports the income from that activity directly on the owner's federal income tax return. Although no separate entity exists, the proprietor may adopt a business name under which the business is conducted. The business name should be registered with the State of Alaska.

Joint Venture

A joint venture is a form of temporary entity organized to carry out a particular business enterprise for profit. Often the joint venture is terminated as of the conclusion of that specific project. The joint venture is thereby differentiated from a partnership or a corporation which is organized to carry on one or more businesses for an indefinite period.

The joint venture is often (but not always) organized in partnership form. Sometimes a corporation or LLC jointly owned by two or more shareholders is called a "joint venture" when created for the completion of a specific project.

General Partnership

A general partnership is an association of two or more persons who organize as co-owners to carry on a business for profit. "Persons" for this purpose can include individuals, other partnerships, corporations, limited liability companies, and other associations. For this purpose, a "business" includes investment, trade, occupation, or profession.

As defined for federal income tax purposes, a "partnership" includes a syndicate, group, pool, joint venture, or unincorporated organization through, or by means of which, any business, financial operation, or venture is carried on, and which is not, for federal income tax purposes, a corporation, trust, or estate. The IRS may, at the election of all partners, exclude the organization from the application of the income tax partnership provisions if the organization is for investment purposes only (not for the active conduct of a business) and for certain other narrow purposes. If the partners so elect, the partnership need not file an income tax return.

For Alaska state law purposes, a partnership is recognized as an entity which is separate from its partners. For example, the assets of a partnership are treated as belonging to a business entity and are considered to be separate and distinct from the individual assets of its partners. Title to property, particularly real estate, may be acquired by a partnership in the name of the partnership. Alternatively, title to real property can be held in the name of a partner on behalf of a partnership.

A partnership is managed by its partners and the partners may appoint one or more partners to serve as managing partners to have the primary management responsibility. Ostensibly, however, all partners can act on behalf of the partnership.

No limitations are imposed on the number of partners. Any individual, or entity, including domestic and foreign persons, trusts, estates, corporations, and other partnerships, may be a partner in a partnership. This includes an S corporation as a possible partner.

Limited Partnership

A limited partnership is a partnership formed by two or more persons under Alaska's limited partnership laws. The partnership must have one or more general partners and one or more limited partners. The general partner is personally liable for debts of a partnership, but the limited partners generally have no personal liability. Because the limited partnership statute requires that at least one partner be a general partner, an alternative business format may be the organization of a limited liability company or a limited liability partnership which limits the liability of every owner of the entity.

A limited partnership must substantially comply with the requirements of the Alaska Revised Limited Partnership Act. If the partnership complies, the liability of a limited partner for the partnership debts or obligations is limited to the extent of the capital which that partner has contributed or agreed to contribute. The general partner remains personally liable, however, for the debts of the partnership. A corporation may function as the general partner.

The *family limited partnership* is a limited partnership used in a special context. The family limited partnership (or "FLP") is a name given to those limited partnerships which are often organized for estate planning purposes. Organized as a limited partnership, the objective on an FLP is to transfer limited partnership interest in the partnership to younger generation members (or trusts for those younger generation members). Upon this transfer, the position is taken that, for federal gift tax purposes, the partnership interest has a depressed value because of its illiquid nature. Further, the fact that the transferor does not own the transferred partnership interest at the time of his death enables his estate to avoid the inclusion of the value of that partnership interest in his estate for federal estate tax purposes. The transferor can still control the management of the partnership property, acting as the general partner.

Limited Liability Partnership

The search for possible relief from liability by professional practitioners (e.g., doctors, accountants, lawyers, etc.) has encouraged states, including Alaska, to enact "limited liability partnership" (LLP) provisions to facilitate an alternative form of doing business. The LLP follows the basic structure of a general partnership but has unique features which allow partners to benefit from partial limited liability. This form of business may be appropriate for any partnership which cannot operate as a limited partnership (thus attaining limited liability for the limited partners) because of the active conduct of the partners in the business.

In a LLP, partners often remain personally liable for their own wrongful acts and the acts of those whom they directly supervise, but their personal assets are protected from claims involving the wrongful acts of another partner. Creditors and others, however, still have recourse against partnership assets.

Limited Liability Limited Partnership

A limited liability limited partnership is a limited partnership providing traditional limited liability to the limited partners. This form of entity also provides, however, limited liability to the general partners to the same extent permitted to a partner of an LLP.

Limited Liability Company

An important development in the choice of entity context in the 1990s has been the availability of the limited liability company (LLC) format. Alaska passed its LLC enabling legislation in 1994. An LLC is a hybrid entity which provides insulation from liability to the same extent as a corporation. Ordinarily, the LLC is treated as a partnership for federal tax purposes, and provides its members with the option of participating directly in the management of the business or designating certain members or non-members as managers. The combination of the protection for all owners from personal liability for the obligations of the entity, coupled with favorable pass-through federal income tax treatment, has spurred the enactment of LLC legislation in almost every state.

The LLC is an alternative to an S Corporation. Prior to the emergence of LLCs, taxpayers seeking to combine corporate limited liability with pass-through tax treatment were limited to the use of the S corporation. LLCs afford more flexibility, however, than S corporations in several respects:

- Unlike S corporations, which may have only 75 shareholders, an LLC may have an unlimited number of members.

- Certain taxpayers are prohibited from holding stock in an S corporation, but no similar restriction applies to LLCs.

- The one class of stock requirements, which may impose a substantial burden on S corporations, does not apply to an LLC. The LLC offers flexibility in specially allocating items of income and deductions pursuant to a partnership approach.

- Like a partnership, an LLC member's proportionate share of indebtedness of the LLC is included in the member's tax basis in the LLC. Consequently, for purposes of the tax basis limitation on deducting allocable entity losses, a member can include the member's share of the LLC's liabilities in determining an allowable loss deduction from activities of the entity. Losses from an S corporation are limited to the shareholder's tax basis in his stock determined without regard to the S corporation's liability.

- Contributions of property to an LLC are governed by the partnership rules, which generally provide that no gain or loss results when a partner (or an LLC member) contributes property to a partnership (or LLC). In contrast, when a shareholder makes a contribution to S and C corporations, the contribution to the corporation is a taxable event to the contributing shareholder, unless the 80% control requirement is satisfied.

- Distributions of appreciated assets from an S (or C) corporation to a shareholder trigger a gain recognition at the corporate level. A partnership (or LLC) realizes no gain on appreciated property distributions.

The primary advantage of an LLC over a partnership is the lack of personal liability of all owners of the business. While limited partners in a limited partnership enjoy similar insulation from liability, the limited partnership must have at least one general partner with personal liability. The alternatives of the limited partnership or the limited liability limited partnership may provide complete insulation in the case of a professional personal service business. The relatively new "check-the-box" tax regulations assure that an LLC organized in Alaska will qualify as a partnership for tax purposes.

LLCs provide more flexibility in the management of the business than do partnerships. If the members so choose, an LLC is permitted to employ decentralized management with the active participation of all members in management. The default under Alaska law if for the LLC to be member-managed, unless the Articles of Organization provide for the LLC to be managed by one or more managers. Unlike partnerships, a severance of management from ownership is possible with an LLC. Managers are not required to be members.

An increasingly popular entity is the single-member LLC. For tax purposes, a single-member LLC is treated as a disregarded entity (i.e., an individual single-member would report the income and expenses from the LLC the same as a sole proprietorship).

Regular (or "C") Corporation

A corporation is an entity created by state law that is separate and distinct from its owners. A corporation in Alaska may be formed only through compliance with Alaska's incorporation statutes. A corporation may be closely-held (i.e., have only one or small number of shareholders) or can be publicly-held (i.e., have a large number of owners with the shares traded on a public market.

A corporation is managed by its directors and officers. The directors and officers do not need to be owners of any shares of the corporation. The directors are elected by the shareholders. The officers are appointed by the directors.

A C corporation is subject to federal income tax separately from its owners. The profits accumulated after payment of corporate level income tax are subject to further federal income tax when those profits are distributed to the shareholders as dividends. For this reason, the extraction of profits from C corporations is generally structured as compensation to the shareholders who work for the corporation. However, the extraction of profits without incurring a second level of tax can be difficult or impossible in many cases.

Tax Option (or "S) Corporation

An S corporation is a special type of corporation for federal income tax purposes that satisfies the qualification requirements of Subchapter S of the Internal Revenue Code. Such a corporation will be organized under the same Alaska corporate law formation requirements as would be a C corporation.

When organized, the S corporation is not specially designated as an S corporation for Alaska state law purposes. The S corporation achieves such status for federal income tax purposes by making a tax election. All shareholders of the corporation must consent to this election. The effect of this election is that the corporation will ordinarily bear no federal income tax consequences at the entity level. All corporate level income will be treated as currently received by (or allocated to) the shareholders without regard to whether that income is actually distributed on a current basis to the shareholders.

In determining a shareholder's income tax liability, the shareholder is treated as in receipt of an allocable share of the S corporation's items of income (including tax-exempt income), loss, deduction, and credit. These items will affect the shareholder's liability for income tax.

To be eligible for S corporation status, the corporation must:

(1) be a domestic corporation;
(2) not be one of a narrow group of "ineligible corporations;"
(3) not have more than 75 shareholders;
(4) not have a shareholder who is not an individual (or certain trusts);
(5) not have any non-resident alien shareholders; and
(6) not have more than one class of stock

The Small Business Job Protection Act of 1996 made several significant changes to the S corporation tax rules. These changes include the elimination of the rule that S corporations cannot own 80% or more of the stock of a C corporation. Under the change, an S corporation can own 100% of the stock of a subsidiary. That corporation, if electing status as a "qualified subchapter S subsidiary," is not treated as a separate taxable entity. Rather, all assets, liabilities, and items of income, deduction, and credit of that subsidiary are to be treated as assets, liabilities, and such items of the parent S corporation.