

### 3.6.1.3. Limited Liability Companies

The **limited liability company (LLC)** is a relatively new form of entity that combines aspects of the corporate form with elements of traditional partnerships, but is different from either. A limited liability company is not a corporation, and LLCs do not issue shares; instead, the owners are *members* of the LLC.

An LLC is formed under state law, and the laws governing limited liability companies vary from state to state. In most states, LLC status is available to most types of businesses, and LLC membership is open to individuals (including resident aliens) as well as corporations, partnerships, and other business entities. Most states allow single-member LLCs, and it is now very common for corporations, including large, publicly held corporations, to form wholly owned LLCs for particular projects or ventures or to own real estate parcels.

Like corporations, LLCs offer limited personal liability to their owners. However, an LLC requires substantially fewer formalities to run than a corporation. (For example, there is no need to hold annual shareholder meetings, elect directors, maintain a minute book, etc.) The IRS does not recognize LLCs as a federal classification, and an LLC may elect to file either as a corporation or as a partnership (or sole proprietorship, in the case of a single-member LLC). This winning combination of limited liability, reduced formality, and tax flexibility has made the LLC a very popular type of business structure.

There are potential downsides to the LLC form. First, because as an entity type it is far newer than the corporation, the law governing LLCs is far less developed, and the legal rights and responsibilities of LLC members are not always clear. (Although it is not required, LLCs typically adopt a detailed operating agreement that sets out the relationships between members.) This legal uncertainty surrounding LLCs also makes it more difficult to raise venture capital. Growth-stage LLCs that are actively courting outside investors often convert into corporations to facilitate investment and make it possible to issue shares.

### 3.6.1.4. Limited Partnerships

**Limited partnerships (LPs)** have become far less common since the advent of the LLC, but they are still used for specific business projects or investment purposes, particularly in the movie industry, real estate development, and oil and gas drilling. A limited partnership has at least one **general partner**, who manages the business and who is personally liable for the liabilities of the LP, and one or more **limited partners**, who contribute capital to the business but are not involved in running it, and whose liability for obligations of the limited partnership is limited to the amount of their contributions. For liability reasons, the general partner is often an LLC, corporation, or other entity with limited liability.

Most states have now adopted the Revised Uniform Limited Partnership Act (RULPA), which sets out the rules for limited partnerships. Unlike a general partnership, which can be formed even if the partners don't intend to form a partnership, a limited partnership must register with the appropriate state authority and may be required to file annual reports. The rights of the partners are governed by a limited partnership agreement, which usually specifies the allocations of profit and loss among the partners. The agreement may also restrict the ability of limited partners to withdraw or to transfer their ownership interests.

Limited partnerships are normally subject to pass-through taxation, like regular partnerships. In some cases, if the limited partnership does not meet certain criteria, it may be taxed at the entity level as a corporation.

Limited partnership interests are considered securities, and are subject to all the registration and associated requirements for the sale of securities. To avoid the need for registration, limited partnership interests are often offered only to accredited investors.

Most limited partnerships are private. **Master limited partnerships (MLPs)**, however, are publicly traded on exchanges and may have hundreds of limited partners, including mutual funds and institutional investors. Qualifying MLPs are not subject to entity-level tax. Unlike many private LP interests, MLP interests are typically freely transferable.

### 3.6.1.5. Trusts

A business trust is an unincorporated business entity that is usually formed to hold real estate, securities, commodities, or other assets for business or investment purposes. The assets are held in trust and managed by trustees on behalf of the beneficial owners. The beneficial owners—investors, in other words—receive transferable certificates showing their interest in the trust assets, and the beneficiaries have limited liability. Business trusts are formed under state law. They are sometimes called Massachusetts trusts or Delaware statutory trusts, even if they are formed in a different state. Trusts can be structured to allow for pass-through taxation.

Many mutual funds and other types of investment companies are structured as trusts. A business trust should not be confused with other types of trusts, such as philanthropic trusts or trusts used for estate planning purposes.

### 3.6.1.6. Real Estate Investment Trusts (REITs)

As you would guess from the name, **Real Estate Investment Trusts (REITs)** are entities that invest in real estate. Much like a mutual fund for real estate, REITs allow individual and institutional investors to invest indirectly without taking direct ownership of the underlying properties.

A REIT is not an organizational structure, but is rather a tax designation available to entities—typically corporations or trusts—that meet certain requirements. The most important of these is the requirement that the entity pay out at least 90% of its taxable income to its investors every year. In addition, at least 75% of the entity's assets must be invested in real estate, and 75% of its gross income must be derived from investments in real estate or mortgages on real property. Ninety-five percent of its gross income must be derived from investments in real estate or mortgages on real property or other investments. There are other requirements relating to the number of shareholders and the concentration of ownership. Assuming the entity meets all IRS requirements, it qualifies as a REIT and can avoid double taxation on income distributed to shareholders. If it does not qualify, it is taxed as a corporation.

REITs typically invest in commercial properties or large developments, such as shopping malls, hotels, office buildings, and multi-family housing. A REIT may concentrate

on a particular type of property or a particular geographical region. REITs may be privately or publicly held; public REITs trade on major exchanges or over the counter.

There are three main types of REITs:

- **Equity REITs** invest directly in real estate and generate income through the collection of rent. This is the most common type of REIT.
- **Mortgage REITs** lend money directly to developers or owners of properties, or invest in securities secured by real estate mortgages. Their income consists of payments of principal and interest.
- **Hybrid REITs** combine the attributes of equity and mortgage REITs. These entities invest directly in real estate and lend money to finance real property transactions.

### 3.6.1.7. Hedge Funds and Private Equity Funds

Although the investment strategies of the two types of funds usually differ, hedge funds and private equity funds are entities formed for the express purpose of pooling capital to make investments and are usually open only to wealthy investors. No organizational structure is unique to hedge funds or private equity funds; for tax reasons, they are usually formed as limited partnerships or LLCs in which the investors are limited partners or members.

Hedge funds may be formed “onshore” (most often in Delaware) or “offshore” in places like the Cayman Islands. Offshore hedge funds may be formed as foreign business corporations.

### 3.6.1.8. Federal, State, and Municipal Governments

Federal, state, and municipal governments are business structures that need no introduction. Except in rare cases, a firm cannot choose to organize as a governmental unit.

Government entities do not issue stock, but they are prolific issuers of bonds.

#### COMMON BUSINESS STRUCTURES

Entity Type	Attributes
<b>C Corporation</b>	<ul style="list-style-type: none"> <li>• Primary organizational structure for large and medium-sized businesses and for publicly held companies</li> <li>• Corporation formed at state level; issues shares of stock to shareholders (owners)</li> <li>• No qualification requirements for shareholders and shares are freely transferable (subject to securities laws)</li> <li>• Shareholders have limited liability for company debts</li> <li>• Unlimited length of existence</li> <li>• Corporations treated as “persons” for many purposes</li> <li>• Subject to <b>double taxation</b>: profits taxed at entity level, dividends are taxable to shareholders</li> </ul>

## COMMON BUSINESS STRUCTURES

Entity Type	Attributes
<b>S Corporation</b>	<ul style="list-style-type: none"> <li>• Not separate type of entity; is corporation that has elected to be taxed on pass-through basis under IRC Subchapter S</li> <li>• Not subject to double taxation: all income and loss passes through to shareholders for tax purposes</li> <li>• Some types of corporations (e.g., banks) ineligible for S corporation status</li> <li>• Shareholders must be individual U.S. residents; corporations, partnerships, non-resident aliens not eligible</li> <li>• 100 shareholders maximum</li> <li>• May only have one class of stock</li> </ul>
<b>Limited Liability Company</b>	<ul style="list-style-type: none"> <li>• Formed under state law</li> <li>• Does not issue shares; owners are members</li> <li>• Members have limited liability for company debts</li> <li>• Requires fewer formalities than a corporation</li> <li>• Can elect either corporate or pass-through taxation</li> <li>• Less established as entity type than corporation; harder to raise venture capital</li> </ul>
<b>Limited Partnership</b>	<ul style="list-style-type: none"> <li>• Used mainly for specific projects in entertainment, real estate, and oil and gas industries</li> <li>• Formed under state law</li> <li>• Managed by at least one <b>general partner</b> with personal liability for limited partnership debts (general partner is often an LLC)</li> <li>• One or more <b>limited partners</b> contribute capital to business, but do not manage the business and have limited liability</li> <li>• Normally subject to pass-through taxation</li> <li>• Limited partnership interests are considered securities</li> <li>• Most limited partnerships are private; <b>master limited partnerships</b> (MLPs) are publicly traded</li> </ul>
<b>Trust</b>	<ul style="list-style-type: none"> <li>• Unincorporated business entity formed under state law</li> <li>• Usually holds assets for business or investment purposes; managed by trustees on behalf of investors</li> <li>• Ownership represented by certificates; owners have limited liability</li> <li>• Can be structured to allow for pass-through taxation</li> <li>• Many mutual funds and other companies structured as trusts</li> </ul>
<b>Real Estate Investment Trust (REIT)</b>	<ul style="list-style-type: none"> <li>• Not an entity type; is a tax designation available to a business entity (e.g., corporation or trust)</li> <li>• Must invest at least 75% of assets directly or indirectly in real estate</li> <li>• Must derive at least 95% of gross income from real estate or other investments</li> <li>• Must pay out at least 90% of taxable income to investors each year</li> <li>• If IRS requirements met, qualify for pass-through taxation</li> <li>• May be privately held or publicly traded</li> </ul>