

SPECIAL TYPES OF BUSINESS ORGANIZATIONS

S CORPORATIONS

Both “S” and “C” corporations are created by filing articles of incorporation with the Secretary of State, after which the shareholders must decide whether to treat the corporation as an S corporation or as a C corporation for tax purposes. An S corporation is a corporation which meets Internal Revenue Service criteria for tax treatment as an S corporation rather than as a C corporation, and whose shareholders unanimously choose to be so treated. An S corporation is subject to the provisions of Subchapter S of the Internal Revenue Code, whereas C corporations are taxed under Subchapter C of the Internal Revenue Code. A corporation that has a valid election to be taxed as an S corporation for federal purposes is also an S corporation for Minnesota tax purposes.

The S corporation is subject to the taxing provisions in much the same manner as a partnership, i.e., the S corporation files an information tax return, Form 1120S, to report its income and expenses, but it is not separately taxed. Income (including, if certain requirements are met, capital gains) and expenses of the S corporation flow through to the shareholders in proportion to their shareholdings, and profits are taxed to the shareholders at the shareholders’ individual tax rates. For Minnesota purposes, the S corporation also pays a minimum fee, based on its Minnesota-sourced property, payroll and sales. See the Tax Rates section of the the Minnesota Small Business Assistance Office publication, *A Guide To Starting A Business In Minnesota*.

By contrast, the C corporation is a separate taxable entity. The C corporation reports its income and expenses on a corporation income tax return and is taxed on its profits at corporation income tax rates. Profits are taxed to the C corporation before dividends are paid. Dividends are taxable income to the shareholders. By choosing S corporation status, all of the income is taxable income to the shareholders whether or not it is distributed to the shareholders as income.

An S corporation is defined by statute as a domestic corporation (i.e., a corporation organized under the law of one of the states of the United States) which:

- Does not have more than 100 shareholders;
- Does not have any non-individual shareholders (other than estates, certain trusts, and certain tax exempt entities);
- Does not have a nonresident alien as a shareholder, and
- Does not have more than one class of stock.

Certain corporations by statute are ineligible for S corporation status. If the corporation qualifies for S corporation status, the shareholders must formally choose to be so treated for tax purposes. This is accomplished by filing Form 2553 with the Internal Revenue Service on which all shareholders consent in writing to have the corporation treated as an S corporation. The election must be made in a timely manner, as prescribed by the Internal Revenue Service.

The election is valid for the taxable year for which it is made, and for all succeeding taxable years of the corporation, until the election is terminated. Statutory procedures determine how the termination is accomplished. In general, S corporation status is terminated when it is revoked by vote of the shareholders, or when the corporation no longer meets the statutory criteria for S

corporation status. S corporation status also may be terminated when passive investment income (income from interest, rents, royalties, dividends and the like) exceeds a certain statutorily defined threshold.

Because of the possibility that S corporation status may be inadvertently terminated, persons planning to establish an S corporation are strongly encouraged to consult in advance with legal and tax counsel in order to properly structure the corporation and its capitalization. In some cases, formation of a limited liability company, rather than an S corporation, may better suit the owners' business and tax objectives. See the discussion of limited liability companies in the sections of the *Guide* titled Choosing the Form of Business Organization and Forming a Minnesota Limited Liability Company.

PROFESSIONAL ENTITIES

The Minnesota Professional Firms Act, Minn. Stat. § 319B, authorizes practitioners of certain licensed professions to elect to be professional firms under any one of three different forms of organization: corporations (either for-profit or nonprofit); limited liability companies; and limited liability partnerships. In the absence of the Minnesota Professional Firms Act and its predecessors, members of such professions would not be able to practice under these forms of organization because the ethics rules of their respective licensing boards prohibit organizing in a way that limits the professional practitioner's professional liability towards clients. The Minnesota Professional Firms Act does not affect a practitioner's liability for her or his own malpractice or other wrongful conduct directly arising from the rendering of professional services, but permits the professional to have limited liability for debts or obligations of the business itself to the extent that the generally applicable governing law for the chosen form of organization permits.

Professional firms are subject to the law under which the entity has been formed as well as the Professional Firms Act which contains additional restrictions; where the two conflict, the Professional Firms Act will control. Members of the professional firm are also subject to the laws, regulations and licensing requirements of their respective licensing boards.

In order to practice a profession in any form other than sole proprietorship or general partnership, professionals must comply with the Professional Firms Act, except as the rules of the respective licensing board provide otherwise.

Members of the following professions may elect to be professional firms: medicine and surgery; chiropractic; registered nursing; optometry; psychology; social work; marriage and family therapy; dentistry and dental hygiene; pharmacy; podiatric medicine; veterinary medicine; physician's assistants; architecture; engineering; surveying; landscape architecture; geoscience; certified interior design; accountancy; and law.

In order to operate as a professional firm, a Minnesota entity must first be formed under the chosen statute: the Minnesota Business Corporation Act (Minn. Stat. § 302A); the Minnesota Nonprofit Corporation Act (Minn. Stat. § 317A); the Minnesota Limited Liability Company Act (Minn. Stat. § 322B); or the Minnesota Limited Liability Partnership Act (Minn. Stat. § 323A). An existing non-Minnesota entity wishing to practice a profession in Minnesota should register under the Minnesota Foreign Corporation Act (Minn. Stat. § 303) or the foreign registration provisions of the Limited Liability Company or Limited Liability Partnership Acts.

Then, either as an addendum to the original documents of formation for the entity or as a later amendment or update to those documents, the firm must file with the Secretary of State language stating:

- that the firm elects to be covered by the Minnesota Professional Firms Act (Minn. Stat. §, sections 319B.01 to 319B.012);
- that the firm acknowledges that it is subject to those sections; and
- specifying from the list of professions set forth above the profession or professions to be practiced by the firm.

A non-Minnesota firm must state in addition to the above that to the extent that its generally applicable governing law differs from or conflicts with Minn. Stat. §, sections 319B.01 to 319B.12, that it has made the necessary changes to the agreements and other documents controlling its structure, governance, operations and internal affairs so as to comply with those sections.

Such a filing constitutes an election to be a professional firm. These entities may rescind such elections, may again elect professional status, and may change the designated practiced profession freely, subject to the regulations of the appropriate governing board(s).

Health professionals (including medicine and surgery; chiropractic; registered nursing; optometry; psychology; dentistry and dental hygiene; pharmacy and podiatric medicine) are specifically authorized to practice in the same professional firm; others should consult their licensing boards for further information on whether joint practices are permitted. Where they are not, a professional firm can provide only those professional services listed in the election described above.

The name of a professional firm which is a corporation must include one of the following designations or abbreviations; Professional Corporation, Professional Service Corporation, Service Corporation, Professional Association, Chartered, Limited, P.C., P.S.C., S.C., P.A., or Ltd.

The name of a professional firm which is an LLC must include Professional Limited Liability Company, Limited Liability Company, P.L.L.C., P.L.C., or L.L.C.

The name of a professional firm which is an LLP must include Professional Limited Liability Partnership, Limited Liability Partnership, P.L.L.P. or L.L.P.

The internal governance of professional firms is governed by the same statutes that apply to non-professional firms. For example, a professional LLP and a non-professional LLP are bound in virtually all respects by the same statutes. The only difference is that the professional LLP may provide professional services as listed above and the non-professional LLP may not.

NONPROFIT CORPORATIONS

A Minnesota nonprofit corporation is defined by statute as a corporation which:

- Is formed for a purpose not involving pecuniary gain to its members (other than members that are nonprofit organizations or governmental units), and
- Pays no dividends or other pecuniary remuneration, directly or indirectly, to its members as such (other than to members that are nonprofit organizations or governmental units).

Thus, a business corporation (regardless of whether it actually makes a profit) cannot be a nonprofit corporation because a primary purpose of every business corporation is to remunerate its shareholders.

A nonprofit corporation may be formed under the Minnesota Nonprofit Corporation Act, Minn. Stat. § 317A, for any lawful purpose, unless another statute requires incorporation for a different or specific purpose. The nonprofit corporation is managed by a board of directors, which must consist of at least three individuals. The nonprofit corporation must have at least two officers, a president and a treasurer. One person may perform both of these functions. The Minnesota Nonprofit Corporation Act does not apply to cooperative associations, public cemetery corporations and associations, and private cemeteries. Religious corporations may be formed under the Minnesota Nonprofit Corporation Act or under the Minnesota religious corporation statute, Minn. Stat. § 315. Nonprofit corporations are required to file an annual registration with the Secretary of State once each calendar year, on a registration form mailed to the corporation's registered office address. Failure to file in a calendar year will result in statutory dissolution, but non-profit corporations may be reinstated at any time upon filing the annual registration. The registered office address may be updated without charge.

A nonprofit corporation may qualify for tax exempt status for some or all of its income, for federal or state tax purposes, or both. Donors to the tax exempt organization may qualify for a tax deduction on their contributions to the organization. Application for tax exempt status must be made with the Internal Revenue Service and the exemption must subsequently be established with the Minnesota Department of Revenue. Additional specific language may be required in the articles of incorporation by the Internal Revenue Service before an application will be granted. Annual federal and state informational filings also are required, and if the organization solicits funds in Minnesota, it also must register with the Charities Division of the Minnesota Attorney General's office. The formation and tax treatment of nonprofit corporations are highly technical areas which should not be attempted without competent advice from qualified professionals. See also www.irs.gov, charities and non-profits.

Forms for nonprofit corporation filings are available at the Secretary of State's website at www.sos.state.mn.us/index.aspx?page=331, and is also available by mail from that office.

COOPERATIVES

A cooperative is a form of business organization in which the business is owned and controlled by those who use its services. A cooperative may be organized as a legal entity or it may be an unincorporated association. Cooperative associations are organized as legal entities under and governed by Minn. Stat. § 308A. Non-Minnesota cooperatives that wish to do business in Minnesota register under Minn. Stat. § 303.

Cooperatives are organized primarily for the purpose of providing service to their user-owners, rather than to generate profit for investors. Although cooperatives had their origins in Minnesota in the agricultural sector, in recent years many consumer cooperatives have been established. Some of the more common purposes for which cooperatives are formed are:

- To supply members with agricultural production components such as fuels, fertilizers, feed and chemicals;

- To provide members with an organizational structure for jointly handling and marketing their products;
- To provide services to members, like housing, electricity, telephone, insurance, and health care.

Cooperatives have several features that distinguish them from for-profit business corporations. These include control of the cooperative by user-owners, services provided at cost, and limited return on equity capital.

Cooperatives are required to file an annual renewal once each calendar year. Failure to file this registration will result in dissolution. The cooperative will have one year to reinstate by filing the registration and paying a \$25 fee.

User-owner Control

Cooperatives are owned and controlled by their members. By statute in Minnesota, members each have one vote, rather than multiple votes based on their capital investment in the cooperative. In some other states, proportional voting based on a member's volume of business with the cooperative is allowed. Operations generally are conducted by a board of directors elected by members, and by management hired and supervised by the board.

Service at Cost

Cooperatives stress providing services to members at the lowest responsible cost. After setting aside reserves to protect the cooperative's financial security and growth, any remaining net margin is distributed to members as a patronage refund, according to the business volume each has done with the cooperative during the year.

Limited Return on Equity Investment

Cooperatives are designed primarily to provide services to members, rather than to produce a profit for investors. Accordingly, the return on investment in the form of dividends is limited. Minn. Stat. permit, but do not require, the payment of dividends on capital stock. Dividends may be paid only when the net income of the cooperative for the previous fiscal year is sufficient, and dividends may not be cumulative.

New Investors

In an effort to encourage capital investment, all forms of cooperatives in Minnesota are allowed to take on investor-members in addition to the traditional patron-members. Investor members may not necessarily purchase products from the cooperative but join the cooperative to earn a profit from an investment and to provide capital funds for cooperative expansion. In allowing for investor-members, the law largely combines portions of the traditional cooperative statute with portions of the limited liability statute.

FRANCHISES

A franchise is an agreement or contract between two or more persons by which the franchisor, for a fee, gives the franchisee the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trademark, servicemark, logotype, advertising, or other commercial symbol. Both the franchisor and the franchisee must have a community of interest in the marketing of the goods or services.

Franchising is a method of distributing and marketing goods or services. It is not a separate form of business organization. The franchisor's business and the franchisee's business each will take one of the forms of organization previously discussed.

Franchises are regulated in Minnesota by the Department of Commerce, and anyone contemplating the sale of a franchise should check with that office for registration and filing requirements and exemptions that may apply. Regulatory requirements applicable to franchises are discussed further in the section of the *Guide* on Franchise Registration.