

STARTING AN INVESTMENT ADVISER

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A financial professional who has decided to go into the advisory business must select the form of organization the business will take. Should the business be conducted through a legal entity? If a legal entity, what kind – corporation, LLC or business trust?

Answers to these and other questions must be made carefully, as they will impact the operation of the financial adviser many years after it is formed. Careful planning at this stage can protect the financial professional's personal assets from creditors of the business, reduce the taxes of the business, and avoid disharmony between the financial professional and his business partners. The formation of the investment adviser is the subject of this White Paper. After reading this paper, we encourage you to become a subscriber of <http://www.moneymanagerservices.com> to learn more about the topics discussed in this paper and other topics of interest to investment advisers.

WHETHER TO FORM A LEGAL ENTITY

A threshold issue for a financial professional is whether to immediately go into business as a sole proprietorship or to undertake the time and expense to set up a legal entity. One can start a sole proprietorship merely by commencing to engage in business. It is not necessary to draft any papers or file documents with a state or local agencies. As a sole proprietor, the financial professional receives all of the profits generated by the business. He or she, however, is personally liable for all of the debts, taxes and other liabilities of the business. If the sole proprietor elects to hire employees, the owner of the sole proprietorship is liable for all of the debts and liabilities incurred by employees of the sole proprietorship created in the course and scope of their employment.

Advantages of a Sole Proprietorship:

1. Easy to Start: Minimal filings necessary to commence operations --- documents filed to register with the SEC or a state securities commission and to register a fictitious business name entity with a local agency;
2. Easy to Dissolve: No filings are necessary to dissolve the business (except a Form ADV-W with the SEC or a state); and
3. Governance: The organizational structure is simple; the owner is boss.

Disadvantages of a Sole Proprietorship

1. Liability: The owner of the business has unlimited personal liability for the debt of, or legal judgments against, the business;
2. Tax: A sole proprietor generally has less flexibility compared to legal entities in managing his or her tax liability; and
3. Succession: When the owner dies, the sole proprietorship automatically terminates.

Corporations, LLCs, partnerships, and business trusts are the principal types of legal entities. A legal entity is regarded in law as having a personality and existence distinct from that of its owners. Like a person, a legal entity can enter into contracts, sue and be sued, and own, purchase and sell assets. The primary reason why a financial professional conducts his or her business through a legal entity is to protect his or her personal assets (e.g., house, automobile and investments) from the creditors of the business. For this reason alone, it is highly recommended that a financial professional set up a legal entity before engaging in the financial advisory business.

TYPES OF ENTITIES

A financial professional forming an investment adviser entity has the option of setting up one of four types of entities: a corporation, limited liability company, partnership or business trust.

CORPORATION

A corporation is the traditional type of business entity form. It consists of tangible assets (e.g., its office), intangible assets (e.g., cash), and three types of persons – directors, officers and shareholders. When forming a corporation, the initial step is to decide whether it will be a C corporation or an S corporation. C corporations and S corporations are identical in every respect, except for their tax status. The “C” in Corporation and the “S” in S corporation are tax designations under the Internal Revenue Code.

If the financial professional elects to operate his or her business through a C corporation, the business will be taxed as a corporation. This means that the income of the C corporation is first taxed at the corporate-level and then it is taxed again when it is distributed to the shareholder at the rate of the particular shareholder’s tax bracket. This “double-taxation” is the principal drawback of forming a financial professional as a C corporation.

If the financial professional elects to operate his or her business through a S corporation, the business will be taxed as a partnership. This means that income and distributions from the S

corporation will flow through to the shareholders without being subject to tax at the corporation level. Such income and distributions (irrespective of whether the S corporation actually made the distributions) are reported on the shareholder's personal tax return.

Unlike a C corporation, a corporation electing S corporation tax treatment is subject to a number of Internal Revenue Code restrictions. A S corporation may not have more than 75 shareholders. It also generally may issue only one class of shares. Financial professional should consult with his or her accountant or adviser to choose the tax status that will result in the most favorable tax treatment of the profits earned by the advisory business.

Corporation Advantages

1. High Insider Ownership: If it is expected that many shareholders will be officers and employees, it may be preferable from a tax standpoint to organize as a C corporation since corporate profits distributed in the form of employee salaries and bonuses will be only subject to a single level of taxation;
2. High Profit Build-Up: If the financial adviser is likely to be profitable and expects to allow the profits to accumulate rather than to distribute them frequently to shareholders, the financial professional may receive more favorable tax treatment if it organizes as a C corporation; and
3. Going Public: If the financial adviser hopes to make an initial public offering (IPO) in the near future, it should organize itself as a C corporation since S corporations are unable to make IPOs.

C Corporation Disadvantages

1. Double Taxation: Income earned by a C corporation is taxed when the corporation earns it and taxed again when the income is distributed to shareholders; and
2. Personal Holding Company Tax: A C corporation is subject to a special tax called the personal holding company tax (PHC tax). The PHC tax is imposed on undistributed personal holding income. If 60% or more of the gross income of the corporation consists of PHC income, then the undistributed income is taxed at a rate of 39.6%.

S Corporation Advantages

1. No Double Taxation: It is taxed on one level, similar to a partnership; and
2. Low Inside Ownership: If the financial professional expects that only a few shareholders will be officers and employees, it may be preferable from a tax standpoint to organize as a S corporation. This is because it is more difficult for a C corporation to avoid double taxation by distributing its profits to a small number of employees in the form of salaries and bonuses.

S Corporation Disadvantages

1. Restrictions: To be eligible for pass-through tax treatment, a S corporation must comply with a number of Internal Revenue Code restrictions (including the 75 shareholder limit); and
2. Profit Build-Up: If the financial adviser is likely to be profitable and the adviser desires to allow the profits to accumulate, the S corporation form should not be chosen since the Internal Revenue Code requires a S corporation to distribute its profits annually to shareholders.

A shareholder's potential liability for debts incurred by the corporation is limited to his or her investment in the corporation. Creditors of a corporation may not sue the directors, officers or shareholders of the corporation, even if the assets of the corporation are insufficient to pay the debt owed to the creditors. Creditors are limited to the assets of the corporation. Corporate directors and officers, however, will have personal liability in connection with actions they take on behalf of the corporation.

LIMITED LIABILITY COMPANY

A limited liability company (LLC) is a type of business entity form with some characteristics that resemble a corporation and other characteristics that resemble a partnership. The LLC consists of property and a single type of owner, who is called a "member." Members are the equivalent of shareholders of a corporation or limited partners of a limited partnership in that they own an economic interest in the LLC. Unlike limited partners, members (called "manager members") can be officers of the LLC and can manage and control the LLC. Unlike a corporation, an LLC is not required to have a board of directors. Some states require an LLC to have two members; other states permit a one-member LLC. The flexibility of an LLC makes it an attractive form of organization for a financial professional.

LLCs, like S corporations, are taxed as partnerships. This means that the LLC does not pay taxes on its income. Instead, the LLC's income flows through to its members, who report the income on their personal tax returns. Before deciding to form a LLC, a financial professional, in consultation with his or her accountant or tax adviser, should weigh the tax consequences of forming an LLC versus a C corporation.

The most attractive feature of an LLC is that all of its members, including manager members, are not liable for the debts and obligations of the LLC. This is in contrast to a general partner of a limited partnership who is personally liable for partnership debts.

PARTNERSHIP

A partnership is an association of two or more persons who have agreed to form and carry on a business for profit. Two kinds of partnerships exist: a general partnership and a limited partnership.

A general partnership springs into existence when two or more persons agree to form a business. In many states, this agreement does not have to be memorialized in writing. Other states require the filing of a certificate that contains a statement that the partners are going to operate a business as partners, and lists the names and addresses of the partners. In the case of a general partnership, each partner can perform all acts that are necessary to operate the business. Each partner can independently hire employees and spend and borrow money. Each partner may also legally bind the partnership.

A limited partnership is created when the partners file the appropriate documents with a state agency. The filing requirement, in the view of the government, is necessary because the limited partners of the limited partnership are not personally liable for partnership debts.

A limited partnership must have at least one general partner. The other partners may be limited partners. The general partner manages the partnership's affairs. Each general partner has the power and authority to bind the limited partnership. The other partners (limited partners) cannot take an active role in the affairs of the partnership without the risk of losing their limited liability status. For example, a limited partner may not sign a lease or borrow money in the name of the limited partnership.

General Partnerships vs. Limited Partnerships		
	<u>General Partnership</u>	<u>Limited Partnership</u>
Legal Entity	No	Yes
Two Classes of Partners	No	Yes
Partner Limited Liability	No	Yes (Limited Partners)
State Filing	No	Yes
Flow-Through Tax Treatment	Yes	Yes

General partnership and limited partnerships are taxed as partnerships. Assuming the partnership complies with certain Internal Revenue Code provisions and Treasury regulations, the partnership will not be taxed at the entity-level. Rather, each partner reports income from the partnership on his or her individual tax return.

Limited Liability Partnership
<p>A limited liability partnership (LLP) is a type of partnership available for professionals such as accountants, attorneys and doctors. In a LLP, one professional partner is not liable for the debts and liabilities incurred by another professional partner caused by that partner's malpractice. However, a professional partner remains liable for the debts and liabilities as a result of his or her malpractice and losses that arise from employees under his or her supervision. A LLP is a form of partnership generally not available to financial professionals.</p>

One of the least attractive features of the general or limited partnership form, from the perspective of a financial professional, is that each of the managers (i.e., the general partners) will be personally liable for all of the debts of the partnership. State laws governing limited partnerships expressly limit the personal liability of each limited partner to his capital contribution. Thus, the limited partner is not liable for his or her pro rata share of the debts and

obligations of the limited partnership. An investor's protected status as a limited partner will be lost if he or she actively participates in the management of the partnership or controls the partnership.

Limited partnership form is not a popular choice for most financial adviser entities. Financial advisers organized as corporations or LLCs, however, frequently form a limited partnership when they desire to manage client assets through an investment vehicle (such as a hedge fund). In that case, the financial professional forms two entities. The financial adviser is a corporation or LLC. The investment vehicle is the limited partnership. The corporation or LLC is the general partner of the limited partnership and the clients of the financial professional (investors) are the limited partners. The limited partnership structure is attractive for investing clients because their liability is limited to the amount of their investment.

BUSINESS TRUST

A business trust is a relatively new business form that is rapidly becoming popular. A business trust is an unincorporated association that is created by a trust instrument and the filing of a declaration of trust with the appropriate state agency. The business trust consists of property, the trustee(s) and the beneficial owners. The title to the property of the trust is held in the name of the trustee for the benefit of the beneficial owners.

The business trust form is extremely flexible. The trustees and beneficial owners can participate in the management of the business or have limited roles. However, one drawback of the business trust form is that, in most cases, at least one trustee must be a resident of the state where the trust is formed. A business trust can be structured so that it is taxable as a corporation, partnership or trust. Thus, trustees and beneficial owners of a business trust can avoid double taxation on the income and other distributions of the trust.

Trustees and beneficial owners are not liable for the debts of the business, even if they participate in the management of the business trust.

SELECTING THE FORM OF ENTITY

After reviewing each of the types of business entity described above, the financial professional must choose the best form of entity for its advisory business. The primary questions a financial professional should ask when selecting a type of entity to form is which type of entity will: (1) minimize the personal liability of the financial professional, (2) result in the financial professional receiving the most favorable tax treatment, and (3) allow the financial professional to structure the ownership in a manner that preserves the financial professional's control over the business.

After considering the advantages and disadvantages of each form of entity, many financial professionals are most attracted to the LLC form. Unlike partnerships, the personal assets of both the managers and investors are protected from creditors of the LLC. Unlike C

corporations, a LLC is not subject to double taxation. Unlike a C corporation or S corporation, an LLC has maximum flexibility in structuring its business.

			Comparison of the Legal Entities			
	C Corporation	S Corporation	LLC	General Partnership	Limited Partnership	Business Trust
Limited Liability	Yes	Yes	Yes	No	No for GPs Yes for LPs	Yes
Flow-Through Taxation	No	Yes	Yes	Yes	Yes	Yes
Owner Limitations	No	Yes	No	No	No	No
Flexible Governing Documents	No	No	Yes	Yes	Yes	Yes
Indefinite Existence	Yes	Yes	No	No	No	Yes
Multiple Classes of Interests	Yes	No	Yes	Yes	Yes	Yes

NAMING THE BUSINESS

Before settling on any particular name, the financial professional should make sure that the name is available. The financial adviser's name must be distinguishable from other businesses organized or qualified to do business. If a name is not available, the state agency will reject the financial professional's filing of the organizational document (e.g., an articles of incorporation).

The financial professional should preclear the proposed name with both the office of the Secretary of State of the state where the financial adviser will be formed and the state where the financial adviser will be located (if different from the state of formation). The financial professional should also contact the SEC and the state securities commissioners (of the states where its clients are located) to check whether any other financial adviser has the same name or a similar name. The SEC or a state securities commissioner may reject a financial adviser's application for investment adviser registration if it has a name that is substantially similar to an existing registrant.

Reserving the Name

During the organization process, a financial professional should consider reserving the proposed name for the financial advisory business. Many states permit a person, for a fee, to reserve a business name for a period of time prior to the filing of any organizational documents.

Even if the applicable states and the SEC inform the financial professional that the proposed name is available, the financial professional still may be unable to use the name if the name is protected by a trademark. Therefore, the financial professional should conduct a trademark search to make sure that the proposed name does not infringe on any company's trademark. Inexpensive trademark search services are available on the Internet. If a financial professional desires to conduct a comprehensive trademark search, it should contact an intellectual property or patent attorney.

The financial professional may also desire to have its name appear in its Internet address – e.g., www.xyzadvisers.com. A financial professional can easily check the availability of domain names by performing a search on the web site of a company that registers domain names (e.g., www.networksolutions.com).

WHERE TO FORM THE ENTITY

Once a financial professional decides upon a type of entity, he or she must decide where to form the entity. The entity that will carry on the business operations can be formed in the state where the operations will take place or in any other state. Why not just form the entity in the state where the adviser and its personnel will be physically located? This is certainly an option. However, a financial professional should consider forming the business in certain other states, particularly the State of Delaware.

ADVANTAGES OF HOME STATE:

1. Single Filing: Only a single filing need be made, as compared to two filings for a Delaware entity (one filing to form the entity in Delaware and another filing to register the Delaware entity in the home state);
2. Employee Agent: Typically an employee of the adviser entity can serve as agent for service of process, whereas a Delaware entity must obtain a corporate agent at a cost of several hundred dollars a year; and
3. Familiarity: The financial professional and its service providers (e.g., accountants and attorneys) may be more comfortable with local law.

ADVANTAGES OF DELAWARE:

1. Legal Certainty: Business law is more developed and the courts are more familiar with business law than other jurisdictions since Delaware is the home of numerous corporate entities;
2. Pro-Business: Delaware is a pro-business state, especially since a large share of the state's revenues comes from fees paid by corporations formed in Delaware;
3. Ease of Formation: Delaware has a sophisticated filing system and knowledgeable employees, which makes the formation process relatively painless; and
4. Flexibility: Delaware corporation statutes and other entity statutes generally allow more flexibility in the structure and operation of the business entity than other states (e.g., the type of consideration that can be used to acquire stock of the company, greater ability for the shareholders to act by written consent instead of a shareholder meeting, and more permissible types of shareholder voting agreements).

REGISTERED AGENT

If the financial professional is organizing the entity in a state other than its location, it will need to appoint and retain a registered agent in the state of organization. For example, a financial professional located in Florida that organizes itself as a Delaware LLC will need to appoint a registered agent in Delaware. The role of the registered agent is to accept service of process on behalf of the entity.

FOREIGN ENTITY REGISTRATION

A financial professional organizing in a state other than its location will have to qualify the business as a "foreign" business entitled to do business in the state where it is located. This is accomplished by making a foreign business filing with the home state.

SETTING UP THE ENTITY

The process of setting up a corporation, LLC, partnership, or a business trust varies from state-to-state. The financial professional must check the appropriate state law prior to making a filing with any state. At a minimum, a financial professional should obtain a copy of the applicable state's laws regulating the type of entity that is being set up. These laws can be found in a public library and, in some cases, on the state's web site. Many states offer kits or pamphlets that provide instructions and helpful hints for setting up an entity. Each state has its own filing fees and other charges that must be paid when forming an entity. Some states may impose annual license or franchise taxes.

Original Certificate

It is advisable to obtain an original version of the organization document that contains the stamp of the state agency. An original stamped version of the organization document is proof that the entity was properly formed. Such a document may be necessary when opening up a bank account or signing a lease in the name of the entity. Often the state agency will send an original version with a state seal or stamp to the organizer or the organizer can file two organizational documents and request that a stamped version be sent back to the organizer.

SETTING UP A CORPORATION

The person setting up a corporation is called the incorporator. To set up a corporation, the incorporator drafts the articles of incorporation, which is a short document setting forth basic information about the corporation. Each state's corporate law varies slightly on what the articles must contain. The following items are contained in a typical articles of incorporation:

- corporation's name (which must have "Corporation," "Company," "Incorporated," "Inc.," or "Co." at the end);
- corporation's address;
- names, addresses and signatures of the incorporators;
- purpose of the corporation;
- number of shares that can be issued, par value of the shares, and the classes of the shares;
- name and address of the agent resident in the state; and
- indemnity provisions that protect directors, officers and employees against liability and damages that arise in connection with the operation of the corporation.

After the articles of incorporation are drafted and signed by the incorporator, the incorporator files them with the department of the state that regulates corporations. The corporate filing fee for most states ranges from \$50 to \$200. After the articles have been processed and approved, the state will make an official entry in its books that the corporation exists and will mail a copy of the articles of incorporation to the financial professional. After the corporation comes into existence under state law, the financial professional must make an election with the Internal Revenue Service as to whether it will be a C or S corporation.

SETTING UP AN LLC

To set up an LLC, the financial professional must file an articles of organization with the appropriate state. The articles of organization is a short document setting forth basic information about the LLC. Each state's LLC law varies slightly on what the articles must contain. A typical articles of organization contains the LLC's name (which must end in "LLC", "L.L.C.", or "Limited Liability Company"), name of the corporate agent, name, address and signatures of the organizers, and the date when the LLC will terminate.

After the articles of organization is drafted and signed by the organizers, the financial professional will file them with the department of the state that regulates LLCs. Most states have a filing fee that ranges from \$50 to \$200. After the articles have been processed and approved, the state will make an official entry in its books that the LLC exists and will mail a copy of the articles of organization to the financial professional.

SETTING UP A PARTNERSHIP

Two persons can set up a general partnership orally by agreeing to go into business. It is not necessary in most states to make any filing to create a general partnership.

Since a limited partnership is a legal entity, the financial professional will have to make a filing with a state agency to create a limited partnership. The general partner (financial professional) files a certificate of limited partnership with the appropriate state agency. Each state's limited partnership laws vary slightly on what the certificate must contain. The certificate typically must set forth the name of the limited partnership (which must have an "LP", "L.P." or Limited Partnership at the end), the address of the limited partnership's office in the state, the name and address of the limited partnership's registered agent for service of process in the state (if the partnership is located in another state), and the name, business and address of the general partner (financial professional).

It may be necessary to draft a short-form partnership agreement prior to the filing of the certificate of partnership. Many state laws require that there be at least two partners before the certificate of partnership can be filed. If a financial professional desires to form the partnership prior to finding a partner, he or she may draft a short-form partnership agreement that names the financial professional as general partner and one of his or her acquaintances as the limited partner. The short form agreement will govern the admittance of the temporary limited partner and his or her withdrawal from the partnership once the other persons are admitted as general partners or limited partners.

SETTING UP A BUSINESS TRUST

To create a business trust, the organizers of a financial professional file a declaration of trust with the appropriate state agency. Each state's business trust laws vary slightly on what the certificate must contain. The certificate typically must set forth the name of the trust, the address of the trust's office in the state, the name and address of the trust's registered agent for service of process in the state (if the trust is located in another state), and any other information that the trustees determine to include. Most states typically charge a fee to process a business trust filing.

EMPLOYER IDENTIFICATION NUMBER

Before the financial professional commences business, it will need to obtain an employer identification number (EIN) from the IRS. A financial professional obtains an EIN by filing a

Form SS-4 with the IRS. The Form SS-4 can be mailed to the financial professional's regional IRS office or it can fax the Form SS-4 to the IRS.

GOVERNING AGREEMENT

After the legal entity is formed, the financial professionals draft the appropriate governing agreement. This legal contract governs the operation of the entity and the relationship between the various persons that make up the legal entity. The governing agreement should be signed by all of the organizers.

Governing Agreements

A sample of the governing agreement for each type of entity is found in the Appendix:

1. Corporation: Bylaws
2. LLC: Operating Agreement
3. Partnership: Partnership Agreement
4. Business Trust: Trust Instrument

In most states, the financial professionals organizing an entity are not required to draft a governing agreement. Nevertheless, it is strongly recommended that the financial professionals draft a governing agreement to establish their own business arrangement. The following topics are covered in a typical governing agreement: (1) officers; (2) profit and loss allocation; (3) meetings; (4) voting; (5) indemnification; (6) admission of new owners; (7) termination of entity.

BUSINESS FORMALITIES

Financial professionals organizing an entity should understand that a legal entity is not a perfect shield against personal liability. Under common law, a court may ignore the legal entity and hold its shareholders personally liable for the obligations of the entity. A classic example is a driver of a poorly maintained taxi who forms a corporation. If the taxi wrecks because of the poor maintenance, a court under the theory of "piercing the corporate veil" could look through the corporation to get at the taxi driver's personal assets to compensate a passenger injured in the wreck.

A financial professional should take the following simple steps to minimize the possibility of a court reaching his or her personal assets to satisfy obligations of the business entity:

1. Make sure the entity is adequately capitalized;
2. Open checking and other financial accounts in the name of the business;
3. Hold meetings of the entity on a regular basis and record actions taken by the meetings in a minute book;
4. When taking actions for the entity, follow procedures set forth in the entity's bylaws or other organizational documents;
5. Sign contracts as an officer on behalf of the entity; and
6. Consider obtaining liability insurance for the entity.

A financial professional should diligently perform these and other administrative functions required to operate a business to shield his or her personal assets from the creditors of the advisory business. He or she should keep separate business and personal affairs and generate documents that prove the separateness.

OTHER CONSIDERATIONS

The financial professional will have to make other decisions and take other steps before commencing operations as an investment adviser, including whether to register with the SEC or a state as an investment adviser. These decisions and steps are discussed in other White Papers on the site and future White Papers. More detailed information on these topics may also be found in <http://www.moneymanagerservices.com>.