

Opening a Gallery in New York: Your Choice of Business Entity Matters

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The artist or gallery owner who desires to commence the business of selling art in New York faces a variety of legal and regulatory issues. One of the more important choices is the form the business will take. The various business forms available in New York and other US states offer a balance between limiting liability for the owner and minimizing exposure to federal, state and city income taxes. The selection of the form of business entity may also be particularly relevant for a foreign artist or dealer who wishes to commence business in the US. The following are a few of the most commonly asked questions relating to the selection of business entity.

Why can't I simply operate my gallery as a sole proprietor?

The simplest form of business ownership is the sole proprietorship. This is where you own directly all of the inventory and other business assets and make all of the business decisions yourself. A sole proprietorship is not considered a separate entity for federal or state tax purposes. You would simply report all of your income and loss on your personal tax return. Although the simplicity of operating as a sole proprietorship has some appeal, as a sole proprietor you have unlimited liability with regard to obligations of the business. By operating through one of the entities described below, your liability for the operations of the business can be limited to the assets or other capital you have transferred to the entity.

Is a corporation the best choice?

In a sense, a traditional corporation (also referred to as a "C" corporation) represents the polar opposite of a sole proprietorship because the corporation is treated as a separate entity under both New York state law and US federal tax law. From the liability perspective, corporate ownership is more desirable than direct ownership, because it limits the owner's liability to the amount of his investment in the corporation. From a tax perspective, a C corporation may not be very desirable. Under US tax law, a corporation is generally taxed at graduated rates ranging from 15% to 35%. Once the net income of a corporation exceeds \$335,000, the corporation is effectively taxed at a flat rate of 34% unless its income exceeds \$10 million, at which threshold a 35% tax rate applies. The corporation would also suffer New York State tax of 7.5% since it is doing business in New York and another 8.85% if it conducts business in New York City. The net profits of the corporation, after payment of the federal, state and local corporate taxes, may suffer an additional tax when distributed to the shareholders (that is, the shareholders may also be subject to federal, state and local taxes on distributed profits). The combined rate of corporate and personal tax is substantially higher than the tax paid by a sole proprietor.

C corporations can also be quite difficult to unwind. If a C corporation liquidates, for example, the corporation must generally treat all of its assets as sold at the time of the liquidation resulting in tax on all underlying gain.

Is using a C corporation ever advisable?

Notwithstanding the drawbacks outlined above, it may still be advisable to use a C corporation in certain circumstances. If the gallery is likely to be the subject of a public offering or may merge with another corporation, the C corporation form may offer certain advantages. C corporations can participate in tax-free mergers and other types of reorganizations on a tax-free basis whereas the transparent entities described below may not. In addition, a C corporation may be appropriate in cases where a non-US gallery wishes to sell art in the US but does not want to establish a related gallery in the US. A non-US gallery wishing to avoid the creation of a business presence in the US (a so called "permanent establishment") may wish to form a US C corporation affiliate to conduct limited activities such as acting as a commission agent. In that manner, only the commissions paid to the US corporation will be subject to US tax rather than the US derived profits earned by the non-US gallery. A non-US gallery which establishes a US LLC or partnership risks having a tax presence in the US.

What is a "pass-through" or "transparent" entity?

Fortunately, there are alternatives to the sole proprietorship or C corporation forms available under New York law that permit limited liability as well as a tax transparency. The terms "pass through" entity or "transparent" entity are general terms for business entities that are recognized as existing separately from their owners (a benefit for liability purposes) but are not taxed on their income. Rather, the income "passes through" the entity and is chargeable directly to the owner or owners of the entity. This broad category of entities encompasses S corporations, partnerships, and limited liability companies (LLCs).

An S corporation is a special type of corporation that was created under federal tax legislation (Subchapter S of the Internal Revenue Code) in order to benefit small businesses. Like a C corporation, an S corporation is a corporation created under state law. The shareholders of the corporation must make an S election with the Internal Revenue Service to treat the corporation as a transparent entity. In keeping with congressional intent to offer the benefits of pass-through taxation only to relatively simple forms of corporate ownership, there are significant limitations on the number and type of shareholders that an S corporation may have. One of the more significant requirements is that all individual shareholders of an S corporation must be US individuals. Certain US estates and trusts are also qualified shareholders, but corporations, partnerships, and foreign trusts may not be S shareholders.

Although S corporations permit their shareholders to be taxed directly, due to the somewhat burdensome requirements necessary to achieve and maintain S status, many businesses choose the limited liability company (LLC) form discussed below. However, the S corporation remains a viable option particularly for the shareholders of C corporations who want the benefits of tax transparent treatment. A C corporation can convert to S Corporation status and thereby achieve tax transparency going forward; however a C corporation cannot convert to a sole proprietorship, LLC or partnership without liquidating first. A liquidation of a corporation often creates an unacceptable tax cost and therefore corporations seldom convert to any form other than an S corporation.

I am familiar with how a partnership works. How is an LLC different?

Limited liability companies (LLCs) are a fairly recent development. All US states, including New York, now offer the LLC form of business entity. As the name implies, the liability of the owners (called members) of the LLC is limited to the company's assets. An LLC can have a single member or, like a partnership, can have many members. The advantage of an LLC is that the members are taxed on a transparent basis unless they elect that the entity be taxed as a C corporation. Such an election is commonly referred to as a "check the box" election. A single member LLC is treated as a sole proprietorship for tax purposes unless a contrary check the box election is made. A multiple member LLC is treated as a partnership for tax purposes if no contrary election is made.

Unlike an S Corporation there are few restrictions as to who may be a member of an LLC. Foreign persons, business entities and trusts are all permissible owners of an LLC.

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