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CHOICE OF BUSINESS ENTITY AND OHIO MECHANIC'S LIEN LAW

by

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CHOICE OF BUSINESS ENTITY

I. COMMON ENTITY TYPES

A. Sole Proprietorship

1. A sole proprietorship is a business owned by a single owner. It is very easy to form and does not require any registration with the state.
2. An owner of a sole proprietorship has unlimited liability — *i.e.* the owner is personally liable for all debts and liabilities of the business.
3. The sole proprietorship does not require that a separate Federal income tax return be filed. Instead, it is subject to flow-through taxation where any net profit or loss flows through to the owner's individual income tax return.
4. Any net profit of the sole proprietorship will be subject to self-employment tax on the owner's Federal income tax return.

B. Partnership

1. A partnership is a business entered into by two or more owners for the purpose of making a profit.
2. A partnership does not require any registration with the state.
3. Although a partnership has flow-through taxation, it is a separate legal entity for state law purposes and can enter into contracts, hold title to real estate, borrow money, bring suit against someone and be sued, and otherwise own business assets and operate business or investment activities.
4. As a separate legal entity, a partnership is primarily liable for all of its debts and liabilities. However, any "general partner" of a partnership is also personally liable on any partnership debt. This is known as "joint and several liability."
5. The liability of any "limited partners" is limited to their capital contribution, plus any debts they personally guarantee. "Limited partners", however, may not be involved in the day-to-day operations of the business.
6. A partnership must file an annual informational return on Form 1065. A schedule K-1 for each partner is included to report each partner's tax information.

7. Partnerships operating a trade or business activity will usually generate self-employment income or loss that will flow through to any individual "general partners".
8. There are many different types of partnerships (*i.e.* partnership, limited partnership, etc.) and each has its own special legal and tax characteristics.

C. Corporation

1. A corporation is a separate legal entity created under the laws of a particular state.
2. Most states require corporations to file Articles of Incorporation with Secretary of State or other designated official.
3. A separate legal document (bylaws, regulations, etc.) governs the operations and management of the corporation.
4. The corporation is owned by Shareholders and is managed by its Directors and Officers. Shareholders elect the Directors and the Directors elect the Officers.
5. A corporation provides limited liability protection to all Shareholders. Shareholders are generally at risk only for capital contributions and any debts they personally guarantee. However, in rare situations, creditors can look through the corporation and hold the Shareholders personally liable. This concept is known as "piercing the corporate veil" and is generally limited to situations where Shareholders have basically ignored the structure of the corporation in their business dealings.
6. Federal tax treatment of the corporation depends upon whether it is classified as an "S" or a "C" corporation. The profits of neither the "C" nor the "S" corporation are subject to self-employment tax. However, the owners are subject to payroll taxes on any wages taken out of either type.
7. "C" and "S" corporations are treated drastically different for other Federal tax purposes. The C corporation is a separate taxable entity in law and is considered an individual separate and apart from the individuals who own the business. Thus, a "C" corporation is taxable on the corporation's income; the after tax net income can be distributed to the owners, and is then taxed on an individual level. This is called double taxation. Conversely, the "S" corporation is a flow-through entity wherein any profit or loss flows through to the individual owner's income tax returns.

D. Limited Liability Company (LLC)

1. Limited liability companies (LLCs) are regulated under a relatively new Ohio statute and are becoming very popular. An LLC provides the limited liability protection of a corporation in combination with the flexibility provided by a partnership.
2. An LLC's owners are called its Members. Most states allow for single-member LLCs in addition to multi-member LLCs.
3. Members generally receive the same liability protection as Shareholders in a corporation and "limited partners" in a partnership. The personal liability of a Member is limited to his capital contribution, plus any debts personally guaranteed. However, unlike the "limited partner" in a partnership who must remain passive in business operations, an LLC Member can be actively involved in the day-to-day operations of the LLC and not risk losing the liability protection.
4. An LLC is managed by its Members. Management provisions are set forth in some type of a governing document, such as an operating agreement.
5. As a general rule, the Members of an LLC must file some type of Articles of Organization in the state in which they are organized.
6. A "single-member" LLC owned by an individual will be taxed as a proprietorship for Federal tax purposes. The single-member LLC does not have a separate tax existence, unless the individual elects to have it taxed as a corporation by filing Form 8832.
7. An advantage to having a "multi-member" LLC is having the flexibility of partnership taxation. For income tax purposes, the LLC will be treated like a general partnership, unless otherwise desired, and the Members will be treated like "general partners".
8. For self-employment tax purposes, the treatment of the LLC will be very similar to that of a limited partnership. The self-employment tax will generally apply to any Member actively involved in the management of the LLC.

II. OTHER ENTITY SELECTION CONSIDERATIONS

A. Bringing in New Business Owners

1. **Proprietorship and Single Member LLC:** Least flexible when it comes to adding new business owners. Will need to be re-structured to accommodate for this.

2. **Corporation:** Greatest ease of transfer and most freedom in terms of transferring ownership to new business owners. Generally very easy to (1) make a transfer of stock from an existing shareholder to a new shareholder, or (2) issue additional stock to a new shareholder.
3. **Partnership and Multi-Member LLC:** A little harder to accomplish than in a corporation. Transfer restrictions are common, and there are generally more legal requirements and tax issues associated with the transfer of a partnership or LLC interest. The sale of an interest or the creation of new ownership often must be approved by a majority of all of the owners.

OHIO MECHANIC'S LIEN LAW

I. WHAT IS A MECHANIC'S LIEN?

- A. A mechanic's lien is a statutory charge on real property for the purpose of securing compensation to persons who perform labor or furnish materials for the improvement of the property. The statutory source of mechanic's liens is Ohio Revised Code Section 1311.01-32 (the "Mechanic's Lien Act").
- B. The Mechanic's Lien Act distinguishes between "private improvements" and "public improvements".
- C. Private improvements constitute labor or work done in furtherance of contract, whether express or implied, with a private individual or organization. An original contractor, a subcontractor, a materialman and any laborer working under an express or implied contract to perform work or furnish materials in furtherance of an improvement, and who otherwise complies with all statutory requirements, is entitled to assert a lien against a private improvement.
- D. Public improvements refer to an improvement that is either owned or being constructed by a public authority and is being financed by a public fund. Only a subcontractor, a materialman and a laborer may assert a claim against the construction fund with respect to a public improvement.
- E. The Mechanic's Lien Act also provides for separate treatment of residential improvements that affords additional protection for consumers in regard to liens in connection with home construction or home purchase contracts.

II. NOTICE OF COMMENCEMENT

A. Private Improvements

- 1. For projects involving private improvements, except in certain instances, the party contracting for the improvement has the affirmative obligation to record a "Notice of Commencement".
- 2. The party contracting for the improvement must record, serve and post a notice of commencement in connection with all private improvements, except in the following instances:
 - a. Home construction contract unless required by lender (special requirements then apply);
 - b. Improvements to oil or gas wells, and oil derricks, tanks and production pipelines; and

- c. Utility company projects (certain rules apply).
- 3. **Recording and Duration of Notice of Commencement:** Before the performance of any labor or the furnishing of any material for an improvement, the contracting party must record the Notice of Commencement with the county recorder's office in each county where property to be improved is located. The Notice of Commencement expires six years after date of recordation, unless specified otherwise.
- 4. **Serving Notice of Commencement:** Either the contracting party or its designees must serve upon any original contractor. If subcontractor, materialman or laborer serves a request upon a contracting party, that person must also be served with a copy within ten days of the request.
- 5. **Posting of Notice of Commencement:** Must post and maintain a copy in a conspicuous place at the construction site during the course of the actual physical improvement to property, unless the improvement is the subject of a home purchase contract.
- 6. **Notice of Commencement Must Contain the Following:**
 - a. Legal description;
 - b. Private improvement;
 - c. Owner;
 - d. Designee of owner;
 - e. Original contractor;
 - f. Contract date;
 - g. Lending institution;
 - h. Surety;
 - i. Person preparing notice; and
 - j. Notice to claimants.

B. Public Improvements:

- 1. Public authority is required to prepare a Notice of Commencement and make it readily available to the public.
- 2. The public authority is not required to file the Notice of Commencement with the county recorder, serve it on the principal contractors or post it on the project.

3. Each contractor and subcontractor must provide to its subcontractors and material suppliers the names and addresses of the public authority and principal contractors.

III. NOTICE OF FURNISHING

A. Private Improvements:

1. Subcontractors and materialman must serve a Notice of Furnishing in order to preserve lien rights according to the following rules:
 - a. If Notice of Commencement is timely recorded and timely served, the Notice of Furnishing must be served within 21 days after first beginning work or providing material;
 - b. If Notice of Commencement is not timely recorded or timely served, Notice of Furnishing must be served within 21 days from the date the contracting owner does finally record or serve Notice of Commencement, whichever is later (would not be required to serve a Notice of Furnishing to preserve lien rights for period prior to date Notice of Commencement is recorded);
 - c. If Notice of Commencement is never recorded, not required to furnish a Notice of Furnishing; and
 - d. If Notice of Commencement is recorded after subcontractor or materialman files its lien affidavit, prudent subcontractor or materialman will serve its Notice of Furnishing even after it has filed its lien affidavit.
2. **The Notice of Furnishing must contain the following information:**
 - a. Name and address of claimant and person preparing Notice of Furnishing;
 - b. Name and address of owner;
 - c. Name and address of original contractor;
 - d. Name and address of person with which claimant contracted;
 - e. Recording reference of Notice of Commencement or a property description or address reasonably describing property being improved;
 - f. Date of the Notice of Furnishing;

- g. Date the labor or work was or will be first performed or the date the material was or will be first furnished; and
 - h. Statutory warning notifying owner that it risks paying twice if it ignores claims of persons service Notice of Furnishing.
- 3. In order to fully preserve lien rights, the Notice of Furnishing must be served on the principal contractor and owner within 21 days after first beginning work or providing materials.
- 4. A subcontractor or materialman is not required to serve a Notice of Furnishing in connection with a home construction contract or in connection with oil and gas wells, oil derricks, tanks and production pipe lines.
- 5. Neither an original contractor nor a laborer is required to serve a Notice of Furnishing.

B. Public Improvements

In order to preserve a lien claim against funds on a public project, any material supplier or lower-tier subcontractor that does not have a contract directly with a principal contractor must serve a Notice of Furnishing on the original contractor. The same 21-day rule for private improvements also applies to public improvements.

IV. RECORDING LIEN AFFIDAVIT

A. Private Improvement

- 1. To perfect a valid and enforceable mechanic's lien in connection with a private improvement, a claimant must record a verified and notarized lien affidavit in a timely manner at the appropriate recorder's office.
- 2. **Lien affidavit must include the following:**
 - a. Date of first activity;
 - b. Except as to oil and gas wells, and oil derricks, tanks and production lines, the recorded lien affidavit must set forth the date the claimant first performed labor or work or furnished material as to the subject improvement;
 - c. Legal description of real property being improved;
 - d. Amount due over and above all legal set offs;

- e. Names and addresses of the claimant, and of the party with which the claimant contracted, and that owes the claimant the stated amount; and
 - f. Name of the owner that contracted for the improvement against whose interest the lien is asserted.
3. Lien affidavit must be recorded within one of the following time periods from the last date the claimant performed labor or work or furnished material:
- a. One or two family dwellings or residential condominium units — 60 days;
 - b. Oil or gas wells, and oil derricks, tanks and production pipe lines under O.R.C. Section 1311.021 — 120 days;
 - c. All other private improvements — 75 days.
4. Generally, to perfect a valid and enforceable mechanic's lien in connection with a private improvement, a claimant must timely serve a copy of the recorded lien affidavit upon the contracting party within 30 days of the recording in accordance with O.R.C. Section 1311.19. If the owner cannot be found, a copy of the lien must be posted conspicuously on the project site within 10 days after the initial 30-day period.
5. All lien rights on a residential project are extinguished if the owner has paid the principal contractor in full before the owner's receipt of the lien affidavit.

B. Public Improvements

Lien claims must be filed with the public authority within 120 days from the last day the claimant provided work or materials for the project. To obtain priority over unrecorded claims, the claimant should also file a copy of the affidavit with the county recorder within 30 days after filing with the public authority. If the claimant is a sub-subcontractor or a supplier to a subcontractor, the claimant must also serve a copy of the lien affidavit on the subcontractor within 20 days after serving the affidavit on the public authority.