

CHOOSING THE APPROPRIATE BUSINESS ENTITY

By Don J. Miner

When starting a new business, it is important to carefully choose the appropriate business entity as the choice of entity can significantly affect tax benefits, profits and losses. Arizona's five main forms of business entities are sole proprietorship, general partnership, limited partnership, corporation, and limited liability company. These entities and variations therefrom are discussed in this article.

Sole proprietorships ("SP") constitute an individual transacting business for profit. The SP is easy to operate and inexpensive. No franchisee taxes, corporate formalities or double taxation are involved. A disadvantage is that the owner is personally liable for its obligations.

The **corporation, including "C" and "S" corporations**, is a separate entity from its owners and is not liable for any of its obligations. Income of a corporation, other than an "S" corporation, is taxable at the corporate level and at the shareholder level. This double taxation can be minimized by making an "S" corporation election or by paying salaries to shareholders. Restrictions applying to an "S" corporation include the number of shareholders, only one class of stock (limiting economic arrangements between shareholders); limitations on losses shareholders are allowed for federal tax purposes (limited to value of investment in corporate stock), and limitations on transfers of appreciated property.

The **limited liability company ("LLC")** is a popular form for service businesses, real estate holdings and small businesses. Professional LLCs (A.R.S. Sections 29-841, et seq.) are used for providing professional services. The LLC combines the tax advantages of a sole proprietorship with the limited liability of a corporation. The members of an LLC are not liable for debts and obligations of the company. Income and losses are passed to and taxed at the members' level in accordance with the operating agreement. The LLC eliminates many formal requirements of corporations, making it easier and less expensive to maintain and requiring less public disclosure of information.

A **general partnership ("GP")** consists of two or more persons transacting business as co-owners for profit. All partners are liable for partnership obligations and have the authority to bind the partnership. Profits and losses are distributed in accordance with the partnership agreement. Partnerships allow flexibility in allocation of income and losses.

A **limited liability partnership ("LLP")** is a GP that has registered as an LLP. Partners are responsible for the management but are not liable for obligations. LLPs allow legal protections without the formalities of a corporation. Profits and losses are not double taxed and are reported on the partners' tax returns. If the LLP is dissolved, there are no capital gains taxes on assets. Disadvantages include the payment of a self-employment tax on profits and filing requirements for maintaining the status.

A **limited partnership ("LP")** is a derivation of a GP. Owners are classified as either "general" or "limited" partners. In a GP, each partner is liable for the obligations and is given the authority to act on behalf of the partnership. Limited partners of an LP have no power to

bind the partnership and are only liable for obligations to the extent of their ownership interest. The “general partners” have the authority to act on behalf of the partnership and are liable for its obligations.

A **limited liability limited partnership** (“LLLP”) is an LP that has registered as an LLP with the same classes of partners as an LP. Neither the general partners nor the limited partners are liable for debts. The advantage of the LLLP is that self-employment taxes are reduced by allocating a share of profits to the limited partners. Profits allocated to the GP interest or to individual salaries are subject to the self employment tax. Combining the limited liability associated with corporations and the tax advantages of the LP makes the LLLP attractive.

Choosing a business entity requires consideration of factors such as ease of formation, transaction costs, owners’ liability, licensing for services, tax benefits or consequences with respect to entity owned real estate, tax consequences, transferability, and the continuity of business. Advice from qualified professionals should be sought in considering which entity will be the most advantageous.