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## **A Primer on Choice of Business Entity**

Clients often ask: "What type of entity should I use for my new business and why?" This article will briefly summarize the tax and non-tax differences between limited liability companies, corporations, partnerships (general and limited) and sole proprietorships in Arizona.

### **Limited Liability Companies ("LLCs"):**

An LLC is an entity in which the members generally have limited personal liability for company obligations. Members are the owners of the LLC; similar to shareholders in a corporation or partners in a partnership. An LLC can be "member-managed" or "manager-managed." If the LLC is "member-managed", the members manage the business of the LLC and the acts of any one member can bind the company. If the LLC is "manager-managed", the person(s) who are designated as a "manager" manage the business of the LLC. Managers and members of an LLC generally are not liable for the LLC's obligations solely by reason of being managers or members (similar to shareholders in corporation).

To form an Arizona LLC, Articles of Organization must be filed with the Arizona Corporation Commission. Upon approval by the Arizona Corporation Commission, the LLC's Articles of Organization must be published. Unlike corporations, LLCs do not have annual report filing requirements. Instead of Bylaws, the LLC's business and affairs are controlled by the Operating Agreement. The typical Operating Agreement is similar to a partnership agreement, with elements of a corporation's bylaws. Under the terms of the Operating Agreement, a member's ability to transfer its membership interest may be restricted or require the consent of other members.

No special tax elections must be filed with an LLC, unless the members wish to be taxed as an S Corporation (discussed more fully below). If there is one member, the LLC is disregarded for tax purposes. If there is more than one member, the LLC is usually taxed as a partnership. If an LLC is taxed as a partnership, profits and losses for tax purposes pass through to members and may be allocated differently than ownership percentage.

### **Corporations:**

A corporation is an entity in which the shareholders have limited personal liability for corporate obligations. The shareholders are the owners of the corporation. At annual meetings, shareholders elect directors, who manage the corporation, elect and authorize officers to carry out corporate policies. Shareholders are generally not liable for corporation's obligations; however, there are circumstances where the corporate veil of limited liability may be "pierced" and the shareholders held liable for corporate obligations.

To form an Arizona corporation, Articles of Incorporation must be filed with the Arizona Corporation Commission. Upon approval by the Arizona Corporation Commission, the Articles of Incorporation must be published. Thereafter, the corporation must make annual report filings with the Arizona Corporation. Bylaws control the business and affairs of the corporation and may limit/restrict the ability of a shareholder to transfer its shares.



The corporation is a separate taxpaying entity. As a result, there is a potential for double taxation - income of the corporation is taxed at the corporate level and then taxed again at the shareholder level when distributions are made. An "S" corporation is simply a corporation that has made an election to be treated as an "S" corporation for tax purposes. Filing an "S" election with the Internal Revenue Service enables the corporation to receive partnership-like tax treatment (income and expenses flow through to the individual shareholders). Profits and losses for tax purposes pass through to the S corporation's shareholders based on percentage of ownership, making the S corporation less flexible than an LLC that is taxed as a partnership.

### **Partnerships:**

There are four types of partnerships – general partnerships, limited partnerships, limited liability partnerships and limited liability limited partnerships. A general partnership is created by an agreement between persons to carry on business together for a profit. The agreement does not have to be in writing. To form a limited partnership, limited liability partnership and limited liability limited partnership, a certificate of limited partnership must be signed by the general partner and filed with the Arizona Secretary of State. Annually, each limited liability partnership and limited liability limited partnership must file an application for renewal with the Arizona Secretary of State.

In general partnerships and limited liability partnerships, each partner has the authority to bind the partnership. With limited partnerships and limited liability limited partnerships, however, there are two classes of partners - general and limited – with only the general partners having the authority to bind the partnership. Profits and losses in a partnership, regardless of type, are allocated to partners based upon their partnership percentage (or in accordance with the partnership agreement). Different distribution rights may be created in the partnership agreement for different classes of partners.

Personal liability of the partners for the obligations of the partnership varies depending upon the type of partnership. Each partner in a general partnership and each general partner in a limited partnership has unlimited joint and several liability for partnership obligations. Limited partners in a limited partnership (so long as they do not participate in management of the partnership), partners in a limited liability partnership and all partners, general and limited in a limited liability limited partnership have limited liability for partnership obligations.

Which entity is right for you? As you can see, several factors may influence the choice of entity decision. This article is intended to provide you with a basic overview of the differences between LLCs, corporations and partnerships. There are other tax and non-tax issues that you may wish to consider, such as self-employment tax liability, the tax costs if you choose to combine with other entities and whether you plan to "go public." Mistakes can have unintended consequences. Your attorney and financial advisors can assist you in reviewing your plans to help avoid an undesirable choice.