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“How should we do business?”

Choices of legal entity for Arizona companies

Sole Proprietorship

Highlights: Taxes paid by individual owner using Schedule C of Form 1040. Simplest form of business. Must be sole owner. Relatively little record keeping. No liability protection unless operating as an LLC. Relatively inexpensive to set up. A legal filing is not required, but business name should be registered. Can easily convert to other type of entity. Good for very small, simple or startup businesses. No requirement for double-entry bookkeeping (“shoe box” accounting). *See page 2 for details*

Regular Corporation

Highlights: Also known as “C-corporation.” Initial tax rates are generally lower. Liability is limited to amount invested. Fringe benefits can be excellent. Can have any year-end for tax filing. Good for situations where corporation needs to acquire many assets in order to compete (e.g., heavy equipment or substantial inventory). *See page 3*

S Corporation

Highlights: Also known as “Subchapter S corporation.” Taxes generally paid by individual owners. FICA taxes may be lower than other forms. Liability is limited to amount invested. Generally should be calendar year-end for tax filing. Good for situations where a high profit on sale of the business is likely. *See page 4*

General Partnership

Highlights: No limit on liability. Must have two or more owners. Generally calendar year. LLCs (*see below*) are probably better. Good way to hold real estate. *See page 5*

Limited Liability Company and Limited Liability Partnership

Highlights: Known respectively as “LLC” and “LLP.” Taxes are paid by individual owners. Liability is limited to amount invested. Very flexible form of doing business. Generally must be calendar year-end for tax filing. One-member LLCs are now available. Good way to hold real estate. Now can easily convert to Corporation or S-Corporation. *See page 6*

Professional Corporation

Highlights: Also known as “P.C.” Normally used by doctors, lawyers, accountants and other non-sales professionals. Generally calendar year-end. Highest tax rate (35% of net income). Enjoys the same fringe benefit deductions as the C-corp. Professionals considering this form of business should compare and contrast with S-corps and LLCs. *See page 7*

Sole Proprietorship

Simple form of organization. No extra tax return needed; just schedules in Form 1040. No extra organization or corporate minutes. No annual corporate meeting or filing.

Liability

- No limited liability unless operating as an LLC; owner fully liable; purchase of business liability insurance is a very important consideration
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Taxes

- Schedule C, Form 1040
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Attributes

- All taxes paid by individuals
 - Medical costs not deductible as a business expense
 - Easier to get home office deduction
 - Full FICA (self employment tax) paid
 - Can deduct 100% of owner's health insurance as above the line non-business expense
 - Can put children under 18 on payroll to save tax; they do not pay FICA tax and may not pay income tax
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Ownership

- One individual owner
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Tax Year-End

- Must be calendar year-end
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Special Advantages

- Simplicity; may not need double-entry bookkeeping ("shoe box" accounting)
 - No extra tax return needed
 - Legal, accounting and administrative costs lower
 - Can later shift to other forms of business with relative ease
 - Easier to get out of business
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Major Disadvantages

- Full FICA tax paid (sole proprietors are often shocked at the amount of tax they pay (federal + FICA + state tax))
 - Personal liability for business lawsuits and debt
 - Cannot split income between years or family members
 - Probably higher audit risk
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Regular or "C" Corporation

The regular corporation requires a separate corporate entity with separate corporate tax returns, plus annual reporting to the Arizona Corporation Commission.

Liability

- Shareholder liability is limited to money invested
- Liability is never limited for one's own professional malpractice)

Taxes

- Initial tax rates are very low (15% on first \$50,000)
- Double tax danger: without proper planning, shareholders may pay tax once in the corporation, then again as they take money out. However, with dividends currently taxed at 15% this double tax is not as onerous as it used to be!

Fringe Benefits

- Shareholder's medical expenses can be 100% deductible business expense (not true for most other forms of business)
- Real estate generally should not be held in corporation
- Can plan to shift income
- Possible exclusion of 50% of long term capital gains for sale of small business stock issued after 4-10-93
- Cafeteria plans for medical expenses and day care available
- Can use employee stock ownership plans for deduction
- Meals and lodging for benefit of employer is not income
- Life insurance benefits up to \$50,000 policy can be tax free

Ownership

- At least one shareholder
- No maximum number of shareholders

Tax Year-end

- Any tax year-end available

Special Advantages

- Good way to build up capital in business at low tax rates
- Good way to split income between personal and business
- Easier to plan between tax years if non calendar year-end
- Can pass shares of stock to family members for estate planning
- Less problem with passive loss rules

Major Disadvantages

- Should have annual minutes and board of directors meeting
- Alternative minimum tax (AMT) in some situations
- Accumulated earnings tax (15% of monies accumulated that exceed reasonable needs of business)
- Double taxation; if care is not taken, earnings can be taxed once in the corporation and then again as shareholders draw out profit
- Asset sale of business is complicated

"S Corporation

S-corps (formerly known as "Subchapter S corporations") have been around since the 1950s. A regular corporation can become an S by filing a special election (Form 2553). Separate corporate tax returns and annual reporting to the Arizona Corporation Commission are required.

Liability

- Shareholder liability is limited to money invested
- Liability is never limited for ones own professional malpractice

Taxes

- Generally all taxes are paid by shareholders
- All losses and income flow to individual shareholders
- No FICA tax paid by shareholders on corporate net income
- Shareholders can deduct 100% of their health insurance as an above the line non-business deduction

Attributes

- Real estate should not be held in S-corporations
- No double taxation on earnings
- Business losses passed through to individuals for tax benefits, but they are limited to shareholder's basis in stock and direct loans to S-corp

Ownership

- One to 75 shareholders
- A C-Corporation may not own S corporation stock
- A Partnership or L.L.C. may not own S-Corporation stock
- A S-Corporation may own up to 100% of partnership or L.L.C.

Tax Year-End

- Generally must be calendar year-end (unless business purpose established to IRS, or can have September, October or November year-end with possible extra tax to pay)

Special Advantages

- Ability to avoid some FICA tax (shareholders must still take reasonable salary). Can save thousands!!
- Debt to acquire S-corp stock is deductible business interest (as opposed to investment interest)
- No double taxation on earnings
- No accumulated earnings tax or personal holdings company tax
- No alternative minimum tax

Major Disadvantages

- If shareholder owns more than 5% of stock, he cannot borrow from pension plan
- Partnerships and corporations cannot be shareholders; only U.S. citizens or residents and some trusts
- Must be a U.S. corporation with one class of stock
- Cannot borrow money from pension plan
- Dissatisfied shareholder can terminate S election by transferring stock to C-corporation
- Unlike partnerships, debts of S-corps do not cause basis for loss, only actual money loaned by owner
- S-Corporation owners cannot deduct medical expenses as a corporate expense

General Partnership

Two or more partners required. Partners can be individuals, corporations, trusts and/or other partnerships. Very flexible form of doing business. There must be at least one general partner. Separate partnership tax returns are required. Business owners considering a partnership should look closely at an LLC or LLP as an alternative entity. Existing partnerships should consider converting to an LLC or LLP.

Liability

- No limit on liability for general partners

Taxes

- All income and expenses flow through to the partners, usually based on their ownership percentage
- Good way to hold real estate with multiple owners
- Can deduct 100% of partner's health insurance as an above the line non-business deduction

Benefits

- Easy to form; written agreement recommended but not required
- Can easily allocate income and deductions among partners
- Business losses passed through to partners for tax benefits

Ownership

- Two or more partners
- Some can be limited partners with liability no greater than their investment

Tax Year-End

- Generally must be calendar year-end, unless business purpose established to IRS, or can have September, October or November year-end with possible extra tax to pay

Special Advantages

- Annual minutes not required
- Written agreement technically not required
- Family limited partnerships good vehicle for estate planning
- No double tax on earnings
- No accumulated earnings tax or personal holding company tax
- No alternative minimum tax (AMT)
- Good way to hold real estate
- Debts of partnership give tax basis to general partners

Major Disadvantages

- General partners can be fully liable for all debt and all actions incurred by partnership or partners

Limited Liability Company and Partnership

The LLC is a relatively new form of doing business. Also can be a PLLC (Professional Limited Liability Company) or LLP (Limited Liability Partnership), which are basically the same as an LLC.

Liability

- Liability of owner limited to investment; this is a major advantage over partnership
 - Liability is never limited for one's own professional malpractice
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Taxes

- All income and expenses flow through to members (partners)
 - Good way to hold real estate with multiple owners
 - Can deduct 100% of owner's health insurance as an above the line non-business deduction
 - Can easily allocate income and deductions between partners
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Benefits

- One-member LLC can file Schedule C
 - Unlike corporations, no annual report to Arizona Corporation Commission
 - Can easily convert to Corporation (File form 8332)
 - Can easily convert to S-Corporation (File form 2553)
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Ownership

- One or more owners (properly known as "members")
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Tax Year-End

- Generally must be calendar year-end, unless business purpose established to IRS, or can have September, October or November year-end with possible extra tax to pay
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Special Advantages

- Owners can participate in management without risking personal liability
 - No requirement for annual minutes
 - Family limited partnerships good vehicle for estate planning
 - No double tax on earnings
 - No accumulated earnings tax or personal holding company tax
 - No alternative minimum tax (AMT)
 - Some members may not be subject to FICA tax
 - Good way to hold real estate
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Potential Disadvantages

- LLCs laws not uniform from state to state

- Because LLCs are relatively new, much of the tax law has not been tested

Professional Corporation

Doctors, lawyers, accountants and other non-sales professionals who are incorporated as a regular corporation usually end up being classed as PCs – often referred to as “personal service corporations” in tax parlance.

Liability

- Shareholder liability is limited
- Liability is never limited for ones own professional malpractice

Taxes

- Taxes are always at high corporate tax rate of 35%
- Double tax danger – without proper planning, owners may pay tax once in the Corporation, then again as shareholder takes money out

Fringe Benefits

- Shareholder's medical expenses can be 100% deductible business expense (not true for most other forms of business)
- Cafeteria plans for medical expenses and day care available
- Meals and lodging for benefit of employer is not income
- Life insurance benefits up to \$50,000 policy can be tax free

Ownership

- One or more shareholders

Tax Year-End

- Generally calendar year-end required

Special Advantages

- Fringe benefits
- Limited liability

Major Disadvantages

- Should distribute income out every year
- Generally should have calendar year
- High tax bracket on net income (35%)
- Real estate should not be held in a corporation