Garland W. Binns, Jr.
Dover Dixon Horne PLLC
Attorneys at Law
425 West Capitol, Suite 3700
Little Rock, Arkansas 72201
Telephone: (501) 978-9923
Facsimile: (501) 375-6484
Email: gbinns@ddh-ar.com
Web Site: www.GWBinns.com

November 2020

U P D A T E

News of Developments in the Financial Sector and Related Areas

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Selection of the Right Business Entity

In evaluating the risks and tax consequences of operating a business, it is necessary to select the right business entity. A business entity will generally fall in one of the categories as follows:

- Sole Proprietorship
- General Partnership
- Corporation
- Limited Liability Company

A sole proprietorship is a business that is operated by an individual which has no separate identity from its owner. The income and expenses of the sole proprietorship are reported on the individual tax return of the owner. The primary disadvantage of a sole proprietorship is that the owner is personally liable for the debts of the business, thus placing the owner's entire personal assets and wealth at risk.

A general partnership exists when two or more co-owners engage in a trade or business. In the absence of a partnership agreement, profits are shared equally by the owners. A written partnership agreement will usually provide the manner in which profits and losses are shared by the owners. As in a sole proprietorship, the owners are personally liable for the debts of the partnership. Since the partnership is not a separate legal entity, the profits and losses are included on the individual tax returns of the owners based on their ownership of the partnership. In the absence of a partnership agreement, each owner has an equal right to participate in the management and control of the business. Another form of the general partnership is the joint venture, which is typically formed to undertake a specific business transaction such as in the development of a piece of real property. A variation of the general partnership is the limited partnership. In a limited partnership, a "general" partner manages the business, while the "limited partners" contribute capital and share in the profits. The general partner is personally liable for the debts of the partnership while the limited partners incur no liability with respect to the partnership obligations beyond their capital contributions.

A C corporation is a separate legal entity organized under state law which is created when the owners, known as shareholders, transfer cash or property in exchange for stock of the corporation. The profits of the corporation are taxed to both the corporation and also to the shareholders when the profits are distributed in the form of dividends. Unlike a sole proprietorship or partnership, shareholders cannot deduct any losses incurred by the corporation. The shareholders' liability is limited to the amount of their investment in the corporation. The corporation pays taxes at its own corporate income rates and files its own corporate tax returns each year. The management and control of the corporation is vested in the board of directors, who are elected by the shareholders of the corporation.

A S corporation is a standard corporation that has elected a special tax status with the Internal Revenue Service which eliminates the possibility of the double taxation that occurs with a C corporation. By making the S corporation election, the income and losses of the corporation are reported on the tax returns of the shareholders. There are certain restrictions on qualifying as a S corporation with the Internal Revenue Service including, but not limited to, that the corporation have only one class of stock and there be no more than 100 shareholders. An S Corporation may only have certain types of shareholders, i.e., individuals and certain trusts, and may not have any shareholders that are corporations, partnerships, pensions, charitable organizations, complex trusts or nonresident aliens.

Corporations have certain tax advantages that are attractive to shareholders. A corporation may merge with another corporation in a reorganization under Section 368 of the Internal Revenue Code in which a portion of the consideration (the rule of thumb is at least fifty percent) being received by the existing shareholders is stock, and the shareholders incur no income tax on the stock that is received until the stock is sold. In addition, Section 338(h)(10) of the Internal Revenue Code allows the sale of a business in a stock transaction to be treated as though the transaction was a sale of the assets of the corporation.

The limited liability company, which is generally known as a "LLC," is a business entity that has the characteristics of both partnerships and corporations by combining the corporate advantage of the limited liability with the income and losses being passed through to the owners, meaning that the LLC is taxed like a partnership or S corporation. Since the LLC is not taxed as a separate entity, the income and losses are reported on the tax returns of the owners. A LLC is owned by its members and does not have any restrictions on the number of members it can have. The members of a LLC are similar to partners in a partnership or shareholders in a corporation. The members of a LLC have the same limited personal liability provided to shareholders of a corporation. A member of a LLC will resemble shareholders in a corporation if the LLC utilizes a manager, since the members will not participate in the management of the LLC. However, if the LLC does not utilize a manager, then the members will be similar to partners in a partnership, since they will have a direct voice in decisions made by the LLC.

Although a limited partnership is similar to a LLC, it is substantially different in that a limited partnership has one or more general partners which have unlimited liability that manage the business and limited partners having limited liability with no management responsibility. An LLC will generally be a preferable business entity to a limited partnership.

One of the primary reasons for choosing the corporation or the LLC as the business entity is to protect the owners' personal assets from potential liabilities that may occur in the operation of the business. Without the protection afforded by a corporation or LLC, the owners will remain personally liable for the debts of the business. In operating a business, one should carefully consider the selection of the right business entity in evaluating the risks and tax consequences.

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