ARCADIA NEWS
Vol. 21 No. 10 AWARD WINNING NEIGHBORHOOD NEWS SINCE 1993 January 2014
ARCADIANEWS.COM / ARCADIAHO.ME

Starting a Business: One size doesn't fit all

By Jonathan Hasebe

For many entrepreneurs who want to start a business, one of the first questions they'll need to answer is what form the business should take.

In Arizona, business organizations primarily take one of two main forms: a "C" corporation, or a limited liability company ("LLC"). Other common forms include an "S" corporation or a limited partnership. Many entrepreneurs who are unaware of the different distinctions between the types of business entities may immediately gravitate towards a "C" corporation because it's a form that we often hear about in the news.

Still, for many small businesses an LLC might be better tailored for the owner's needs over a more rigid and formal "C" corporation. In general, a business owner should consider a number of factors when determining the structure of his/her business, including formation requirements, ownership, tax considerations, and management structure.

The formation of either a "C" corporation or an LLC is similar. When incorporating a business in Arizona, the incorporator will file Articles of Incorporation and a Certificate of Disclosure with the Arizona Corporation Commission ("ACC"). Bylaws will need to be drafted and adopted and a board of directors will need to be appointed. Additionally, within 60 days of their filing, the articles of incorporation must be published and an affidavit of publication should be filed with the ACC. Similarly, an LLC will need to file and publish its Articles of Organization.

The governing document of an LLC is called an Operating Agreement or Limited Liability Company Agreement.

The ownership of a corporation is similar to that of a limited liability company with a few key differences. Owners of a corporation in Arizona are called shareholders. A "C" corporation must have at least one shareholder but there is no upper limit on how many shareholders a "C" corporation may have. The shareholders hold capital stock in the corporation, which can be broken down

into multiple classes with different rights and preferences. Although preferential distributions may be permitted for one class over another, distributions within each class of stock must be proportionate to the ownership.

As a corporation has shareholders, an LLC has members. Like a "C" corporation, an LLC must have at least one member. While it is permissible to classify membership interests into multiple classes with different rights and preferences like a corporation, it is also permissible to provide for different distribution rights within the same class of interests. As an example, an LLC may be owned on an equal 50/50 basis by two owners but provide in its operating agreement that one owner who does the lion's share of the work shall receive a higher portion of the profits.

One of the main considerations when deciding between an LLC or a corporation is tax implications. In a "C" corporation, the IRS taxes at both the corporate and shareholder level. However, only the salary paid to a shareholder-employee is subject to employment tax while all other income is not subject to employment tax. In contrast, income in an LLC is only taxed at the member level. However, all trade or business income of an LLC is considered self-employment income to the members and is subject to the self-employment tax.

In a corporation, the management of the entity is vested in a board of directors. The board of directors must designate day-to-day operations in officers, but certain major decisions need to be approved by the shareholders. In contrast, management of an LLC is vested in either the members or a delegated managing member. The manager can (but does not have to) delegate day to day operations to officers. Like a corporation, certain major decisions typically have to be approved by the members. The management structure of an LLC provides more flexibility as rights and responsibilities are laid out in the operating agreement. The flip side of this is that there is less case law regarding duties owed by managers and members in the LLC context versus the well-developed body of corporation case law which may provide less certainty in the enforceability of certain provisions in an LLC's operating agreement.

Overall, business owners should carefully weigh the pros and cons of each type of structure before deciding what form their entity should take. "C" corporations, "S" corporations, LLCs, and limited partnerships each have a unique nature which might fit well for one type of business but not for another.

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