

Sue and Bill plan to open an accounting firm and expect to work full time in the firm. They expect to incur a small loss during their first year of operation and expect to be profitable after the first year. What are the tax law requirements for structuring the business as a partnership or an S corporation? Which would you recommend and why?

Sue and Bill could form partnerships under:

General partnership – each partner could manage the business but both would have unlimited liability and share in profits and losses.

Limited partnerships – has at least one general partner (manages) and one with limited liability but no authority to manage.

Limited Liability Limited Partnership – not in all states and general partner has liability

Limited Liability Company – some states do not allow personal service firms to have LLC (offer LLLP instead). Every partner has limited liability and tax rules allow the check-the-box regulations to be treated as a partnership or taxed as a corporation

Limited Liability Partnerships – has a default classification as a partnership as the LLC and can use the check-the-box regulations.

S-Corporations – eligible entity is treated under the rules of Subchapter S of the IRC. The LLC can elect to be treated as a corporation with the check-the-box or they can file a partnership tax return where partnership tax rules apply.

State law governs the regulations so the legal entity is created by the state (pass through entity), whereas tax authorities do not consider partnerships as taxing entities. Each partner reports tax items on individual returns (tax liability passes through each partner). Form 1065 is completed for the IRS as an information return about income and allocations to partners.

All the profits and losses for the LLC pass through to the LLC who report on individual tax returns. Employment/payroll taxes are a consideration since the S-corporation would create a saving for the partners in this area.

I think the LLC should be considered since the LLC can elect to be taxed as a corporation and will have much less cost and administration.

Response 2

General partnerships are not available to service companies wishing to start a business as a partnership which is worrisome since all partners have unlimited liability for all partnership debts. In a general partnership it is possible for each partner to pay more than the amount they invested in the company. This is the largest disadvantage to a general partnership. For Sue and Bill I would recommend a LLP since this type of partnership protects the partners individually. "A partner is not liable for damages resulting from failures in the work of other partners or of people supervised by other partners in a LLP" (p. 9-3). If their state recognizes a LLLP (Limited Liability Limited Partnership) then Sue and Bill should take advantage of that structure of business. Basically an LLLP is like a traditional LLP, with the benefits of an LLC as General Partner built in. Another advantage to a LLLP is that under check the box

regulations the LLLP can be treated as a partnership or a corporation. The default classification is a partnership. A suggestion I might give is to structure the business as a LLLP and elect to be taxed as an s-corporation.

If the business expects to be profitable after the first year but have a loss during the first year forming an LLP or an LLC is a good idea for those losses to pass through to the owners, but as the business grows incorporating may be a good idea.

Reference

Anderson, K., Pope, T., & Kramer, J. (Eds.). (2010). *Prentice Hall's federal taxation 2010: Corporations, partnerships, estates, and trusts* (23rd ed.). Upper Saddle River, NJ: Prentice Hall.

<http://www.lodmell.com/llp-limited-liability-limited-partnership>