

# SOLE PROPRIETORSHIP, LLC, OR CORPORATION?

Choosing an Appropriate  
Legal Entity

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**Practice Areas Include:**

- Business
- Taxes

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# Disclaimer

- Limited overview
- General discussion / specific facts matter
- Laws change

# Forms of Entities

- Governed by state law and the agreements entered into by the owners.
- Sole Proprietorship
- Partnerships (not used much anymore)
- LLCs
- Corporations

# Sole Proprietorship

- One person operating on their own
- No separate filing requirements
- No operating documents
- No liability protection
- Good idea – sell dolls on eBay
- Bad idea – home builder

# What is limited liability?

- Assets of entity are separate from owners
- If you “respect the form,” recovery will be limited to the assets of the entity. To respect the form:
  - Maintain separate accounts
  - Follow rules of governing documents
  - Fund the entity with adequate capital.
  - Entity is not an “alter ego.”
  - Limited liability is...limited.

# LLC / limited liability company

- Can be the simplest formalized entity
- Often ideal combination of asset protection and flexibility
- Created by filing Articles of Organization with Secretary of State
- Owners (“members”) should adopt an operating agreement. Sets the rules for how LLC will operate



# LLC / limited liability company

- Pros
  - Tax efficient.
  - Liability protection. Recovery limited to assets of LLC.
  - Very flexible.
- Cons
  - Cost – filing fee and operating agreement
  - Must “respect the corporate form”

# LLC / limited liability company

- The operating agreement
  - An LLC without an operating agreement is governed by state law. Bad for multiple owners.
  - One owner – simple operating agreement
  - Multiple – a contract. Establishes the rights of the members.
- Where to get operating agreement

# LLC / Sole Proprietor Tax

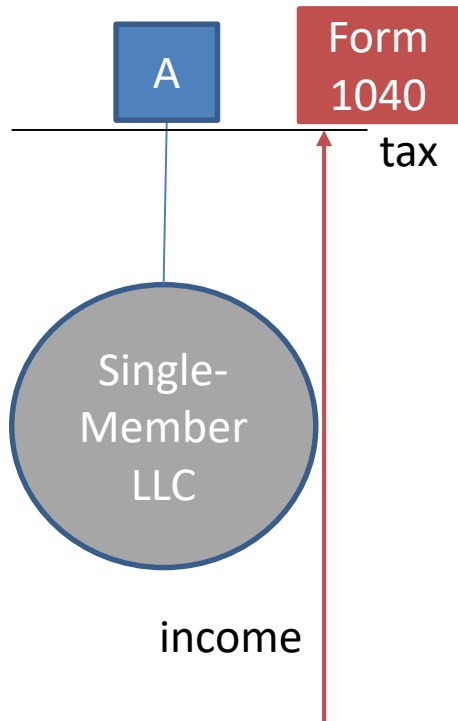
- Taxation:
  - Single-member LLC is a “disregarded entity” – for tax purposes, doesn’t exist.
    - Report on 1040.
    - Self employment tax @ 15.3%
    - Half of SE tax is deductible (normally employer pays this)

# LLC / Multi-owner Tax

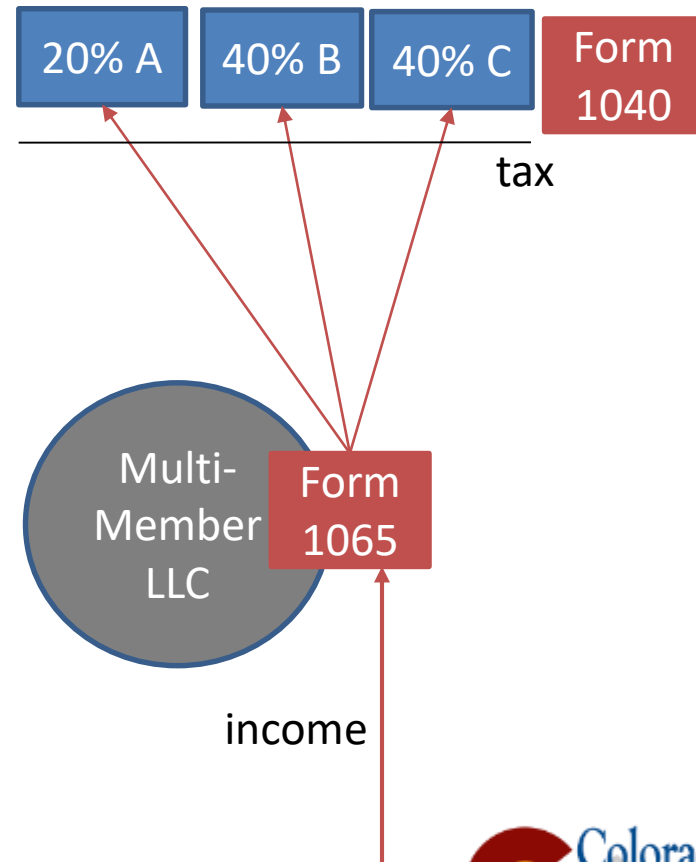
- Two or more owners: Default partnership treatment. "Pass through" structure - income passes through to the individual.
  - Company files Form 1065, tax return for partnership income.
  - K-1 issued to each owner. Reports owner's share of income, loss, etc.
  - Owners pay income tax at their individual rates.
  - Services payments - will owe self employment tax.
  - LLC can elect to be treated as S corp or C corp.

# Tax Structures

Single Member LLC or  
Sole Proprietorship –  
Disregarded Entity



Multiple Member LLC



# Corporation

- The classic
- Built for outside investors, reliance on state corporation laws.
- Uses multiple agreements instead of an operating agreement – articles of incorporation, bylaws, shareholder agreements, more.
- Taxed as a C-corp or S-corp: these are purely tax elections, not types of entities.

# Corporation

- Pros
  - Can rely more heavily on statutes than LLCs
  - Shares make ownership easy to track
  - Preferred by outside investors
- Cons
  - Tax structure
  - Cost to operate
  - Complexity of management – officers and directors
  - Structural rigidity compared to LLC

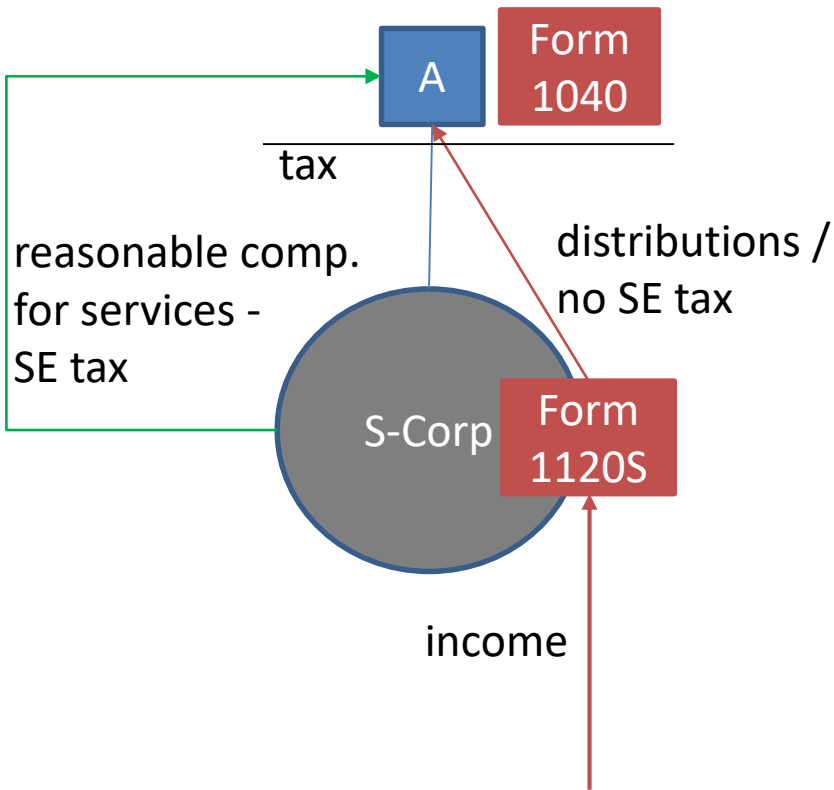
# Corporation Tax

- Default treatment is as a C-Corp, subject to double taxation
  - C corporation pays income tax at the corporate level
  - Owners pay income tax on dividends paid to them
- Can elect treatment as an S-Corp.
  - A “pass through” entity like a partnership, taxes are not paid at the corporate level
  - Restrictions on ownership, classes of interest
  - Owners are subject to SE tax on reasonable compensation for services. Excess is not subject to SE tax.
- LLCs can also elect C-corp or S-corp treatment. If it does, needs to be addressed in operating agreement.

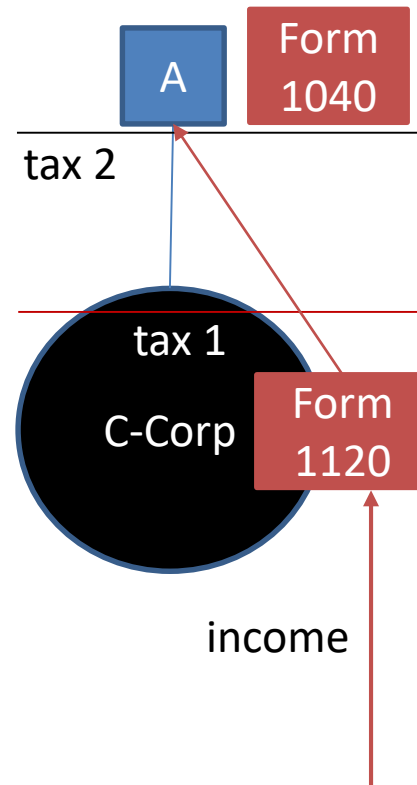


# Tax Structures

## S-Corp



## C-Corp



# Other Entity Types

- Nonprofit – no private inurement; state and federal restrictions
  - Annual reporting requirements
  - Generally tax exempt
- Public benefit – weird middle ground between nonprofit and for profit.
  - Investors accept lower returns in exchange for doing good.

# Items to Consider

- Changes in tax laws
- Conversion of entity:
  - Out of state to in-state
  - LLC to corporation or vice versa
- Sales and Use Tax
  - When/how to collect
- Tax withholding/employees

# Wrap Up

- Choices range from simple to complex
- Things to consider in choosing form:
  - Objectives. Side hustle? Full time job? Scalable business? Needs investors?
  - Potential for liability. Who is your customer/client? Consequences if something goes wrong?
  - Burdens of compliance.
- Not in this alone!

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