



SOLE PROPRIETORSHIP, LLC, OR CORPORATION? CHOOSING AN APPROPRIATE LEGAL ENTITY





Pikes Peak Small Business Development Center

FREE CONSULTING | PRACTICAL TRAINING | BUSINESS RESOURCES

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Steve Ogle

Attorney at Law, Sparks Wilson, P.C.

Expertise Includes:

Business Law

Estate Planning and Probate

Tax

[View Steve's Bio](#)

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
- Risk tolerance factors:
 - Earnings / cost
 - Potential for harm
 - Severity of harm

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

LLC / limited liability company

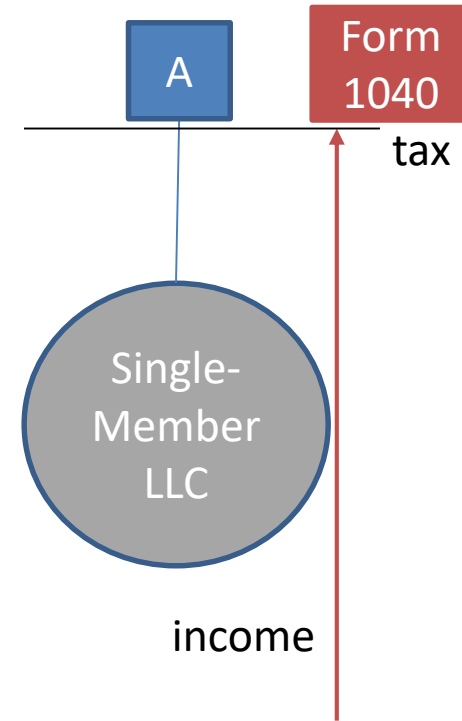
- Pros
 - Tax efficient.
 - Liability protection. Recovery limited to assets of LLC.
 - Very flexible.
- Cons
 - Cost – filing fee and operating agreement
 - Must “respect the corporate form”

LLC / limited liability company

- Owners (“members”) should adopt an operating agreement.
 - Sets the rules for how LLC will operate
 - 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

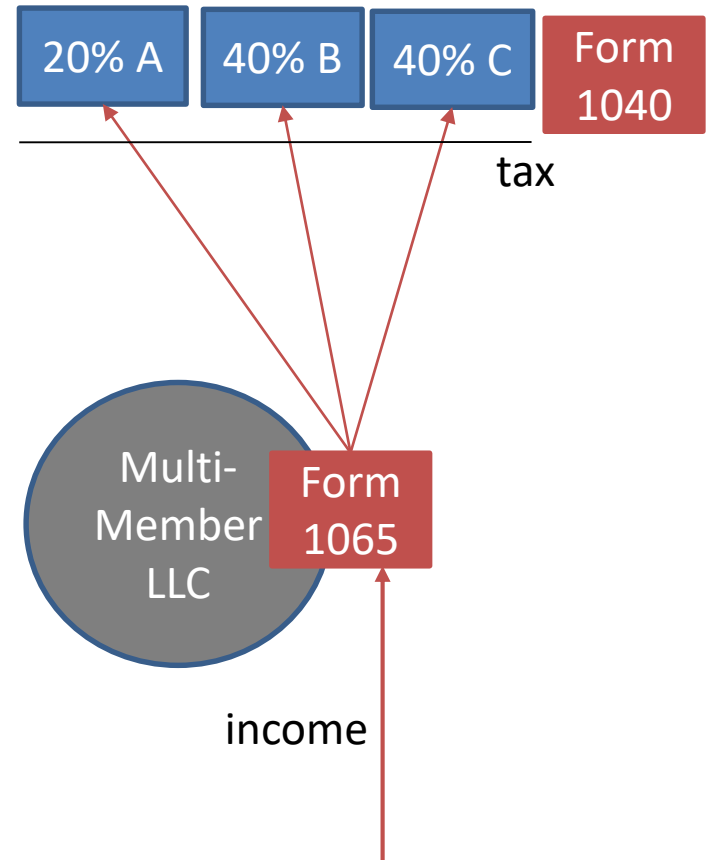
LLC / Sole Proprietor Tax

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



LLC / Multi-owner Tax

- 2 or more owners:
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.
 - LLC can elect to be treated as
S-corp or C-corp.



Corporation

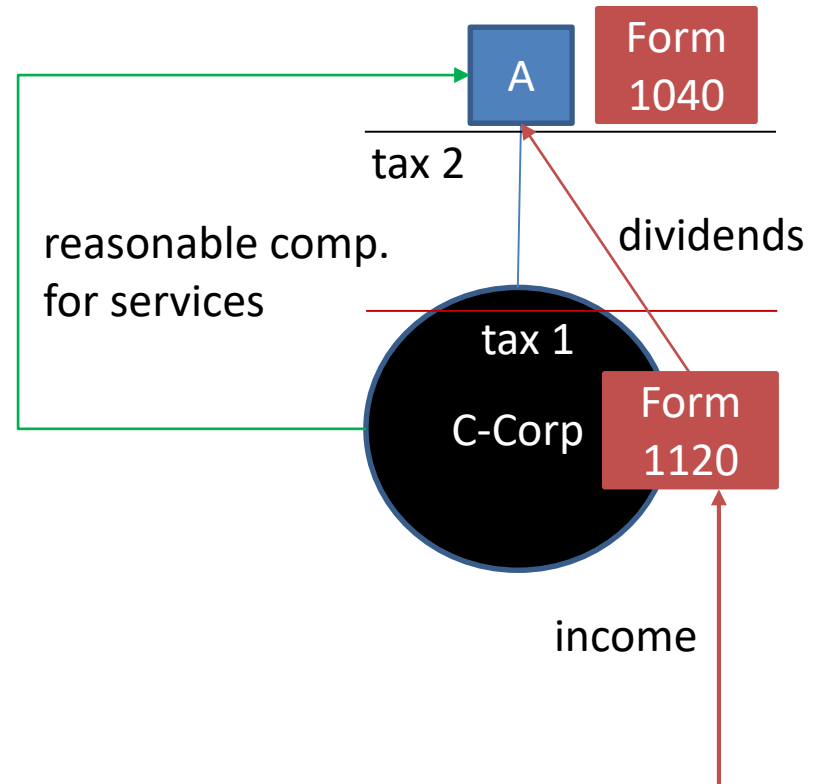
- The classic
- Built for outside investors, reliance on state corporation laws.
- Uses multiple agreements instead of an operating agreement – articles of incorporation, bylaws, shareholder agreements, more.
- Taxed as a C-corp or S-corp: these are purely tax elections, not types of entities.

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

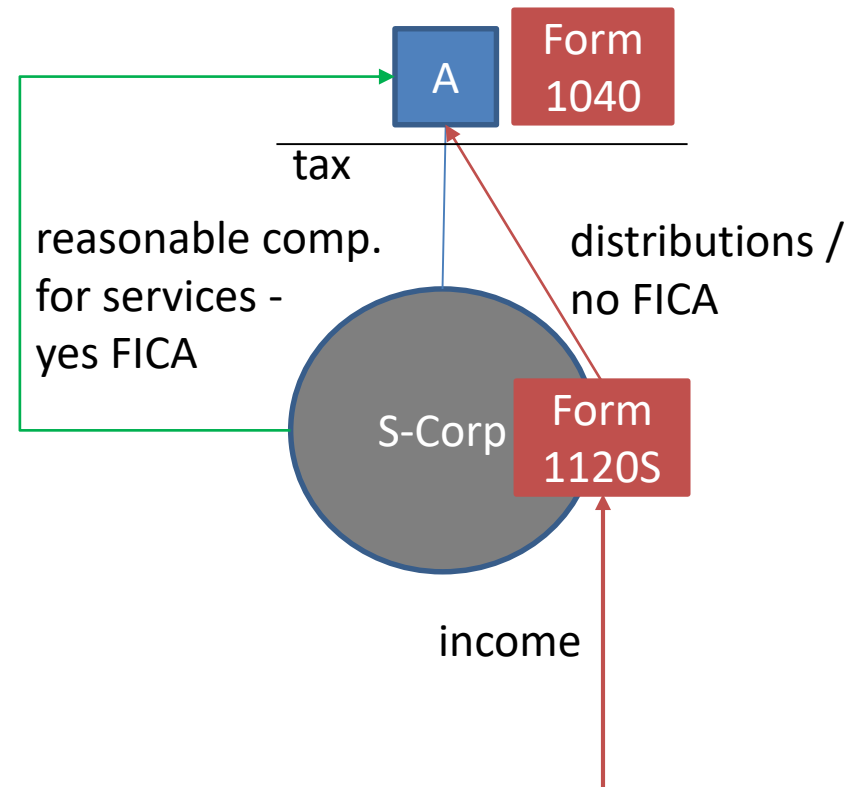
C Corporation

- Default treatment is as a C-Corp. Double taxation:
 - C corporation pays income tax at the corporate level
 - Owners pay income tax on dividends paid to them
- Reasons for using this structure:
 - Outside investors
 - Benefits available only to C corps



S Corporation

- 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 FICA on reasonable compensation for services. Excess is not.
- LLCs can also elect C-corp or S-corp treatment. If it does, needs to be reflected in operating agreement.



Other Entity Types

- Nonprofit – no private inurement; state and federal restrictions
 - Annual reporting requirements
 - Generally tax exempt
 - Can still receive compensation. Effective where no profit motive
- Public benefit –nonprofit and for profit hybrid.
 - Investors accept lower returns in exchange for doing good.
 - Greenwash hazards; accountability

Items to Consider

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

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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