Sole Proprietorship, LLC, or Corporation? Choosing an Appropriate Legal Entity

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Presented by

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- **Expertise Includes:**
- Business Law
- Estate Planning and Probate
- Tax

- View Steve's Bio

Disclaimer

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

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Forms of Entities

- Governed by state law and the agreements entered into by the owners.

- Sole Proprietorship (not an entity)
- 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.

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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”

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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

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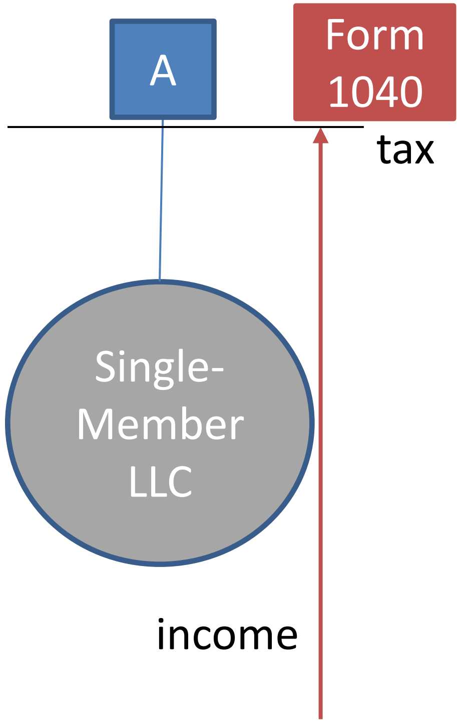
LLC / Sole Proprietor Tax

- 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)



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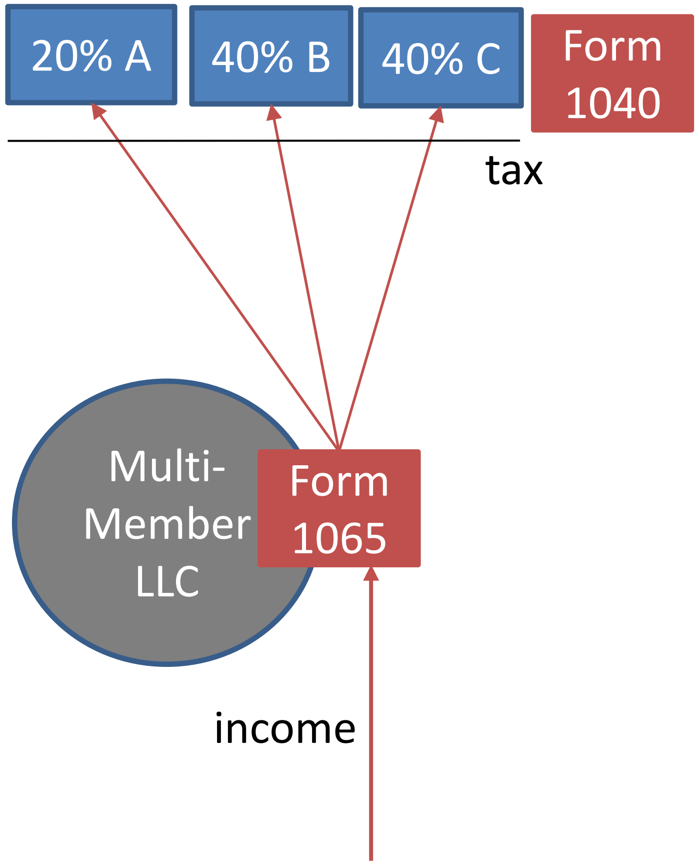
LLC / Multi-owner Tax

- 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.



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Corporation

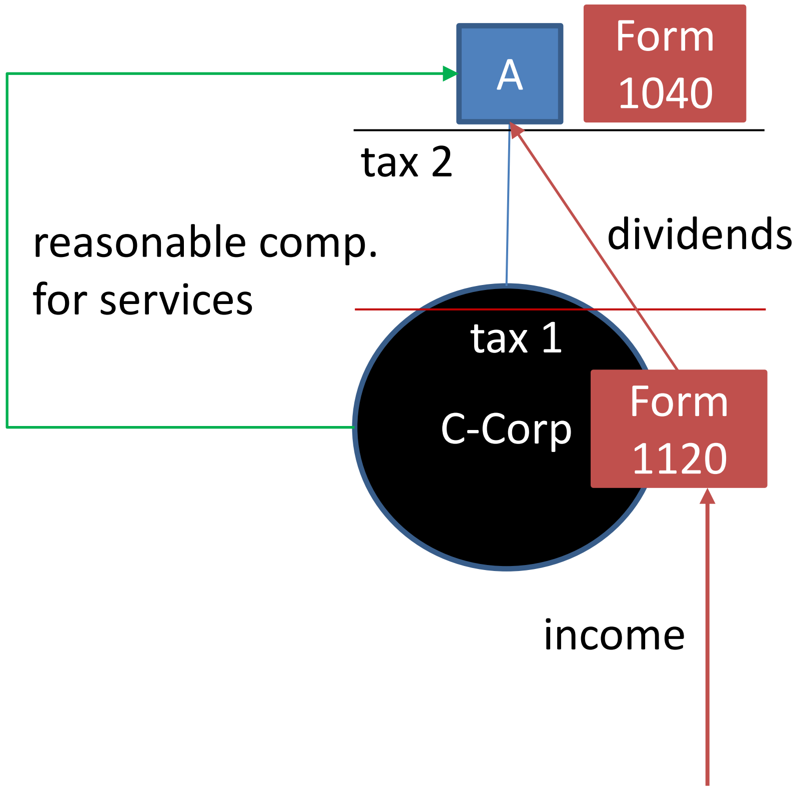
- The classic
- Built for outside investors, reliance on state corporation laws.
- Uses multiple agreements instead of an operating agreement – articles of incorporation, bylaws, shareholder agreements, more.
- Taxed as a C-corp or S-corp: these are purely tax elections, not types of entities.

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



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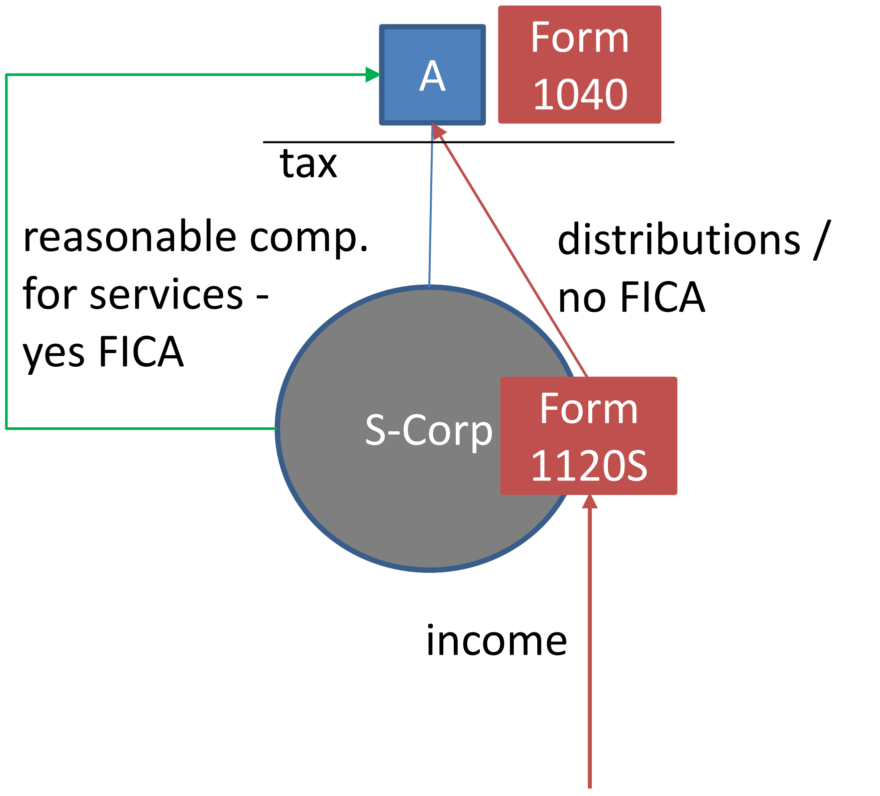
S Corporation

- 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

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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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