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**IN THE BLACK
BUSINESS SELECTION
WORKBOOK**

Use the following workbook to help you determine
which business entity is right for you.



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Congratulations on deciding to grab your life by the horns and start your own business! This workbook was designed to help you think about the form in which your business will operate, as it outlines some of the considerations that bear on that decision. It will also help you understand the effect of choosing alternative forms and assist you in formulating your tentative thoughts about what is appropriate for your business.

Alternatives Available

There are several types of business entities, the most common being sole proprietorships, general partnerships, limited liability partnerships, limited partnerships, limited liability companies, S corporations, and C corporations. But absent unique state law considerations, most start-up businesses are organized as sole proprietorships, limited liability companies, or S corporations.

Sole Proprietorship

New businesses are often short on cash, and a sole proprietorship is an inexpensive way to organize and operate a business. No formalities or filings are required to create a sole proprietorship--an individual simply begins operating the business. A sole proprietorship must obtain business licenses like other businesses and may want to preclude others from using a similar name by registering an assumed business name, but it does not have an obligation to register with the state and keep the registration current and decision-making need not follow any formal structure.

The tax treatment of a sole proprietorship is also favorable. The profit or loss of the business is reported on the owner's individual tax return. If the business incurs losses in its formative years, they can be deducted against income received by the owner from other sources.

A sole proprietorship does, however, have two disadvantages. First, this form for doing business presupposes that the business has one owner. If there are two or more owners, another form must be used. Second, the owner of a sole proprietorship is personally responsible for all the debts and liabilities of the business. If the business fails or if its operations or products injure a customer or other person, the personal assets of the owner, including personal bank accounts and investments, are at risk for payment of claims.

Partnership

Partnerships have the same advantages as sole proprietorships--they are inexpensive to create and operate, and their income and losses pass through and is reported on the individual income tax returns of the partners. This allows partners to use start-up losses to reduce their income from other sources. In addition, partnerships can accommodate more than one owner.

Unfortunately, partnerships have the same disadvantage of sole proprietorships in terms of liability exposure. Partners are jointly liable for all partnership debts and liabilities. A creditor of the partnership can satisfy its claims out of the assets of a single partner, although a partner who pays more than her share has a right of reimbursement from the other partners.

There are types of partnerships that provide liability exposure, but they are not suitable for most businesses. For example, limited partners in a limited partnership are not personally responsible for the partnership's obligations. But limited partnerships are used almost exclusively as vehicles to make gifts of interests in investment assets to family members in connection with individuals' estate planning and for widely held interests in mineral or other property syndications. Limited liability partnerships provide

Limited Liability Company

Limited liability companies can have one member like a sole proprietorship or more than one member like a partnership. But unlike a sole proprietorship or partnership, they provide limited liability to their members. An LLC is an entity separate from its owners and as such is responsible for its debts and liabilities. If the business fails or the claims against it exceed its assets, the members may lose their investment in the LLC, but their personal assets generally are safe.

Because they offer limited liability protections for all owners, LLCs have supplanted both general and limited partnerships as a form for operating new active businesses. They are also used frequently in lieu of sole proprietorships.

An LLC provides the same favorable income tax treatment as a sole proprietorship and partnerships--all income or loss of an LLC is divided between its members and is reported on their individual tax returns. As a result, losses may be used to offset against other income of the owners.

The primary disadvantage of an LLC is that it is more expensive to create and operate than a sole proprietorship or partnership. Creation of an LLC requires a filing with a state and filing fees, and sometimes taxes, must be paid. Annual reports must be filed with the state to maintain an LLC's existence, and fees and taxes are due with those reports. In this state, the fees and taxes payable by an LLC are relatively low, but they can be considerable in some states and may be a consideration if you intend to do business in one of those states.

Subchapter S-Corporation

The advantages and disadvantages of an S corporation are similar to those of an LLC. Both can have one or more owners, all of whom enjoy the protection of limited liability. Both are created by filing documents at the state level and must file annual reports, making the cost of their creation and operation similar. But S corporations must follow corporate formalities and hold annual shareholder and director meetings, which adds to the cost of their operation.

S corporations feature pass-through income tax treatment, and their income or loss is reported on the individual tax returns of its shareholders, so start-up losses can be claimed by the shareholders. But there are some differences in the tax treatment of S corporations and that of sole proprietorships, partnerships, and LLCs that I will discuss later.

C-Corporation

The last form of business entity used by small businesses is a C corporation. This is a corporation that has not elected to be taxed as an S corporation. C corporations provide limited liability for all of their owners and are comparable to LLCs and S corporations in terms of creation and maintenance costs.

But a major difference is that a C Corporation is not a pass-through entity for income tax purposes. A C corporation reports its income or loss on its own tax returns. This means that start-up losses cannot be used by shareholders to offset income from other sources. It also means that C corporation income is subject to a double tax. The corporation pays tax on its income when it is earned and, if the income is distributed to shareholders as a dividend, they have taxable income and pay a second tax. If corporate earnings are accumulated rather than being distributed, they may increase the value of the corporation's stock and the shareholders will have taxable gain when they sell their stock or the corporation is liquidated. This double tax deters most small businesses from using the C corporation form.

Selecting a Form of Entity

A sole proprietorship is a viable way to operate your business if you will be the sole owner and are not concerned about the consequences of being exposed to its liabilities, believe that insurance or other protections will be available to cushion the blow from any conceivable losses, or are concerned that the additional cost of using another form of entity could substantially limit the chances that the business will be successful. If a sole proprietorship is not appropriate, you will need to decide between an LLC and an S corporation. They share common attributes, but there are important differences that may determine which entity is best for your business.

Advantages of LLCs Transparent Income Tax Treatment

Although both LLCs and S corporations feature pass-through treatment for income tax purposes, an LLC is more transparent. For example, a member can generally transfer assets to an LLC tax-free and an LLC can often distribute assets to members tax-free. The transfer of assets to an S corporation is tax-free when the corporation is created, but shareholders may be taxed if they transfer assets other than money later. Moreover, all distributions of hard assets by an S corporation to its shareholders have the potential to create taxable gain.

An S corporation's lack of tax transparency makes this form of entity particularly unsuitable for the ownership of investment real estate or other property that is likely to appreciate in value. After the corporation acquires the property, it may be difficult to restructure the ownership of the property without incurring a tax.

Inclusion of LLC Debt in Basis

Start-up businesses often operate at a loss initially, and an LLC may allow a greater amount of these losses to be passed through to its owners for deduction on their current income tax returns than an S corporation can. Neither LLC members nor S corporation shareholders are allowed to deduct losses that exceed the tax basis in their membership interests or stock, but the basis of LLC members is increased by the amount of the LLC's obligations owed to third parties, while third-party indebtedness does not affect the basis of S corporation shareholders' stock, even if they guarantee its payment.

Variety in Owner's Interests

Owners of a business can have different financial or tax goals, and differences can be accommodated more easily with an LLC than with an S corporation. For example, an LLC can have members who participate actively in the business and have interests similar to common stock and members who are mere investors and have interests similar to preferred stock. An S corporation can only issue one class of stock.

If some owners of a business are in higher income tax brackets than others, it may be possible to allocate a disproportionate share of an LLC's deductions or losses to them, thus minimizing the combined income tax burden on all members. The one class of stock rule prevents S corporations from making special allocations. An LLC member's receipt of an interest in profits in exchange for services is not typically a taxable transaction as long as the member receives only a profits interest and no interest in capital. An interest in S corporation stock transferred in exchange for services is, on the other hand, compensation income to the recipient.

An LLC can also have a greater number of owners and more diverse owners than an S corporation. S corporations cannot have more than 100 shareholders and all shareholders must be individuals who are citizens or residents of the United States, estates, certain types of trusts, or tax-exempt organizations. Corporations, partnerships, and LLCs cannot own stock in an S corporation. Neither of these restrictions applies to LLCs.

Flexible Management Structure

An LLC can elect to be managed by its members and have decentralized management like a partnership. Alternatively, it can be managed by managers and have centralized management similar to a corporation or limited partnership. There is also a good deal of flexibility to tweak the chosen management structure under the terms of an LLC's operating agreement.

An S corporation must adhere to strict rules for the management of corporations. The shareholders elect directors who are responsible for the management of the corporation, and the directors appoint officers who carry out their management policies. Some small businesses consider this overly rigid and formalistic.

Securities Law Exemption

Stock, including that of S corporations, is considered to be a security subject to state and federal securities laws. Some states specifically treat LLC members' interests as securities, but most follow the federal rule that makes such interests securities only if they are "investment contracts." With an investment contract, an investor relies on managers to produce income and make the investment valuable. This occurs in a manager-managed LLC, and interests in such entities are securities. But members of a member-managed LLC have the right to participate directly in management, and their interests are not generally considered to be investment contracts. Therefore, interests in LLCs do not need to be registered as securities or qualify for any of the narrow exemptions.

Advantages of S Corporations Employment Tax Treatment

S corporations enjoy favorable employment tax treatment, which can be quite valuable in some circumstances. Most income of LLCs taxed as partnerships is treated as earnings of the members from self-employment and is subject to self-employment tax in the year earned, even if it is not distributed. In contrast, S corporation income that passes through to shareholders is not treated as earnings from self-employment. It is subject to employment tax, in the form of FICA and hospital insurance taxes, only to the extent used to pay compensation to shareholder-employees. S corporation income retained as working capital, used to acquire capital assets, or retained for future use is not subject to employment tax, nor is income distributed to shareholders as dividends.

The self-employment tax and the combined FICA and hospital insurance taxes imposed on employers and employees are imposed at the same rates. The rate is 15.3% on earnings up to the social security wage limit, and additional amounts are taxed at lower rates. Employment taxes can be substantial and merit consideration in selecting a form of business entity.

Familiar Management Structure

Although the management structure of an S corporation may be considered rigid and formalistic, the corporate law of most states is based on model legislation that has been widely adopted or on long-standing legal concepts recognized in other states. In contrast, LLC laws are of relatively recent origin and there is a good deal of variation between states' laws. As a consequence, the rules necessary to quickly and efficiently resolve disputes involving LLCs and their members may not be settled.

Choosing Between an LLC and S Corporation

The form of entity that is appropriate for your business will depend upon which of the advantages and disadvantages of the likely alternatives is the most important. A business interested in attracting outside investors will, for example, typically be organized as an LLC because of the absence of rules limiting

types and numbers of investors and the ability to structure ownership interests that are attractive to many different people. On the other hand, a business that will be owned and operated by its members may find the employment tax savings available with an S corporation compelling, especially if a large share of the business's income will be used to provide working capital or make capital investments.

Conclusion

Use the following exercise to help you determine the form of entity that should operate your business.

Need additional help? Book a consultation with an attorney at The Dean Law Firm, PLLC for further assistance. Good luck on starting your new business!

WHICH BUSINESS ENTITY BEST SUITS YOUR CORPORATE NEEDS?

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ACTION ITEMS

Do you need business agreements to run your business? Do you need to file a copyright or trademark application to protect your intellectual property? Do you have a corporate handbook? What do you need to do next to accomplish your business goals?

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