Entity Selection

Introduction

Before you actually start the business, you need to decide what type of tax entity you will select. This decision is not irreversible. There are procedures to change from one entity to another. You must decide if you will own this business yourself or if the business will have multiple owners. Again, this decision is not irreversible. You must decide whether the nature of your business or personal attitude requires limiting liability. You must decide which entity taxation and benefits deductibility best meets your situation. You must understand that the tax people will receive their taxes no matter which entity you select. You must understand that no one entity is head and shoulders better than the others. Otherwise, every business would be structured the same. This is not the case. The entity you select should be selected based upon your personal preferences and personal tax structure.

You Have a Partner – The Government

No matter what type of entity you select, the government has a tax structure in effect to make sure they collect their taxes. You most likely have worked for someone and received a paycheck. Did you ever get to take the gross amount home? No. The government deducted their taxes before you got to take home your net pay. What came out of your pay? The following is a summary of typical deductions:

Federal withholding tax	15.00%
Social Security	6.20%
Medicare	1.45%
State withholding	2.00%
State unemployment/disability	1.00%
And then the company matched:	
Social Security	6.20%
Medicare	1.45%
Total taxes	33.30%

You have a one-third partner in the government. You need to accept this fact. You need to include this fact in pricing. You need to start saving and paying taxes when you make it. Do not wait until you file your first business income tax return on April 15th next year. The biggest reason I see businesses going out of business is not providing for taxes during the first critical year. They get their hands on tax money that they were never able to touch before. They build the new deck on the house they always wanted. Then on April 15th, they owe the 33% taxes from last year during this year, as well as having to pay the 33% for this year. The 66% tax in one year puts them out of business.

If you need to take home $40,000, you need to gross $60,000 for yourself and set aside $20,000 for taxes. In this example, multiply your draw by 50% to determine estimated taxes.

If you take home a gross of $60,000, multiply by 33% to determine the government's share.

Start setting aside taxes from day one, no matter what entity type you select. Not providing for taxes will put you out of business.

WARNING: The above 33% is just a guideline. Your actual rate may be higher or lower.

Proprietorships and Partnerships

The first decision in selecting an entity is to decide if you are going to establish this business alone or with other individuals.

If you do it alone, you make all the decisions, reap all the rewards, and incur all the initial costs. If you do it with others, you segregate responsibilities, share the rewards, and share the initial costs. Setting up with others creates other factors that will need to be documented such as:

What happens if one partner works 40 hours a week and the other does not work?

What happens if one partner puts in all the initial money and the other has no money?

What happens if one partner should want to leave?

What happens if one partner should die?

What happens if one partner should become disabled?

What is the Partnership value in these circumstances?

It is not enough in a Partnership simply to shake hands and say we share everything 50/50. Just because your partner is a relative does not change the situation. You need a Partnership Agreement if you elect to have a partner.

The first hat you need to put on when you start a business is a salesman's hat. If you do not have customers, you do not have a business. It is imperative to evaluate your own ability. If you are a production person, hesitant in selling, you may be wise to partner with a salesman hesitant in producing. Two salesmen may make large initial sales, but can't deliver the product or service. Two production people may have super-efficient ways to deliver the product, but no customers to deliver it to. One person responsible for sales and one person responsible for production is usually the better combination.

In a Partnership, it is imperative that a listing of responsibilities be assigned to each partner. It is imperative that each partner allows the other partner to do his assigned tasks without interfering.

Time is your most valuable asset. The successful business owner finds a balance between business, family and self. Yes, as a business owner, you will work longer hours than an employee. However, you cannot spend 80 hours a week on business. Neglecting the family can lead to divorce which often leads to the end of the business. Find your balance between work, family and self. Establish a workable policy; I don't work Sundays, I go home to eat dinner with the family, I play golf once a week, etc. The person who gets the right balance improves their chances for success.

Have you decided to go it alone? You have decided to be a Proprietorship. Have you decided to establish the business with others? You have decided to be a Partnership.

But, not so fast! You need to ask yourself the next question. Am I concerned about losing my personal residence and personal investments?

Corporation and Limited Liability Companies

Every business entity, right from the startup phase, should have liability insurance. In the event you do something to cause damage or personal injury, you need to have insurance to cover the liability. This liability is usually limited to a certain dollar amount. What happens if you are found negligent beyond that amount? First, they will come after the business assets. If there are not enough business assets, the next step is to go after your personal assets including your personal residence and personal savings.

You could be a painter using a new chemical brush cleaner. It spills down the drain and goes into the local river. The crabs become contaminated. People eat the crabs and 100 die. They trace it back to your negligent act. A $100,000,000 judgment is filed against you. They take what they can and a judgment against your business and you personally are filed and continue on record. Three years later, you win a multi-state lottery for $75,000,000. Who do you think will get the money?

If you deal with toxic chemicals, cars or trucks across the road, airplanes, boats, heavy equipment, etc., you are in a dangerous industry and should consider ways to limit your liability.

If you are in roofing, electrical, plumbing, home construction, siding, etc., the potential for lawsuits is less, but personal injury occurs and you should consider ways to limit your liability.

If you are in bookkeeping, secretarial, retail, food service, etc., the potential for lawsuits is lower, however, you should consider ways to limit your liability.

Many people simply do not want to take the chance that a business could result in a lien against their home or personal assets. If that is your case, you should limit your liability.

Limiting your liability simply means that in the event of a judgment against your business, they can go after the business assets, but not your personal assets.

At this point, you need to understand personal guarantees. If your business borrows money from a bank, they most likely will make you sign personally on the debt. If you rent business property, the lease may require a personal guarantee. If you have a business credit card, they probably required you to sign personally. Other business owners understand the limited liability structure and will require your personal guarantee to circumvent limited liability. If you want the loan, you will have to sign personally. The real benefit of limited liability is the result of judgment against the business for an unforeseen circumstance.

To limit your liability to business assets, you should set up either a Corporation or Limited Liability Company.

A Corporation is a totally separate entity from you. The Corporation issues you corporation common stock and you become a stockholder. The company can issue the stock to only one person or to more than one person. The stockholders appoint a board of directors. The board of directors appoints the company officers that run the company. A single person can be the only stockholder, the only board member, the only company officer and the only employee. The Corporation files a corporation income tax return and pays taxes based on corporation tax rates. The Corporation gives you a W-2 for wages paid you and a 1099 for dividends paid you (small businesses do not normally issue dividends). You report the salary and dividends on your personal return.

A Limited Liability Company (LLC) does not have the formal structure of a Corporation. It functions as a Proprietorship or Partnership, but with the benefit of limited liability. A single owner LLC files a business income Schedule C as an attachment to their personal return. A multi-owner LLC files a Partnership income tax return but does not pay tax. Each partner receives a K-1 that tells him how much to report on his personal returns. Each member of the LLC pays quarterly estimated taxes.

People are familiar with being employees. When you make $750 per week, you never get to take home the full amount. You receive a net check of say $500. Your company sends your taxes to the government. The only money you had a possibility of spending was the after tax dollars.

The biggest problem with businesses going out of business is not providing for the first year income taxes. In selecting the corporation structure, you become an employee and only get to spend the net check. Your personal lifestyle does not change. The Corporation sends in the taxes every month.

As an LLC (as well as a Proprietorship or Partnership), you get your gross pay and you are expected to send your taxes into the government each quarter. Instead of receiving the $500 net check, you get your hands on the $750. Too often, new business owners spend the $250 tax money on a new deck, business equipment or some item other than taxes. You get to the end of the quarter and the $3,250 ($250 X 13 weeks), required to be sent in, is not paid. You get to the end of the year and file your tax return. You now owe last year's taxes plus, this year's taxes. You are out of business.

If you do not have the discipline to save and pay the taxes, then you have a better chance of survival by being a Corporation.

If you have the discipline to save money and want a less structured approach, you can choose a Limited Liability Company.

If you expect to carry receivables, inventory or have a large equipment need, which requires that cash be retained in the business, corporation tax rates on profits are most likely less than personal taxes. A Corporation is probably your right choice.

If you are a doctor, lawyer, accountant, consultant, etc., you are subject to personal service corporation rules. Your corporation tax rates are most likely higher than personal tax rates. An LLC is probably your right choice.

As a Corporation, you can have a corporation year-end other than December 31st. An LLC (Proprietorship or Partnership) requires a December 31st year-end. Having the Corporation with one-year end and the personal with another, helps in tax planning.

In a Corporation, group health insurance and other benefit programs, including yours, are 100% deductible. As an LLC (Proprietorship or Partnership), the deduction for you is limited. If you need benefits, consider the Corporation structure.

The Corporation structure requires you to be an employee with payroll deductions. You can have a fiscal rather than a calendar year-end. You can fully deduct health insurance and other benefits. For non-professionals, corporation tax rates on the first $50,000 in profits are usually lower than personal tax rates.

The LLC structure does not require the owner to be on a payroll. Your business year-end must be December 31st. Deductions for health insurance and other benefits may be limited.

S-Corporation

When you set up a Corporation, it is not automatically an S-Corporation. We differentiate the regular corporation above as a C-Corporation. To become an S-Corporation, you must register with the federal and state governments. The S-Corporation is an election to have the corporation profits reported on your personal return and to pay taxes at personal rates rather than corporate rates. You are still an employee. However, certain expenses for benefits are not deductible on the corporation but, passed through and reported on the personal return.

The S-Corporation has the tax discipline of the owner being an employee, but the taxability of profits as an LLC (Proprietorship or Partnership).

One Shoe Does Not Fit All

If one structure was right for everyone, we would all be Corporations, Limited Liability Companies, Proprietorships, or Partnerships.

Most small businesses start off as Proprietorships or Partnerships and, as they feel they will survive, convert to Corporations, S-Corporations or LLCs.

If you are in a dangerous industry or have any concern about personal liability, you should incorporate or establish an LLC.

If you want limited liability, the discipline of employee status for taxes, health benefits, and are not a professional, C-Corporation status may be the most appropriate.

If you are a professional, want limited liability, and the discipline of employee status, S-Corporation status may be the most appropriate.

If you are a professional, want limited liability, and do not want your structure to be employee, LLC may be the most appropriate.

If you want limited liability and expect recurring losses, an S-Corporation or LLC may be the most appropriate.

Selecting the right entity is not an easy decision. It is always appropriate to have a professional review your exact set of circumstances.

If you made or make the wrong decision, you can always change it in the future.

Setting Up Your Proprietorship or Partnership

You set up your Proprietorship or Partnership on the local municipal level or county level depending on your state. Your can do it yourself at the municipal clerk or county clerk office. You review name availability, fill out a form, and pay a fee. You then receive a trade name or doing business as certificate. It is not that hard to do it yourself. You need this certificate before opening a bank account, getting an IRS number, registering with your state taxation agency, or registering for local requirements.

Setting Up Your Corporation or LLC

You set up your Corporation or Limited Liability Company at the state level through the Secretary of State office. You can do it yourself by going to your state website, checking for name availability, completing a registration form, and making a fee payment to the state. The state will provide you a certificate of formation as a Limited Liability Company or a Corporation. It is not that hard to do it yourself. Go to www.aicpa.org. Click on research, external links, Secretaries of State. You need this certificate before opening a bank account, getting an IRS number, registering with your state taxation agency, or registering for local requirements.

Using a Website to Assist You

Again, I want to say it is not that hard to set up your own business entity. However, if you google "form an LLC" on page one I found nine websites providing this service. With this many websites it just may be harder than I think for most people. All these websites have you decide if you want to be a Corporation or a Limited Liability Company. They then have you provide them the information they need to put onto the state forms. They file the forms for you. You pay them a fee plus the state filing fee. This certainly sounds simple. It gets complex the way they add additional services and price package those services.

In Connecticut I recently formed an LLC. Since I lived in Connecticut and had a Connecticut address I was able to make myself the registered agent who receives all notices from the state. To change the registered agent, I would need to file a change form and pay a fee. Many of the pricing packages include registered agent service even if you could serve as your own registered agent. This could lead to a fee to change to yourself or an annual fee for the website to continue as registered agent another year.

If you do use a website recognize that their lowest level service will legally form your LLC or Corporation. Before ordering any higher cost services make sure you understand what you are getting.

Business Name

When a person sees your business name they should know who you are and what you do. There is a major difference between John Doe LLC and John Doe Plumbing LLC. There is a major difference between Doe Contracting and Doe Home Builders. Think about your business name before you register your business. You can change your name after forming your LLC or Corporation. You will need to go back to the Secretary of State and file a name change and pay a fee.

For more resources visit www.rjclark.com.