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What You Should Know About Which Business Form (LLC, Corporation, S-Corp or Sole Proprietorship) You Should Select When You Start A Business

As a Certified Public Accountant (C.P.A.) and Attorney, I have had my share of questions from clients regarding which type of entity a person should set up if they want to start a business. I too had to ask myself the same question when I started my law firm, <http://www.legalservicesincorporated.com> and was surprised at how much inaccurate and confusing information exists on the Internet. Moreover, as this is a complicated area, some advisors and accountants often give misleading and unclear advice on the topic. As a result, I decided to write this article to break down exactly how you should go about selecting your business entity and some of the things you should consider.

When deciding which entity to select for your business your decision will be based primarily on flexibility in the ownership structure, limited liability protection & tax reasons. For the most part, your decision will be between a Sole Proprietorship (“SP”), Corporation (“C”) or Limited Liability Company (“LLC”) so those are the entities we will focus on. We will examine Partnerships in another article. Let us look at the SP, C and LLC in turn.

What Is A Sole Proprietorship & What are The Advantages & Disadvantages?

When you were a child, you may have had a lemonade stand where you bought, peeled and juiced lemons, marketed your event and took in revenue from your lemonade sales. If so, your business would have been a Sole Proprietorship. This type of business is easy to set up and in many places you are not required to do anything in terms of registration with the government. For legitimacy and because some of the entities you deal with (a bank for example) will insist that you register your business, it is always a good idea to register your small business with the Government. In terms of the process, you simply fill out some forms with your State or local Government office, pick a name, pay a fee and start business. When you file your taxes, you will simply list the name of the business on your tax return and also itemize all of your revenues and expenses on your personal return. All in all a very simple set up and generally you would not need a lawyer to help you with the set up.

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So if it is so simple, why doesn't everybody pick this business form? The key reason is that this business form does not protect the owner's personal property if someone decides to sue the business. The legal terminology for this is that a Sole Proprietorship does not have "limited liability" protection. Instead, the company and the individual are considered the same person and if the business is sued or incurs debts, you, the business owner, will be personally liable. As you can imagine this can be a scary proposition as the end result of a bad business decision could be the loss of a home, car or personal belongings. You should also note that even though you may face a low risk of being sued, this risk jumps significantly if you deal with vendors, hire employees or have clients visit your premises. Even a picture on your website can result in a law suit. As such, this entity is often not selected when people set up a business and instead a limited liability entity (a Corporation or LLC) is selected.

Is A Corporation The Way To Go To Eliminate My Personal Liability?

In order to better separate personal & business finances (and for a number of other reasons too complicated to get into now), Corporations were formed and offer a business owner limited liability protection. As such, generally speaking the individual business owner and the Corporation are two completely different people and you will only stand to lose what is invested in the business. Accordingly, if someone sues the business they can only reach the assets in the business and not your personal assets. The same concept applies to debts but as a practical matter, if you have a new Corporation a bank or other lender will usually ask for a personal guarantee as they are fully aware that a Corporation has limited liability. Remember to always try to ONLY include the name of the business on any legal documents such as a loan document, lease, etc., to avoid exposing yourself to liability even with the limited liability protection.

This limited liability protection gives a business owner peace of mind but there are issues associated with a Corporation. The first is that in order to form a Corporation you must adhere to a certain amount of formality which requires time and expense. For example, you must appoint a board (this can be yourself) and also hold board meetings, develop bylaws and develop minutes. You must also fund the corporation and issue stock to yourself.

The second is the issue of double taxation. As a corporation is a separate entity, the government will tax the Corporation and then tax the business owner again on their personal tax return. This also means that you must file a Corporate tax return. While double taxation may seem reasonable for IBM or Apple (in that the Corporation's profits are taxed and then distributions to shareholders through dividends are also taxed) it hardly seems fair for a small business who simply set up the Corporation to avoid their home being taken away from them if they were sued. As such, the government created what is called the "pass through entity." The two forms of pass through entities are a Limited Liability Company (LLC) and S tax status. Let us first look at the LLC.

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What is A Limited Liability Company (LLC) & Why Would I Opt For This Entity?

A LLC is a relatively new creation that was established to offer the business owner limited liability protection while addressing both of the problems outlined regarding a Corporation above. The first is the formality associated with setting up a Corporation. To address this, a LLC has the advantage that the business owner is not required to adhere to the strict Corporate formality. Instead, a flexible operating agreement is drawn up to describe how the LLC will operate. A LLC also addresses the problem of double taxation as a LLC is a “pass through entity.” This means that all of the earnings in the LLC are taxed as if you earned them personally. As such, the entity itself is not taxed but rather the earning “pass through” to you. The tax preparation is much simpler than a Corporate tax return and is very similar to how you would file as a Sole Proprietorship.

In terms of set up, the process is simple in that you submit forms to the local government, pick a name, pay a fee and you will have to draw up an operating agreement.

Regrettably, there are two downsides to a LLC. First, many States have what is called a publication requirement where you must publish in local newspapers that you plan to open a LLC. (A very odd requirement indeed as I cannot imagine who would read it – do you remember the last time you saw a LLC announced in the newspaper) In some locations, this can be very expensive. For example, in Manhattan, this requirement would cost approximately \$1500. You should consult your local lawyer and ask about the impact of not meeting the publication requirement as it may not be as bad as you think. The second disadvantage is that a LLC is subject to self-employment taxes on all of the income earned. There is relief on the employment taxes though as the LLC can elect “S status” to eliminate this requirement on at least a portion of the employment taxes. This is further described below.

Is “S Status” The Same As A S-Corporation and Can I Elect S Status For A LLC?

When you search the Internet, you will see many references to an “entity” referred to as a S-Corporation and you will often see self-employment taxes as one of the advantages of a S-Corporation over a LLC. You should get all of that out of your mind and think of S as a TAX STATUS rather than as a type of entity. If you do, most of your confusion will vanish. So here is the lowdown.

BOTH a Corporation and a LLC may elect S status and if they do, they will avoid self-employment taxes on at least a portion of their earnings. Here is a brief and simple example. An entity (LLC or Corporation) makes \$100,000 and the owner assigns themselves a salary of \$60,000 (salary must be reasonable in order to qualify). When this occurs, and S status is

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elected, the owner will only have to pay self-employment tax on the \$60,000 rather than the full \$100,000. Do not confuse self-employment tax with income tax as income tax is paid on the full \$100,000 and this cannot be avoided. In order to be eligible, you must file the S tax status election with the IRS right after you set up the LLC or Corporation (they give you around 60 days).

We just explained how S status works and it may seem like the perfect middle ground. Regrettably though, it too has its drawbacks as the ownership structure has certain requirements and you must be a U.S. resident for tax purposes to be eligible. In addition, if you elect S Status there is a limitation on the amount of owners that may hold shares or membership units in the company. If you are considering electing S Status, you should consult a Lawyer or Accountant as it is a complicated area.

How Does A Professional Corporation Fit Into All Of This?

If you are a doctor, lawyer or other professional, you cannot just set up a “regular” LLC or Corporation. Instead, you must set up a Professional Corporation or a Professional LLC. All this means is that the limited liability will not protect the business owner against malpractice. As such, if you are a professional you must also get malpractice insurance. The idea here is that the Government does not want professionals setting up a limited liability entity and then shirking their professional responsibilities. The entities are the same as a regular Corporation or LLC in all other regards.

Do I Need A Lawyer To Set Up My Business And Guide Me?

Yes and in most cases and Accountant too. Well guess what, at Scott Legal Services you have both as our founder Ian E. Scott is a qualified C.P.A and a Lawyer! While you do not have to hire a lawyer to set up a business, the choice of business form has significant tax, financial and liability implications that you should carefully consider so that you set up your business the right way. Let Scott Legal Services, P.C., at <http://www.legalservicesincorporated.com> be your guide. Also, if you require further assistance, please contact Scott Legal Services, P.C. at 1-888-LAW-2964 or email us at iscott@legalservicesincorporated.com.

Get Your Free Chart That Summarizes What To Consider When Forming A Business

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