WHAT'S IN A NAME?

HOW TO CHOOSE THE RIGHT ENTITY FOR YOUR BUSINESS

You finally did it. You are starting a business. Time to be your own boss and tackle a new adventure. You have a great idea and a catchy name. You are ready to get your hands dirty and start working in your business so can't you just rush through the boring legal stuff and tack an LLC onto the end of your name using one of those online services?

The answer is a big NO! Many businesses fail within the first 5 years because they do not take time to set up their business properly—resulting in legal and tax ramifications that shut the business down. You want to be a success? Then don't rush through the entity selection process. Slow down and get your business set up RIGHT.

Choosing the right entity is more important than you think. Your choice of entity affects:

- Number of Owners (Shareholders, Partners, Members)
- Identity of Owners
- Tax Efficiency & Deductions
- Equity Structure
- Liability Protection
- Control & Management
- Ability to Receive Funding
- Division of Profits & Losses

I know what you are thinking—I'll just get it set up "for now" and change it later. This is a trap many new businesses fall into. Yes, you can change your entity selection down the road, but doing so often results in severe tax and other penalties. Some businesses cannot afford to take the hit and end up closing shop instead. Not to mention that "for now" often ends up being a lot longer than we anticipate when we are starting a new business. It is easy for 1 year to turn into 3 then 5. 5 years of paying more to uncle sam and being greater exposed. 5 years that easily could be avoided, saving your business hundreds of thousands of dollars.

Entity selection laws vary greatly from state to state and on the federal level, changing the level of protection and tax efficiency. For example, an LLC may be set up in South Dakota (one of the most business friendly states in the US), but may elect to be taxed as a S-Corporation at the federal level. Entity selection can get pretty complex and there is a lot to consider chiefly: liability, control, & taxes. So what's in a name?

SOLE PROPRIETORSHIPS

Simplest business entity with no protections or tax efficiencies. There are no forms to fill out or state organizations to register with. Transferring assets in and out of the business is easy with no formal accounting requirements. This simplicity comes with a hefty price. The owner is held personally liable for the debts and obligations of the business—meaning personal assets (think your house, car, checking account) can be treated as business assets.

No separate tax return is filed for a sole proprietorship. Rather, your income and expenses are reported on your 1040, schedule C. This limits you to personal deductions for certain expenses that

WHAT 50% DO YOU WANT TO END UP IN?

50% of new businesses fail in the first 5 years according to the Small Business Administration (SBA). One of the main reasons – failing to plan and set up the RIGHT way. Is your business protected from Divorce, Death, Bankruptcy, Disability, and During Life Transfers? Are you set up to be as tax efficient as possible? Do your tax returns match your legal documents?

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creates a far less favorable tax environment for you and your business.

CORPORATIONS

2 types of Corporations exist with very different tax and legal boundaries: C-Corporations and S-Corporations.

C-CORPORATIONS

When most people think of businesses, they think of C-corporations (corporations with stock offerings). C-corporations are owned by shareholders who own stock in the corporation – called shares. Although the shareholders may vote on certain actions, the corporation is guided by a board of directors, who are usually elected by the shareholders. The day to day management is then governed by the officers of the corporations, think CEO and COO. One of the benefits of a Corporation is that the shareholders are not liable for the debts and obligations of the corporation. This protection comes at a price. C-Corporations face "double taxation". The Corporation is a separate entity and pays taxes on the profits earned and then the individual shareholders pay taxes again on the dividends they receive. C-corporations have their place, but there are few situations where this tax hit makes sense.

S-CORPORATIONS

S-Corporations refer more to a tax designation then a legal entity. Corporations and LLCs may elect S-Corporation status at the federal level even though they set up at the state level in another entity type. S-Corporations have a number of limitations: there is a cap on the number of shareholders, there can be only one class of stock, and there cannot be any foreign shareholders. S-Corporations are the small business saviors when it comes to tax efficiency. S-Corporations have pass through taxation and the entity does not pay taxes on the income, but the shareholders do pay taxes on distributions. This allows small businesses a way to avoid employment taxes (social security and Medicare) on distributions. However, they will still pay these taxes on compensation. The split between distributions and compensation in a S-Corporation is tricky and while it can save a significant amount of money, it can also trigger an audit risk and penalties if not done properly. Key takeaway—don't be greedy. S-corporations can also lose their s-election if they are not managed properly and fail to follow all of the rules. This results in c-corporation treatment, which can have devastating financial consequences for the business.

LIMITED LIABILITY COMPANIES (LLC)

Perhaps the most popular entity today is the LLC due to its flexibility and hybrid nature. You get the legal and liability advantages of a corporations, with the tax efficiency of a S-corporation or partnership. Unlike corporations, LLCs are owned by the Members who own units in the Company. Provided the Company is run properly and adheres to the required formalities, then the Members are not liable for any debts and obligations. However, the formalities required with an LLC are often far less than that of a corporation.

So what entity is right for you? Entity selection is an imperative part of setting up a business. Don't take a short cut and try to save a quick buck if you want your business to succeed. Discuss your business plan and finances with your CPA and your attorney and together (Yes they need to work together on this one), they can recommend the best entity for your business that provides you tax efficiency and liability protection. Choosing the right entity is the first step. Protecting the owners and the business is the second. Learn more about the risk a divorce, creditor, bankruptcy, sale, disability, or death of any one owner can have on your business without the right plan in place. Schedule a complimentary initial consultation to learn more about how to ensure the success of your business from day 1.

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