LEGAL ENTITIES

WHAT YOU NEED TO KNOW

LEGAL ENTITIES - WHAT YOU NEED TO KNOW:

Entity selection at the inception of an organization is critical. The goals of the company should be discussed with both legal and accounting counsel.

How business owners pay themselves is dependent on their legal entity. Paying yourself as a business owner is a common mistake that can be avoided.

This is a simple guide and it does not replace advice from your tax and legal team. The guide is designed to provide business owners with basic information regarding each entity type.

SOLE PROPRIETORSHIP

Sole proprietorships are you as an individual acting as a business. You might have named your business Services by Sarah, but you did not create a new legal entity.

An additional step you may take to increase the separation of your business and personal identities is to create a "doing business as" (DBA) status at the county or state level.

If you are a solo entrepreneur and do not have employees, you may use your social security number for all banking and tax reporting. If you decide to hire employees, you will need to apply for an employer identification number (EIN) to make submissions and file quarterly employment reports.

A sole proprietorship is the simplest start to launching a business. If you are starting something low-risk or have a side hustle, this is the likely starting point. If you are considering investors or starting something with increased risk, consider setting up a legal entity instead of a sole proprietorship.

HOW TO FILE TAXES

Sole proprietorships are not legal entities and therefore are reported on your individual income tax return. The annual profit and loss activity is reported on Schedule C of IRS Form 1040. In addition to the expenses recorded you also have the opportunity to take deductions such as mileage, home office square footage, and any self-employed health insurance. If you have received your own employer identification number, then this will be reported at the top of the Schedule C Form.

As part of the 1040 calculation, you will pay self-employment taxes on your Schedule C income. Self-employment tax is calculated as 15.3%. This accounts for the employer and employee portion of the FICA (Medicare and Social Security). You are allowed to deduct half of this amount as a self-employment tax deduction.

HOW TO PAY YOURSELF

Self-employed business owners who are sole proprietorships and file a Schedule C are not allowed to pay themselves W-2 Wages. Even if you have employees, you may not add yourself to the payroll. In sole proprietorships, owners take “owner’s draw.” Owner’s draw are not part of payroll and no FICA is submitted at the time the draw is taken (this will be calculated as part of the Schedule C self-employment taxes on the 1040).

<u>To-do List</u>

1 - Determine if you will file under your social security number or if you need to apply for an employer identification number. If you are starting solo, I recommend using your social security number for simplicity.

2 - Open a new bank account using your social security number or employer identification number. Treat this as a business-only checking account. DO NOT mix business and personal expenses into a single account (unless you want to spend significant time and money with an accountant to solve this for you).

3 - Consider if you want to file a “doing business as” – not absolutely necessary but helpful if clients write checks or you want to specifically establish a brand separate from your individual self.

4 - Establish an accounting system like Quickbooks Online to record all your income and expenses.

5 - Schedule an appointment with a tax preparer to determine if you should file quarterly estimated tax payments. Mark your calendar for your return, which is due annually on April 15th.

<u>Pros</u>

- Easy to start, low cost
- Owner's draw are easy to administer

<u>Cons</u>

- Higher taxes with self-employment taxes
- Need to file quarterly estimated tax payments if profitable
- Owner is personally liable

RECOMMENDATION

Start your business as a sole proprietor to validate your business idea. After the idea is solid and you have repeatable revenue streams consider changing to a different legal entity type to reduce taxes.

LIMITED LIABILITY COMPANY

Limited Liability Companies (LLC) are a type of entity that have some business features. LLCs are designed for legal protection between an individual or a group of individuals and the business. LLCs are not “taxed.” LLCs choose to make an election to be recognized by the IRS as a certain type of taxable entity.

HOW TO FILE TAXES

- One Person LLC – This is a Single Member LLC and is reported on Schedule C of the IRS 1040 Form.
- Multi-Member LLC
  - May choose to be taxed as a Partnership by filing a Form 1065
  - May choose to be taxed as a Corporation by filing a Form 1120
  - May choose to be taxed as an S-Corporation by filing Form 1120-S

To-do List

1 - Determine if you need to be an LLC versus a sole proprietorship based on the legal risk of your activities.

2 - If a multi-member entity, reach out to your legal and tax team to determine the type of selection that best fits your overall goals.

Pros

- Single Member – easy to establish, can do-it-yourself
- Pass through entity – pays taxes at the individual level
- Legal protection

Cons

- If multi-member, need to consult legal counsel
- May not become a publicly traded entity

DISREGARDED ENTITIES

Disregarded entities are entities that do not file separate tax returns. Sole proprietorships and single-member limited liability companies are considered disregarded entities.

PASS-THROUGH ENTITIES

Pass-Through Entities are entities in which the taxes pass through to the owners. No tax is paid at the entity level and the owner or owners report the income on their individual income tax returns. Sole proprietorships, partnerships, and S-Corps are all examples of pass-through entities because the entity does not pay tax the owner does.

PARTNERSHIPS

A partnership is defined as at least two people forming a business together that is not a corporation. The type of partnership is dependent on the type of partners that make up the partnership.

There are several different types of partnerships:

- General partnerships – without written documentation all partners are general partners by default. The most common situation is two individuals coming together and having joint finances in running the business. Partnership agreements are not required, but HIGHLY recommended. Income, expenses, assets, and liabilities are split equally between the number of partners.

- Limited partnerships – these are partnerships that consist of general and limited partners. Limited partners do not have to take on the same level of liability as general partners.

- Limited liability partnerships – all partners in the partnership are limited partners and there are no general partners.

- Limited liability limited partnerships – includes limited partners that only have liability up to the amount contributed. Limited partners are also protected from the actions of other partners.

HOW TO FILE TAXES

Partnerships file an annual Form 1065 US Return of Partnership Income with an initial due date of March 15th for calendar year entities. This return reports the annual net income of the partnership operations.

Each partner receives a K-1 (Partner’s Share of Income, Credits, and Deductions) which reports their percentage of the ownership and allocation of each of these items.

The allocation is specified in the partnership agreement and can be dependent on the type of partner and partnership. Each partner uses the K-1 to report income on their individual income tax return (Form 1040). Partnerships are pass-through entities.

HOW TO PAY YOURSELF

If you are a partner, you may receive distributions of income from the operations of the partnership. If you perform services for the partnership, you may receive guaranteed payments. Partners may not receive wages from the partnership.

To-do List

1 - Confirm what type of partnership you have and the type of your individual partnership interest.

2 - If you perform services for the partnership, confirm that you will receive guaranteed payments. Discuss with your tax advisor how this will impact your own individual income taxes.

Pros

- Easy to set up a general partnership with a few partners to get a business started

Cons

- Partnerships can be complex with different types of partners and partnerships
- Guaranteed payments are subject to self-employment taxes
- Partners need to pay estimated tax payments

RECOMMENDATIONS

In my experience, partnerships do not survive a long period of time unless they are structured family partnerships protecting a large asset such as a business or land. Partner conflict arises when one partner is working in the partnership and the others are acting as investors/advisors. I've witnessed 100s of partnerships fail because of compensation, control, and distributions.

I do see conflict in S-Corps as well, but not to the magnitude of partnerships. Because partnerships are more easily formed, I've observed the partners give little thought to how they will operate and pay themselves in the future. Guaranteed payments versus wages confuse partners and leads to conflict. If I were setting up a business with another individual I would choose an S-Corp or C-Corp.

S-CORPORATIONS

An S-Corp is a corporation that elects to be taxed as a subchapter of a corporation. This "S" election allows pass-through taxation versus taxation at the C or Corporate level.

Because of this pass-through taxation, it has many characteristics of a partnership but has legal protections like a corporation.

HOW TO FILE TAXES

Limited Liability Companies and incorporated entities have 75 days from formation to file Form 2253, Election by a Small Business Corporation. Once accepted by the IRS, the entity may file an annual Form 1120-S, US Income Tax Return for an S Corporation.

A few rules regarding S-Corps:

- Must be a domestic corporation – no foreign corporations or shareholders
- No more than 100 allowable shareholders (no partnerships or corporations)
- One allowable class of stock
- No ineligible corporations – think banks and insurance

Most common for our clients is a small group of individual shareholders who are working in the business as employees and are also owners. With the filing of Form 1120-S, shareholders will receive a K-1 that reports their share of the business income or loss.

HOW TO PAY YOURSELF

Shareholders who work in the business (i.e. owner-operators) receive reasonable compensation in the form of W-2 wages. Additionally, all shareholders may receive distributions from the company.

A common strategy is for owner-operators to receive a standard salary and then a distribution related to the income of the organization. This two-part strategy allows owners to minimize the amount of income subject to FICA and take a portion of them as ordinary income.

A challenge for single-employee/shareholder organizations is that you have the additional compliance burden of running payroll. You need to pay yourself at least monthly and file quarterly and annual returns. This compliance burden along with the annual return needs to outweigh the tax savings. Some CPAs do not recommend an S-Election until the net income is greater than $250,000.

To-do List

1 - Make sure you file a timely S-Election, within 75 days of formation. You may file a late S-election, but it is not guaranteed to be accepted by the IRS.

2 - Consider a reasonable compensation study. The IRS is very aware of the strategy to pay low salaries and high distributions to minimize FICA taxes. What would your organization pay someone in a similar role? You can't say you have wages of $60,000 and pay yourself only $60,000. That's not reasonable.

Pros

- Easy to set up and great for a small set of employee/owners
- Savings of FICA with a two part strategy of wages/distributions

Cons

- Challening, but not impossible, if you miss the initial 75 day S-Election
- Compliance needed to run payroll even if it is only for the owner

RECOMMENDATIONS

This is my most preferred legal entity structure for small groups of professionals working together or for single-person entities with high income. The S-Corp is great for small groups of owners because you have a mix of wages and distributions instead of guaranteed payments.

I've deployed a very specific strategy in wages, bonuses, and distributions with physicians and attorneys to have a performance pay component while not diluting overall ownership through distributions.

A S-Corporation can also be good for single-owner organizations that already have employees, or plan to quickly, and are on track for a continuing increase in net income. If an entity has been operating as a sole proprietorship, you can easily form a limited liability company and make an S election. As a favor to your accountant, implement this strategy either on January 1 or July 1 though it can be done any time of the year.

C-CORPORATIONS

C-Corporations are my least preferred entity for small businesses and professional service firms. If you plan for your organization to go public or need to raise funds through selling equity, this can be a great structure.

If you are maintaining 100% of the ownership or only need a handful of owners, there are other structures that are more flexible and provide greater tax savings (my favorite is the S-Corp).

C-Corporations are allows for unlimited shareholders, may have multiple classes of shareholders, and may include international investors. This type of entity is incorporated.

In most cases where shareholders/founders go public they sell shares of their organization to others to raise capital.

HOW TO FILE TAXES

Corporations file an annual tax return, the Form 1120 US Income Tax Return for a Corporation. Taxes are paid at the entity level (this is NOT a pass-through entity).

Income is taxed twice: once at the entity level and again when shareholders receive dividends.

HOW TO PAY YOURSELF

Shareholders who work in the business are paid W-2 wages. Shareholders may also be paid dividends along with other non-employee shareholders. If the company is sold for a lump sum, the shareholders will receive a payout equivalent to the percentage of ownership and class of stock ownership.

To-do List

Review your long-term goals to determine if you need the additional complexity and taxation of a corporation.

Pros

- Great for companies whose long-term strategy is to go public
- Unlimited number of shareholders and can include foreign investors

Cons

- Double taxation; both at the corporate level and the personal level
- Increased compliance with the number of shareholders and tax preparation

RECOMMENDATIONS

Consider if your company needs to raise equity or go public at some point. Consult with an attorney to determine how your organization's legal entity might evolve. Could you be a sole proprietorship or single-member limited liability company and transition into a corporation? An C-Corporation would be my last legal entity of choice for small business owners.

WORKING WITH WEBB CFO

Most business owners didn't start their companies so they could become accounting and human resource experts. It takes time, energy and expertise to fully manage and optimize your finances.

With Webb CFO, our clients are able to focus on what they do BEST, while we handle the necessary accounting and HR responsibilities that keep your company running to position you for future success.

At Webb CFO, we know you want peace of mind as your business grows. In order to do so, a trusted partner is vital to handle your accounting and human resources.

When you are ready to add financial transparency and clarity in decision making, our team is here to share our expertise. We work directly with business owners and management teams to create financial stability for future decision making.
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