

## **Business Law Series**

### **The Right Business Structure**

By Michelle Hayden Bomberger

I often get calls from prospective clients asking, “How much do you charge to set up an LLC?” My first question to them is, “How do you know that an LLC is the business structure that’s right for you?” So, how do you know which way to go? The most common business structures for small businesses are: 1) the sole proprietorship, 2) the corporation, and 3) the limited liability company. There are five key criteria to consider in deciding which one is right. First, who owns the business -- are the owners active or passive participants. Second, who manages the business – are the managers the same people as the owners. Third, who is responsible for the business’ liabilities if the business can’t pay. Fourth, what are the tax implications of a particular business structure to the business. And finally, what are the startup and ongoing maintenance costs of a particular structure. Let’s look at how these criteria play into the three most common business structures.

#### *Sole Proprietorship*

The sole proprietorship is the simplest and most common of the options where the company is an individual or a married couple. The sole proprietorship, though, does not offer you liability protection. What this means is that if the business incurs debts that it cannot pay, you will be held personally responsible for those debts. Insurance can mitigate some of the risk but it is critical that you understand what your insurance does *not* cover. If you feel comfortable taking on the exposure of what is not covered (i.e. bankruptcy), then the sole proprietorship may be a solution for your business. From a tax standpoint, the income from the business is self-employment income and taxed at the self-employment tax rate.

#### *Corporation*

The corporation is the most formal of the choices. A corporation is a separate entity from you individually and, as such, files its own tax return. Its owners are called “shareholders,” just as owners of publicly traded corporations are; and the shareholders are protected from the liabilities of the business. If you, as a shareholder, invest \$5000 in the business and the business is sued for \$10 million or goes under, no one can come after you individually for additional money. You are only liable for your investment in the business. From a management standpoint, the shareholders elect a Board of Directors who are the strategic governing body which appoints the officers who manage the day-to-day operations of the business. In your corporation, you may serve in all these roles. This process is a formal one and must be performed and documented each year through annual meetings. The formalities of running a corporation aren’t as onerous as they sound and are absolutely necessary to maintain the liability protection for the shareholders. If you own a corporation and have never held or documented an annual meeting, you must immediately get these documents in place. If your business is audited or sued and these formalities are not maintained, the liability protection you believe you have solidly in place, may be disregarded because you weren’t treating your business as a corporation. Lastly, as for taxes, a regular (or “C”) corporation is “double taxed” – the corporation pays taxes on income it brings in and then the shareholders pay taxes on the same money when it is distributed to them as profits. Businesses with fewer than 100 owners (among other criteria) can choose to be taxed differently, as an “S” corporation. This election eliminates the tax paid by the corporation so that the funds are only taxed when distributed to the owners. This tax election is often what drives small business owners to choose the S-corporation.

#### *Limited Liability Company*

The limited liability company (LLC) is a hybrid between a partnership and a corporation. It offers the same liability protection to the owners as a corporation does but does not require the formalities such as a Board of Directors, Annual Meetings, or a Corporate Minute Book. For this reason, many entrepreneurs lean toward the LLC. Keep in mind, though, that LLCs are relatively new entity types and their corporate heritage tends

to govern when a question arises. Therefore, I do recommend that LLC owners hold and document an annual meeting of the owners and maintain an LLC Record Book. Organization of documents and formalities in processes will help to ensure your personal assets are not on the hook for the liabilities of the business. For taxes, the LLC, by default, is taxed as a sole proprietorship or partnership, meaning that all income to the business is taxed as self-employment income to the owners. The LLC may also elect to be taxed as an S-corporation, giving it some of the tax benefits that a corporation might otherwise provide with the added flexibility of an LLC structure.

In deciding which business structure is right for you, take a critical look at the risks your business poses to you. Ask yourself questions about how many people are involved in the business, how many outside relationships will you have with vendors, contractors, clients you will have and most importantly, ask yourself what could go wrong. Also consider who the owners and managers of the business are and ask whether one entity type is more or less beneficial to each based on voting and decision making, taxes, and roles and responsibilities. These questions will help you evaluate the ownership and management structure as well as the need for liability protection and tax planning. Both your attorney and your tax advisor should work together in weighing the needs of the business, both practically and financially. The analysis rarely results a clear winner but rather provides the tools necessary to make an educated choice based on risk, cost and operational practicality.

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