

Module 1.1: The Importance of Choosing a Legal Format

While the last thing most small business people want to worry about is how their business is set up, the first pillar of a solid business foundation involves protecting the owners from liabilities that could not only destroy their business, but their personal assets as well.

Choosing the correct legal format can have a tremendous impact on your future profitability. The time the prospective businessperson takes to study and decide on the proper business entity for their situation will pay off many times over. It can minimize expenses, including taxes, and it can prevent penalties and fees for improperly running your business.

When a businessperson decides to start a business, as well as when the business grows into a larger enterprise, one of the decisions that must be made is selecting the type of entity and the corresponding tax treatment. While we will be discussing the tax treatments of each type of entity in Module 3, just be aware that each affects the other.

The three main choices of entity types you have to choose from are Sole Proprietorship, Partnership, or Corporation. Unless you choose one of these, there are some default rules that apply. For instance,

- If you are the 100% owner of a business, you are a sole proprietorship by default.
- If a married couple decides to run a business together (and file a joint tax return) they will be able to choose from a partnership, corporation, or qualified joint venture.
- If you decide to run the business as a corporation, you will choose either a C corporation or an S corporation. Each of these have different rules.

Another entity choice available in all 50 states, not recognized by the Internal Revenue Service (IRS), but governed by state law, is a Limited Liability Company (LLC). Because the IRS does not recognize LLCs as entities, a single-member LLC will default to sole proprietorship and a multi-member LLC will default to a partnership. Or either of these can choose to be taxed as a C corporation or an S corporation.

Confused yet? Don't be. By the end of this course you will know what path to take to put your business on a solid foundation as it progresses to keep your profits up and your liabilities down.

— I want to mention here that when we talk about entities, we are referring to all legal formats other than sole proprietorships. This is because sole proprietors are considered to just be an extension of the owner. —

The first thing we need to discuss is the fact that State laws and regulations have primary control over a business entity started in and operating within the state you register it.

The information for your particular state is usually found in two places on your state's websites. The information on how legal entities are handled is through the Secretary of State's Office, often the Corporations Division. The Department of Revenue has all of the information on the taxation requirements in your state.

It would be difficult to list all of the differences in this course among the various state rules and regulations. For instance, some states without a personal income tax only tax C corporations and only require tax filings for them. Some states don't tax partnerships, but require you to file a return telling the state how much each partner was paid. Some states don't tax business profits, but instead tax the gross sales of all businesses. While all states have practically the same legal entity formats, they vary widely on how they have to be reported and taxed.

All states require that you register business entities with the state and pay a yearly fee to renew them. That fee runs between \$100 to \$400 a year, depending on your state and the type of business entity that you create. Sole proprietors are generally required to register with all the counties they do business in, instead of the state. Although, in some states, entities are required to register with both the state and the county.

Now, to go through all of the differences between all 50 states would make this course very, very long. Our purpose here is to give you the knowledge to understand what these websites are talking about when you do the research for your particular state. And you need to do the research to understand the whole picture.

To make it easier for you find where the information for your state is located, check out the Bonus section for the links to your state's business and tax sites. Some states make it easier than others to find the information you need and some states actually have created one-stop centers for small businesses to walk them through the whole process. I created the bonus chart to make it easier to do your research.

This research is important to building that solid foundation under your business and not have to pay penalties later.

I can hear many of you saying, "I don't need to know all of this information. I'll just hire someone to do it"

Over the last two decades I have set with many small business people who hired a company to take care of all the legal stuff and I've seen quite a few done incorrectly. For instance, filing the articles of incorporation with the state, but forgetting to file the S corporation election with the Internal Revenue Service.

By learning what is in this course and your state requirements, you can help protect yourself if you choose to do it yourself or hire someone to do it for you.

In this module, we will be discussing the various business formats. These include:

- In 1.2, we will discuss the Sole Proprietorship business format, along with the advantages and disadvantages.
- In 1.3, we delve into Partnership businesses, why partnership agreements are so important, and why you need to pay so much attention to basis.
- In 1.4, we show how Limited Liability Companies can help to prevent your personal assets from being lost and why this is vital to your business.
- In 1.5, we discuss C corporations and why they are important to consider for your future growth and the overhead associated with them.
- In 1.6, we will view how S corporations are one of the only ways left to protect your profits from the tax codes while giving you liability protection.
- In 1.7, we end up with a discussion of what is best for you now and how you may wish to change business formats as your business grows.

Let's dive in....