Module 1.7: What's Best for You

While there is no foolproof way for me to help you choose which legal format is best for you, by studying the previous 1.x modules should give you a pretty good idea what direction should be best for you. And remember, your initial business format doesn't have to stay the same throughout the life of your business. You may want to start with a sole proprietorship to see if your business model going to make money and move to a partnership or corporation if the business takes off.

If you decide to start your business as a sole proprietorship or partnership, then I highly advise that you form a single-member or multi-member Limited Liability Company to protect your personal assets. The small cost and minimal time involved is well worth the protection.

If you want to shelter part of your profits from payroll taxes, then you should consider creating an S corporation. While the additional cost and paperwork requirements have to be dealt with, it could save you a lot of money.

While none of us can totally predict what the future will hold, a good business person will sit down and create a general roadmap. The detours along the way is what makes things interesting and by knowing all of your options, you will be able to get to your destination a whole lot faster and lose a lot less money learning from your mistakes.

In this module, I want review some additional considerations that I believe you should be aware of to make an informed decision. First up, let's take a look at the factors in choosing between an S corp and a LLC.

LLCs and S corporations are often popular choices due to their benefits of liability protection and pass-through taxation. LLCs protect the owner's personal assets from losses, company debts, or court rulings against the company. LLCs also avoid double taxation by passing company income to the personal returns of the owners. An S corporation structure also protects personal assets from any corporate liability and passes through income, usually as dividends that are not double taxed. While both options offer the same basic benefits of liability protection and pass-through taxation, there are significant differences between them that we should consider.

A business owner who wants to have the *maximum* amount of personal liability protection, plans on seeking investment or envisions becoming a publicly traded company and selling common stock will likely want to form a C corporation and then making the S corporation tax election. As we mentioned before, the S corporation designation is just a tax choice.

A LLC is the appropriate choice for business owners whose primary concern is business management flexibility. This owner wants to avoid all but a minimum of corporate paperwork.

In general, the smaller, simpler, and more personally operationally managed the business is, the more appropriate the LLC structure is. If your business is larger and more complex, such a multinational financial services firm, an S corporation structure is more appropriate.

There are structural differences between the two. S corporations can't have more than 100 shareholders. LLCs may have unlimited members. LLCs can also have members that are non-U.S. citizens or permanent residents, while S corporations can't. S corporations can't be owned by other companies, while LLCs may be owned by any corporate entity. And LLCs enjoy the benefit of less regulation in forming subsidiaries.

When it comes to legal structures, S corporations face much more legal scrutiny. Part of the rigid legalities S corporations face are the corporate bylaw requirements, initial and annual shareholder meetings, maintaining corporate minutes of these meetings, and regulations pertaining to the issuance of stock. While LLCs are recommended to follow the same guidelines, they are not legally required to do so. LLCs may simply draft a LLC operating agreement.

There are also differences in management structure. S corps are required to have a board of directors and corporate officers - even it is only one person doing it all. Multi-member LLCs may choose if their members are involved in the day-to-day operations. Multi-member LLCs face a drawback of lifespan because the business may be dissolved if a member departs and also face strict transfer of ownership regulations. S corporations may easily transfer ownership by simply selling stock.

When it comes to profit and loss allocations, S corporations are required to allocate profits and losses among the owners based on the percentage of ownership or number of shares held. In contrast, an LLC is able to allocate its profits and losses in whatever proportions the owners decided in the LLC Operation Contract.

And lastly, there are initial startup costs associated with both, and maintaining either comes with upkeep costs. Generally, LLCs are less expensive to run than S corporations. S corporations pay more in taxes through payroll and corporate taxes. The salaries of S corporation's owner/employees are subject to unemployment and disability taxes, whereas LLCs do not have to pay these taxes. Consequently, owners of LLCs are not entitled to unemployment or disability benefits. S corporations are often required to pay a minimum corporation state tax, but the amount varies by state.

I realize that there are a lot of things to consider in setting up your business to help give you the best chance of success. I've included in the bonus section a Legal Format Comparison Chart that lists all the five major categories and how they differ between formats.

So, what happens if you have formed an S corporation for the tax advantages, become wildly successful and want to become a public company? You can just do a reverse conversion. Generally, a voluntary conversion of an S corporation, when all shareholders vote to revoke the S election, back to a C corporation happens when the corporation want to broaden their investor base and/or when the corporation has become profitable and wants to offset income with tax-deductible fringe benefits.

While the paperwork to accomplish this is relatively simple, the consequences of when to do are very important. A review of your corporate documents to see if they need to be updated and a review of the tax consequences of the conversion to best minimize tax liability should be done. This is especially true if you plan to start selling shares to the public.   If would be well worth the money to hire an attorney specializing in startups or strategic business growth and an Enrolled Agent specializing in business returns to review your situation.

Module Review

In the module one series of lessons we have covered a lot of ground. I have found that most people I've worked with only knew a fraction of this information and thus have made mistakes that have cost them a lot of money.

While I've touch on some of the tax implications of the different legal formats, in module three section of this course, we will delve into the tax treatments of each legal format in more depth. While I can't include everything I've dealt with over the last two decades, I want to make sure you have enough information to help prevent you from making mistake that could cost you hundreds of dollars, if not thousands, of dollars.