From "Wantrepreneur" to Entrepreneur Series: Formation

wellth
FINANCIAL SERVICES

Where to Start?

For many budding business owners, the most important question to answer (*after what it is you're going to sell, of course)* is how to start. This can be and, rightly so, a paralyzing decision point. The choice of entity structure and formation is a critically important first step that has implications that impact not only the business but the business owners as well. Of course, we should make a distinction here between the entity structure for legal,

tax, and operational purposes. That is to say that each of these domains characterize the relationship and existence of your business, with respect to entity selection, in a slightly different but often interrelated way. Let's consider your typical LLC, which from a legal liability standpoint is an entity that is generally separate from the owners. From a tax perspective it may or may not be; dependent on any tax treatment elections the entity might have made. From an operational perspective, the owners may be directly involved in the day to day despite the legal and tax treatments. Or, the owners could be completely silent partners who seldom interact with the business activity.

Bottom Line up Front

I often advise my small business clients who may be aiming to transition a hobby to a bonified business endeavor, to do so as a sole proprietorship. For those with a proven and profitable business that they've been carrying on for a number of years an LLC ***might*** be the next step. Consider reaching out to a Wellth Financial Services Advisor for a thorough analysis of the potential implications.

Sole Proprietorship

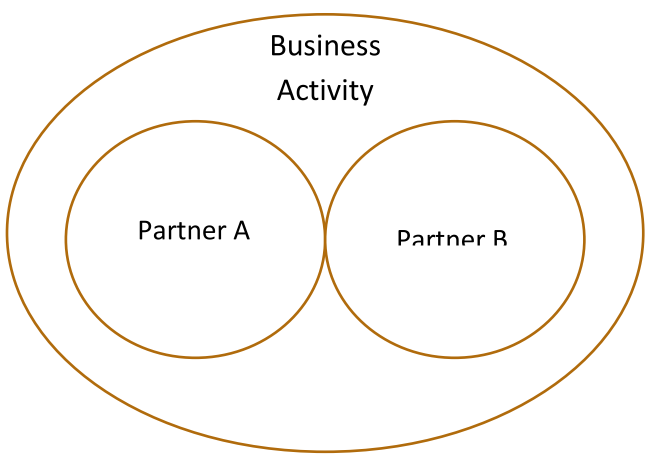
The sole proprietorship is the form of organization that is the simplest in terms of reporting and compliance. The sole proprietorship can be summed up by simply thinking of any business activity and the owner (called the proprietor) as one in the same. In other words, when another entity or individual transacts with your business they may as well (and are) doing business with you the proprietor, as an individual.

OWNER/OPERATOR = BUSINESS

Thus, any activity would also be subject to tax implications commensurate with the tax attributes of the individual, i.e. tax is paid based on proprietor's tax rates. This does not necessarily lessen the burden of carrying on a legitimate business or lawful business conduct. Rather, it's the form of business entity which is favorable for individuals proving out their business concept, since no official paperwork must be filed, and no filing fees must be paid. This is perfect for the business owner seeking maximum autonomy and minimal regulatory burdens.

General Partnership

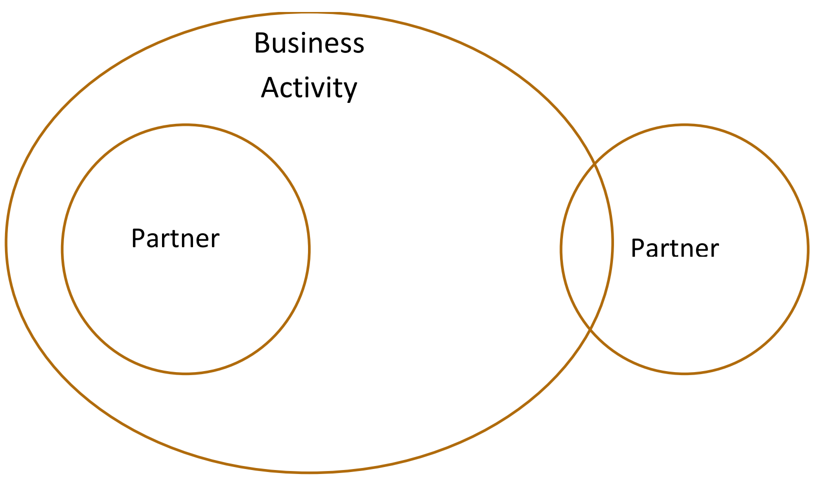
The simplest way to think about a partnership is to imagine you want to build a fence along your property line, you ask your neighbor if they'd like to split the cost 50/50 since you'll both benefit from the fence. They say yes. If you were a business this would be a partnership—it is an arrangement to share and enjoy revenues and expenses. This also means that you both are effectively equals in every way, shape, and form. Both of you are on the hook when the HOA decides to sue you, both of you can destroy the fence, both of you are required to maintain the fence, etc. Just to be entirely clear you are unilateral equals, meaning that you both have the exact same powers to encumber, dissolve, and operate the business. This can get a bit hairy when a single partner takes out a massive loan on behalf of the partnership or gets bamboozled into selling a valuable piece of equipment for less than market value to the detriment of the other partners. For better or worse the revenues and expenses are also *passed through* to the partners, meaning the profits and deductions are taken on each partner's return. Generally, the paperwork associated with this structure is minimal and it is highly recommended to have an attorney draft a partnership agreement. Often labeled as *passthrough entity or* PTE.



Limited Partnership

Passive activity limitations are a significant and complex tax consideration and it is recommended that you consult with a Wellth Financial Services Advisor if you are considering joining or forming a limited partnership

The limited partnership is a spin on the general partnership, let's take the example where your partner tried to take out a massive loan on behalf of the partnership. Well, if they were a limited partner they would be limited in their ability to do so. By the same token, if the partnership was to be sued, their exposure would be limited, given their limited powers. Again here the tax related items *pass through* to the partners, the limited partners may be limited in some of their tax benefits. The concept of limited liability (and benefit) is a pervasive one and is a significant consideration for some people. Thus, the limited partnership is best for passive investors or those concerned with liability, but which may not be concerned with the limited tax benefits. The extent of this limitation is extremely complex and cannot be touched on in this piece but is a significant consideration. Like the general partnership it is highly recommended to have a legal professional draft your agreement. Although like the general partnership there is little formation related red tape beyond this.



Here the diagram shows that Partner B's exposure is limited.

C Corporation

In the case of corporations, the owners are called shareholders. Corporations are significantly more complex than the previous entities because they entail a more formal management and ownership structure, they are also highly regulated. This is partly due to the potential for relevant securities laws to be triggered by various ownership transactions. However, this may also enable a growing business to raise capital to undertake massive investments. For example, "shares" can be bought and sold amongst a few or many investors without having to rethink the entire structure and governance, since the entity itself exists independent of ownership. Although this ability comes with an increased burden of filing articles of incorporation and or bylaws that govern the conduct of the entity. This structure is often favored for its ability to isolate profits of the business from those of the investors. Thus, there are effectively two levels of tax, one at the corporate level and another at the individual investor level when/if distributions are made. However, the corporate structure also offers nearly unmatched liability protections provided that it does undertake activities that would allow authorities to *pierce the veil.*

S Corporation

The S Corporation, much like the limited partnership being a spin on the general partnership, is a spin on the C corporation. The main difference between the two is the S corporation's *pass-through* treatment of profits, which is similar to that of sole proprietorships and partnerships. As a result of this privilege there are some restrictions on who may own shares in an S corporation, and as a result of that fact extra care must be paid to not misstep with respect to ownership. Although if the protection offered by an S corporation is the principal reason for pursuing this path, then a limited liability company may be more advantageous, best to check with an expert at Wellth Financial Services. Generally, some business owners opt for this structure in order to save on self-employment taxes. Although in the early stages of a business this may not be necessary since there would not be significant savings when compared to the added reporting and compliance requirements.

Limited Liability Company

The Limited Liability Company or LLC is truly the best of all worlds, it has grown in popularity for its flexibility and ease of formation. Typically, this entity is formed by filing articles of organization with the state and paying a filing fee. As the name implies, this entity provides a level of protection from liability on par with that of a corporation or limited partnership. The *tax treatment* can vary greatly depending on which elections the owners make. For example, an LLC with only one member (owner) is typically treated as a sole proprietorship yet, in some states an LLC where two married individuals are the sole members, an LLC may be treated as a sole proprietorship as well, subject to some reporting nuance. Despite this fact the LLC still may opt for corporate tax treatment. As you can tell the LLC is an incredibly nimble and versatile structure that can suit many needs and grow alongside your business as needed. The profits and deductions largely *pass through* to the members but for, when an alternate treatment is elected. However, in the case of an LLC it is typically formed for the protection *and pass through* treatment, thus electing an alternate treatment might be counterintuitive.

Confused yet?

Selecting the right entity at the outset is much more than a legal formality it can make or break a small business. Therefore, as an owner, you should take care to research and consider all the factors that play into this decision, and when in doubt reach out to experts at Wellth Financial Services. After all the right structure can make all the difference when it comes to your business.

Our Vision

Feeling limited by traditional accounting firms and their approach, Flavio set out to create Wellth Financial Services as an accounting firm that is focused on the needs of today's modern entrepreneurs. One that would easily adapt to change and is at the forefront of technology and innovation. A firm that embraces today's businesses, thrives on diversity and partners with clients from all lines of work including trailblazers, innovators, influencers, disruptors and content creators. One that would be approachable, an equal and a partner.

Get in touch

Wellth Financial Services
Website: WellthSolutions.com
Phone: (703) 881-7602
Email: Flavio@WellthSolutions.com
Address:
Wellth Financial Services
10432 Balls Ford Road Suite 300
Manassas, Virginia 22195