

Business Formation Workshop

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Mass Challenge
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TOPICS TO BE COVERED:

- The various legal entities in which a business can be operated
- How owners are paid, taxed, and what type of liability they are exposed to
- How to form and maintain the business entity
- Federal, state and local tax on business entity

Business Organization Forms

- Sole Proprietorship
- General Partnership
- Limited Liability Company
- Corporation
 - C Corporation - taxed at corporation and at shareholder level
 - S Corporation - only shareholders are taxed

Sole Proprietorship

ADVANTAGES

- Easiest and least expensive to start
- Minimal filing and record keeping
- Owner is the sole manager
- Profits are not shared
- Income taxed on owner's individual return
- Easy to dissolve if needed
- Not subject to Texas franchise tax

DISADVANTAGES

- Unlimited owner liability
- Owner needs diversified talents
- Start-up capital difficult to raise
- Less attractive to prospective employees
- No difference between you and your business
- Permits, licenses and contracts may be lost when owner dies

HOW OWNER IS PAID AND TAXED

Sole Proprietorship – Pass Through Entity

HOW YOU GET PAID: Generated income goes to owner to keep or reinvest in the business. Owner may draw funds out of the business as needed. Amount the owner takes out is ***not*** the amount of income she will be taxed on.

TAX REQUIREMENTS: Owner reports business income and expenses on **Schedule C** to her personal **Form 1040** tax return. Owner will pay tax at her personal tax rate on the amount of business income shown on that Schedule.

General Partnership

ADVANTAGES

- Partners share management
- Capabilities should complement one another
- Partner may bring in capital (partner of necessity)
- Potential partnership incentives for future employees.
- Income taxed at the partner level
- Not subject to Texas franchise tax if ALL the partners are individuals

DISADVANTAGES

- Unlimited liability – each partner individually
- Should have extensive Partnership Agreement
- Finding suitable partner(s)
- Disagreements/authority
- Profits shared between partners
- Complex Partnership Tax Report

HOW OWNERS ARE PAID AND TAXED

General Partnership – Pass Through Entity

HOW PARTNERS GET PAID: Partners may receive distributions of funds from the business as needed, typically in the same proportions as their ownership interest in the Partnership. The amount the partners are distributed is ***not*** the amount of income they will be taxed on.

TAX REQUIREMENTS: The Partnership is not taxed, but must file an informational **Form 1065** Partnership Tax Return reporting income and deductions, and must also provide a **Schedule K-1** to the IRS and each partner, containing each partner's share of the company's profits and losses. In turn, each partner reports this profit and loss information on **Schedule E** to her individual **Form 1040** tax return.

Limited Liability Company (LLC)

ADVANTAGES

- Limited liability protection for owners
- Not difficult or expensive to form
- Fewer rules and restrictions than corporations
- More simplified management than corporations
- Profits taxed only once at owner's level
- Can CHOOSE to be taxed as C or S Corp or Partnership; no separate tax filing if single owner

DISADVANTAGES

- Should have extensive Operating (Company) Agreement
- Must file & keep current with TX Secretary of State and Comptroller
- Should have written agreement restricting ownership transfer if >1 member
- Subject to Texas franchise tax

HOW LLC OWNERS ARE PAID AND TAXED

Options for payment and taxation of LLC:

- If single member (including married couple) - As sole proprietor/individual – see previous slide 5
- If multiple members – As Partnership – see previous slide 7
- As C Corp – see subsequent slide 11
- As S Corp – see subsequent slides 12 and 13

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Corporation

ADVANTAGES

- Easier to raise capital through sale of shares
- Easier to transfer ownership – sale of shares
- Limited liability for shareholders/owners
- Continues to exist until intentionally dissolved
- May appear more substantial, serious than other entity forms
- Potential for employee partial ownership through stock options

DISADVANTAGES

- Must file and keep current with TX Secretary of State and Comptroller
- More extensive legal requirements than LLC
- Profits may be taxed twice – at corporate and shareholder levels
- Needs Bylaws and stock ledger
- Should have written agreement restricting stock transfer if >1 shareholder
- Subject to Texas franchise tax

HOW OWNERS ARE PAID AND TAXED

C CORPORATION – Double Taxation

HOW OWNERS GET PAID: Owners will be paid a salary as W-2 employees. Income tax withholding, Medicare and Social Security will be withheld from each paycheck and paid by the company to the IRS quarterly. Dividends may also be distributed to the owners.

TAX REQUIREMENTS: Company is taxed on its income at corporate tax rate and files a **Form 1120**. Owners are taxed again on those amounts distributed to them at their individual tax rate, as well as being taxed on their W-2 salary as earned income. Both are included on their individual Form 1040 tax return.

QUALIFICATIONS FOR LLC OR CORPORATION TO BE TAXED AS AN S CORP – PASS THROUGH ENTITY

- Entity cannot have more than 100 shareholders.
- Shareholders must be individuals, estates or certain trusts.
- Shareholders may not be non-resident aliens.
- Election must be filed with the IRS on Form 2553 (+ Form 8832 for LLCs) within 75 days of organization.
- Entity cannot have classes of stock with different distribution or liquidation rights.
- Certain financial institutions, insurance companies, and domestic international sales corporations are ineligible

HOW OWNERS ARE PAID AND TAXED

S CORPORATION – Pass Through Entity

HOW OWNERS GET PAID: Owners will be paid a salary as W-2 employees, which is a deductible expense of the entity and taxable to the owner/employee. Income tax withholding, Medicare and Social Security will be withheld from each paycheck and paid to IRS quarterly on Form 941 based on that salary. Remaining profits can be distributed to owners as income.

TAX REQUIREMENTS: The business does not pay income tax but must report its income and expenses on **Form 1120S** and pass through profits or losses to its owners on **Schedule K-1**. Owners include Schedule K-1 amounts on **Schedule E** to their Form 1040 individual tax returns.

HOW TO ESTABLISH A TEXAS LLC

File Form 205 Certificate of Formation with TX SoS either:

- In hardcopy sent by U.S. mail:
https://www.sos.state.tx.us/corp/forms/205_boc.pdf
- Online through SOS Direct at:
<https://www.sos.state.tx.us/corp/sosda/index.shtml>

On top bar: Business Organizations; Web Filings: Reservation-Formation-Registration Documents; Domestic Limited Liability Company; File Document; Filing Type: Certificate of Formation

NOW THAT YOU ARE AN LLC . . .NEXT STEPS

- Receive, print out and keep Certificate of Filing of Certificate of Formation from TX Secretary of State
- Apply for EIN from IRS (During banker's hours): [https://
www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online](https://www.irs.gov/businesses/small-businesses-self-employed/apply-for-an-employer-identification-number-ein-online). Print out and keep EIN assignment.
- Set up corporate bank account with 2 documents listed above
- Adopt Operating Agreement

Maintaining the Business Organization

- Maintain minutes of meetings of members/managers if multiple owners.
- Keep current record of owners and their percentage ownership.
- Keep corporate bank account separate from personal funds.
- Maintain adequate capital for risk involved in business (insurance).
- Sign documents in name of company By officer; not in individual name.
- Keep full company name, with LLC, on website, business cards, stationery.
- Title business property in the name of the LLC.
- Obtain NAICS code <https://www.naics.com> for tax and marketing purposes.
- File federal, state and local tax reports and returns; pay taxes timely.

GOAL: Business recognized as a separate entity, not alter ego of the owner, so corporate veil will not be pierced to attach personal assets to satisfy business liabilities.

FEDERAL, STATE AND LOCAL TAXES

Federal:

- *Obtain EIN from [irs.gov](https://www.irs.gov)*
- Income, payroll and unemployment insurance taxes

State:

- Franchise, sales and unemployment insurance taxes

County:

- Business real and personal property taxes

Recommendations For Start-ups

Keep it simple:

- Operate as a sole proprietorship or partnership until business plan is proven
- Once operational, if liability is a concern, form an LLC
- Purchase sufficient insurance to cover your risks
- *In Texas, 90% of start-ups use these forms*
- *You can “upscale” your structure later*
- *Focus your start-up energies on perfecting your business plan and a successful launch !*

LEGAL DISCLAIMER

The information contained in these slides and presented at the related webinar is designed to enable listeners to better understand the Texas laws regarding establishment of, and limitation of liability for, LLCs. Due to the very complex nature of the topic, this treatment is necessarily limited and should not be relied on by the listener as legal advice for the listener's particular business situation. SBA/SCORE recommends that its small business clients consult their legal counsel for issues arising in their business regarding the protection of their personal assets for liabilities arising in the operation of their businesses.



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