Season 1 – Episode 18 - Navigating the Maze of Business Entities - From Sole Proprietorships to Corporations

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, Personal Financial Specialist and Enrolled Agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

Today I'm going to discuss choice of entity basics. This is a complex topic, but I wanted to at least provide an overview of each type of entity available to your business. As a general guide, before fully committing to a specific type of entity, I recommend you speak to a tax professional who will take your specific circumstances into account when providing advice specific to your business. The type of entity you choose will have lasting implications on various aspects of your business, ranging from taxation and financial obligations to legal liabilities and operational intricacies. So let's start with sole proprietorships, the most basic and straightforward business structure you can choose. One of the most significant advantages of a sole proprietorship is its simplicity. There's hardly any paperwork or compliance overhead to worry about. And with Sole prop, you and the business are the same in the eyes of the IRS.

All the business income is reported on your personal income tax return on Schedule C. One of the biggest downsides is that there is no separation between your personal and business assets, meaning your personal assets are exposed to business risks. The lack of legal separation means you are personally on the hook for all the business debts and liabilities, including legal actions against the business. So, for example, imagine you're a freelance photographer. A sole proprietorship may suit your needs because it's simple and easy to set up. However, if a client sues you over a contractual dispute, your personal assets, like your home and personal savings, could be at risk. Now, let's talk about partnerships. Partnerships are like sole proprietorships, but for businesses run by more than one person. Much like a sole prop, partnerships are relatively simple to form, usually entailing only a partnership agreement. Partnerships are valuable in their ability to divvy up profits and losses in any manner the partners decide as long as the allocation reflects the economic reality of the partner's contributions and risk in the partnership, often referred to as the substantial economic effect test.

From a tax standpoint, even if there isn't a partnership agreement in place, the Uniform Partnership Act will govern and you will still be taxed as a partnership. If two or more individuals or entities operate a for-profit business together as co-owners, liability wise, partnerships are subject to joint and several liabilities. This essentially means that each partner can be held responsible for the business's entire debts as well as the actions of the other partners. If you want to limit this exposure to partner actions, you can set up with your state a limited liability partnership. Partnerships do file a separate tax return via form 1065. The income and losses are passed through to the individual partners by way of Form K, one who report this income on their personal tax returns. Even though not necessarily required, it is highly recommended to formalize the partnership with an operating agreement.

The operating agreement should clearly outline the division of profits, losses and responsibilities among partners. But remember that each partner is still liable for the business's financial obligations. So, for example, let's say you and a friend decide to start a small boutique marketing agency. A partnership can offer a simple way to pool resources and expertise. However, if one partner signs an unfavorable contract, both are liable for any ensuing debts or obligations. Now, let's talk about limited liability companies or LLCs, which offer a blend of features from partnerships and corporations. LLC owners are called members, and they enjoy liability protection, meaning their personal assets are generally shielded from business debts. LLCs that are not taxed as corporations offer flexibility in management and distribution of profits, just like sole props and partnerships. You can, however, elect to file an LLC as being taxed as a corporation. And if you do, you can choose to have them taxed as a C Corp or an S Corp, and the taxation of those entities will apply to the LLC, just as if you had created a C Corp or an S Corp in the first place.

LLCs can have a single member or multiple members. If only one owner, the LLC is disregarded for tax purposes, and it's treated as a sole proprietorship. If there are multiple members, the LLC defaults to being taxed as a partnership. In California, if a husband and wife are the only members of the LLC, they can be treated as one owner, allowing their income to be taxed as a sole proprietorship. This removes the need to file a separate tax return on form 1065, like a partnership. And this can be pretty valuable in terms of cost savings each year due to having to file a separate tax return. Now, state laws govern LLCs, so the legal requirements will vary. However, most states require periodic filing of annual reports and associated fees. For California LLCs, they are required to pay $800 a year as a minimum, plus a gross receipts fee that range from $900 all the way up to $11,790 a year.

The $900 gross receipts fee starts when your gross receipts are over $250,000, I want to be clear that's gross receipts not net income, so you can make $0 after all expenses. But if your gross receipts are 250,000 or up, you will be subject to a gross receipts fee. So, for example, suppose you're creating a software application with three other individuals, and now each bring a unique set of skills development, marketing, finance operations. And an LLC would probably be suitable choice, as it offers protection against personal liability while allowing the flexibility to allocate profits in a way that doesn't strictly correspond to ownership percentages. All right, now let's move to S corporations, like LLCs and C Corps. S Corps offer their shareholders liability protection. S Corps offer the best of both worlds, though, by combining the liability protection of a corporation with the tax benefits of a pass-through entity.

There are restrictions, though, on the number and type of shareholders an S Corp can have to qualify for S Corp status. All shareholders must be us. Citizens or residents, and you can't have more than 100 shareholders. One of the unique benefits of an S Corp is the ability to save on self-employment taxes, so you can draw a reasonable salary as an employee and take the remainder of profits as dividends and distributions which aren't subject to self-employment taxes. I have done a deeper dive podcast on S corporations. It's episode six of Tax Blueprints, and I recommend checking that out if you want to learn more about how to utilize S Corps and their unique attributes. So finally, let's dive into C corporations, which is the entity of choice for larger businesses and those seeking venture capital. A C Corp is a completely separate legal entity, and it offers the highest level of protection against personal liability for its owners.

Unlike S Corps, C Corps can have an unlimited number of shareholders, and they can have different classes of stock. C Corps face the most stringent regulatory requirements, including governance obligations. One significant drawback is double taxation. The corporation pays income tax on its profits, and then shareholders pay taxes again on any dividends they receive. This fact alone typically causes small businesses to shy away from the C Corp entity. If you're planning to go public or attract venture capital, though, C Corps are generally the preferred entity due to their governance structure and the ease in which shares can be transferred. So, for example, imagine you're the founder of a tech startup in the artificial intelligence space, and you're seeking significant venture capital funding. A C Corp would likely be the best choice because it's the preferred structure for venture capitalists and allows for different classes of stock.

We've covered a lot of ground today, and I hope this episode has shed some light on the complex decision-making process involved in selecting a business entity. Remember, this choice impacts every facet of your business operations, from how much you pay in taxes to your level of personal liability and your ability to raise capital. Therefore, it's imperative to consult with qualified tax advisors and legal professionals to determine the most suitable structure for your unique business needs.

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