PacificCPE

COURSE

81651A

Business Entities: Fundamentals and Personal Liability

Starting with the building blocks of business structure, this course covers the core characteristics of each major entity type and what they mean for owners and practitioners. You'll also dig into personal liability concerns—one of the most critical factors clients consider when choosing how to organize a business. Whether you're advising a startup or reviewing an existing structure, this course gives you a solid foundation for guiding clients through entity selection decisions with confidence.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the main benefits of forming a limited liability company (LLC) as opposed to other business structures.
- Recall the characteristics of various types of business insurance.

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Chapter 1: BUSINESS ENTITY BASICS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the main benefits of forming a limited liability company (LLC) as opposed to other business structures.

Do you really have time to read this course? Shouldn't you be devoting more time to your accounting, your competition, your overhead, or your business plan? After all, as Calvin Coolidge once said, "The chief business of the American people is business"—so why not hire a lawyer to advise you about your choosing a legal entity for your business, put down this course, and get back to work?

WHY YOUR CHOICE OF ENTITY MATTERS

Here are three reasons why you need to learn more about the various legal forms your business might take:

- **You're making a business decision.** Your choice of business entity affects how ownership is structured, how the company is managed, how the business is taxed, how you take money out of the business, and how you can raise capital. In other words, your decision about what type of business entity to form can be as crucial to your business success as your marketing, hiring, or sales decisions. If you want limited liability protection, which we discuss in this chapter and explore further in Chapter 2, your choice will be between an LLC or a corporation. This book will help you understand the legal and financial basics of each business structure.
- **You can save money**. Hiring a lawyer *can* be helpful, particularly if there are disputes among multiple owners of a business. But hiring a lawyer can also be expensive or unnecessary. If you take the time to read this book, you can save money and make a reasoned decision about your choice of entity. You can also save money by using products or services that specialize in business formation. If you do hire a lawyer, the knowledge you gain from this book will help you to work more efficiently together.
- **You'll keep your options open.** As businesses grow, they often change their form of entity. A business might start as a sole proprietorship or partnership and then evolve into a corporation or LLC. The business entity you choose today might affect your choice of entity in the future. In other words, you're not just picking a business entity; you're

plotting a business strategy. The more information you have, the better equipped you'll be to plot the right course.

Now that you know why this is an important decision, it's time to learn some basic information about each type of business entity.

SOLE PROPRIETORSHIPS

The simplest way to be in business for yourself is as a "sole proprietor." This is just a fancy way of saying that you are the owner of a one-person business. Forming a sole proprietorship involves almost no cost or bureaucratic red tape, other than the usual license, permit, and other regulatory requirements that your state, locality, or both imposes on any business. And you don't have to do anything to create a sole proprietorship: If you start a one-person business and don't form a corporation or LLC, you have created a sole proprietorship, and that's how the state and the IRS will treat your business.

As a practical matter, most one-person businesses start out as sole proprietorships just to keep things simple.

Example

Winston is a graphic artist who started a sideline computer graphics business in his garage. Winston works only part time in his own business and has no employees. He has just a couple of clients and no pressing personal liability issues, so he chooses to operate as a sole proprietor (his other choices would be to form an LLC or a corporation). Outside of a business license, fictitious name filing, and tax permit, Winston does not need to file any legal paperwork. Unless Winston takes steps to change the legal structure of his business—by filing the necessary papers with his state to form a one-person LLC or corporation—his business will automatically be classified and treated as a sole proprietorship.

Number of Owners

By definition, a sole proprietorship has only one owner. If your one-person business grows and you wish to include other owners, you'll need to choose another business structure, such as a partnership, LLC, or corporation.

Liability for Business Debts: No Limited Liability

Unfortunately, although forming and running a sole proprietorship is simple, it can also be risky. That's because sole proprietors are 100% personally liable for all business debts and legal claims. To put it another way, sole proprietors do not have limited liability protection against creditors of the business, the way an owner of an LLC or corporation does.

For example, if someone slips and falls in a sole proprietor's office or store and then sues, the owner is responsible for paying any resulting court award (unless commercial liability insurance covers it). Similarly, if the business fails to pay suppliers, banks, or bills from other businesses, the owner is personally liable for the unpaid debts. This means that the owner's personal assets, such as bank accounts, equity in a house or car, and other personal assets, can be taken by court order and sold to repay business debts and judgments.

Of course, some businesses are much more vulnerable to debts and lawsuits than others. If you run a business that doesn't operate on credit and is unlikely to be sued, limited liability might not be essential for you. (Chapter 2 provides more information about personal liability.)

Income Tax Treatment

In the eyes of the IRS, a sole proprietorship is a "disregarded entity." The IRS does not have a tax return for the sole proprietorship. Instead, sole proprietors report their business profits or losses on IRS Schedule C, *Profit or Loss From Business (Sole Proprietorship)*, which they file with their 1040 individual federal tax returns. The owner's profits are taxed at his or her individual income tax rate. This is called "pass-through" taxation because the income passes through the business to the owner's individual tax return. Partnerships, LLCs, and S corporations, each of which we discuss below, are also pass-through entities. C corporations aren't.

Schedule C is simpler than corporate and partnership tax returns. If you prepare your own individual tax returns, you might find it easy to add Schedule C for your business. Or, if you pay a tax preparer, the cost for Schedule C should be less than what you would pay for a partnership or corporate return.

Because sole proprietors are self-employed, they have no employer to chip in part of their Social Security and Medicare taxes (called "self-employment taxes" for those working for themselves and "FICA taxes" for regular employees). Regular employees generally pay half of these taxes through payroll deductions, and the employer pays the other half. Sole proprietors must pay the entire amount themselves (by preparing Schedule SE, the *Self-Employment Tax* return, which must be filed along with a Schedule C and 1040 income tax return each year).

Although having to pay all of the Social Security and Medicare taxes might seem like a disadvantage of forming a sole proprietorship, it actually isn't. If that same sole proprietor had instead formed a one-person corporation, he or she would personally pay half of the tax and the corporation would pay the other half. The money would come from two different sources, and the tax reporting requirements are different, but the whole amount still ultimately comes out of the owner's pocket.

Generally, sole proprietors, partners, and LLC members can be eligible to deduct the cost of health insurance premiums, but the requirements, limitations, and manner of reporting vary.

GENERAL PARTNERSHIPS

A partnership is a business in which two or more owners agree to share profits (and losses). If you go into business with at least one other person, you have automatically formed a general partnership—even if you never signed a formal partnership agreement. A general partnership really can be started with a handshake (although it makes far more sense to prepare and sign a written partnership agreement—see "Create a Written Partnership Agreement," on the next page).

Create a Written Partnership Agreement

While it's not required by law, general partners should always create a written partnership agreement. Without an agreement, the default rules under the state's general partnership laws will apply to the partnership. For example, state partnership law might say that the business's profits and losses must be divided up equally among the partners (or according to the partners' capital contributions, in some states), unless the partners have agreed to a different division.

Rather than relying on state law, general partners should prepare a written partnership agreement that sets forth agreed-upon rules for handling issues important to their business relationship, including division of profits and losses, partnership draws (payments in lieu of salary), and procedures for selling a partnership interest back to the partnership or to an outsider, should a partner die or want to move on. Even a small general partnership should start off with a written general partnership agreement. If you hire a lawyer to write it, you might pay anywhere from a few hundred to a few thousand dollars in legal fees, depending on the complexity of your partnership.

Of course, many partners do the work themselves—and avoid those legal fees—using a self-help tool.

Example

Two web designers set up a side business to design websites for nonprofit organizations. They are too busy working to bother thinking about the best business structure for their new sideline business. Without taking any formal action or creating a partnership agreement, they have formed a partnership. If the partners were to have a dispute—over the division of profits, perhaps—in the absence of an agreement, state partnership law would control the outcome. Once they realize that their informality might subject them to rules that aren't of their choosing, they decide to prepare a written partnership agreement.

Number of Partners

General partnerships may be formed by two or more people; by definition, there is no such thing as a one-person partnership. Legally, there is no upper limit on the number of partners who may be admitted into a partnership, but general partnerships with many owners tend to have problems reaching a consensus on business decisions and may be subject to divisive disputes among contending management factions. In larger partnerships, one or more partners may be designated as managing partners to eliminate day-to-day bickering, but delegating authority to a select group of managing partners is rare in small business partnerships. Why? Because doing so can be risky for the nonmanaging partners—who, by definition, won't be keeping a close eye on the business, but will still be personally liable for partnership debts. So, to minimize risks and keep all the partners honest, all general partners usually take an active hand in management.

Liability for Business Debts: No Limited Liability

Like sole proprietors, general partners do not have limited liability protection. Each partner is personally liable for all business debts and any claims (including court judgments) against the partnership that the business can't pay. For example, if the business fails to pay its suppliers, the partners are personally responsible for paying these business debts, even if that means mortgaging their houses, selling their cars, and emptying personal bank accounts to come up with the necessary cash.

And creditors don't have to respect the partners' internal arrangements about who owns what percentage of the company's assets, or who is responsible for what share of the partnership's debts. If the business owes money it can't pay, the creditor may go after any general partner for the entire debt, regardless of his or her partnership ownership percentage. (If this happens, the partner who is sued can in turn sue the other partners to force them to repay their shares of the debt, but suing can be costly and time-consuming.)

Personal liability for business debts is even more worrisome, because each general partner may bind the entire partnership (and all of the partners) to a contract or business deal. In legal jargon, each partner is an agent of the partnership, with the right to undertake obligations on its behalf. (Fortunately, this agency rule has a few significant limitations—to be valid, a contract or deal must generally be within the scope of the partnership's business, and the outside person who makes the deal with a partner must reasonably think that the partner is authorized to act on behalf of the partnership.)

If a partnership can't fulfill a valid contract or other business deal, each partner may be held personally liable for the amount owed. This personal liability for the debts of the entire partnership, coupled with the agency authority of each partner to bind the others, makes the general partnership riskier than a sole proprietorship (where only the proprietor can legally bind the business) and far riskier than entities such as LLCs, corporations, and limited partnerships, which offer at least some of the owners limited personal liability for business debts.

Because general partners have unlimited personal liability for business debts, most multi-owner businesses are much better off as LLCs than as general partnerships.

General Partnership Income Taxation

Like a sole proprietorship, a general partnership is treated as a pass-through tax entity. The profits (and losses) pass through the business entity to the partners, who pay taxes on any profits on their individual returns at their individual tax rates.

Partnership taxation is more complicated than sole proprietorship taxation, however, and most partnerships of any size will likely need a tax adviser who understands partnership tax and procedures. Although a partnership does not pay its own taxes, it must file an informational return each year, IRS Form 1065, *U.S. Return of Partnership Income*. In addition, the partnership must give each partner a filled-in IRS Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, which shows the proportionate share of partnership profits or losses each person carries over to his or her individual 1040 tax return at the end of the year.

Each partner must pay taxes on his or her entire share of profits, even if the partnership chooses to reinvest the profits in the business rather than distributing all of them to the partners. The technical way of saying this is that the partners are taxed on their "allocated" profits, not on their "distributed" profits.

What about self-employment (Social Security and Medicare) taxes? General partners, those involved in the business, aren't considered employees of the partnership, and they must pay self-employment taxes on their share of partnership income.

LIMITED LIABILITY COMPANIES (LLCS)

The limited liability company (LLC) is popular with many small business owners because it provides both pass-through taxation of business profits (like a partnership or sole proprietorship) and limited personal liability for business debts (like a corporation).