PacificCPE

COURSE
81652A

# Business Entities: Formation, Operations, Taxes, and Profit Allocation

Choosing the right entity is only the beginning—understanding how to form it, run it, and manage the financial consequences is where the real work starts. This course walks through the practical steps of getting a business up and running, then shifts to the money side: taxation, profit and loss treatment, and investment considerations. Ideal for practitioners who want a clearer picture of how operational and tax factors interact when advising business owner clients.

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

Start Course ↓ | Final Exam Copy ↓

## 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 role of an agent in a business context.
-

Recall which business entities have pass-through tax treatment as a default.

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# Chapter 1: FORMING AND RUNNING YOUR BUSINESS

*Chapter Objective*

**After completing this chapter, you should be able to:**

- Recognize the role of an agent in a business context.

This chapter examines the process of forming each type of business entity—that is, it explains the steps you can take to start up and run each type of business.

## FORMING AND RUNNING A SOLE PROPRIETORSHIP

The majority of the businesses in the United States are sole proprietorships—and it's easy to see why they're so popular. Forming and running one is effortless, at least with respect to formation paperwork. To get started, just start selling your goods or services. If you're running your business by yourself—that is, without anyone sharing the expenses and profits—and you haven't formed an LLC or a corporation, you've already created a sole proprietorship.

### Forming a Sole Proprietorship

Starting a sole proprietorship requires little more than hanging out a sign or shingle or opening a storefront. This is the primary convenience associated with creating sole proprietorships as compared to LLCs and corporations—you don't have to make a formal filing with the state to start up your business.

Although a sole proprietorship is easy to form, you will still have to deal with paperwork and forms —for example, reporting and paying income taxes, sales taxes, payroll taxes—to keep the business running. In other words, regardless of how casually you start your sole proprietorship, you will need to meet certain formalities, depending on the type of business. (See "Paperwork Required for All Businesses," below.)

### Running a Sole Proprietorship

For those in business, the ultimate freedom and independence come from running a sole proprietorship. You can make business decisions as you wish, without consulting investors, managers, members, or partners. As a sole proprietor, you will need to abide by state and federal tax laws, and obey any other municipal, state, or federal government rules that are specific to your enterprise—for example, laws regarding the sale of specific products and services. Unlike corporations and LLCs, no laws or formalities dictate how you must manage and document the decision you make in your sole proprietorship.

### *Paperwork Required for All Businesses*

If you're starting a new business from scratch, you'll have to take care of some paperwork, no matter what business form you choose. Most businesses will need to obtain one or more of the following:

- **EIN.** An employer identification number (EIN) is generally required for partnerships, co-owned LLCs, all corporations, and, under some circumstances, sole proprietorships. If you are a sole proprietor without employees, or a one-owner LLC without employees, you can use your Social Security number for preparing your income tax returns, opening up a bank account, and most other tax chores. (Note that some banks (and some states) might require your one-owner LLC to have its own EIN. In such cases, you should obtain an EIN for your LLC and use it with your bank or state tax returns, but continue to use your Social Security number when filing your federal income tax returns (that's what the IRS expects sole-owners of LLCs to do).) However, a sole proprietorship or a one-owner LLC must have an EIN if it has employees or if it sets up a qualified retirement plan. You must furnish the EIN when you file employment tax returns as well as retirement plan returns with the IRS (but continue to use your Social Security number when filing federal income tax returns). Obtain an EIN online at the IRS website (www.irs.gov).
- **DBA.** If you're doing business under an assumed name, most local governments require you to file a DBA ("doing business as") statement. You can find out the details from the county clerk at your local courthouse. (If you're doing business under your own name (that is, your last name—for example, Wellhausen's Welding Studio), you won't need to file.) Registering your business name as a DBA with your county clerk or filing incorporation papers doesn't guarantee your right to use your name in business or to identify your products. Before choosing a name for your business, you might need to review legal rules regarding trade names and trademarks.
- **Local permits.** In addition to filing a DBA, your local or state government might have other permit or licensing requirements. You can usually find out the details at your county clerk's office.

## FORMING AND RUNNING A PARTNERSHIP

For most partnerships, the legal side of forming and running the business is similar to sole proprietorships: a lot of freedom and few legal restrictions. Like a sole proprietorship, a partnership need only follow established accounting principles, abide by the tax laws, and obey laws specific to the business. However, there are a few additional issues to consider when forming and running a general partnership.

### Forming a Partnership

To create a partnership (also known as a general partnership), you don't have to do anything other than start your business with one or more other people. A general partnership has no required paperwork formalities to get started—that is, you don't have to file formal paperwork or pay fees to the state to formalize its existence. In short, partners, like sole proprietors, can simply start doing business.

You must, however, file forms with your state to create a limited partnership (LP) or a registered limited liability partnership (RLLP). Go to your state's corporate filing office website for information on the process. (See the appendix.)

The only problem with this let's-get-together-and-start-a-business approach is that unless the partners have a written agreement, certain partnership obligations and rules can be unclear. For example:

- How much money, property, or services does each partner pay into the partnership to get it started?
- Who will work for the partnership?
- How will profits and losses be divided and paid out to the partners?
- What happens if the partners split up—who buys the other person(s) out, and for how much?
- What happens if a partner gets divorced, wants to retire, or dies?
- If the partnership folds, who gets to use the name in a new business?

If the partners get in a dispute and they have not prepared a written partnership agreement, the default provisions of state partnership law may decide some or all of these issues for them—and the legal result might not be to their liking.

That's why every partnership should start by preparing a written agreement establishing each partner's share of the income and setting out what will happen if one of the events mentioned above occurs.

*Obtain Spousal Consent in Community Property States*

In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse automatically has partial ownership in all property acquired during the marriage (including LLC interests and corporate shares, as well as partnership interests). If there's a divorce, a partner's interest in the business could end up going to the spouse—something that other partners might not be too happy about.

To prevent this from happening, partners have their spouses sign the partnership agreement. By signing a spousal consent provision in the agreement, the spouses acknowledge that they have read the agreement and agree to its terms, which typically include mechanisms to keep ownership and voting interests with the original or remaining partners in the event of a partner's divorce, disability, or death.

**Running a Partnership**

Running a sole proprietorship has its benefits—including the freedom to make decisions alone and to keep all the profits—but it also has its disadvantages: There's nobody to help run the show or to share the expenses and work.

Although state law generally does not require that specific formalities be followed to run a partnership—for example, state law doesn't dictate how often you must hold partnership meetings or how you must make decisions at these meetings—the truth is that you can't always do what you want in a partnership, because your actions and decisions affect the other partners. And because partners can be liable for the actions of the other partners, running a partnership can get a bit complicated.

*Example*

Allen has run a successful audio-production business for several years. He decides to take on a partner, Phoebe, a recording engineer who will bring her skills—and her expensive recording equipment—to the partnership. Phoebe has no experience running a business, and Allen is concerned that she will make decisions that could affect his personal liability and his relationship with the clients. He enters into a partnership agreement with Phoebe that details who will make certain decisions.

When it comes to making important decisions, it's always wise to talk things over with all the partners and respect each other's opinions. But achieving unanimity on everything can be hard—which makes it impractical to choose unanimity as a standard for decision making. A majority vote on routine decisions allows you more flexibility and probably won't cause any serious disputes. Most

partnerships require unanimity only on major business decisions such as adding a new partner or closing down the business. You can specify these standards and rules in your partnership agreement.

Similarly, your agreement can establish guidelines for other issues, such as what happens when one partner leaves, where the partnership records are kept and who maintains them, what happens when you want to add a new partner, what happens if a partner dies, and how you value each partner's contributions.

Of course, creating a partnership agreement is no guarantee that the partnership will run smoothly. The reality is that for a small partnership to succeed, the partners need to have shared goals and confidence in one another's judgment. If those elements don't exist, a partnership agreement won't help, no matter how detailed it is. Put more bluntly, if you don't trust your partners and enjoy working with them, it's probably best not to bother creating a partnership in the first place.

### FORMING AND RUNNING AN LLC

In many ways, the LLC is the business entity that gets it right for the small business owner. It eliminates the downside of sole proprietorships and partnerships—personal liability for business debts and claims—but it keeps the upside—pass-through taxation rules. And an LLC is also fairly easy to form and run.

#### *Is It Time to Form an LLC?*

Many entrepreneurs feel that forming an LLC is so simple and inexpensive—and provides a comfortable level of personal insurance against legal claims—that it is the best way to do business right from the start. Others decide to do business informally as a sole proprietor or partnership first, then ease their way into an LLC once they feel more certain that their business has a good chance of success.

Only you can decide if and when it makes sense to take the time and trouble to form an LLC—there's no one correct approach. It depends on your type of business, how comfortable you are with risk, whether you feel the need to limit your personal liability, and your willingness to take on the required paperwork and fees, among other things. Chapter 2 of course 81653C, Chapter 3 of course 81653C explain how to convert your business from a sole proprietorship or partnership to an LLC.

#### Forming an LLC

However, just like partners in a partnership, LLC owners should do more than just the minimum required paperwork. LLC owners should prepare an LLC operating agreement—a document similar to a partnership agreement, which defines the rights, responsibilities, and relationship among the

owners. And while LLCs aren't legally required to hold meetings, it makes sense for LLC managers and members to meet when they have to make and document important LLC legal, tax, or business decisions.

When you're trying to choose the right business entity, you should consider how many owners you expect in your business. You can form an LLC with as few as one member or as many as you want—state LLC laws don't impose a maximum number of members. However, if you plan to have more than 35 owners, securities law considerations suggest that forming a corporation might be a better choice.

*Tip*

**Securities laws favor businesses with 35 or fewer investors.** Federal and many state securities laws treat 35 as a "magic" number—if you have 35 or fewer investors, your LLC stands a good chance of being exempt from state and federal security registration filings and fees for private sales of business ownership interests, such as issuing LLC memberships or corporate stock.

*Related Topic*

**Want help forming your LLC?** In the final section of this chapter, resources are provided to help small business entrepreneurs prepare and file articles of organization and complete the other paperwork associated with organizing an LLC (or a corporation)

*Check State LLC Annual Fees Before Forming an LLC*

In most states, LLCs aren't charged a separate entity-level tax, or, if they are, such taxes normally (but not always) are modest in amount and are calculated on actual net income (profits) earned by the LLC. You can view information on LLC annual taxes at your state's business filing website. (See the appendix.)

**Running an LLC**

LLCs are a good choice for small businesses operated by one person or a close-knit group of people who want the freedom to run their business as they see fit—and to change the rules as they go along (with the consent of all owners, of course).

State LLC laws set up very basic ground rules for running an LLC, but these rules act only as defaults. In other words, most of these rules apply only if you don't create your own rule on the same topic in your LLC's articles or operating agreement.

The default rules in a state LLC act might say: