

Choice of Entity and Accounting for Start-Ups

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Entity Classification Overview



- Business entities are classified under **2** separate and distinct (but similar) classification systems.
- First, what type of business entity are you for state law (non-tax) purposes?
 - Business Entity classification is a matter of state, not Federal, law.
- Second, how is the business entity classified for Federal income tax purposes?
 - State tax classification generally follows the Federal classification

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Choice of Entity

- **Limited Liability Company**
 - Single Member
 - Multiple Member
- **Corporation**
 - C Corporation
 - S Corporation
- Owners of LLCs and Corporations enjoy limited personal liability under state law.


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Choice of Entity (cont.)

- **Partnership**
 - **General Partnership** – All partners are General Partners
 - **Limited Partnership** – Must have 1 general partner
- **Sole Proprietorship** – a self-employed individual
- Sole Proprietors and General Partners do NOT have limited personal liability under state law.


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Entity Tax Classifications

- Check-the-Box Rules
 - IRS Form 8832 – Entity Classification Election
- Limited Liability Company
 - Single Member LLC
 - Default Classification: Sole Proprietorship ("Disregarded Entity")
 - May elect to be classified as a corporation
 - Default is C Corporation; may further elect S Corporation Classification

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Entity Tax Classifications (cont.)

- Multiple Member LLC
 - Default Classification is Partnership
 - May elect to be classified as a corporation
 - Default is C Corporation; may further elect S Corporation Classification

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Entity Tax Classifications (cont.)



- Partnerships
 - Partnerships do not pay income taxes.
 - Partnership income or loss "flows through" the partnership to the partners.
 - A Partner reports his/her share of partnership income or loss on the Partner's personal income tax return.

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Entity Tax Classifications (cont.)



- Corporation
 - C Corporation
 - Pays income tax at the corporate level.
 - Dividends distributed to shareholders are also taxed on the Shareholder's personal return.
 - S Corporation
 - The corporation does not pay tax at the corporate level.
 - The corporation's income "flows through" to the shareholders and is taxed on the shareholder's return.

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Entity Tax Classifications (cont.)



- Sole Proprietorship
 - A self employed individual who reports business taxable income or loss on his/her individual income tax return (Schedule C).
 - Pays self-employment tax (13%) in addition to regular income taxes.

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Tax Matters



- Federal, State and Local Taxes
- Quarterly Payments
- Understanding Credits and Deductions
- Self-Employment Taxes

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Governance: Corporations vs. LLCs



- More formal requirements for corporations
 - Bylaws, Minutes
- Corporations must hold Annual Meetings
 - Shareholders
 - Directors
 - Option to take action by written consent

State law requirement to "observe corporate formalities."

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Governance (Cont.)



- Limited Liability Company
 - Flexibility of Operating Agreements
 - A contract among the LLC members
 - Addresses issues such as governance, restrictions on transfers of membership interests, et.
 - LLCs are managed by the Members or by Managers.
 - No statutory requirements for annual meetings

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