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
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.

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.
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

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
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.

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.
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.

Tax Matters

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

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