STARTUP, LEGALLY!
with Wesley Henderson, Esq

The Ultimate Business Entity Guide

DISCLAIMER

This is not legal advice. This is general information to equip you with a resource to make better decisions. Personalized legal advice is always preferable, but I hope this information helps you in your business journey.

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A LEGAL FICTION

Entities can be tricky to wrap your head around. Why? Well, they are essentially made up. Unlike your car, your dog, or your clothes, these "legal fictions" can't be touched. They're conceptual. They exist only because we all agree they exist.

Business entities like corporations, limited liability companies, partnerships, and sole proprietorships may appear confusing at first, especially when you're just starting out in your own business venture. But, bear with me and you might realize they aren't as elusive as you first thought. I've been a business attorney for the better part of a decade and have helped hundreds of businesses get off the ground (and navigate legal obstacles), and I can tell you that you will thank yourself later for taking the time now to learn about business entities and get it right from the start.

To me, the entity conversation is an exciting time because it is often the first real step towards starting a business. A lot of planning and daydreaming precedes it, but most people that spend the time and money to choose an entity are serious about their business and are finally taking the leap! I want to help you make that first step with confidence.

So grab a cup of coffee and take some time to read this guide. I'm going to take the long road and give you some high-level perspective (trust me, it helps connect the dots) before getting into the nitty-gritty of each of the main business entity types. By the end of this guide, you'll have a better understanding of business entity than 99% of people, and you'll be ready to confidently choose the entity that's right for you so you can get started making your business dreams come true.

Let's dive in.

PART 1:
UNDERSTANDING ENTITIES AND WHY THEY EXIST

What do a freelance graphic designer and Walmart have in common? The answer is simple: they both exist because they are based on a business entity that gives them the legal structure to operate their businesses.

That's what's so powerful about business entities. They can accommodate the business needs of a single-person, online-based company that clears $20,000 a year in profit, or a large, multinational corporation like Walmart, which employs over 2 million people and rakes in almost $500 billion per year in gross revenue – and everything in between.

Good business is good for everyone

The purpose of the entity is to encourage you to start and invest in your business without risking everything you own. By having a business entity, you separate yourself from your company in a way that takes much (not all) of the risk off of you personally.

It's win-win. Society benefits as jobs are created, new products and services are available in the marketplace, and the economy grows. You benefit as you get to live your dream of being a business owner.

The consequence of failure

We take this protection for granted now, but let's put it in perspective. For most of human history, business entities did not exist. There was no separation between business owner and business. So if you borrowed money to start a bakery, for example, and it failed, you would personally be responsible for that failure. That meant selling off your house, your land, your chickens, or whatever else you personally owned, to settle debts associated with the business failure. And that's if you were lucky; there was even a time where you could end up in prison or enslaved by your creditor.

In short, the consequences for failure back then were severe. You had to risk a lot – including your very freedom – to start a business. Does this sound like a world where you want to start a business? I don't think so.

The possibility of success

Fast forward to modern times where we can control how much and what we risk when starting a business (if planned correctly). Through a combination of federal tax law and state statutes, everyone in the U.S. has the opportunity to start a business to benefit themselves and others without taking on more risk than one is comfortable with. Yes, you might lose money if your business fails, and you will lose the time you put into it, but nothing more. Building your own business from the ground up gives you the opportunity to create great wealth, be your own boss, build a legacy, and make your mark on the world.

Now it's time to take the first step.

PART 2:
BUSINESS ENTITY AS ONE LINE OF DEFENSE IN RISK MANAGEMENT

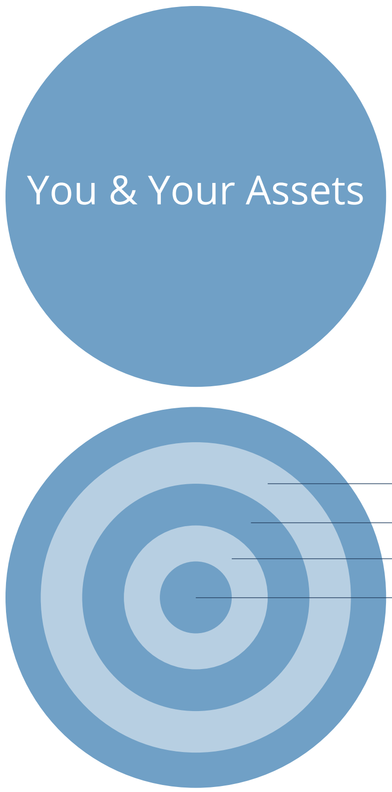
As stated before, business entities reduce risk but they don't eliminate it entirely. They are just one piece (albeit a major piece) of the puzzle when it comes to protecting yourself. Let's look at the others, and how the entity fits in.

Here's what you need to reduce the risk you and your business take on:

- A business entity
- Insurance
- Contracts
- Good conduct

Together, these four things create levels of protection around your business that stop problems from happening in the first place and help you manage them when they do arise. They also help keep you and your personal assets separate from your business. In other words, have these things in place, and if your business tanks, you won't have to sell off your chickens to pay your debts.

Lines of defense



Your first line of defense is **Conduct**. This has to do with how you treat your customers, vendors, and employees. This is not a legal concept, but I can't stress how important it is. How you conduct yourself in business matters because people are more likely to take legal action against those who have behaved rudely, unprofessionally, and unethically. Behave like a professional and treat people with respect, and you'll avoid many problems, I promise.

On par with Conduct is **Contracts**. Contracts matter because they give you legal recourse if something goes wrong, but more importantly, they help avoid problems in the first place by clearly laying out expectations for all parties involved.

The next line of defense is **Insurance**. Business insurance is too wide a subject to go into here, but suffice it to say, you will likely want or need some, depending on what kind of business you're running, whether you have a physical location and many employees or whether you work at home by yourself. I recommend you speak to someone who does business insurance to find out what's necessary versus what's nice to have.

The last and final line of defense is the business **Entity** you've chosen. The rest of this guide will go into how each type of entity offers that protection and how to determine which is the right fit for you.

PART 3:

WHAT TO LOOK FOR IN A BUSINESS ENTITY

Enough intro. Now you understand why business entities exist, why they matter, and how they fit into overall risk management. Now let's get into the meat of the subject.

Considerations when choosing an entity

So far, the only benefit of the business entity we've discussed is liability protection. But that's not the only thing to be aware of when you choose what kind of entity you want your business to be.

In the next section we'll look at the business types themselves but first, it's important to understand how choosing a business entity impacts various aspects of business.

Liability Protection. As we've discussed before, liability protection means that you are not personally responsible for your company's debts or failures. This is the main reason people select a business entity. Note that you do ***not*** get this liability protection automatically just by starting to sell your products or services, even if you've chosen a name, have a logo, printed business cards, built a website, etc. You have to file with the appropriate government agency and follow some other formalities to protect your "corporate veil." (More on that later.)

Who should care about Liability Protection? All business owners would benefit from having liability protection.

Taxes. All income made through a business will be taxed, there's no getting around that. However, how that income is taxed is a different matter. Some income is taxed at the level of the business, while other income "passes through" and is reported on the owner's (or owners') personal tax return. This is the other big consideration when it comes to business entity along with liability protection.

Who should care about Taxes? All business owners need to take this into consideration when selecting and setting up their entity.

Raising Money. Some business entities are better able than others to help you raise capital throughout the life of your business.

Who should care about Raising Money? If you're starting a business that needs a lot of money from outside investors to get off the ground, this will be a very important consideration. If instead you're planning to put your own money in to start and to let the business grow over time, this is not an important factor to consider.

NOTE: If you do expect to raise money from outside investors, you will need to speak with an attorney before you solicit any money. You will need to ensure compliance with securities regulations (a topic far beyond the scope of this material). Who you accept money from has a big impact on the regulations you must comply with, so I recommend immediately scheduling a meeting with a business attorney to assist in this process. P.S. If you are raising capital, you need to budget about $5,000 - $20,000 on legal to make sure it is done correctly.

Paperwork. Amount and type of paperwork required like initial filings, governing documents, minutes, and so on vary by business type. To get the valuable protection of an entity, this paperwork is part of the deal and should not be a significant deterrent. The requirements vary from state to state, and some are more burdensome than others. In most states, you will need to file annual reports and pay fees, typically not more than a couple hundred dollars (except for California at $800 per year, Nevada and Massachusetts at $500 per year, and several other states including Delaware at $300 per year).

Who should care about Paperwork? All business owners should be aware of what their responsibilities are depending on the entity they choose, but this is typically not a make-or-break issue. That is, it's unlikely that you would choose one entity over another because of varying amounts of paperwork.

Making Decisions. Who can make decisions for the company, or who has "management rights," depends greatly on entity type.

Who should care about Making Decision? If you're the sole business owner, this is not a consideration because you know you'll be making all the decisions in your business. If you're going into business with other people, this is a major consideration. By going into business with other people, you can be bound by decisions that your partners make.

A Word on Delaware. I'm always surprised by how many of my clients come into my office wanting a Delaware entity. At the end of the day, incorporating in Delaware if you're not a resident there only makes sense on rare occasions. Delaware has always been at the forefront of business. They even set up specialized business courts to handle nothing but business disputes. The result has been a robust body of law that makes investors and sophisticated entrepreneurs comfortable (i.e., they know what to expect from Delaware). There are many investors that require an entity be a Delaware one so that they know the rules that will apply. So, whenever a business is looking to attract investors, the Delaware conversation is an important one to have. Delaware does have some favorable state tax laws for corporations. I'm not a tax attorney but most CPAs we use do not find it advantageous for smaller businesses.

But in many if not most scenarios, setting up your business in Delaware overcomplicates the process. And makes it more expensive. You will likely have to pay a Delaware attorney to get things set up. You will then also have to file and pay the same fees to get permission for that entity to operate in your state (also known as a Certificate of Authority). Oh, and if there is a lawsuit, you may have to use Delaware courts (and a Delaware attorney) to pursue your action rather than a local attorney, which further drives up the cost to pursue legal action. For the overwhelming majority of my clients, setting up an entity where it's actually doing business makes the most sense. In other words, I always start with using one's home state unless there is a compelling reason otherwise.

Next, let's take a first look at the actual entities themselves.

PART 4:
TYPES OF BUSINESSES

Here's a quick overview of each of the four main business types that are of interest to someone just starting up.

SOLE PROPRIETORSHIP. Restricted to businesses with just one owner. By selling products or services to others, you are a sole proprietor in the eyes of the IRS. No filing, no paperwork, nothing. It happens automatically. A sole proprietorship is technically not a business entity but is a common business type for solo business owners starting out. It's simple but risky because you have no liability protection.

PARTNERSHIP. There are many forms of the partnership, including the limited partnership, but the most common form is the general partnership. This is similar to a sole proprietorship except it's for businesses with more than one owner. Like a sole proprietorship, it's the default business type for those who start selling products or services and haven't actively filed to become another business type, and it offers no liability protection. In fact, it's even riskier because with a general partnership, you're not only liable for yourself, but for all of your partners, too.

CORPORATION. This is the original and most formal entity. It's designed to protect your personal assets and to allow for transferring of ownership through the selling of shares. Mounds of tax provisions and case law have been added to this over the years. This way is usually a bit more expensive than an LLC (and a lot more expensive than a Sole Proprietorship) and much heavier on the paperwork but can provide you a good structure to grow your business. Most commonly used for larger businesses and businesses trying to raise capital.

When speaking of a "corporation," that usually refers to a C-Corp. There's also the S-Corp, which is a little different from a C-Corp. It has restrictions on who can be shareholders but more importantly to our discussion here, it handles taxes differently than a C-Corp does.

LLC. The limited liability company is relatively new in the history of business. It's designed to be a more accessible version of the corporation. That is, it gives you the personal liability protection of a corporation without the clunkiness of a corporation. The LLC is very flexible and can be single-owner or multiple owner and can be taxed in different ways. It's usually less expensive to form and maintain compared to a corporation. In many states, an attorney must sign off on a corporation but not with an LLC, meaning you can DIY. This is where most of my clients and most online businesses belong.

Business entities at a glance

*Entities vary state by state. Although most states are fairly similar, these are general guidelines but you will need to research your particular state.

	Sole Pro prietorship	General Partnership	Limited Partnership	Limited Liability Company	Business Corporation
Defined	Owned by a single person and not incorporated or otherwise formally organized.	An association of two or more co-owners.	Form of partnership in which a least one partner (general partner) is personally liable for all debts and obligations of partnership. This partnership is an entity separate from its partners.	Legal entity separate and distinct from its owner with flexible structure.	A legal entity separate and distinct from its owners structured with shareholders, Board of Directors, and officers.
Liability Limitation	No	No. You are liable for your acts and those of your partners.	General Partner(s): No Limited Partner(s): Yes	Yes	Yes
Taxation	Proprietor pays all taxes at individual level.	No entity level tax; each partners taxed at individual level.	No entity level tax; each partners taxed at individual level.	Default: no entity level tax; each member taxed at individual level; can elect to be taxed at entity level.	Corporation pays tax (unless S-Corporation): shareholders pay taxes on distributions.
Filings	None	None	Certificate of Limited Partnership.	Articles of Organization.	Articles of Incorporation.
Governing Documents	None	Partnership Agreement	Partnership Agreement.	Operating Agreement.	Articles of Incorporation and its bylaws.
Management Rights	Proprietor has sole right to manage business.	Partners have equal rights unless modified by agreement.	General partners manages business; limited partners have limited control.	Member-managed: members have equal rights if member-managed unless modified by agreement; Manager-managed: managers manage business.	Directors and officers manage business.

PART 5:

DECIDE ON THE BEST ENTITY FOR YOU

Now that you know the things you should consider when choosing an entity and what entities are available, you have the information you need to choose the right entity for the business you want to build.

The entity flow chart

Here's a handy dandy flow chart to help you figure what entity is the best fit for you.

Do you want to protect your personal assets?

NO → **Do you have more than 1 owner?**

- **NO** → **SOLE PROPRIETORSHIP** (by default)
  Also consider a single member LLC.
- **YES** → **PARTNERSHIP** (by default)
  Strong consideration for an LLC.

YES → **Are you looking to raise money from new investors or new owners in the next year?**

- **NO** → **LLC**
  Alternative would be a corporation.
- **YES** → **CORPORATION**
  Also consider an LLC if you don't want the formalities and don't need to pitch investors using stock.

Or, what's the downside?

Let's look at this decision a different way in case you're still struggling to decide. Another way to choose your entity is not to consider what you do want, but what you don't want. Here are the common downsides and hassles associated with each business type:

	Downside	Hassle
Sole Proprietorship	Business gets wiped out. You get your pants sued and/or private property taken to pay off debts.	None
General Partnership	Same as sole proprietorship, except this can even happen for debts and suits of your partner(s).	None
LLC	LLC gets wiped out. But you keep your private property.	Filing fees, annual fees (may vary from state to state), LLC formalities such separation of business and personal accounts.
Corporation	Corp. gets wiped out. But you keep your private property.	Filing fees, annual fees (may vary from state to state), formalities such separation of business and personal accounts, board of directors, annual meetings, minutes, and more.

PART 6:
A DEEPER DIVE INTO THE LLC

I'll admit it, I'm biased towards the limited liability company. I think it's the ideal business structure for many people, including freelancers and solo entrepreneurs, online ventures, and other small businesses. It was purposely created by state statute (not by federal tax law) to encourage entrepreneurship, and it definitely does that.

What's to like about LLCs:

To me, the LLC is the safest play for almost any new business owner. Here's why:

Limited liability. It does create a separate entity that protects your personal property when you have a debt or judgment against the LLC. This is hugely important and this is what makes the LLC superior to the sole proprietorship or the general partnership.

Flexible tax options. As an LLC, you can be taxed as a sole proprietor, which means the business income or loss passes through to the owner(s) and goes on their personal tax return(s). Or you can be taxed like an S-Corporation, which can save you money on employment taxes once your business is taking in significant money. I recommend you speak with an accountant early on in the life of your business to understand your options and how they affect what you keep and what you pay. In short, know that being an LLC gives you options that other entities don't.

Fewer formalities. Compared to a corporation, that is. LLCs typically have fewer corporate formality requirements like annual meetings and minutes. This varies by state; research your state to see what LLCs in your state require.

Flexibility of structure and management. You can usually structure your ownership and management however you want. You can keep it simple or you can even set it up with a similar structure as a corporation would have. You can have a member-managed LLC or a manager-managed LLC. I've created LLCs with a Board of Mangers that act like a corporation, where the members act like shareholders would in a corporation where they choose the board of managers. Or, the members can run it. I wouldn't try to get too clever without the assistance of an attorney, but the point is you do have lots of options here with an LLC.

Also, if you decide in the future you want your business to be a corporation, you can convert your LLC to a corporation relatively easily in most states. Going from a corporation to an LLC, on the other hand, is typically more difficult.

Easy to understand. Ownership is easier to understand than with the corporate structure of stocks. LLCs are owned by its members. Members collectively own 100% of the business, whether there's one member or multiple members. And that ownership can be perfectly even or not. For example, Mary, Katherine, and Jill can each own a third of their LLC, or they can make it so Mary owns 25%, Katherine owns 25%, and Jill owns 50%.

You can sell it. It's much easier to sell your business when wrapped up nicely in an LLC rather than just as yourself. You can also transfer and sell your membership interest out of LLCs. While corporations also provide this neatly-wrapped package for sale, selling can be more challenging.

What's concerning about LLCs:

Difficulty raising capital and getting investors. If you're looking for traditional investors, you might be better served in the long run by taking the time and money to comply with all the requirements and formalities of the corporation. Investors are comfortable with it, they understand, and they usually require it.

Expense (in some states). In many states, the cost to register your LLC is somewhere between $100 and $200. However, some states make LLCs too expensive for the casual side business. I'm looking at you, California.

How the LLC compares to the alternatives:

Sole proprietorship or general partnership versus LLC. In my opinion, the LLC is always a better move due to its liability protection. The only reason to choose a sole proprietorship or a general partnership over an LLC is if your industry is very low risk, it's a side venture, and the state you live in makes it prohibitively expensive to form an LLC while you're bootstrapping.

Corporation versus LLC. Again, if you're interested in seed money or expect to get a lot of outside investors, a corporation is probably a better choice. If not, the LLC is simpler to set up and operate in comparison.

The flexibility and aim of the LLC is to make it accessible to many situations. The result is that an overwhelming majority of my clients find themselves in an LLC. For many businesses, it is a comfortable place to start.

PART 7.

A DEEPER DIVE INTO LIABILITY PROTECTION

Back in Part 3 we looked at what to consider when choosing a business. The first item listed was "liability protection." That was no accident – liability protection is the single biggest reason to incorporate in the first place and it's something every entrepreneur should understand.

What is "the corporate veil"?

You've probably heard this term before. The "corporate veil" describes how an entity, like an LLC or corporation, protects your personal assets. When you hear the phrase "piercing the corporate veil," it refers to a plaintiff's lawyer trying to access money outside the business – usually personal assets, or assets of another business you own. Piercing the corporate veil sets aside the personal liability protection of the entity to reach you personally.

In other words, piercing the corporate veil is a bad thing. As a business owner, it's crucial to understand how you can protect yourself from having a plaintiff's lawyer pierce the corporate veil of your business.

The idea here is that the state will provide you with this protection but, in return, you must prove that you are actually a business and are operating the business in good faith to take advantage of these protections. Here's how.

Don’t commingle funds

Commingling funds happens when a business and personal account are not separated but are mixed together.

To prevent this situation, follow proper accounting procedures. ***Never*** use your business bank account for personal reasons. Only business-related income and expenses should be going and in and out of that account. Otherwise, you risk commingling.

Maintain corporate records, status, and formalities

It’s not enough to just file an LLC with the Secretary of State and forget about it. Make sure you stay in good standing. This means paying fees that your state requires and updating them when you change addresses. You should also have formal documents like operating agreements and bylaws. If you are a corporation, you are likely required to hold meetings, keep minutes, and utilize mechanisms like resolutions. If you are an LLC, you likely have fewer record keeping requirements. The lesson here is that you must act like a business on paper.

Don't use your personal signature on documents

You go through all this effort to set up your LLC and maintain proper accounting and business structures, but then you sign documents with just your name. This means you are personally signing. Instead, start signing as a member of your company. It looks like this: "Wesley Henderson, Manager."

Note: There are times where you will be asked to personally guarantees things like a loan or a lease agreement. Only sign personally if you intend to be personally liable and put your personal assets on the line.

It takes effort

You won't gain maximum protection from your business entity just by setting it up in the first place. You need to continually and consistently look and act like a business on paper and in practice.

PART 8:
A TALE OF TWO BUSINESS OWNERS

Until now, everything's been pretty theoretical and intangible, so let me tell you a story to put these concepts into a real life context. Here's the tale of two different clients of mine, both business owners, both involved in lawsuits.

Client #1 gets talked into an elaborate asset protection plan that involves corporations, LLCs, splitting up ownership so that his wife owns certain LLCs, and other effective but high maintenance schemes. This client is not very organized but has a bookkeeper on staff to process income and payroll. Five years into it, Client #1 gets dragged into a nasty lawsuit with his biggest customer. The customer sues him, his wife, the main corporation, and all of the LLCs. Unfortunately for Client #1, he didn't keep records, and at times he didn't keep the different entities separate, so the plaintiff in this case (his customer) had a lot of ammunition to argue that Client #1 didn't follow the necessary rules for asset protection. In other words, it cost Client #1 a ton of money in the end, and he not only had to defend the underlying lawsuit but he also had to defend the very legitimacy of his entity formation.

Meet Client #2. This one also runs a large business but is the sole owner. She gets in an LLC. She maintains pretty good records and always keeps her personal bank account separate from the business. She uses online accounting software with a bookkeeper to keep everything organized. When she gets sued, the suit will likely be against the LLC only and not a lawsuit against her personally, as in the above scenario. No business wants to be involved in litigation, but the comfort here is that the owner's personal bank accounts and personal belongings are not at risk, only the assets of the business itself.

The moral of the story is to understand your business structure and keep it simple enough that you can operate within the rules. While the first client had lots of exciting asset protection strategies, he did not maintain them appropriately and it cost him in the long run. The second client kept it simple, followed the basic rules, and was able to benefit.

PART 9:
WHAT'S NEXT & WHEN TO GET THE PROS INVOLVED

Congratulations, you've now chosen the entity you want your business to be! What comes next?

Set up your business properly

What happens next depends on the entity you've chosen. Don't forget that no matter what kind of business you're running, you'll need to get the necessary business licenses depending on the type of business you run. Call your local government and see what you need.

Sole Proprietorship. You're all set. You have no paperwork to file with the IRS or with the state. I strongly recommend you get insurance if you go this route. This way you have some protection if things go south unexpectedly.

Partnership. Same as with sole proprietorship. Also, it's very important that you and your co-owners understand ownership percentages and agree on basic terms from the outset for your own sake.

LLC. Look up information on how to form an LLC in your state on your state's Secretary of State website; most have all the information you need, including instructions and forms to download and fill out. Setting up an LLC can be done without an attorney, but contact one if you'd like personalized guidance or have additional questions. Be sure you get the necessary documents like an operating agreement and have all owners sign them, too.

Corporation. Find a local attorney that can help you set this up correctly.

Get legal help once you need it

I always recommend utilizing professionals to make sure things are done correctly but I know that's not always in the budget. The purpose of this guide is to give you the information and confidence you need to start your business. However, there are times when you will want to speak with an attorney. Here's what I recommend.

When starting a corporation, as stated above, you must get an attorney.

When you're going into business with other people, you should also consult with an attorney. Your attorney can advise you on the decisions you need to make in terms of ownership and management and can help you make sure your paperwork is rock solid.

If you expect this venture to be your livelihood and provide an income that you depend on (as opposed to a side business), then I would recommend investing in an attorney to get it done correctly. It's worth the money now to hire an attorney to guide you through the entity selection process and help set up the corresponding documents to reflect your personal situation.

Depending on your location, you may be able to get a consultation for as low as $250. If you want the attorney to set up the entity and basic documents for you, you're probably looking at a minimum of $1,000. For my small business clients that are setting up entities with multiple owners and taking some measures to risk management such as contracts and policies, I usually have them budget for around $2,500.

Owning a business is exciting – and stressful.

There are things you can control and things you can't.
For the things you can control, do them right the first time.
It will help you build a solid foundation that can withstand the ups and downs of business and allow you to thrive.

Good luck!

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