

Choosing the Right Entity for Your Business

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La Cocina

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Disclaimer

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Overview

Who We Are

- Start Small Think Big believes that access to high-quality legal, financial management, and marketing services is an essential part of starting or growing a successful small business
- A nonprofit organization that focuses on pairing entrepreneurs positioned to grow their businesses with top pro bono attorneys and financial and marketing experts

Who We Serve

- We work with underserved small business owners.

What We Do

Legal Assistance

- Provide clients access to legal assistance by referring our clients to firms for pro bono counsel
- Volunteer attorneys address various issues including forming an appropriate legal structure for the business, contract review and drafting, and commercial lease review

Financial Assistance

- Provide access to in-house staff as well as pro bono financial advisors through a referral program to assist with small business financial management

Marketing Assistance

- Provide access to pro bono marketing advisors through a referral program and hands-on workshops
- Connect clients to vending opportunities such as tastings, Pop Up shops, street markets/fairs, and business-to-business sales

Eligibility Criteria

1. Business stage

- We serve applicants who are currently selling goods and/or services (defined as having sales over the past 3 months of \$500) OR have a legal need that is keeping them from selling
- Certain businesses up to \$1M in annual business revenue

2. Under-resourced Business Owners

- Generally, Household income must be less than 500% of the Federal Poverty Guidelines. Client's household must have less than \$100,000 in eligible assets,
- Or, certain businesses with less than \$1 million in revenue, where the owners qualify as under resourced as part of traditionally disadvantaged groups (i.e.: woman-owned businesses, entrepreneurs of color, veterans, disability and others).

What are we doing about COVID19?

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Assistance during COVID19

1. Understanding Grants and Loans Available

- Our financial program is running a series of **office hours** to help understand the funding options available. SSTB entrepreneurs can also receive 1-1 assistance **costs of pivoting to a new channel/product, general cash flow planning.**

2. Addressing Legal Concerns

- Our legal program is offering **webinars** to help with risks and mitigation. These include labor and employment, **contract reviewing**, and doing business online; &
- **Direct 1 to 1 assistance for any small business owners with legal or loan/grant assistance questions stemming from the Covid-19 crisis.**

3. Planning for New Marketing and Sales Channels

- **Weekly sessions** on messaging and marketing. Eligible entrepreneurs can receive **assistance 1-1** exploring new sales channels and products, and marketing their existing services.

Next Steps

If you want to become a client, you can follow the below links:

English language Application: <http://bit.ly/SSTbApp>

Spanish Language Application: <https://bit.ly/sstbspanishapp>

If you want to apply to our Rapid Response Program:

<https://bit.ly/sstbcovid19probono> - **English**

<https://covid19.startsmallthinkbig.org/request/esp> - **Spanish**

Free webinars that we are offering: <https://bit.ly/sstbwebinars>



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Today's Focus

1. Business Structures 101
2. Why Form a Limited Liability Entity? Today's Focus
3. Choice of Entity: if you decide to form a limited liability entity, which is right for you?
4. Tax Considerations
5. Q & A

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Part One: Business Structures 101

PREVIEW: Presentation covers six common business structures.

1. Sole Proprietorship
2. General Partnership
3. Limited Liability Company (LLC)
4. S-Corporation
5. C-Corporation
6. Worker Cooperative (Co-op or Coop)

GOAL: Start thinking about the best structure for YOUR business!

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Part One: Business Structures 101

Unincorporated Entities (business and owner are legally indistinguishable):

- Sole Proprietorship
 - Unincorporated business with **one owner**
 - Simplest structure – **no legal distinction** between business and owner
 - **Default structure** (but Business Certificate and Fictitious Business Name filing may be required)
- General Partnership
 - Unincorporated business with two (or more) owners
 - Unless otherwise specified, all profits, liability, and management duties are shared among owners

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Part One: Business Structures 101

Limited Liability Entities (business legally distinct from owner):

- Limited Liability Company (LLC)
 - Governed by California Uniform Limited Liability Company Act
 - Less formal than a corporation
 - Owners of LLC are called “members”
- Corporations
 - Governed by California Corporations Code
 - Owners are called “shareholders” (very big corps sell ownership shares to the public – “go public”)
 - Two Types (Tax Designations)
 - C Corp. (“regular” corporations)
 - S Corp. (“special” status with tax implications)

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Part One: Business Structures 101

Limited Liability Entities (business legally distinct from owner):

- Worker Cooperative (Co-Op or Coop)
 - Governed by California Corporations Code
 - Owners are called “members”
 - With limited exceptions, all owners of a Co-op are employees of the business
 - At least 51% of workers must be worker-owners
 - If outside investors are allowed their voting rights must be strictly limited and minimal.
 - Is a form of corporation.
 - Is the only entity in California legally permitted to use the word “cooperative” or any abbreviation thereof in their company name
 - Can have either a Collective Board or Representative Board

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Part One: Business Structures 101

Other Common Business Structures (not covered here):

- Limited Partnership
- Joint Venture
- Not-for-Profit Organization - 501(c)(3)
- Benefit corporation

Considerations in Selecting a Business Entity

Information contained in this handout should not be construed as legal or tax advice.

	Sole Proprietor <u>or</u> General Partnership	Worker Co-Op	LLC	S Corporation	C Corporation
Protection from personal liability	None (although you can purchase insurance)	Members enjoy limited liability (as long as they maintain corporate formalities)	Members enjoy limited liability (as long as they maintain corporate formalities)	Shareholders enjoy limited liability (as long as they maintain corporate formalities)	Shareholders enjoy limited liability (as long as they maintain corporate formalities)
Legitimacy	Least	More	More	More	More
Formation cost	\$0 if you use your personal name. Additional cost if file FBN statement	\$100 to file. Additional Cost if file FBN statement	\$70 to file. Additional cost if file FBN statement	\$100 to file. Additional cost if file FBN statement	\$100 to file. Additional cost if file FBN statement
Record-keeping complexity	Very simple	More Complex	Simple	Most complex	Most complex
Control over how relationships with co-owners are structured	SP – Most control GP - Depends	Operates under “one worker one vote” principle	Flexible, lots of control (less important when only 1 owner)	Least control (Less important when only 1 owner)	Least control (Less important when only 1 owner)
Tax Treatment	Pass-Through	Double Taxation (On some earnings)	Pass-Through	Pass-Through	Double Taxation
Self-Employment Tax	Must pay SE tax on all profits	Do not have to pay SE tax	Must pay SE tax on all profits	Only pay SE tax on portion that’s “reasonable salary”	Only pay SE tax on portion that’s “reasonable salary”
Ongoing Costs (e.g., cost of tax preparation services, payroll processor, etc.)	Low	Probably More	Probably Less	Probably More	Probably More

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Part One: Business Structures 101

Is your business a....

- Sole proprietorship?
- General partnership?
- LLC?
- Corporation?
- Worker Cooperative?
- Other type of business structure?

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Part Two: Business Risk & Limited Liability

Reasons to Form a Limited Liability Entity

- Protect your personal assets from business liabilities and business creditors.
- Gain credibility in the eyes of third parties, such as:
 - Potential investors;
 - Customers; and
 - Government agencies.

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Credibility/Legitimacy

In addition to protecting you from personal liability, forming a limited liability entity can boost your business via enhanced credibility.

External third parties (landlords, lenders, investors, regulators, customers, and others) may take your business more seriously if you have formed an LLC or Corporation, and might be the only way certain investors will be willing to provide start-up capital both due to credibility and liability protection.

NOTE: LLC's, Worker Cooperatives and Corporation all offer a similar boost to credibility at small scale; at larger scale (bigger corporations poised to go public), investors may favor corporate form.

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Business Creditors & **Personal** Liability

If you, **the sole owner** of your business, have not formed a Corporation or LLC then you are a **Sole Proprietor**, which means:

- You and your business are legally the same.
- You are personally responsible for every penny that your business owes to business creditors and personally liable for liabilities of business

Forming a Limited Liability Entity (Corporation, Cooperative, or LLC) can help to protect your personal savings and assets from business creditors.

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Business Creditors & **Personal** Liability

General Partnerships also carry the risk of personal liability with this added twist: Each partner is personally liable for 100% of the business's debts.

This means that if there aren't enough business assets to pay the partnership's debts, and your partners are broke, creditors can take your personal assets to pay all of the business's debts, not just your pro rata share of the debts.

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Consequences of **Personal** Liability

A creditor that sues you and wins a judgment against you in your personal capacity might be able to:

- garnish some of your wages;
- freeze your bank account; or
- recover their debt by foreclosing on certain personal property.

Having personal accounts in collection and judgments against you in your personal capacity can impact your [personal credit](#).

Limited Liability can protect you from these consequences.

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The Limited Liability Entity: Limiting your Personal Liability

LLCs and Corporations are “Limited Liability Entities” which means, generally:

- The business owner is not personally on the hook for business debts;
- The business owner’s personal assets and personal credit are protected; and
- The LLC or Corporation has a separate legal identity from its owner.

*** In other words, forming an LLC or Corporation is one way to avoid the consequences outlined on the previous three slides.

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Business Liability: Potential Business Creditors

Operating a business can be exciting, rewarding, and profitable, but it is important to understand that you are incurring **obligations** and **potential liabilities** that you would not incur if you were not operating a business, especially when you are:

- hiring employees;
- promising (**contracting**) to provide goods or services;
- buying supplies or services on credit;
- borrowing to fund your business; and/or
- leasing a commercial space.

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Business Liability: Potential Business Creditors

The greater your exposure to potential creditors, the more advisable it is to limit your liability.

Examples of potential business **creditors***:

1. Employees
2. Customers
3. Competitors
4. Landlord
5. Government
6. Suppliers or Service Providers
7. Lenders
8. Third Parties Harmed by the Business

* Creditors are people, businesses, or entities you owe money to, sometimes as a result of legal action.

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Business Liability: Potential Business Creditors

1. EMPLOYEES

You may owe money to employees who have been (or who allege to have been):

- Injured at work
- Owed unpaid wages, unpaid overtime
- Discriminated against based on race, ethnicity, disability, or sexual orientation

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Business Liability: Potential Business Creditors

2. CUSTOMERS

Customers may argue that you did not provide services as promised, causing them further financial harm:

Examples:

- A small business sues a caterer who showed up 4 hours late for an important party.
- A business customer sues a videographer who failed to provide video needed for an important promotional campaign

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Business Liability: Potential Business Creditors

3. COMPETITORS

Examples:

- Barbara Baker alleges that you stole her recipes and sues you for theft and intellectual property violation
- A fellow food truck operator claims you damaged his truck

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Business Liability: Potential Business Creditors

4. LANDLORDS

You may owe your landlord money if your lease is breached in some way

Example

- You sign a 10-year lease, but after year 2 it becomes clear that the location is not profitable and you are not able to pay the rent

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Business Liability: Potential Business Creditors

5. GOVERNMENT

Government agencies (city, state, and federal) impose taxes and fees (and maybe fines and penalties).

Examples:

- The Department of Health fines a business for operating without the proper permits
- Your business fails to collect and remit sales tax on taxable goods

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Business Liability: Potential Business Creditors

6. SUPPLIERS & SERVICE PROVIDERS

You may owe money for any supplies or services you purchased through suppliers or service providers

Example: you purchase goods or services on credit (e.g., buy now, pay in 30 days), but do not have the money to pay when the bill is due

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Business Liability: Potential Business Creditors

7. LENDERS

A lender may be any person or entity that you borrowed money from and must pay back.

Examples

- You receive business loan from bank, and during several slow months, you are unable to make monthly payments
- You receive money from friend, but fail to pay your friend her agreed upon payouts

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Business Liability: Potential Business Creditors

8. THIRD PARTIES INJURED BY YOUR BUSINESS

You may owe money if an accident occurs at your business and harms a third party.

Examples

- A repair person is injured while working on your premises
- Your delivery van runs into a parked car

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Recap: When should I form a limited liability entity?

- Do you plan to operate a business that involves taking on liability or building debt?
- Are you looking for investors?
- Are you hoping to secure major contracts (e.g. with producers, major retailers)?
- Are you ready to start doing business? Are the associated costs (filing fees, publication, other incidental fees) a worthwhile investment for you right now?
- Have you met with a lawyer to discuss choice of entity?
- Have you selected a business name and confirmed that it is available for you to use?
- Have you decided whether you will have co-owners and if so, how you will share ownership and control?
- If your LLC/Corporation is sued, can you afford an attorney?

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Recap: When should I form a limited liability entity? Can you pay the required taxes?

- All Limited Liability Entities (LLC, Corp, Coop) in the State of California are required to pay an annual California Franchise Tax.
- The Franchise Tax minimum is \$800, regardless of how much your business makes it will have to pay at least that minimum amount.
- The First Year Franchise Tax Exemption waives the \$800 minimum for businesses that are taxed as an entity for their first year of existence. Businesses that qualify for the exemption will still have to pay the applicable tax on their net income but that amount may be lower than the \$800 minimum.
- Before deciding to start a limited liability entity consider whether you will be able to pay the minimum franchise tax even if your business will not have significant revenue for a number of years.

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Limited Liability is Limited!

- Invested assets (what you, the business owner, have invested in your business) are vulnerable.
- Third parties may still require you to be personally on the hook. Be aware of personal guarantees, and of signing in your personal name instead of the business name.
- Certain taxes and other obligations will become the personal responsibility of the business owner(s) if the business cannot/does not pay them.

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Limited Liability is Limited!

- Negligence/Misconduct: An individual who is negligent (carelessly causes a reasonably foreseeable injury to a person or damage to property) or who engages in gross negligence or intentional misconduct is personally liable to the aggrieved party.

Takeaways:

- An individual is responsible for his or her own actions.
- If you are unreasonably careless, and someone or something is hurt as a result, and it was reasonably foreseeable that your actions could cause such an injury → that's on you, regardless of whether you were working for your company at the time.

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Limited Liability is Limited!

5. "Piercing the Corporate Veil" / Alter Ego Claims
 - Courts may "pierce the corporate veil" (i.e., take away limited liability and make you personally liable for corporate debts) based on the following, among others:
 - failure to observe corporate formalities (e.g., holding regular meetings, keeping minutes, maintaining separate books and records);
 - insufficient capital;
 - co-mingling of funds or other property;
 - whether the owners abused the privilege of doing business in the corporate form intentionally, to perpetrate a wrong or injustice.

Takeaways: Run your business like a real business! There are consequences in failing to follow corporate formalities or using your business in irresponsible ways!

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Part Three: Choice of Entity

Primary Considerations:

1. Formation Process & Cost
2. Structure & Governance
3. Tax Treatment

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Part Three: Choice of Entity

Step 1: Consult an attorney to help you select the best entity for your business and help guide you through the formation steps.

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Part Three: Choice of Entity

Formation: Sole Proprietorship

1. Obtain an EIN (Employer Identification Number)
 - Not technically required for sole proprietorships with no employees, BUT, most banks will require this in order to open business bank account.
 - File a form SS-4 (Application for Employer Identification Number) with the IRS. Can be completed online within minutes.
 - No cost.
2. File Fictitious Business Name Statement (if applicable), also known as “Doing Business As” Certificate (DBA)
 - Required if you do business under a name that does not include the sole proprietor’s surname or that implies additional owners
 - Must file in the county where your principal place of business is located (or Sacramento County, if you have no place of business in California)
 - Within 30 days of filing, must advertise the name in a newspaper of general circulation
 - Filing fees vary by county.

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Part Three: Choice of Entity

Formation: General Partnership

1. Register the General Partnership – File a Statement of Partnership Authority with the California Secretary of State's office to register at the state level (note: registration is entirely optional).
2. File a Fictitious Business Name Statement – As with a sole proprietorship, partners must file this if they do business under a name that does not include the surnames of the individual partners (in every county where they intend to do business). Filing fees vary by county. Must advertise the name in a newspaper of general circulation.
1. Partnership Agreement – Prepare a Partnership Agreement that outlines specifics so that the partners know their rights and responsibilities (note: not required by law).
1. EIN Application - File a form SS-4 (Application for Employer Identification Number) with the IRS.

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Part Three: Choice of Entity

Formation: Corporation

1. Select Name – may, but need not, include the words “corporation”, “incorporation” or “limited” (or abbreviation thereof)
 - Must not be the same as or deceptively similar to an existing name
 - Check name availability by doing a preliminary search online through the California Secretary of State’s website. If you submitted a completed “Name Availability Inquiry Letter” to the California Secretary of State before June 1, 2020, you will hear back from them on that, but they are no longer offering that service to check name availability.
 - Can reserve a name for 60 days by filing a “Name Reservation Request Form” and paying a \$10 fee
 - Fictitious Business Name Statement required to be filed if the corporation does business under a name other than exact corporation name

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Part Three: Choice of Entity

Formation: Corporation

2. File “Articles of Incorporation” (\$100) with the California Secretary of State
2. Appoint a Registered Agent
2. Create “Bylaws” (note: not required by law, but highly advisable)

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Part Three: Choice of Entity

Formation: Corporation

5. Hold an “organizational meeting”:
 - This is a formality
 - Approve bylaws
 - Issue shares
 - Ownership in corporation is represented by shares
 - Corporations can issue multiple “classes” of shares (except S-Corporations)
 - Certificates should be issued documenting each shareholder’s ownership
 - Keep meeting minutes

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Part Three: Choice of Entity

Formation: Corporation

6. Obtain EIN and open business bank account
7. If forming an S-Corporation, file Form 2553 with the IRS

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Part Three: Choice of Entity

Formation: Cooperative

1. Select Name – may, but need not, include the words “cooperative” (or abbreviation thereof)
 - Must not be the same as or deceptively similar to an existing name
 - Check name availability by doing a preliminary search online through the California Secretary of State’s website. If you submitted a completed “Name Availability Inquiry Letter” to the California Secretary of State before June 1, 2020, you will hear back from them on that, but they are no longer offering that service to check name availability.
 - Can reserve a name for 60 days by filing a “Name Reservation Request Form” and paying a \$10 fee
 - Fictitious Business Name Statement required to be filed if the cooperative does business under a name other than exact cooperative name

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Part Three: Choice of Entity

Formation: Cooperative

2. File “Articles of Incorporation” (\$100) with the California Secretary of State
3. Appoint a Registered Agent
4. Create “Bylaws” (note: not required by law, but highly advisable)

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Part Three: Choice of Entity

Formation: Cooperative

6. Obtain EIN and open business bank account
6. Consult a tax attorney or CPA on issues of cooperative taxation

(note: coop taxation is more complex because coops are taxed pursuant to IRS subchapter T, and of the issue of “patronage dividends”)

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Part Three: Choice of Entity

Formation: Worker Cooperative

Follows the same steps as forming a corporation **PLUS**:

- The Articles of Incorporation must include the following statements:

“This corporation is a cooperative corporation organized under the Cooperative Corporation Law. The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under the law.”

AND

“This corporation is a **worker cooperative** corporation organized under the Cooperative Corporation Law.”

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Part Three: Choice of Entity

Formation: Cooperative

Additional Steps Different From a C or S Corporation

- Develop a membership agreement (disclosure document) and receipt to be given to individuals before they are accepted as members
- Determine whether the cooperative will be organized as a collective cooperative or representative cooperative
- Determine whether the cooperative will be entirely worker-owned or have outside investors (outside investors can own a maximum of 15% of the company)
- These considerations are important because they will affect provisions you want to include in the articles of incorporation and business structure

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Part Three: Choice of Entity

Formation: Limited Liability Company

1. Select Name – must include words “limited liability company” or the abbreviations “L.L.C” or LLC”
 - Must be distinguishable from an existing name
 - Check name availability by mailing a completed “Name Availability Inquiry Letter” to the California Secretary of State. **Effective June 1, 2020**, the Sacramento Office will no longer offer the free Name Inquiry mail service. Applicants may utilize the California Secretary of State Business Search (<https://businesssearch.sos.ca.gov/>) to preliminary search LLC names already of record with the California Secretary of State (“SOS”).
 - Can reserve a name for 60 days by filing a “Name Reservation Request Form” and paying a \$10 fee
 - Fictitious Business Name Statement required to be filed if LLC does business under name other than exact LLC name

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Part Three: Choice of Entity

Formation: Limited Liability Company

2. File "Articles of Organization" (\$70) with the CA SOS
3. Appoint a Registered Agent
4. Adopt an LLC Operating Agreement (note: not required by law, but highly advisable)
 - Not required in CA, but highly recommended if more than one member
 - Describes business operations and member responsibilities
 - Be sure to revise when making changes to operations or ownership; this serves as the "blueprint for your business"
2. Obtain EIN and open business bank account

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Part Three: Choice of Entity

Structure & Governance: Corporations

Key Characteristics of the Corporation:

- Business has a separate legal identity from owner(s)
- Corporation can have one or more owners (“shareholders”)
- Ownership is represented by shares
 - Control over company corresponds with shares owned -- someone who owns 5 shares has more voting power than someone who owns 2 shares, meaning they have more sway over important decisions (unless shares with different voting rights issued)
- All shareholders have limited liability
- Two primary types: “C-Corporation” and “S-Corporation”

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Part Three: Choice of Entity

Structure & Governance: Corporations

Components of Corporation (NOTE: can all be one person)

- Shareholders
 - Owners of the Corporation
 - Ownership percentage referred to as “shares”
- Board of Directors
 - Must have at least one “Director”
 - The Board: controls operations and designates day-to-day management to officers through a clearly articulated chain of command
 - Bound by “Duty of Loyalty”: place business interests above personal interests.
- Officers
 - Responsible for day-to-day management as determined by Board
 - Common Examples: President/CEO, Treasurer/CFO, Secretary
 - Also bound by “Duty of Loyalty”

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Part Three: Choice of Entity

Structure & Governance: Corporations

Ongoing Formalities (Governance Obligations)

- Organizational Meeting (once, at formation)
 - Elect initial Board of Directors
 - Formally issue and record all share purchases
 - Record meeting minutes
- Annual Meetings (every year, minutes always required)
 - Annual meeting of Shareholders
 - Annual meeting of Board of Directors
- Statement of Information (every year)
 - File with CA Secretary of State
- Major Corporate Action
 - Requires votes and meeting minutes

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Part Three: Choice of Entity

Structure & Governance: Cooperatives

Key Characteristics of the Worker Cooperative

- The Cooperative is a separate legal entity from the owners
- The Cooperative can have multiple owners (members)
 - Must have a Minimum of Three Members
- Ownership is represented by membership
 - Voting interests are equal among all members (one member one vote) but proprietary interests may be unequal
- Can have a “collective board” or “representative board”

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Part Three: Choice of Entity

Structure & Governance: Cooperatives

Components of Worker Cooperatives

- Members
 - Worker-owners of the business
 - Bylaws should set out the process for approval of new members
- Board of Directors
 - In a “Collective Board” each member is also a director
 - In a “Representative Board” directors are appointed pursuant to procedures set out in the bylaws
 - Bound by “Duty of Loyalty”: place business interests above personal interests.
- Officers
 - Responsible for day-to-day management as determined by Board
 - Common Examples: President/CEO, Treasurer/CFO, Secretary
 - Also bound by “Duty of Loyalty”

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Part Three: Choice of Entity

Structure & Governance: Cooperatives

Ongoing Formalities (Governance Obligations)

- Organizational Meeting (once, at formation)
 - Elect initial Board of Directors if representative, appoint officers
 - Adopt bylaws
 - Record meeting minutes
- Annual Meetings (every year, minutes always required)
 - Annual meeting of Members
 - Annual meeting of Board of Directors (If representative)
- Statement of Information (within 90 days of filing and every year after)
 - File with CA Secretary of State (Cost \$20)
- Major Corporate Action
 - Requires member votes and meeting minutes

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Part Three: Choice of Entity

Structure & Governance: LLC

Key Characteristics

- Like Corporation, LLC has a separate legal identity from owners
- Can have one or more owners, referred to as “members”
- All members have limited liability
- Flexible management structure
 - You decide what you want it to look like, and then write that structure into the Operating Agreement.
 - The members of an LLC can manage the LLC themselves (“member-managed”) or they can appoint a manager to manage the LLC (“manager-managed”).
- Flexibility in dividing economics and control. Unlike with a corporation, profits/losses can be allocated differently than ownership interests.

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Part Three: Choice of Entity

Structure & Governance: LLC

Multi-Member Operating Agreements

- Contributions and capital accounts. Contributions can take different forms, e.g. cash, promissory note, services rendered
- Allocation of profits, losses, distributions, voting rights. Default rule is that these correspond to % of membership interest, but you can provide for a different allocation.
- How are new members brought in and what happens to the ownership interests of existing members?
- Buyout rights in the event of death or departure of members.
- Establish process for how important decisions will be made.

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Part Three: Choice of Entity

Structure & Governance: LLC

Ongoing Formalities

- Much less complex and cumbersome than Corporation
- Only default requirement: file Statement of Information with CA SOS
- Otherwise, internal processes governed by Operating Agreement
- Formal meetings (to which all members are invited) for important decisions, meeting minutes, and other record keeping always highly advisable.

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Part Four: Taxation

Three Kinds of Taxes

1. Income Tax:

- Tax on business profits (total gross revenue less deductible business expenses).

2. Social Security & Medicare Tax:

- These taxes exist solely to fund the Social Security and Medicare programs.
- Tax on most earnings of pass-through business treated as self employment income.

3. Sales Tax:

- Tax for the sales of certain goods or services. Usually, the seller is allowed to collect the tax from the consumer at the point of purchase.

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Part Four: Taxation

Three Taxing Authorities

1. Federal Government:

- Income Tax (corporate & personal)
- SECA/FICA Tax (i.e., Social Security + Medicare)

2. California State:

- Income Tax (corporate & personal)
- Sales Tax (on certain kinds of goods and services)

Not Covered in this Presentation

3. City of San Francisco (or other local jurisdiction):

- Income and Gross Receipts Tax (corporate & personal)
- Sales Tax (on certain kinds of goods and services)

Not Covered in this Presentation

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Part Four: Taxation

“C” Corporation Taxation

- Treated as a separate entity for tax purposes and files its own return.
- Subject to double taxation: profits are taxed at the corporate level, and again if and when issued as dividends to shareholders.
- Shareholder/employees pay themselves “reasonable compensation” in the form of salary and distribute the corporate profits to themselves as dividends.
- Shareholder/employees pay FICA on their reasonable compensation, but not on their dividend distributions

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Part Four: Taxation

"S" Corporation Taxation

Special tax treatment for eligible corporations:

- S Corporation files its own return
- Permits "pass-through" taxation in that corporate profits pass through to the owners and the corporation does not pay a federal entity-level tax
- Shareholder/employees pay themselves "reasonable compensation" in the form of salary and distribute the corporate profits to themselves as distributions
- Shareholder/employees pay FICA on their reasonable compensation, but not on their distributions
- No special formation requirements: a Corporation can simply file a form with the IRS to make the "S election" to be taxed as a S Corporation at the federal level and state level.
 - Many states follow the federal status and do not require state level election (including California).

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Part Four: Taxation

LLC Taxation

- Single-member LLC is a “disregarded entity” for tax purposes – does not file a separate income tax return or pay any tax at the entity level
- Multi-member LLC is treated as a partnership so pass through taxation applies and the LLC is required to file a separate return
- Unless a different tax election is made, LLCs enjoy “pass-through” taxation at the federal and state level similar to S Corporation election
- Rather, members report their share of profits or losses individually
 - Members pay self-employment tax (SECA) on all business profits
 - NOTE: Members are taxed on the basis of the LLC’s profits in the year earned, even if no distribution is made (but the LLC can be set up so that it must reimburse them the cost of that tax)

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Part Four: Taxation

Cooperative Taxation

Special tax treatment for cooperatives: IRS Subchapter T

- Cooperatives are able to deduct from their gross taxable income the amount they pay in “patronage refunds” or “patronage dividends”

Patronage Refunds/Dividends

- At the end of a fiscal period if the cooperative has surplus funds it may elect to reserve it, reinvest it, or pay it out to members as a patronage refund.
- Money paid to members based on the number of hours worked or their contribution to the coop can be considered patronage refunds *but not in all circumstances*.
- Determining how much a member contributed is a fact-specific inquiry that needs to be discussed with an attorney and/or accountant.
- Wages paid to non-member employees are not patronage dividends

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Insurance: another way to protect your business

- Examples of Types of Insurance You Might Consider:
 - General Liability Insurance
 - Property Liability Insurance
 - Workers' Compensation Insurance (This is required by law for employees!!!)
 - Auto Insurance
 - Business Interruption Insurance
- Business owners must understand their insurance policies—not every claim is covered! Insurance can cover most injury and property damage claims but it will not protect you from claims by business creditors, competitors or government entities, or from employee wage claims.
- Certain types of insurance – general liability and workers' compensation, in particular – are often required under the law...

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Thank you for coming!

Nothing in this presentation should be interpreted as tax advice. Internal Revenue Service regulations provide that, for the purpose of avoiding certain penalties under the Internal Revenue Code, taxpayers may rely only on opinions of counsel that meet specific requirements set forth in the regulations, including a requirement that such opinions contain extensive factual and legal discussion and analysis. Any tax advice that may be contained herein does not constitute an opinion that meets the requirements of the regulations. Any such tax advice therefore cannot be used, and was not intended or written to be used, for the purpose of avoiding any federal tax penalties that the Internal Revenue Service may attempt to impose.

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