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WHY DO I NEED A CORPORATION OR LLC FOR MY BUSINESS?

A Guide to Choosing The Right Business Entity for Your Business

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Why Do I Need a Corporation or LLC?

When starting a business, one of the most important decisions you'll make is how you'll structure your business entity. Remaining a sole proprietorship isn't the best option for most business owners. Instead, many choose either a corporation or LLC. Here's why it's important to make this choice and the differences between a corporation and an LLC.

Why Do I Need a Corporation or LLC?

Every business entity choice has its pros and cons. There's no one-size-fits-all solution if you're going to start and run your own business. While it may be tempting to operate as a sole proprietorship because it's the easiest option, it can also be the costliest one for many reasons.

Here are just a few reasons why you should consider establishing your business as either a corporation or LLC:

1. Limiting Your Personal Liability

If you operate as a sole proprietorship, you will be personally liable for all of the company's debts and liabilities. Without establishing a separate entity, like a corporation or LLC, a court is more likely to group all of your assets and liabilities, whether they are personal or business-related, together.

If your business gets sued, the courts could rule that your personal bank accounts and other assets must be used to pay any judgments. If you have outstanding taxes or other obligations, those entities can pursue you personally instead of just the business entity.

2. Ability to Raise Investment Capital

As a sole proprietor, you have no way to sell ownership of your business to an investor or share ownership with a business partner or executive. In fact, this isn't possible. But other types of business entities make this much easier to accomplish.

3. Ease of Getting a Business Loan or Line of Credit

Sole proprietors will find it challenging to qualify for any type of business financing. In fact, many discover they must rely on friends, family, or personal credit to finance business endeavors. But a formal business entity like a corporation or LLC can establish separate credit and secure financing through various types of lenders.

4. More Business Write-Offs

Business write-offs reduce the amount of your taxable income, which also lowers your overall taxes due. If you do not have a business entity, like a corporation or LLC, you are severely limiting your ability to take business write-offs.

Corporation vs. LLC - What You Need to Know

Most business owners choose to create either a corporation or LLC. Prior to starting your business, you'll want to collect enough information to make an informed decision. Here's what you need to know about both of these entities.

What is a Corporation?

A corporation establishes your business as an independent legal entity. The business is separate from its owner in terms of corporate debt and liability. It also allows the business to pay taxes, enter into legal agreements, and incur debts separate from its owners. If the owner passes away or the business ownership changes, this does not impact the status of the corporation.

What is an LLC?

LLC is short for Limited Liability Company. This is also a legal entity that is a hybrid between a corporation and a sole proprietorship. With an LLC, owners are shielded from personal responsibility for business debts and liabilities. Owners are referred to as "members," and taxes are handled differently than with a corporation.

Corporation vs. LLC - Setting Up a Separate Entity

There are similarities and differences in forming a corporation vs. an LLC. Both require filing certain documentation with the Secretary of State. If you are creating a corporation, you must draft bylaws and *Articles of Incorporation*.

Articles of Incorporation can include certain provisions that change or opt out of specific statutory requirements. If these aren't included, the business would be subject to them. Certain governing provisions must also be included in this document for it to be valid and effective.

If you are forming an LLC, you would need an operating agreement and *Articles of Organization*. This second document is not as detailed as the one required for a corporation because the operating agreement outlines most of the details about how the LLC will be managed and the duties, rights, and liabilities of its managers and members.

Corporation vs. LLC - How Ownership Works

When it comes to owning your business, both corporate shareholders and LLC members have financial rights and management rights. With a Subchapter S corporation (aka “S-Corp”), the small business owner is usually the corporation's sole shareholder.

Management Rights and Compensation

Management rights with corporations and LLCs include the right to inspect records and financials as well as file suit on behalf of the corporation or LLC. Financial rights include the right to share in the profits in various ways.

With a corporation, shareholders own stock and usually receive dividend payments. With an LLC, members can apportion the rights so that some members receive a larger dividend than others. There is no limit to the number of shareholders or members you can have with a corporation or LLC. But shareholders are limited if you elect to be taxed as an S-Corp or an LLC taxed as an S-Corp.

Transferring Interests

If you have a corporation, you can easily transfer shares to someone else unless a legal agreement states otherwise. But it's not as simple to transfer ownership interests for members of an LLC. Sometimes, all of the other members must consent to this transfer for it to take effect.

Corporations are also permitted to issue various classes of stock, which have different voting rights. For example, some classes might receive dividends but have no voting rights at all. LLCs are also permitted to have different classes of members. However, an S-Corp can only have one class of stock.

Corporation vs. LLC - Protection for Owners

One of the primary reasons to form a corporation or LLC for your business is to shield yourself from various business liabilities. As mentioned earlier, corporations and LLCs are considered their own separate legal entities. It's the corporation or LLC owning the business, including all its assets, debts, and liabilities. Liability for shareholders (corporations) or members (LLCs) is limited by their investment.

While it's generally established and respected that shareholders and members have limited liability, there is still a possibility of personal liability in business if a party breaches their agreement or the business is no longer in existence.

A legal concept referred to as "piercing the veil" happens when the court decides to disregard an LLC or corporation's separate existence. When courts do this, they apply a variety of tests, such as looking at whether the business was used to perpetrate fraud.

Corporation vs. LLC - Tax Treatment

If you're starting and running a business, taxes should be a primary concern. Depending on how you structure your business and the elections you make, a corporation may be taxed the same as an LLC or much differently.

Taxes for Corporations

There are two types of tax structures for corporations, depending on your specific entity:

- **C Corporations** — These corporations are usually larger and more complex businesses that are taxed under Subchapter C of the Internal Revenue Code (IRC).
- **S Corporations** — Smaller businesses usually choose the S-Corp option, which is taxed under Subchapter S of the IRC.

When you incorporate, you are automatically classified as a Subchapter C. This type of entity is taxed separately from its owners at the corporate tax rate. If shareholders receive income, they must report that amount on their personal taxes, which can lead to double taxation.

If your business qualifies, you can choose for it to be taxed as an S-Corporation, making it a pass-through entity. In this case, the business's earnings "pass-through" to its owner(s), who pay taxes on them on their personal tax returns.

Taxes for LLCs

For federal tax purposes, an LLC is a pass-through business entity. Similarly to an S-Corp, the business doesn't pay federal income tax. Instead, the net income or loss gets transferred to the owner, who pays any taxes at their personal income tax rate.

But an LLC also has the option to be taxed as a corporation by filing a form with the IRS. This may be beneficial if there are more deductions available as a corporation or if the self-employment tax makes payments higher under the default arrangement.

It is always a good idea to speak with your tax professional before you make any decisions regarding how you structure your business and the elections you make.

Corporation vs. LLC - Management and Compliance Matters

Corporations and LLCs can vary greatly regarding their management and compliance with various regulations.

Management

Corporations and LLCs differ in their management structures, which are governed by a combination of the entity's governing documents and state statutes. The governing documents include the bylaws and *Articles of Incorporation* for a corporation or the operating agreement and *Articles of Organization* for an LLC.

In general, there are more management requirements for corporations than for LLCs. For example, corporations must hold annual shareholder meetings and director meetings for which they are required to provide notice. Also, a director must be a natural person and isn't permitted to vote by proxy.

By law, corporations are managed by a board of directors, who will appoint officers to handle the day-to-day responsibilities of running the business. Shareholders are able to elect directors and vote on major issues like mergers. If you have an S-Corp, things are much more simplified. For example, you probably won't have a board of directors or the board of directors will consist of a few people.

LLCs can have two different management structures. They can be member-managed, meaning all members of the LLC will participate in making decisions about the business. Or they can be manager-managed, meaning members act more like shareholders with limited managed responsibilities.

Compliance

Both corporations and LLCs have certain things they must do to remain in good standing in their states. These include paying franchise taxes, filing an annual report, and appointing and maintaining a registered agent.

The annual report is simple for most companies. It includes the name of the business, the principal business address, the names and addresses of managing officials, and the name and address of the registered agent. The fee, or franchise tax, is simply the state's annual fee for allowing the business to operate within the state.

If a corporation (including an S-Corp) or an LLC fails to file its annual report or pay its franchise tax fee, the company will no longer be in good standing in the state. It will have to pay the fee, with penalties, and file the report to get back on track. After a period of time, however, the business will be considered to be administratively dissolved.

A registered agent must be appointed and continually maintained, whether you choose a corporation or LLC. This is a company or individual designated to receive and forward various office state communications, such as the annual report form or any court documents. Most businesses choose to appoint a professional registered agent, such as a qualified business attorney.

Recordkeeping

Both corporations and LLCs are required to maintain various records, including member and shareholder roles, governing documents, financial records, and tax returns. And shareholders, members, directors, and managers have a legal right to inspect those documents.

Shareholders and members can also ask to inspect other records if they follow statutory guidelines and have a proper purpose. While recordkeeping is a major aspect of running a formal business, you'll want to examine the various requirements for each type of entity before making your choice.

Corporation vs. LLC - Forming Your Business Entity of Choice

There are similarities and differences between forming a corporation vs. an LLC. Both require that you file documentation with the Secretary of State where you plan to base your business. You must also create either corporate bylaws and *Articles of Incorporation* or an LLC operating agreement. These can be complex documents that you want to ensure you get right the first time.

At Garmo & Garmo, LLP, we help California businesses form business entities, such as LLCs, Corporations, and Partnership Agreements. For more information about our Business Entity Formation services, please call us at 619-441-2500 or contact us online to schedule a free initial consultation.