

THE ABC's OF BUSINESS FORMATION

Forming a new business can be overwhelming! Hiring employees, leasing commercial space, marketing . . . in addition to actually selling the product or performing the service that sparked your interest in entrepreneurship - is an amazing process. Your decisions regarding business formation are an important step in this process. What type of entity works best for your business?

Taking a simplistic approach, in essence, there are two key factors to examine. Those factors are:

1. What types of potential liabilities does my business face, and can I purchase adequate insurance coverage to handle these liabilities?
2. What tax savings, if any, would I receive from forming a business entity?

In analyzing these two factors, you need the help of your "Formation Team," consisting of three key professionals: a business attorney, an accountant and a commercial insurance broker. First, your commercial insurance broker will advise you regarding the potential risks faced by your business, and will help you determine the types of coverage available. Your broker will help you answer the question: Is it helpful and/or necessary to form a business entity, such as a corporation or a limited liability company, in order to decrease the risk of personal liability related to my business? Second, your accountant can help you answer the question: Is it financially beneficial for me to form a business entity, such as a corporation or a limited liability company, in order to decrease my tax liability? If so, the follow up questions to ask your accountant are: What type of entity would work the best for my particular situation? How will that entity be taxed? What on-going accounting responsibilities do I need to meet? Third, your business attorney can help you answer the question: How do I form a business entity? Your attorney can explain to you the nature of what you are forming. And, significantly, your attorney can explain to you how to operate and maintain the entity, once formed, in a way that minimizes the chances that your personal assets could be at risk for a business-related liability.

There are four basic types of business entities: sole proprietorships, partnerships, corporations and limited liability companies (also known as LLC's). Other types of business entities that may work for you, which are beyond the scope of this article, include: limited partnerships, professional service corporations and professional limited liability companies.

A sole proprietorship is a common, simple type of business ownership. If you are in business by yourself and obtain your Washington business license, you are a sole proprietorship. A sole proprietorship is an appropriate and proper form of business ownership for many small businesses. For federal income tax purposes, the income from the business flows through to the individual, and is reported on the business owner's Schedule C. A sole proprietorship offers no protection from individual liability, so it essential for sole proprietorships to maintain adequate insurance coverage.

A partnership is similar to a sole proprietorship. If you are in business with at least one other person, and obtain your Washington business license, you have a partnership. The partnership exists regardless of whether the partners have formalized their relationship by executing a partnership agreement. However, a partnership agreement is desirable in order to set forth the rights and obligations of each party, and describe what would happen if a partner dies or wants to sell his or her interest in the business. A partnership, similarly to a sole proprietorship, results in federal income tax liability flowing from the entity to the individual partners. A partnership tax return is required, but each individual partner pays his or her share of the business taxes instead of the business itself paying the tax. Similarly to a sole proprietorship, a partnership offers no protection from individual liability.

A corporation is formed by filing Articles of Incorporation with the Washington Secretary of State's office. One or more individuals can create a corporation. A key initial decision in forming a corporation is whether the corporation should be a C-Corporation or an S-Corporation. A C-Corporation

pays federal taxes both on the corporate level, and on the level of individual shareholders. An S-Corporation pays taxes only on the shareholder level. However, certain qualifications must be met in order to register as an S-Corporation. Unlike a sole proprietorship or a partnership, a corporation which is properly formed and maintained can offer protections against individual liability. In order to form and maintain a corporation, you need to retain both an accountant and an attorney to comply with the complex requirements of taxing entities and the corporate formalities set forth in the Revised Code of Washington.

A limited liability company, or LLC, is formed by filing a Certificate of Formation with the Washington Secretary of State's office. One or more individuals can create an LLC. An LLC may be taxed in different ways. You need to consult with your accountant in order to make an informed decision about how your LLC will be taxed, and file the corresponding documents with the IRS. Similarly to a corporation, a properly formed and maintained LLC can offer protections against individual liability. And, similarly to a corporation, you need to retain both an accountant and an attorney in forming an LLC. An attorney can help you prepare key documents, including the LLC Operating Agreement.

To beat the odds and ensure success for your business, you need to be smart about your strengths and weaknesses. You cannot do it all and be successful! Assemble your "Formation Team" of an accountant, an attorney and a commercial insurance broker; and consult with your team continually in the formation of your business. Work with your team to develop a thriving and profitable new venture!

Stacey L. Romberg, Attorney at Law, is a sole practitioner located in the Greenwood/Phinney neighborhood in Seattle, Washington. Stacey can be reached at 206-784-5305 or info@staceyromberg.com. Please visit Stacey's website at: www.staceyromberg.com.