

Small Business Pro Tip Series: Choose the Right Legal Entity for Your Small Business

October 22, 2020



About Small Business Majority

- **Small business education and advocacy organization** – founded and run by small business owners. Been in business since 2005.
- **National** – 7 offices in Washington, D.C., California, Colorado, Georgia, Illinois, Maryland and Virginia
- **Focus on issues of top importance to small businesses** (<100 employees) and the self-employed, including access to capital, healthcare, retirement, entrepreneurship, taxes and more; work supported by extensive research
- Our online resource hub located at **Venturize.org** brings resources and education to small business owners in key areas of running and growing a small business.

About Small Business Majority: Our Model

RESEARCH

Start with extensive research (polling, economic studies) to gauge small business owner views and speak to their bottom line



EDUCATION

Partner with business groups to hold seminars and roundtables to educate small business owners and get their personal views



ADVOCACY

Enact change by elevating small business views in public policy debates



NETWORK

Use real small business voices with lawmakers and the media
(more than 20,000 earned media hits)





Start Small Think Big: An Introduction

Overview



Heidi Kim, CA Staff Attorney
Start Small Think Big

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?

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 crise.**

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.

Rapid Response Program: FAQs

Who can apply?

Any business owner who has legal or financial questions, including on grants and loan assistance, due to COVID-19 pandemic. This program does not have any other eligibility requirements.

How much does it cost?

This assistance, including legal and financial consultations, is absolutely free

What do I need to show?

Simply, submit an application and someone will be in touch with you soon.

¿I speak Spanish. Will I have a consultation in Spanish?

The form asks you questions related to your language and if you need an interpreter. Generally, we expect that a Spanish speaker has an interpreter (whether it be a family member or friend). At this time, we cannot guarantee that your attorney or financial specialist speaks Spanish, though we will make every attempt to try and support you in accessing this information in the language you prefer.

¿Do you help undocumented business owners?

First, we focus our support on small business owners and in some cases, independent contractors, regardless of status. We cannot help undocumented individuals if they do not own a business. Additionally, we do not ask individuals about their status as there are very few questions that are affected by that. We make every attempt so that a person's legal status is not an impediment to obtaining services, especially if the individuals met all of our criteria to become a client or to access the Rapid Response program.

Overview

- If you want to become a client, you can follow the below links:
 - **English** language Application: <http://bit.ly/SBMSSTBapp>
 - **Spanish** Language Application: <https://bit.ly/sstbspanishapp>
- If you want to apply to our Rapid Response Program:
 - **English** language Application : <https://bit.ly/sstbcovid19probono>
 - **Spanish** Language Application <https://covid19.startsmallthinkbig.org/request/esp>
- Free webinars that we are offering: <https://bit.ly/sstbwebinars>

Disclaimer

The things you read in this presentation and the things we discuss today should not be construed as legal or tax advice and should not substitute for a consultation with an attorney and/or an accountant. You are not permitted to distribute, publicize, or otherwise use this presentation without requesting and obtaining written consent and authorization from Start Small Think Big.

> In this presentation

- Child care and the Economy
- Business Structures 101
- Reasons to Form a Limited Liability Entity
- Choice of Entity: If You Decide to Form a LLC, Which Entity is Right for You?
- Tax Considerations
- How to Join, Q&A



Child Care and the Economy

National lens



- 75% of all children under 6 have all available parents in the labor force
- 63% of caregivers have made career changes based on child care costs
 - Changed jobs for higher pay
 - Asked for more flexibility
 - Switched from full time to part time work

According to [Morning Consult](#), additional caregiving responsibility to employees are challenges top of mind to small business owners

- 74% of small biz executives are concerned about their employees who have children at home
- 23% say family, child care and homeschooling needs is the most significant challenge to having employees working remotely



Child Care and the Economy

Disparities in child care

The issue of child care remains an issue of private responsibility rather than public good, which means employers are more frequently expected to help employees with child care than the government. This creates disparities between those who can afford child care and those who cannot:

- 93% of men with kids under 6 continue to work compared to 64% of women
- Black mothers are disproportionately the “bread winners” of the family, thus child care issues are felt more acutely

Child care “deserts” plagued minority populations even before COVID

- 51% of people in the U.S. are living in a child care desert
- 60% in Hispanic/Latinx and American Indian and Alaska Native communities
- 60% in California



Child care and the Economy During COVID-19

The current recession is called a women's recession as women's unemployment has risen more sharply than men's, particularly for women of color.

- Service industry and child care

Almost half of working parents are now remote.

- 65% have had to change their child care arrangements
- 40% of employers have offered additional child care accommodations
- 40% of employers are concerned that some employees will not fully return
- Cleanliness and sanitation are the most important factors for families when choosing child care right now, followed by group size and cost.



Child Care and the Economy

Cost of Child Care in CA

- California is home to the **3rd most expensive** child care costs in the nation
- \$1,412/month or \$16,945/year
- 17.6% of the child care workforce is living in poverty



2nd
Percentile

15th
Percentile

49th
Percentile

61st
Percentile

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POLL

What type of business do you own or are considering owning?

- ☐ Childcare business
- ☐ Other (if other, feel free to write what type of business in the chat box)
- ☐ I am not a business owner

Business Structures 101

There are six common business structures in CA:

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

GOAL: Think about the best structure for YOUR business!

Unincorporated Entities

- An unincorporated entity is one in which the business and the owner are treated as one and the same by law
- A sole proprietorship and a general partnership are unincorporated entities

Unincorporated Entities

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

Limited Liability Entities

A limited liability entity is one in which the law treats the business as a distinct entity from the owner. Generally limits the personal liability of the owner.

Types:

- Limited Liability Company (LLC)
- Corporations
- Worker Cooperatives

Limited Liability Entities

Limited Liability Company (LLC)

- Governed by the California Uniform Limited Liability Company Act
- Less formal than a corporation (not as many requirements)
- Owners of LLCs are called “members”
- Most common entity for childcare providers

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)

Limited Liability Entities

Potential Advantages to becoming a corporation:

- There may be some tax savings if you operate as an S-corp or C-corp, but only if your profits are high (check with accountant as to what that line is)

Disadvantages of becoming a corporation:

- If you run an in-home childcare, you will lose the ability to deduct your house depreciation if you form a partnership or S or C corporation
- The cost to set up a corporation can be hundreds of dollars and there are annual fees for corporations and LLCs
- Your tax preparer will probably charge you more to do corporate tax returns. Ask your tax preparer to show you exactly how much in taxes, if any, you would save by incorporating.

Limited Liability Entities

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
- Type of a corporation
- The only entity in California legally permitted to use the word “cooperative” or any abbreviation thereof in their company name
- Must have a board of directors

Cooperatives (Co-ops or Coops)

How does the worker coop model translate to a childcare/preschool business?

A parent cooperative preschool is organized by a group of families with similar philosophies who hire a trained teacher to provide their children with a quality preschool experience. The preschool is administered and maintained by the parents. The parents assist the professional teachers in the classroom on a rotating basis and participate in the educational program of all the children. Each family shares in the business operation of the school (usually a nonprofit venture), thus making it truly a cooperative venture. Parents, preschool children and their teachers all go to school together and learn together.

Other Business Structures (not covered here):

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

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POLL

If you run a business, which type of business do you have?

- ☐ Sole proprietorship
- ☐ General Partnership
- ☐ Limited Liability Company (LLC)
- ☐ S-Corporation
- ☐ C-Corporation
- ☐ Worker Cooperative (Co-op)

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.

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.

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.
- 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.

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.

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.

Business Liability: Potential Business Creditors

Creditors are people, businesses, or entities you owe money to, sometimes as a result of legal action. The greater your exposure to potential creditors, the more advisable 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

Business Liability: Potential Business Creditors

1. EMPLOYEES

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

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

Business Liability: Potential Business Creditors

2. CLIENTS OR CUSTOMERS

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

Examples:

- Small business sues caterer who showed up 4 hours late for important party.
- Business customer sues videographer who failed to provide video needed for important promotional campaign

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

Business Liability: Potential Business Creditors

4. LANDLORDS

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

Business Liability: Potential Business Creditors

5. GOVERNMENT

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

Examples:

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

Business Liability: Potential Business Creditors

6. SUPPLIERS & 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

Business Liability: Potential Business Creditors

7. LENDERS

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

Business Liability: Potential Business Creditors

8. THIRD PARTIES INJURED BY YOUR BUSINESS

Examples:

- A repair person is injured while working on your premises
- Your childcare worker runs into another car while running job-related errands

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?

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.
- Certain taxes and other obligations will become the personal responsibility of the business owner(s) if the business cannot/does not pay them.

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.

Limited Liability is Limited!

“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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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.

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 Jose (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

“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

“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).

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)

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...

Concluding Thoughts

- Personal liability, tax considerations, record keeping considerations are the main factors for a business owner deciding whether
 1. To incorporate their business, and
 2. Which form of incorporation to use (LLC, C-corp or S-corp, or co-op)
- In the childcare provider business, LLCs and co-ops are popular forms of entities
- If you would like advice about which entity is right for your business or would like to proceed with forming an entity, please apply at:
 - **English** language Application: <http://bit.ly/SBMSSTBapp>
 - **Spanish** Language Application: <https://bit.ly/sstbspanishapp>

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Join Our Network



Ways to get involved:

- Receive a monthly newsletter
- Share your story for media requests
- Letters to the editor/Op-eds
- State events/Roundtables
- Fly-ins
- Webinars for business organizations

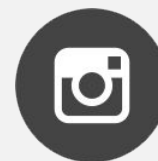
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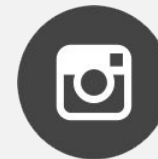
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