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Top 8 Legal and Tax Mistakes Small Businesses and Startups make

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Overview

You've got a business idea... now what?

Presentation Objectives

- a) Understand the need for and basics of legal entity selection
- b) Understand other legal documents needed for formation
- c) Understand the types of filings you need to make with Texas and the U.S. Government
- d) Briefly discuss business tax concepts

1. Not Forming a Legal Entity

- **Personal Liability**
 - Analyze Risk
 - Determine Exposure

- **Business Legitimacy**

- **Growth and Expansion**



1. Not Forming a Legal Entity

■ **Steps for Forming a Business**

- Choose Entity
- File Document with Secretary of State (\$300 Filing Fee for LLCs)
- Obtain EIN from IRS
- Open Bank Account
- Other Corporate Documents (if necessary)
- Proper Recordkeeping
- State and Federal Filing Requirements



2. Choosing the Wrong Entity Type

- **The Problem:**
 - Tax Inefficiencies
 - Management Issues
 - Ineligible Business Partners/Investors



Texas Legal Entity Choices

1. Corporations

- a) For-Profit
- b) Non-Profit
- c) Professional

2. Partnerships

- a) General Partnership (GP)
 - i. LLP Registration (LLP)
- b) Limited Partnership (LP)
 - i. LLP Registration (LLLP)

3. Limited Liability Companies

- a) LLC
- b) PLLC

4. Associations

- a) Cooperative
- b) Professional

Federal Taxation Types (Federal Tax Form)

- Corporation

- C Corporation (1120)
- S Corporation (1120S)

- REIT (1120-REIT)
- Tax Exempt (990)

- Partnership

- General (1065)
- Limited (1065)

- MLP (1065)

- Sole Proprietorship (Schedule C)

Federal Tax Treatment of Domestic Entities

Default Treatment

- a) Corporations and “Associations” = C Corporation
- b) Partnerships = Partnership (*unless partners are disregarded*)
- c) LLCs
 - i. One Member = Disregarded entity (sole proprietorship)
 - ii. Two or More Members = Partnership

Note – Rules for state tax and foreign entities are different

Federal Tax Treatment of Domestic Entities (Continued)

- Check The Box Flexibility (Form 8832):
ONLY Associations, Partnerships, and LLCs
 - a) Can only elect once every 5 years
 - b) Foreign rules are different
 - c) Corporations cannot check the box

- Corporations: S Corporation Elections (Form 2553)

Tax Driver Comparison By Tax Status

Federal Tax Status

<u>Taxation Attribute</u>	C Corp	S Corp	Partnership	Sole Proprietorship	Tax Exempt
Levels of Taxation	Entity AND Owner	Owner; Sometimes Entity	Owner ONLY	Owner ONLY	Sometimes Entity
In-Kind Distributions Taxed	Yes	Yes	No	No	N/A - Distributions prohibited
Eligible for Tax-Free Merger	Yes	Yes	Yes	N/A - Sole proprietor is tax owner of assets	Yes

State Entity

<u>Taxation Attribute</u>	Corporation	LLC	Partnerships	Sole Propr. (No Entity)	Non-Profit Corp.
Subject to Texas Franchise Tax	Yes	Yes	Yes, unless liability is not limited or meets passive entity exception	No	No (if also tax exempt for state tax purposes)

Common Function Driver Comparison By Entity

Table One: Corporate Formalities and Management

<i>Functional/Structural Attribute</i>	<i>State Entity Type</i>				
	Corporation	General Partnership	Limited Partnership	Limited Liability Company	Non Profit Corporation
Formation Document must be Filed with State	Yes	No	Yes	Yes	Yes
Written Organizational Agreement Required	Yes	No	No	No	Yes
Corporate Formalities Required (Issued shares, minutes, resolutions)	Yes	No	No	No (unless required by agreement)	Yes
Governing Persons	Board of Directors; Shareholders; President & Secretary required, other Officers optional.	General Partner; Officers are optional.	General Partner; Officers are optional.	Managers (optional); Members; Officers are optional.	Directors; Members (optional); President & Secretary required, other Officers optional.

Common Function Driver Comparison By Entity

Table Two: Ownership Restrictions and Income Allocation

<u>Functional/Structural Attribute</u>	<u>Federal Tax Status</u>				
	C Corp	S Corp	Partnership	Sole Proprietorship	Tax Exempt
Number of Owners Allocated	Unlimited	100 or Less	Unlimited ¹	1	N/A (in Texas may have "Members")
Foreign Owner Allowed	Yes	No	Yes	Yes	Yes
Different Classes of Stock Allowed	Yes	No	N/A	N/A	N/A
Disproportionate Distribution of Cash Allowed	Yes (Through preferred stock)	No	Yes	N/A	N/A - Distributions prohibited

¹Note, however, that an established market for the purchase and sale of partnership interests may create a publicly traded partnership, which is subject to numerous special tax rules (like REITs).

3. Operating without an Agreement

- **Issues:**
 - Ownership Amount
 - Salary/Guaranteed Payments
 - Management
 - Non-Compete
 - Non-Solicit
 - Property Disposition Upon Dissolution

- **Put it all in Writing!**



4. Telling your Secrets without an NDA

- Non Disclosure Agreements
- Confidentiality in Employment Agreements
- Confidentiality in Operating Agreements



5. Messing with Texas: Texas Taxes

- **Texas Franchise Tax: May 15**

- Can file online – Keep your webfile number!
- No Tax Due if Revenues Under \$1,000,000, inflation adjusted
- **MUST STILL FILE RETURN IF NO TAX DUE**

- **Texas Sales Tax: Monthly, Quarterly, or Annual Returns**

- Need to obtain Permit
- Sale for Resale Exemption
- Manufacturing Exemption



5. Messing with Texas: Texas Taxes

- **Texas Worker Unemployment Insurance Returns:** Quarterly
- **Texas Property Tax:** Business Personal Property Rendition Due April 15
- **Business in other states** – you may need to register and pay taxes in the other state too!



6. Forgetting the Feds

- **Annual Income Tax Return**

- Disregarded Entity (Single Memb. LLC): Schedule C
- Partnership: Form 1065
- C Corporation: Form 1120 (S Corporation: 1120S)

- **Employment Tax Returns**

- Forms 940, 941, 945

- **Payment Information Returns**

- Forms 1099
- Forms W-2

7. Mixing Personal and Business

- Contemporaneous Documentation
- Credit Card Statements DON'T COUNT
- Separate Bank Accounts
- Recordkeeping Requirements



8. Not Capturing Deductions

- Personal Use Property Converted to Business
- Travel, Meals and Entertainment -- Still Deductible Even if Personal Aspect Exists

Covered in Detail at the NEXT Workshop!

February 17th
6-8pm
Leonel Castillo Center