

# 3-Minute Audit to Answer the Question "Do I Need an LLC Now?"



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# 3-Minute Audit to Answer the Question "Do I Need an LLC Now?"

Your CPA says "No".

Your Attorney says "Maybe."

Your business coach says "Yes".

Who's right?

Do you need to set up a Limited Liability Company for your business right now? Can it wait? Or did it need to be done yesterday?



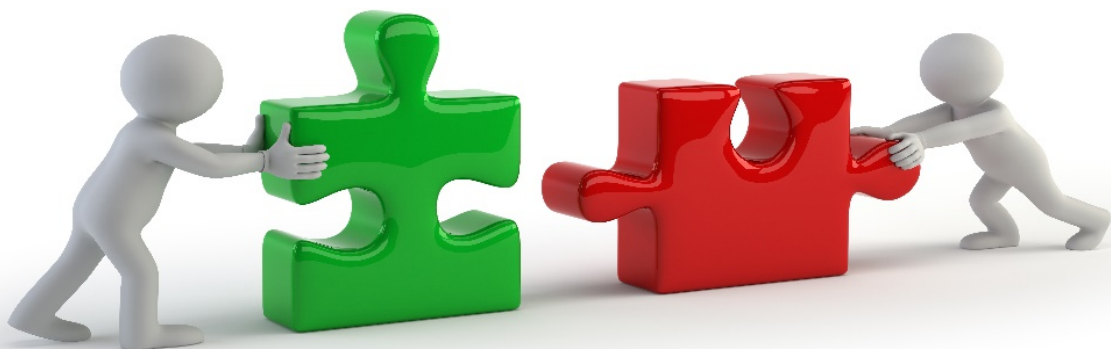
## Why Can't I Get a Straight Answer?

Several years ago, I took a trip to Egypt and visited the famed pyramids of Giza.

Looking at the pyramids from one vantage point, I could snap photos of windswept desert, palm trees, and a gentleman riding a donkey along the horizon.

From a different vantage point, I could take pictures of the television antennas and washing lines of Heliopolis, a crowded suburb of Cairo.

Which view was more accurate?



Well, neither. To get a complete picture both views were needed.

Like my pictures from the pyramids, each of the individuals you're speaking with is looking at the question from a different point of view.

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Your CPA is looking at the amount of money you will earn this year and is giving you an opinion from a tax perspective.

Your attorney is looking at the risk you're taking as a sole proprietor or general partner, and giving you an opinion from a legal perspective.

Your coach is looking at your marketing and the psychological aspects of being an entrepreneur, and is giving you an opinion from a business perspective.

With several hundred dollars on the line, however, you need to know if this is money you have to spend today or can it wait.

Let's look at the factors involved, so you can take the audit at the end of this discussion and determine exactly where you stand.

## My CPA Says "No".

Many CPAs and accountants look at the question of whether or not to incorporate solely from the vantage point of how much taxable income you'll have at the end of the year.

For them, if there is no tax advantage to forming an LLC or corporation, why would you do it?

It's a needless expense, best put off until there is a tax advantage.

There was a time when you could take more deductions if your business was in a corporation or an LLC taxed as a corporation, lowering your taxable income considerably.

So, business coaches and CPAs would push you to form your LLC or corporation much sooner.

But changes to the tax laws over the past several years have resulted in the entrepreneur's ability, as a sole proprietor, to take most deductions - albeit, in a different fashion than you would in a corporation.

As a consequence, many tax professionals have adopted an attitude of delaying entity formation until the entrepreneur is earning at least \$100,000.

Why is \$100,000 a magic number?



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This is generally the point at which you, the entrepreneur, has enough taxable income at the end of the year to make taking a sub-chapter S tax election worthwhile.

A sub-chapter S tax election for a corporation (S-corp.) or LLC (LLC-S) allows you to take money out of the company, split between a W-2 paycheck and a distribution of profit<sup>[1]</sup>.

Since there is no self-employment tax or payroll tax on the distribution, the entrepreneur can lower his or her taxes considerably.

However, since an entity taxed under sub-chapter S must file an 1120S tax return – which is more expensive to prepare - and since you'll need to pay a payroll company or bookkeeper to prepare your paychecks, submit your withholding, and track your distributions, you want to ensure that the amount you'll save on taxes exceeds your additional costs.

Hence, the \$100,000.

So, it's not surprising that most tax professionals will say you don't need an entity in your first year unless you have a sure-fire way of earning \$100,000 or more.

## My Attorney Says "Maybe".

Your attorney, on the other hand, is generally not concerned with your taxable income.

He or she is much more concerned about protection.

Liability protection and asset protection to be exact.

And, depending on your situation, he or she may be concerned about privacy as well.

## Liability Protection

A liability is responsibility or accountability for a financial or other obligation.

You probably have liability already for credit card balances, a mortgage perhaps, or car payments.

But what about a business? What kind of liability does it have, other than a responsibility to pay its bills?



1. A sub-chapter S tax election can be taken by a corporation or LLC. It cannot be taken by an individual sole proprietor or general partner.

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Let's say, for example, that you have a rental property.

Your tenant has a serious accident on the property and sues the property owner.

You lose the lawsuit and the judgment exceeds what your insurance will pay.

Who pays the rest?

Well, if you own the property in your own name, then you personally are responsible – liable - to pay the rest of the judgment.

That may mean you have to sell your home, your car and your investments, and empty your bank account, to pay the bill.

If your property is owned by your LLC, and you have been running the LLC like a professional business separate and distinct from you, the owner, then the LLC is responsible.

But what happens if there aren't enough assets in the LLC to cover the rest of the judgment?

After everything in the LLC has been sold and the money paid to the judgment creditor (the person who won the case), then the LLC declares bankruptcy and that's it. There are no assets left in the LLC to generate income or to sell.

And as long as you have been running the LLC professionally, as outlined above, your assets as the owner of the LLC are safe.

Now, there may be issues if you have been managing the property and doing repairs yourself.

However, if you have employed a property management company and have agreed to reasonable repairs and required upgrades, what is outlined above should stand<sup>[2]</sup>.

Note: If you are in a business where you are offering personal services, such as coaching and consulting, or you're offering professional services, such as accounting, legal or medical services, an LLC will not protect you for actions you have performed. For that you will need Errors and Omissions or Malpractice insurance.

However, the LLC should protect you for actions performed by partners, employees or independent contractors.



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## Asset Protection

What about asset protection?

No one wants to think that they may one day be the victim of a lawsuit against them personally, but things happen.

You may be sued as the driver of a car involved in a tragic accident.

You may be sued as the parent of a teenager who holds a party at your home when you are away and allows his friends to drive home drunk.

The last thing you would want in these situations is to lose everything you have spent a lifetime building, including your business.

This is particularly true if you are building a brand, have a client base or following, have intellectual property, or have any kind of business asset that has value outside of you, the owner, and can be sold for a profit<sup>[3]</sup>.

But this is what could happen if you lose the lawsuit and the judgment exceeds what your insurance will pay.

You could be ordered to sell your personal assets to pay the judgment.

Assets held in different types of entities are owned by the entities, however, not by you. So, the court may not be able to order you to sell these assets.

A good Estate Planning attorney can help you with a structure that is very difficult to break. Just bear in mind that structures like this are expensive to set up and maintain, so you'll want to ensure your net worth warrants the time and money.

## Privacy

Another requirement your attorney will want to look at is the need for privacy.



3. Asset protection falls under Estate Planning. If you are sued, you want the judge to look at your entity structure and see that it makes sense from an estate planning perspective. He or she should not conclude that you created it in advance to protect you against creditors, including judgment creditors.

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Some people are natural targets for frivolous lawsuits because the person targeting them believes these people have money and will be willing to just pay them to go away or, worse, lose a lawsuit to them.

Your attorney will look at what business you are starting, what the risk may be, what you stand to lose if you are sued, and what the need for privacy is.

After looking at all the factors, he or she can give you his or her opinion on whether or not you should incorporate or form an LLC for protection, privacy or both.

Hence the "maybe" when you initially ask the question. He or she won't know until you've discussed your situation.

However, bear in mind that attorneys are focused on the law, not taxes. So, the answer from your attorney and the answer from your CPA may conflict.

This could be true if you are a consultant and ramping quickly.



## My Coach Says "Yes".

To make matters more confusing, your business coach is looking at factors different from both your CPA and your attorney.

Chances are good that what is on his mind are things like building your brand, credibility, and separation of your business and personal life.

## Building a Brand

One of the first things most new entrepreneurs strive to build is a brand – something that is recognizable to the people they are trying to attract.

If you are a solopreneur, working as a coach or consultant, you may start to build a brand in your own name.

However, if you are part of a partnership or you are targeting larger clients or you are starting a business not centered on yourself, you may want to adopt a different name.





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The issue with starting a business under a dba (fictitious business name) instead of an LLC is that the name may not be available when you are ready to set up your LLC.

In many states dbas are filed at the county level, and the filing does not lock in the name at the state level where LLCs are filed.

That means you will be obliged to select a different name under which to do business, at least in that state, when you want to setup your entity.

And if the person who took the name has filed a trademark for it, you will not be allowed to expand your business under that name.

Now, filing an LLC in your state does not establish a trademark, so someone else can certainly use the name in a different state or country.

You should check registered trademarks before you settle on the name you want.

And if you plan on building a nationwide brand, you may want to consider establishing a trademark before you invest a lot in marketing materials.

If you aren't sure the name you have chosen is the one you want to brand, and your research shows the name is free of trademarks and service marks, forming an LLC will establish that name in your state so you can try the name out in your business and see how it plays out.

If the name works, you can establish a trademark.

If the name does not work, you can rename the LLC to something else down the road.



## Credibility

Running your business from inside an entity often gives you more credibility inside the business community.

Taking the time and expense to set up an LLC shows that you are serious about what you are doing.

When colleagues refer clients to other people, their reputation is on the line. They want to ensure that you are competent in your field, and you will treat their clients with the same care and professionalism as they would.

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That means they want to ensure that not only will you be there to provide the quality of service promised: you will also be around to provide on-going support.

Merchant service providers are also more comfortable with businesses that are in entities with their own EINs (federal tax ids).

And some retailers with wholesale programs will not sell to individuals at wholesale prices – only businesses in entities.



## Separation of Business and Personal Life

Business coaches understand that, when establishing a new business, the biggest game is played inside your head.

You need to acquire the mindset of a successful business owner.

These coaches have also learned that setting up an LLC from the beginning makes the business more real for most new entrepreneurs.

Placing a business inside an LLC, with its own name, branding, business bank account, business credit cards, and accounting books helps to reinforce the separation of business and personal life.

It helps the entrepreneur to think about the business as something different and distinct from him or her, and what is good for him or her is not necessarily what is best for the business.

Given the role that LLCs play in establishing a brand, supporting credibility and emphasizing the separation of business and personal life, most business coaches are in favor of setting up an LLC from the beginning.

To see where you stand, take the audit below.



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## 3-Minute Audit

Answer these questions to discover if you need an LLC now or you can wait.

### What liability risks do you have?

**Business:**

<input type="checkbox"/>	Rental properties with tenants
<input type="checkbox"/>	General Partner(s)
<input type="checkbox"/>	Client- or public-facing employees
<input type="checkbox"/>	Profession with inherent risk, such as construction or property management
<input type="checkbox"/>	Product with inherent risk, such as IT equipment or firearms
<input type="checkbox"/>	Business with heavy driving demands
<input type="checkbox"/>	Unsophisticated clients
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____

Give yourself 1 point for each check mark.

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## Personal:

<input type="checkbox"/>	Children, especially teenagers
<input type="checkbox"/>	Potentially dangerous assets, such as an airplane or speedboat
<input type="checkbox"/>	Potentially dangerous hobbies, such as hunting
<input type="checkbox"/>	Frequent entertaining with alcohol
<input type="checkbox"/>	High-stress driving conditions
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____

Give yourself 1 point for each check mark.

What liability risks do you have that would not be covered by an LLC?

<input type="checkbox"/>	Profession where you do the work personally; e.g. coach, consultant, blogger, legal, accounting or medical professional, handyman
<input type="checkbox"/>	_____
<input type="checkbox"/>	_____

Subtract 1 point for each check mark.

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What tax benefits do you need?

<input type="checkbox"/>	Lower taxable income
<input type="checkbox"/>	Lower self-employment or payroll taxes
<input type="checkbox"/>	Using passive income to offset passive losses
<input type="checkbox"/>	Managing taxes as income rises

Give yourself 1 point for each check mark.

What Tax benefits would not be helped by an LLC

<input type="checkbox"/>	High W-2 income from corporate job, starting small side hustle not intended to replace corporate income.
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Subtract 1 point for each check mark.

What personal benefits do you need?

<input type="checkbox"/>	Medical reimbursement plan
<input type="checkbox"/>	Retirement plan
<input type="checkbox"/>	Day-care program
<input type="checkbox"/>	Scholarship program
<input type="checkbox"/>	Company car(s)
<input type="checkbox"/>	Tax-free giving
<input type="checkbox"/>	Hiring your children

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<input type="checkbox"/>	Business education
<input type="checkbox"/>	Assisting elderly parents
<input type="checkbox"/>	Turning pleasure into business
<input type="checkbox"/>	_____

Give yourself 1 point for each check mark.

What assets do you need to protect?

Business:

_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

Personal:

_____	_____
_____	_____
_____	_____
_____	_____
_____	_____

Give yourself 1 point for each asset.

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## What organizational benefits do you need?

	Are you a public figure?
	Are you in a profession or business where you are perceived to be wealthy?
	Are you planning to grow your business through affiliations?
	Are you planning to grow through referrals?
	Are you planning to take on a partner?
	Are you in a profession that expects its professionals to be incorporated?
	Are you planning to apply for a merchant services account?
	Are you currently using a business name that ends in LLC, Inc., Corp., or LP without an entity?
	Are you required to be incorporated for licensing reasons?
	Are you required to be incorporated to access wholesale pricing?
	Do you need business credit?
	Are you in business and frequently use personal funds for expenses that are legitimate write-offs?
	Do you have a difficult time keeping your personal and business expenses separate?
	Do you have a business checking account?
	Do you know the profitability and net worth of your business?

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<input type="checkbox"/>	Is it obvious that you are the business?
<input type="checkbox"/>	Are you marketing your service?
<input type="checkbox"/>	Are you branding your service?
<input type="checkbox"/>	Are you planning to give employees profit-sharing benefits or company ownership benefits?

Give yourself 1 point for each check mark.

## Time to Add Up Your Score

If you scored 5 points or higher in the audit above, you may want to seriously consider setting up an LLC now.

If you scored fewer than 5 points, an LLC may not provide the benefits you need right now, and insurance may be a better option.

As always, speak with your professional team before making your final decision. You will need to speak with both your CPA and your attorney.

Your CPA will advise you on which tax elections you will need in order to take all the deductions you may want.

While LLCs taxed as sole proprietorships and general partnerships will allow you to take most business deductions, there are still some that require your LLC to be taxed as a corporation, and some that will need a custodian as well.

If you do not have a good business attorney or CPA, you will find the professionals we recommend in the Specialists section at [www.bizEngaged.com](http://www.bizEngaged.com).



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It can be frustrating to find the answers you're looking for when there are so many new things you need to learn - and so little time to do it in.

BizEngaged was established to bring together the information you need to get your business off to a great start.

And our quarterly live Q&A calls give you an opportunity to ask your own questions as well.

Stay tuned. We're adding new material every month and we welcome suggestions.

See you there.

To Your Success,

Wendy