DO I REALLY NEED TO FORM A LEGAL ENTITY?

By Michelle Bufano, Founder and CEO, Michelle Bufano Business Consulting LLC

"Do I really need to form a legal entity if it's just me?"

It is a reasonable question. When you are starting a business, you are already spending money before you know how much you will make. You are finding clients, setting prices, building a website, and trying to figure out which expenses can wait.

Forming a company can feel like something you will get to once the business is bigger. But deciding how to structure your business deserves attention early. The question is not simply whether you are big enough. It is what you are doing, what obligations you are taking on, and what you could personally stand to lose.

This month's Tuesday Tips focus on things entrepreneurs wish they had understood sooner. Let's start with the foundation: your business structure.

1. **You Can Be in Business Without Having Formed a Separate Entity**
If you operate a business by yourself without forming a separate entity, you generally operate as a sole proprietor. That can be a straightforward way to begin, particularly while testing a low-risk idea.
The tradeoff is significant: there is no legal separation between you and the business. You can be personally responsible for its debts and obligations. A business name does not change that. [1]

Think about what your business actually does. Are you making commitments to clients? Handling valuable information? Selling products? Signing a lease?

"I'm only one person" does not answer those questions.

My suggestion is to assess the risk before deciding that forming an entity can wait. The cost of getting started matters, but so does the exposure you accept along the way.

2. An LLC Offers Separation and Flexibility
A limited liability company, or LLC, is a business structure created under state law. It can have one owner or multiple owners, called members. You do not need a business partner to form one. State requirements and restrictions vary. [2]

An LLC generally protects members from personal liability for the company's obligations simply because they own it. It can appeal to entrepreneurs seeking that protection with more flexibility and fewer corporate formalities. [1]
But choosing an LLC raises business questions beyond filing paperwork.

If you have a co-owner, consider:

- Who can make decisions or commit the business to an expense?
- What happens if one person contributes more time or money?
- How will profits be distributed?
- What happens if someone wants to leave?

These are issues to address in an operating agreement with appropriate guidance. Working through them while everyone is enthusiastic is often easier than doing so after a disagreement.

There is also a tax distinction worth understanding. An LLC does not have one automatic tax treatment for every situation. For federal income tax purposes, a single-member LLC is generally treated as part of its owner's return, while an LLC with multiple members is generally treated as a partnership, unless an election changes that classification. Eligible LLCs can elect corporate tax treatment. [2]

Forming an LLC and deciding how it will be taxed are related decisions, but they are different decisions.

3. A Corporation May Fit a Different Growth Plan

A corporation is a separate legal entity owned by shareholders. It generally offers limited liability and a structure for issuing stock, but comes with more formal governance and recordkeeping. [1]

For a founder considering outside investment, employee equity, or a more complex ownership arrangement, it deserves a closer look. Ask what your anticipated investors and growth plans will require before choosing.

The tax treatment also matters. A corporation taxed as a C corporation generally pays income tax on its profits. If it distributes those profits as dividends, shareholders may also owe tax on the dividends. This is what people mean by "double taxation." [3]

That does not make a corporation the wrong choice. It means you should understand how the structure will work for your particular business.

A consultant building a solo practice and a founder planning to raise investment for a technology company should not assume they need the same setup.

4. "Should I Be an LLC or an S Corp?" Needs a Little Unpacking

You may have heard another business owner say, "You should become an S corp. You'll save on taxes."

That skips several steps.

S corporation status is a federal tax election. An eligible corporation—or an eligible LLC—can elect that treatment. An LLC making the election remains an LLC under state law. [1, 2]

S corporations generally pass income and losses through to shareholders for federal income tax purposes. Eligibility restrictions

include limits on the number and types of shareholders and a requirement for only one class of stock. [4]

There are also compensation requirements. An owner who works in the business cannot simply label all payments as distributions to avoid employment taxes; reasonable compensation rules apply. [5]

Before making an election, ask your accountant to walk you through the expected benefit, payroll obligations, administrative costs, and state tax consequences. Someone else's tax savings are not a substitute for understanding your own numbers.

5. Choose for the Business You Are Actually Building

Before you file anything, work through these questions:

- What could go wrong? Identify the commitments, services, products, and relationships that create exposure.
- Who will own the business? Consider both today's owners and anyone you expect to bring in.
- How will you fund growth? Your own revenue, borrowing, and outside investment raise different questions.
- What will it cost to maintain? Look beyond the initial filing fee to ongoing administration and professional support.
- What do you want this business to become? A solo practice, a family business, and a company built for investment may have different priorities.

If you are starting with another person, include partnership options in the conversation. If you work in a licensed profession, ask about profession-specific entity requirements. Your state and industry can affect the available choices. [1, 2]

Bring your legal and tax advisers into the same discussion. Ask them to explain both why they recommend a structure and what responsibilities come with it.

You do not need to become an expert in business formation. You do need to understand the decision well enough to make it intentionally.

You have put time, money, and courage into building your business. Choosing its structure deserves that same care—before a problem makes the decision urgent.



Sources

[1] U.S. Small Business Administration — Choose a business structure

[2] IRS — Limited liability company (LLC)

[3] **IRS — Forming a corporation**

[4] IRS — S corporations

[5] **IRS — S corporation employees, shareholders and corporate officers**

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