THEME: BUSINESS ORGANIZATIONS

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ACCOUNTING TERM: Entity

In business, an **entity** is referred to as a separate organization unto itself. In accounting, it is an organization for which a set of accounts is kept. Therefore, each entity has financial statements that reflect the financial activity that goes on within it. The entity itself does not *use* the financial statements because only people can do that. There are several reasons why it is important to understand the distinction between a business entity and the people who run the business.

- To avoid confusion by keeping the business activities separate from personal activities.
- To recognize legal liabilities of the business entity as opposed to those of the individual.
- To recognize the tax obligations of the entity as opposed to the individual.

FEATURE ARTICLE: Choosing the Right Business Entity

When starting a new business, one of your first decisions will be to determine what type of business entity will work best for you. Essentially, there are six types of business entities from which to choose:

- **Sole Proprietor**
- **Partnership**
- **C Corporation**
- **S Corporation**
- **Limited Liability Company (LLC)**
- **Non-Profit Organization**

Each entity has its particular advantages and disadvantages that you should weigh before choosing. There are too many to cover in this article, but you may find it useful to know a few general characteristics of each one. Keep in mind that these entities and their legal and tax characteristics are U.S. based. For instance:

- Is it a “pass-through” entity?
- What federal tax form does it use?
- What is the liability factor?
- Is it administratively easy or expensive to set up and operate?

Before starting, let’s make sure you know what a “pass-through” entity is. Pass-through means that the entity itself does not pay taxes. It means that the profit or losses of the

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business are “passed-through” to the owner/s and reported on their personal tax returns.

Sole Proprietorship

For most small businesses, a sole proprietorship is by far the easiest and least expensive to set up and operate. It is a pass-through entity in that the profit or losses from the business are reported on the individual’s personal Form 1040 tax return. Only the income and expenses are reported on Schedule C. No Balance Sheet is required on the tax return. From a legal standpoint, no differentiation is made between the business entity and the individual. This means that if you get sued over a business transaction, your personal assets are at risk.

Partnership

By definition, there must be at least two individuals or entities that own the business. A partnership is a pass-through entity, however, it is required to file its own Form 1065 tax return. The pass-through information (profit or loss) is reported on a K-1 form that is given to the partners to report on their respective tax returns. For partners who are individuals, the K-1 information is reported on Schedule E of their Form 1040 tax return. If the partner is a General Partner then that partner is personally liable up to the amount his percent of ownership represents. A partner can be a “limited” partner who has no say in management decisions. A limited partner is liable only to the amount invested in the company. A Balance Sheet and Income Statement is usually required. A partnership is fairly simple to set up, but a comprehensive partnership agreement should be worked out beforehand.

C Corporation

A C Corporation is more difficult and expensive to set up because of state registration requirements. Most people hire an attorney to initiate the process of obtaining the Articles of Incorporation, establishing the by-laws, issuing stock certificates, writing a stockholder’s agreement, and chairing the first stockholder’s meeting where the new officers are voted in, etc. Annual stockholders’ meetings are required. A Balance Sheet and Income Statement is also required. A C Corporation is not a pass-through entity. It pays its own taxes based on taxable income. C Corporations file a Form 1120 to report taxable information. Stockholders who work in the company are considered employees and must be included in a formal payroll withholding process. Stockholders are not personally at risk, as the corporate entity assumes that responsibility.

S Corporation

An S Corporation has features found in both a C Corporation and a Partnership. It is a pass-through entity like a partnership in that the stockholders receive a K-1 form. The limited liability protection remains the same as the C Corporation. The set up is similarly difficult and expensive, as in the C Corporation, and there are the same

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requirements of structure and accounting, as in a C Corporation. The S Corporation files a Form 1120-S to report tax information. S Corporations have special rules that one should be aware of before choosing this organizational form.

Limited Liability Company (LLC)

This form of business organization is relatively new and becoming quite popular. It is easy to set up, like a partnership. However, rules may vary from state to state. Some states require at least two members (rather than stockholders or partners) to establish an LLC. Other states, such as California, now allow one member. It is a pass-through entity like a partnership and actually files the Form 1065 as a partnership does. This means the members will receive a K-1 form. Like there is in corporations, liability is limited. One area to be aware of with an LLC is whether there is a "gross receipts fee", as there is in California. These fees can be a deciding factor when choosing this form of entity.

Non-Profit Organizations

These entities are much more difficult to set up than any of the others. An application must be filed with both federal and state taxing authorities to find out whether they agree with your reasons to establish a not-for-profit organization. This process can take weeks or months. Structure is formal as in a for-profit organization. There is more scrutiny, not only by the federal and state taxing authorities, but also by the state Attorney General's office. Formal accounting is required and, in many cases, budgeting. There are no owners in a non-profit organization, only a board of directors who may be at risk for some liabilities. No taxes are paid unless there happens to be "unrelated business income". A federal Form 990 informational return must be filed each year, with certain parts available for public inspection. Accounting procedures are similar in many ways to for-profit entities but unique in other ways.

Try to keep your choices as simple and inexpensive as possible when starting out. Keep in mind that as your needs change and you outgrow one entity, you can always evolve into another.

QUESTION: When Should I Incorporate?

This is a question that is often asked. Some people think they should incorporate right away because being incorporated makes their business sound more legitimate. Immediately they discover, if they are working stockholders, they have to include themselves as employees and pay payroll taxes on a regular schedule. They have given up the flexibility that comes with a sole proprietorship. When businesses start out on a "shoe string", cash flow is often a determining factor. Therefore, the funds required for payroll taxes might not be available on demand.

I counsel clients not to incorporate until it makes sense to do so. Need for the limited liability afforded by corporation status should be a secondary consideration. The first

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consideration or line of defense from lawsuits should be an adequate insurance policy. However, perhaps it would benefit your company to have more structure for planning and organizational purposes. Or, maybe your company is making decent money and would like to raise more by selling shares of ownership interest. Stocks are a convenient way to do that. These are the primary considerations when deciding to incorporate small businesses. The essential questions are, 1) Can I afford to? Or, 2) Can I afford not to?

TIP: How Contributions are Recorded Within the Entities

Contributions can be a big source of confusion because they are recorded differently, depending on the entity. First, let's be clear what a contribution is. If you gift money or property to a registered charitable organization (Non-Profit Organization), you are entitled to a deduction against the income in your business. This is simple enough, but if your business entity is a pass-through entity, contributions are passed-through directly to you, the owner. Let's review how contributions are recorded in a journal entry for a sole proprietor. If you need a review of how debits and credits work, click on the "Accounting Model" link: http://www.reallifeaccounting.com/accounting_model.asp.

Sole Proprietorship

DESCRIPTION	DEBIT	CREDIT
Owner's Draw	100.00	
Cash		100.00
To record contribution to Heart Fund.		

As a sole proprietor, contributions are not a business deduction, therefore, they must be recorded as an owner's draw. The owner must remember to add them to the federal 1040, Schedule A, Itemized Deductions on his or her personal tax return.

A controversial rationale some owners use is that the contribution to a charitable organization is really a business promotion expense, e.g., promoting good will in the community. If this approach is taken, then the journal entry is as follows:

DESCRIPTION	DEBIT	CREDIT
Advertising & Promotion	100.00	
Cash		100.00
To record contribution to Heart Fund.		

The IRS may disagree with this approach, but if your contributions are minimal, then, so is your risk. In contrast, C Corporation contributions are considered a regular business expense. It is the same with a Non-Profit Organization. It is the pass-through entities, i.e., Sole Proprietorship, Partnership, and S-Corporation, where you can choose to categorize the contribution as a promotional expense or as a contribution that "passes-through" and is recorded on the owner's personal tax returns.

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But what happens when you decide to donate your services to a charitable organization? This is an area fraught with confusion. The issue came up a while back with one of my clients who is a boat rigger. He donated some of his time to rig some sailboats for a non-profit organization that teaches underprivileged kids how to sail. He charges $40 an hour and spent eight hours one day working for them. He wanted to deduct $320 as a business expense. I said that was fine, but he first needed to record the income from his services. It didn't take him long to figure out that they canceled each other out (wash).

DESCRIPTION	DEBIT	CREDIT
Accounts Receivable	320.00	
Services Rendered		$320.00

DESCRIPTION	DEBIT	CREDIT
Promotion	320.00	
Accounts Receivable		320.00

So why bother? It's just extra accounting work. My client wasn't happy. This didn't seem reasonable. His reasoning was that he did the work and didn't get paid for it so he should get a deduction. However, look at the issue from the IRS's standpoint. I decide to volunteer my labor for a worthy cause. My hourly charge is arbitrary. Maybe I'll just say I charge $1500 an hour. You see how out-of-control this could become and subject to abuse? If this were allowed, not many of us would be paying any taxes.

Only something like money that has an established value, or property, that has an appraised value can be deducted. Another way to think about this is that whatever it is that you are contributing must have "tax basis". This relates to the concept that "to get, you have to give". Or, "there is no free lunch". In other words, taxes must have been previously paid on the property being given in order to receive a deduction. On the surface it doesn't seem fair, yet, when examined in depth, it is fair.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at http://www.reallifeaccounting.com to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

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