

00:00:04 Welcome back. Okay. So now that we've considered why to incorporate and whether you should own your business outright in a revocable living trust or in an irrevocable trust, let's look at which form of business entity is right for you. As I mentioned in the prior lesson, there are four questions to consider here. Question one, what's the exit plan for your business?

00:00:32 Fancy way of saying, do you want to sell it, work at it until you die or something else altogether. Two, who owns and manages the business? Meaning just you or you and partners. Three, who is liable for the debts and liabilities of the business. So who's going to take on all the risk? And four how is your business going to be taxed?

00:00:55 And yes, we know you'd prefer no tax at all, but there will be taxes so best if you choose. And that's what entity selection is all about. These questions will be the same questions to ask an answer when determining the right business structure for you, no matter whether you are in the US or any other country, because while the answers will be specific to your country,

00:01:21 the questions are not. And you want to know the answers to these questions before you either choose the right kind of business entity, based on your knowledge of the laws of your state and country, a business entity options, or when you talk with a lawyer about your options. So diving in here at the beginning of the end, with the end in mind,

00:01:45 let's look at your options for how you want to exit your business, and take notes in your journal, once you've gotten clear on how you want to end things. So again, here we have some options. Option 1: You want to work in the business until you die. At which point it's okay, if the business dies too. It's an income source for you for your life,

00:02:09 and it will generate all the cash you need while you're living so that you can pay your living expenses and invest in other assets, but you aren't really planning on the business, having any residual value once you are gone. So that's option one. Option two, is you want to work in the business until you die, and you expect it to have value that you'll leave behind to your kids, and their kids, and their kids

00:02:36 after that. We're talking millions, multi-millions, or billions here. That's option number two. Number three is you want to sell the business before you die, but not really for that much, maybe just enough, so you can live on the proceeds for the rest of your life, and you don't plan to leave that much to future generations. That's not really what you're in it for.

00:02:57 And then option number four, is you want to sell your business before you die for millions and millions, and maybe even billions, and leave all that behind. So basically are you building a business just for you or for you and for future generations? Knowing the answer to this question is critically important when determining which business entity to use, because there are going to be tax consequences to consider.

00:03:24 If you're going to sell your business one day for a big value or a small value, and there are going to be estate taxes to consider, if you are going to die owning a business with a big value. Once you know how you plan to exit, next, do you want to consider who will own and manage your business? Are you planning to own and manage this business alone?

00:03:49 If so, will you ever bring in partners in the future? What about investors? Are you providing all of the funding? Will you take out loans, use credit cards to fund your growth. Who will own and manage the business is all about your funding and growth plan. So, take some time to consider what that will look like both now and into the future.

00:04:13 Next let's consider who will be responsible for the debts and other liabilities of the business. Is it all you? Or will you have partners to shoulder the burden? If the company needs more capital, where will that capital come from? If the debts can't be paid back, who will be responsible for paying the debts, and finally, how should your business be taxed.

00:04:37 Meaning who should pay taxes on the income earned by the business and how. So take some time to journal on all of those questions and come up with the answers that you already know. And if you don't know, putting those into our forum and to our coaching calls so that you can share what you do know, and receive some reflection from those Eyes Wide Open members who can help you to get clear on these answers

00:05:10 Now for the rest of this lesson, I'm going to be speaking in terms of US business entity options. But if you're a business owner outside the US these are the questions that you will need to have answered in your own country to choose the right best entity for you and your business. But if you're here in the US let's begin with the most simple type of business entities,

00:05:34 the ones that you'll use, if you're not planning to sell your business for millions of dollars. The two most common types of business entities that small business owners use are the Limited Liability Company or LLC for short, or an S corporation. And sometimes, actually most often really the right form is a combination or a hybrid of these two. It's an LLC, Limited Liability Company,

00:06:03 taxed as an S corporation. So you get the best of all the worlds. Now let's break this down, as clearly as I possibly can. An LLC is a business entity form that many people think is the way to go, because in some respects, it's the most flexible. Yay, flexibility! But there's some real risks of having an LLC because you might think to yourself,

00:06:27 "Oh, I'm incorporated great", but then not really treat your business like a business or filed to have your taxes handled properly. And you could end up with a big mess or owing a lot more money than is necessary. I'm going to explain the tax part in a separate lesson because it involves numbers, and numbers need visuals, not just my face. So stay tuned for that,

00:06:51 but suffice it to say, this is if you form an LLC and you do nothing else, other than form that LLC, meaning you don't set up your operating agreement or keep your business and personal assets separate or maintain other corporate formalities. And then you have a problem like a client sues you because you were painting their house and accidentally spilled paint all over their brand new hardwood floors.

00:07:17 Your LLC is not going to provide you with any protection from your business activities at all. And guess who's paying the judgment? You are, out of your personal assets. And if you don't file to have your LLC taxed as an S corporation, then your LLC is going to be taxed as a sole proprietorship, meaning you won't have any tax savings from incorporating at all.

00:07:42 And you'll be at that higher risk of audit that we talked about before. And you basically didn't do anything of real value, really. So, if you are going to file as an LLC, don't do it just because you think it's simpler or because your best friend told you, that's what they did. It's not the best reason to do it. The best reason to do it, is because you want the flexibility of the LLC form and taxation,

00:08:12 And because it's inexpensive to set it up in your state. Most common is that your LLC will be a member managed LLC, meaning that the members of the LLC or you, yourself and you, because you're probably the only member who will manage the LLC. But in some cases you may want a manager managed LLC, meaning that not all of the members are involved in the day to day operations,

00:08:40 but instead the managers run the day to day operations, because maybe you're the manager, and your members who are like your shareholders, they're the people that invested in your LLC, just vote on the big issues, all which would be outlined in the operating agreement. So bottom line here is if it's just you single member, LLC, your LLC can be member managed.

00:09:05 But if it's you and a whole bunch of members who are investors in your LLC, well, you're going to want your LLC to be manager managed, because you're going to be the manager, and you don't want all of those members making all of the day to day decisions. If you are going to have more than one member of an LLC, it is critically important,

00:09:25 like critically, I cannot say this enough important that your operating agreement is customized, and that you work with a lawyer on the customization of your operating agreement. Your operating agreement is what governs all the terms of how you run your business, how you transfer your business interests down the road in the future, and most importantly, how you deal with conflicts. One of the biggest,

00:09:52 most costly and common problems I see in business are problems between business partners, who did not give enough consideration to issues of governance and conflict

resolution upfront, and then vest a lot of time and money together only to find out that they will not work well together; or when the money starts coming in, they don't know how to handle it; or when the money doesn't come in,

00:10:14 they don't know how to handle it. And it is costly, not just financially, but from the time energy and attention perspective and to your heart. We'll talk more about all of this in future lessons, but here's the bottom line on LLCs. They are great. They are flexible, and don't just choose an LLC to avoid the corporate record keeping requirements of an S corporation.

00:10:38 Because in most cases, you are going to want to file to have your LLC taxed as an S corporation, anyway, because otherwise you'll be taxed as a sole proprietor, which we know is not ideal. And because unless you are a single member LLC, you still have to customize all your governance documents. If you are a single owner, starting off with an LLC can be simplest,

00:11:05 just remember to elect to have your LLC taxed as an S corporation so that you aren't being taxed as a sole proprietor. File your separate tax return, get your operating agreement in place and keep your corporate records up to date, even though you aren't legally required to do so. LLC ownership is typically trapped on what's called a capitalization table or a cap table. That cap table lists out,

00:11:36 it's basically just a spreadsheet by the way, that lists out the relative ownership interests of each of the members. Now, one thing that is important to know is that LLCs are frequently used to hold real estate as they are a very simple way to provide asset protection for real estate investments. LLCs are formed by filing articles of organization with the state in which you are incorporating your entity.

00:12:06 Once you do that, you'll receive back stamped articles that are kept with your corporate records. Now you can do this by using a corporate formation service, going directly to your secretary of state, or working with a lawyer to save yourself the time, energy and attention. The other most common option for small business owners is to use an S corporation and S corporation is basically a C corporation,

00:12:33 but with a special election filed that says to the government, we're going to pay taxes for this corporation on the tax returns of each of the shareholders. This is called pass through taxation. And because of this, and S-corporation cannot have more than 100 shareholders, and there can only be one class of stock. So that makes an S corporation less flexible from a governance perspective than an LLC,

00:13:01 which can have multiple levels of membership interests with different rights and responsibilities. If you form an S corporation, it is super important that you issue shares of your company stock, ideally to your revokable living trust. As we discussed in the lesson on who should own your company. Now, this often doesn't happen, especially when people set up their

own corporations and sometimes even when lawyers do it.

00:13:28 So make sure that it happens, whether you do it yourself or work with an attorney on it, you form an S corporation by using a corporate formation service, just like with the LLC or going directly through your secretary of state, or again, by working with a lawyer. In any of those cases, you will file articles of incorporation, get a tax ID number from the IRS,

00:13:53 and then be able to open your business bank account. I've laid out all the steps for you on how to do this, both for an LLC or a corporation in the business, formation checklist included here in your materials. But here's the thing, whether you use an LLC or an S corporation, the most important thing is that if you are going to have partners,

00:14:17 additional shareholders or investors, you can't go this alone. Seriously. And I'm not just saying this because I'm a lawyer. I tried to go it alone. And as a lawyer, I could not do it. It did not work out. Did not work out. Cannot emphasize that enough. Pretty much every single person I know who has tried to start a business with a partner even,

00:14:45 and maybe especially where that partner was a spouse or a best friend, and did not have the support of a legal counselor, to help them work out the terms, has ended up in an expensive, painful conflict that hurt the business, took up their time and wasted tons of money, including me. It is just not worth it. Now notice I said legal counselor,

00:15:10 this does not mean hiring a lawyer who's going to print out a form legal template for you and call it a day. No. I mean a legal counselor who is going to ask you the right questions about the structure of your business, the governance of your business, while you're operating your plans for exit, how you want to make decisions and resolve conflicts.

00:15:31 If you are working with a lawyer who does not ask you these questions, you are not working with a strategic legal counselor, but instead, a form document provider, and you're not getting anything for your investment, that you could not do yourself. Instead, if you are going to work with a lawyer rather than do it yourself, you want to make sure you are working with a lawyer who understands you and your business cares about you and your business and gets to know you and your business and your strategic goals before you helping you to make the right decisions on type of entity or on how to customize your governance documents or anything else for that matter.

00:16:13 Now, there are a couple of other business entity types that we're not going to touch on here very much, but I will share a bit with you about them briefly. So you know what they are, but if you are going to be using them, you really need to work with a lawyer. Okay? So you don't need to know about them too much in depth,

00:16:32 just enough to say, Oh, Ali said, if I'm thinking about this, then I should be working with a lawyer. So sometimes you may want to form a straight up C corporation, not an

LLC or an S corporation. This is the case. If you are going to raise money from private equity or venture capital funds, or if you are anticipating it's \$10 million plus exit of your company through a sale of your shares.

00:17:07 This is because venture capital doesn't typically want to invest in a pass through entity because they want the corporation paying the taxes, not them as the investors. And if you are going to have an exit of your company by selling your shares for \$10 million or more than you want your company stock structured as qualified small business stock, which allows for the sale of your shares up to \$10 million to have zero capital gains tax and zero capital gains tax is fantastic.

00:17:41 This can be a \$2 million or more savings. And I say, or more, because we can even stack these savings with these of trusts saving you big time on taxes when it's time to sell. So obviously this is not somebody you should be structuring on your own. Now, sometimes you may want form a partnership, which is either a general partnership with limited partnership interests,

00:18:06 or a straight up general partnership. Like if you're raising money for co-investment, but you definitely don't want to do that without a lawyer who really understands what you're doing and how to structure your deal for your protection and for the greatest chance of success for you and your co-investors. Finally, you may be thinking about a B Corp, an L3C, a public benefit corporation,

00:18:30 or even a nonprofit. If you're creating a heart project and not a for-profit make money as its purpose enterprise. If that's the case, here's one very important thing to note. Your business, whether it's for profit or not, has to make money to support itself, you, and everyone else working for it, and everyone that it serves. So please do not plan to use one of these structures just to get out of thinking

00:19:00 you have to make money. Making money is important, no matter what business structure you have, even if it's full on nonprofit, nonprofit simply means that there's no shareholders or owners. Not that there's no money. You need the money and you need to take care of the money as we'll cover in the financial section of LIFT. Next, a B Corp is not a business entity type.

00:19:29 It is a certification you will apply for and get from a third party certification administered by the nonprofit B lab, based in part on your company's verified performance, on the B impact assessment. Okay. So B Corp, not business entity type. In contrast, the benefit corporation is a legal structure for a business like an LLC or an S corporation. Benefit corporations are legally empowered to pursue positive stakeholder impact alongside profit.

00:20:05 Some companies are both certified B corporations and benefit corporations. And The benefit corporation structure fulfills the legal accountability requirement for B Corp

certification. But to be clear, a B Corp certification is not your entity structure or your tax structure. It's a certification. You can incorporate as a benefit corporation. And then that would be the legal structure that would then support your application for B Corp certification,

00:20:39 because you're then legally able to consider the impact of all of the decisions on all of your stakeholders, not just your shareholders, including the social and environmental impacts of your decisions. If you want to choose to be a benefit corporation, you can go to www.benefitcorp.net and all the information you need to get started is right there. All right. I look forward to seeing you in our next session.