

# Tab M: Starting a New Business

See IRS Publication 583, *Starting a Business and Keeping Records*

## Related Information

[Partnerships—Tab B](#)

[LLCs—Tab F](#)

[Corporations—Tab C](#)


[Employee Benefits—Tab K](#)

[S Corporations—Tab D](#)

[S Corporation vs. C Corporation—Tab P](#)

## Checklist for Creating a Business Entity

- 1) Consult an accountant. Compare the tax aspects of various business entities. See the [Entity Comparison Chart](#).
- 2) Choose a business entity.
- 3) Consult an attorney regarding federal and state laws governing creation, ownership and operation of the entity.
- 4) Draft and execute agreement among principals. Target the business start date. See [Pre-Incorporation/LLC/Partnership Agreements](#).
- 5) File with state for certificate of assumed name (DBA).
- 6) Obtain a federal employer identification number (EIN). See the [Employer Identification Numbers \(EIN\)](#) chart for information on obtaining an EIN.
- 7) File incorporation, limited liability company (LLC) or partnership documents with state. For corporation electing Subchapter S status, file IRS Form 2553. See [S Corporation Election \(Form 2553\)](#) and [Check-the-Box Rules](#).
- 8) Obtain state tax identification numbers. File required documents with state unemployment and sales taxing authorities.
- 9) Obtain required city/county/local business licenses/permits.
- 10) Establish a business checking account.
- 11) Fund the entity. Corporations issue stock certificates. See [Capital Contributions](#). See [Basis](#) for partnerships.
- 12) Conduct necessary corporate or other organizational meetings. Elect board of directors.
- 13) Establish books for the new entity. Close books on previous entity if changing the form of business.
- 14) Send notification of the business name and business start date to customers, vendors, bankers, etc.
- 15) Consult with an insurance professional to obtain business liability and workers compensation coverage.
- 16) Review wills and estate plans of the owners.
- 17) Hire employees. See [Employer Checklist](#).
- 18) Start business operations.

 **Caution:** Unforeseen consequences can occur when a business is purchased, the name is changed or with the change of business entity.

**Consider the following:**

- Corporate stock acquisitions and reorganizations can trigger taxable income if not properly structured. See [Corporate Reorganizations](#).
- Changes in stock ownership can terminate S corporation status. See [Stock Ownership Requirements](#).
- Successor liability laws can trigger unseen obligations. See [Successor Liability Laws](#).
- Business insurance might not automatically transfer to a new owner or business entity or if a name change occurs.
- A favorable state unemployment tax experience rating may be lost if ownership changes.

Generally, an asset acquisition has more advantages to the buyer than a stock purchase.

## Corporate Considerations

A corporation holds legal status separate and distinct from its shareholders. Individuals considering incorporating a business must be familiar with and willing to adhere to corporate formalities.

**Consider the following:**

- The corporate checkbook is owned by the corporation, not the shareholder. A personal expense paid with a corporate check is treated as a distribution to the shareholder. Such a distribution is taxed as a dividend from a C corporation. In an S corporation, the distribution reduces the shareholder's basis.
- Each time a shareholder makes a contribution to capital in exchange for stock, the corporation must issue a stock certificate signed by the officers. The shareholder should keep a detailed record of all capital contributions, since a taxpayer who is unable to prove cost/basis is deemed to have a basis of zero.
- A double-entry bookkeeping system should be established and maintained, as a balance sheet is generally required for the corporate tax return. Shareholders should consult with or hire an accountant to make sure the corporation has adequate books and records.
- Shareholders performing services for a corporation are generally treated as employees. The corporation must file state and federal payroll tax returns, and issue a Form W-2 to each employee.

At least annually, a corporation must conduct shareholder meetings and maintain corporate minutes documenting shareholder discussions. State law specifies the procedures to be followed at corporate meetings. Shareholders should consult with an attorney to ensure proper procedures are followed.

 **Caution:** Certain events or improper actions by the corporation can automatically terminate S status. See [Terminations](#).

**Subjects to be addressed in the corporate minutes:**

- Acceptance of prior meeting's minutes.
- Election of officers and board of directors.
- Ratification of significant officer actions for the prior year.
- Listing of officer salaries for next year, and reasonableness of the compensation when the officer is also a shareholder.
- Detailed presentation of the need to accumulate earnings for specific future business needs.
- Approval of loans from/to shareholders.

- Annual valuation by the board of directors of the business for buy/sell agreement purposes.
- Approval and accrual of officers' bonuses.
- Determination and approval of retirement plan contributions.
- Establishment of employee benefit plans.
- Approval for stock issuance, redemption and bonuses.
- Approval for sale, liquidation or reorganization.
- Discussion of any Section 351 asset transfers.
- Discussion on election or termination of S corporation status.
- Declaration of dividends to shareholders.
- Approval and discussion of material business transactions including lease agreements, bank loans, and business interest/asset acquisitions.



### Entity Comparison Chart

	<a href="#">Sole Proprietorship—Tab 6**</a>	<a href="#">Partnerships—Tab B</a>	<a href="#">C Corporation—Tab C</a>	<a href="#">S Cor</a>
IRS Pub.	IRS Pub. 334	IRS Pub. 541	IRS Pub. 542	
IRS Form	Schedule C, Form 1040	Form 1065	Form 1120	
Entity Description	A sole proprietorship consists of one individual who carries on an unincorporated trade or business.  (If a husband and wife carry on a business together as partners, they should file Form 1065, U.S. Return of Partnership Income.) <i>Exception:</i> Husband and wife residing in a community property state may treat the business as a sole proprietorship.	A partnership is an organization having two or more owners that functions as a trade or business. A joint undertaking merely to share expenses or ownership of property does not necessarily constitute a partnership. An LLC with two or more members is generally classified as a partnership for tax purposes. A partnership can elect to be taxed as a corporation.	A corporation is a business entity that carries its own legal status, separate and distinct from its owners. A corporation cannot elect out of corporate taxation. See <a href="#">Check-the-Box Rules</a> .	An S corporation is a corporation that has elected S corporation status. An S corporation may not have more than 100 shareholders. The rules for S corporations are found in Subchapter S of the Internal Revenue Code.
Taxation	Net profit or loss is computed on Schedule C and is reported as income or loss on the owner's Form 1040.	Partnership income and expenses flow through to the partners. Income is taxed to the partner whether or not distributed. Pass-through items retain the same character in the partner as they had in the partnership.	A C corporation pays tax on its profits. When shareholders take profits from the corporation, the distributions are usually taxable dividends (double taxation). Personal service corporations are taxed at a high, flat rate.	An S corporation's income and expenses are passed through to the shareholders in the same proportion as their ownership. The income is taxed only once, at the shareholder's rate.
Wages and SE Tax	The owner is subject to SE tax of 15.3% of net earnings from self-employment.  SE tax is computed on Schedule SE and is reported as "Other Taxes" on Form 1040. Deduct one-half of SE tax as an adjustment to income on line 27 of Form 1040.	A general partner's share of business income (including guaranteed payments) is subject to SE tax. A limited partner's share of business income is not subject to SE tax unless the partner performs services for the partnership. Other items, such as interest and dividends, retain their character and are passed through to the partner's individual income tax return.	Shareholders who perform services for a corporation, including officers, are treated as employees. Wages of corporate employees are subject to payroll tax and withholding.  Wages paid to employee-shareholders must be reasonable. Dividend distributions are not subject to SE tax.	An employee-shareholder receives wages; wages must be reported for income tax purposes.  Double taxation applies to dividends.
Losses	Business losses can offset other income such as interest, capital gains or a spouse's wages if filing a joint return. Subject to hobby, passive activity and at-risk loss rules under Sections 183, 469 and 465, respectively.	Losses flow through to partners.  Recognition of loss by a partner is limited by the partner's basis, at-risk rules and passive activity rules. Subject to "hobby loss" rules under Section 183.	Capital losses are allowed only to the extent of capital gains. Net operating loss of a corporation is carried back or forward against corporate income, but is not passed through to shareholders.	Losses flow through to shareholders. Losses are limited by the shareholder's basis and passive activity rules under Section 183.
Fringe	Amounts paid on behalf of employees are deductible; those paid on behalf of proprietor	Generally included in partner's income as a guaranteed payment. <i>Exception:</i> Nontaxable	Owner-employees are entitled to the same tax-free fringe benefits as other employees	Generally include shareholder's own

<b>Benefits</b> (See <a href="#">Tab K</a> )	are not. <i>Exception:</i> Proprietor can deduct medical insurance premiums and reimbursement costs under an accident and health plan that covers all employees. If proprietor's spouse is covered under a plan that also covers owner as part of family, deduction is allowed.	benefits include, among others, legal service plans, educational and dependent care programs and certain working condition and <i>de minimis</i> fringe benefits and employee achievement awards.	(subject to discrimination rules).	<i>Exceptions:</i> Cf plans; comper educational ar employee disc <i>de minimis</i> frin services.
<b>Personal Liability</b>	The sole proprietor is liable for all business debts and actions.	General partner personally liable for all partnership debt. Limited partner's liability usually limited to investment in partnership.	Shareholders not liable for debts incurred by corporation. Liability generally limited to amount invested.*	Shareholders no corporation. Liat invested.*
<b>Organization and Administration</b>	A sole proprietorship is the easiest business to organize. Intermingling of business and personal funds is allowed (although not recommended). Business income is reported on Schedule C, which is filed with the owner's Form 1040.	A partnership is easy to organize. A written partnership agreement is recommended, but not required. The agreement determines how income and losses are allocated to the partners. If a partnership agreement does not exist, partnership items pass through based on partners' ownership interests.	A corporation is difficult and expensive to organize. Corporations must hold periodic board meetings and keep minutes. Corporations must comply with federal and state regulations.	An S corporator corporation. S cc be treated as an 2553. Certain ev termination of S
<b>Bookkeeping and Accounting</b>	There are fewer requirements on what type of bookkeeping system or accounting method is used in sole proprietorships. The system must be consistent, clearly reflect income and expenses, and allow the taxpayer to file an accurate return. The sole proprietorship must use the same tax year as the owner.	Depending on income and assets, the partnership may be required to include a balance sheet with its income tax return.  Therefore, the partnership should use the double-entry bookkeeping method. If a partner exchanges property other than cash in exchange for an interest in a partnership, special accounting rules apply. See <a href="#">Contributed Property</a> .	The balance sheet on a corporation's income tax return must agree with the corporate books. A corporation must use a double-entry bookkeeping system. It must file all necessary employment and income tax returns.	The balance she tax return must t An S corporator bookkeeping. Ar required payroll .
<b>Owner Control and Flexibility</b>	The owner is free to make all business decisions.	Control of the business operations is divided among partners.	Shareholders have control over the corporation to the extent they own voting stock.	Shareholders ha the extent they c
<b>Transfer of Ownership</b>	A sole proprietorship is not a separate entity from its owner. "Sale" of a sole proprietorship is actually a sale of assets.	The partnership agreement may restrict the sale of a partnership interest, and may control the terms of the sale.	Ownership is easily transferred by selling shares of stock. The corporate charter may place certain restrictions on the sale of stock.	Ownership is ea of stock to eligib  The corporate restrictions on
<b>Advantages and Disadvantages</b>	<p>Advantages:</p> <ul style="list-style-type: none"> <li>- Minimum legal restrictions.</li> <li>- Easy to discontinue.</li> </ul> <p>Disadvantages:</p> <ul style="list-style-type: none"> <li>- Unlimited liability.</li> <li>- May not bring in new owners or outside capital contributions.</li> <li>- Income tax cannot be deferred by retaining profits.</li> </ul>	<p>Advantages:</p> <ul style="list-style-type: none"> <li>- A partnership combines the skills and/or financial abilities of several people.</li> <li>- Easy to establish.</li> <li>- Business usually benefits from partners who have complementary skills.</li> </ul> <p>Disadvantages:</p> <ul style="list-style-type: none"> <li>- A partnership is often easier to get into than out of.</li> <li>- General partners are liable for actions of other partners—unlimited liability.</li> <li>- Sharing of profits.</li> <li>- Disagreements in decision making.</li> </ul>	<p>Advantages:</p> <ul style="list-style-type: none"> <li>- Limited liability.</li> <li>- Perpetual life.</li> <li>- Ability to raise capital through issuance of stock.</li> <li>- Ease of transfer of ownership.</li> </ul> <p>Disadvantages:</p> <ul style="list-style-type: none"> <li>- Double taxation of profits.</li> <li>- Corporate charter restricts types of business activities.</li> <li>- Subject to various state and federal controls.</li> </ul>	<p>Advantages:</p> <ul style="list-style-type: none"> <li>- Limited</li> <li>- Avoids c</li> <li>- Profits p subject to S</li> <li>- Ability to issuance of :</li> </ul> <p>Disadvantages:</p> <ul style="list-style-type: none"> <li>- Shareh even if undi</li> <li>- Less fle</li> <li>- Contribut retirement p shareholder' such as a sc</li> </ul>

**Business insurance.** The limited liability characteristics of certain business entities should not be considered a substitute for proper insurance coverage. The business owner's interruption, errors and omissions, employment practices, employee benefit plans and employee dishonesty. General liability coverage, including umbrella policies for person [Compensation](#).

\* **Caution:** The courts may disregard the so-called "corporate liability shield" in the case of single shareholder corporations.

\*\* In the *1040 Quickfinder® Handbook*.

\*\*\* *IRS Pub.589 regarding S corporations was last issued in 1995.*

\*\*\*\* *A disregarded single-member LLC is included on the tax form of its owner (1040, 1120, etc.).*