Legal Basics and Business Entity Formation: Crash Course Business Entrepreneurship #5

Crash Course: Business - Entrepreneurship
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When will your idea transform from a casual side-hustle into a full-blown business?

Is it when your podcast gets sponsorships, when your catering company is booked for 5 weekends straight, or when you've sold your 100th bottle of Slug-be-Gone? Basically, when do things get REAL?

I can't tell you when you'll start to feel like a businessperson, but the world recognizes it when you legally register your formal business structure. You could be an LLC. Or a C-Corp.

Or a B-Corp. Or a Co-op. So many different letters!

It can be daunting to move from the abstract idea stage to the realm of bank accounts, taxes, and liability. Sometimes, it can feel like you're making arbitrary decisions, but we're going to wade through the legalese together. Things are about to get legit.

I'm Anna Akana and this is Crash Course Business: Entrepreneurship. [Theme Music Plays] The legal basics of entrepreneurship aren't as flashy as generating ideas or staking out the competition. But think about them like a Choose Your Own Adventure novel. Choosing a business structure opens up a different future with unique twists and turns.

So buckle up. Legally, you have to register your business. And depending on where you live, your government might have certain requirements to do that.

In the U. S., you register to say a cordial "what's up?" to the state and federal government. They need to know you exist so you can get the licenses and permits you need to do business and -- everyone's favorite topic -- pay your taxes.

For you as the owner, and anyone you're doing business with, registering can create some legal and financial protection. Specifically, we're talking about liability -- or the state of being legally responsible for something -- and potentially using helpful tax structures. We'll talk about a bit of money stuff here, but check with your government's commerce, tax, or treasury departments for more details.

There are lots of different options to pick from when you register your business, so it's time to choose a path. These are most of the U. S. options, but a lot of countries have similar structures.

Let's jump in. A sole proprietorship is a type of business that's owned and run by one person. Think freelance writers, independent landscapers, or even YouTubers.

This is the easiest Choose Your Own Adventure decision: choosing nothing. If you provide a service or product to someone by yourself and get paid without registering for any kind of business, you're considered a sole proprietorship. But it has some drawbacks.

You aren't considered separate from your business -- you're personally liable. That means your business money isn't separate from your personal assets like your money, car, or house -- and your personal assets could be taken in a lawsuit. Yikes.

Raising investment money can be tough because you can't sell stock -- or shares of ownership in the company. And banks might hesitate to lend money because they perceive a bigger risk in lending to just one person. Filing taxes as a sole proprietor is pretty easy.

You have what's called pass-through status, where profits are passed straight to business owners and are just part of personal taxes, instead of also being included in the business taxes. Basically, since the business money isn't separate from your personal money, you just submit once with a few extra forms. Also, you have to factor in self-employment taxes, which are explained on IRS.gov.

The cool thing about a sole-proprietorship is that your business expenses can be tax write-offs! New computer for work? Write it off!

New desk? Write it off! You want to check with an accountant, of course, but that is a real advantage of owning your own business.

A partnership is a way for two or more people to share ownership of a business, which is great if you don't want to go it alone, or for professional groups like attorneys or dentists. All the fun groups. If you choose a partnership, you have to pick one of three flavors that mostly affect power and liability: General, Limited, and Limited Liability.

In a General Partnership, you and one or more partners share personal liability and all have an equal say when making decisions. Just like a sole proprietorship, it's the easiest choice for partners, but personal liability can be risky. In a Limited Partnership, someone takes on unlimited liability, so their personal assets can be seized in a legal battle, and they have to pay self-employment taxes.

But they're the head honcho and own and run most of the business. The other partners have limited input, but also limited liability. They're only responsible for a slice of the business assets so they're personally protected from lawsuits.

These are often silent business partners... who are basically just the money. Shhh! In a Limited Liability Partnership, or LLP, everyone gets limited liability.

It's more work to form than a general partnership, and gives less protection than fancier business structures. But it does give owners at least SOME liability protection. No matter the flavor, you'll have an easier time raising money in a partnership than alone, since banks might be more willing to lend to multiple people.

And you could get investments if you're willing to take on silent partners. Partnerships are also helpful for tax reasons. General partners have pass-through status for taxes, like a sole proprietorship.

Everyone splits the profits through the business, and deals with their own taxes, including self-employment taxes. Overall, partnerships -- especially LPs and LLPs -- are more expensive than sole proprietorships because they need more legal and accounting help. Now a corporation, sometimes called a C-corp, is an entity that's completely separate from its owners.

Like a person, a corporation can have profits, taxes, and liability. The BBC, eBay, and AirBnB are all corporations. Where you incorporate matters for many legal reasons.

In the U. S., for example, lots of people form their legal entity in Delaware. If you choose the C-corp path, you're protected from lawsuits -- you aren't personally liable and have limited liability.

Funding is also easier, because corporations can sell stock to the public. While corporations can borrow from banks, they typically find it too restrictive and find money other ways. Plus, if stockholders -- the people who own shares of your business -- leave or sell their stocks, you can keep chugging along instead of stopping to restructure.

But for all these benefits, you have to be ready to hustle. Any type of corporation needs a giant pile of state and federal paperwork to form. They require extensive record-keeping, operational processes, and annual reports on their activities to the government.

C-corps are also expensive to form. And unlike sole proprietors and partnerships, C-corps pay tax on profits before handing money out to stockholders, who also have to pay their own taxes, which means a little less profit for each owner. C-corps are also beholden to profit.

Their decisions have to be based on what makes the most profit for stockholders. A benefit corporation, sometimes known as a B-corp, focuses on social good. Patagonia, Ben & Jerry's, TOMS, and The Honest Company follow this path!

Like any corporation, B-corps give you lots of protection with limited liability. And maybe more importantly, this structure empowers and protects you to make a difference and a profit. B-corps are designed to let the CEO -- the person in charge of the business who may or may not be an owner -- make decisions for social good.

Even if those decisions are a little less profitable, the CEO won't get in trouble with stockholders. The funding and structure is similar to a C-corp. But you can also look for impact investing -- people investing money to create a specific social or environmental benefit.

It's still really expensive to incorporate, and B-corps are taxed the same as C-corps. Plus, to make sure you're doing social good, you have to create even more reports for transparency. Get ready for mountains of paperwork!

A limited liability company, or LLC, is sort of a corporation-partnership hybrid. LLCs can have one or more owners. Complexly is an LLC!

It's literally in the name: you have limited liability. Plus, you can still choose to become a corporation later if you want -- that path is still open. Many startups begin with an LLC because of the protection and flexibility it has.

In fact, this might help you attract investors. LLC stock is privately owned, so being able to transform into a corporation and eventually sell stock to the public might draw in the financiers. And like a partnership, you have pass-through status for taxes, which can be nice, but you still pay self-employment taxes.

One risk of choosing this path is when an owner joins or leaves an LLC, you might be forced to reform. But you can also create a legal agreement within an LLC to cover ownership transfers. A cooperative, or co-op, is a business owned by the people using it -- like REI or a farming co-op.

An elected board of directors runs the co-op, while every stockholder-slash-owner can vote on the overall direction. So stockholders have a real voice! The main problem is that the wheels of democracy turn slowly.

Stockholders vote on all decisions, which means that responses to market changes are slower. But in the spirit of equality, each owner gets precisely one vote and enjoys limited liability. You can generate money for a co-op by selling stocks, and any profits are distributed among the stockholders.

But you might have a hard time getting outside investment. Traditional banks aren't super excited about lending to businesses where their money won't be guaranteed by one or a few specific owners. And, like a corporation, co-ops have the "double taxation" treatment for stockholders.

And finally [at long last], a nonprofit corporation is created to do charity, education, religious, literary, or scientific work that isn't taxed. Nonprofits include Amnesty International, Better Business Bureau, or the Foundation to Decrease World Suck. If you choose this path, your work benefits the public.

So nonprofits have tons of paperwork and record-keeping, operational processes, and must submit an annual report on their activities to the government, similar to a C-corp. Also, owners are well-protected and have limited liability. After jumping through some hoops with the IRS, the government will grant you tax-exempt status, meaning you don't pay state or federal taxes on any profits.

And there are strict rules on what to do with any profits you earn -- like, you can't distribute them to stockholders or political campaigns. As for funding, nonprofits are often eligible for grants -- or money given by a government or organization for a specific project. Other people and corporations can also just give you money so that they can write it off on their taxes.

And out of the goodness of their hearts, of course. Phew. Got all that?

We made a handy chart for you too, just in case! By choosing our business structure, we're also thinking about who we want to work with, and what future we see for our business. Let's go to the Thought Bubble.

You do a lot of tutoring online using free video chat software. But you notice a gap in the market and want to develop a long-distance tutoring business and potentially a new app. You decide against a business partner, because you don't want to share decision-making or profits with anyone, and you couldn't find a co-founder with skills that complement yours.

But you can't handle all this tutoring yourself, so you plan to hire employees! You dig into the legal requirements for how to pay them, and find some software to help you manage payroll, taxes, and more. It's starting to look like a REAL business, so it's time to choose your own adventure.

You might start out as a sole proprietorship. It's just you and one employee, and you're not sure this is a super long-term endeavor. After a couple years, though, you decide to become an LLC.

You're great at what you do, but some clients get mean when their grades don't skyrocket -- so you need protection from personal liability. And then… you're at a crossroads. The future looks promising for generating a tutoring app, but you're having trouble getting investors.

So you can stick with an LLC or try to transform into a C-corp. Maybe you decide to stay an LLC, but you get an unlucky dice roll while generating your app. You spread yourself too thin, and eventually you can't support all your tutors and developers.

You eventually decide to cut your losses and call it quits. You had a good run! Or maybe you decide to put in a lot of work and incorporate, and luckily hit the jackpot: as your app grows, venture capitalists are clamoring to invest.

You're quickly becoming the premier tutoring organization in the U. S. and this business might outlive you. Thanks Thought Bubble!

There really is no "best" structure because every business is different, your path might change over time, and success involves grit, determination, AND luck. We recommend talking to a trustworthy attorney or tax accountant for specific and nuanced advice, since they'll know your business idea inside and out. Once

we've chosen a legal structure, we still have to say "what's up?" to the government so they know we exist.

And this means… paperwork. Let's start with the feds. In the U.

S., you need an Employer Identification Number from the federal government, which will help you with taxes and getting a bank account. If you open a branch of your business in the Scottish Highlands or the Bolivian Salt Flats, you'll need to look at what those countries require. Next, register your business through your Secretary of State's website.

There are often small filing fees, and if that's a barrier, try to find an advocate at a local Small Business Development Center, bank, or your state's Department of Commerce. Someone may know someone who knows a program to get your fee waived. It never hurts to ask!

The worst they can say is no, go away! Then, check in with your local government. Are there requirements to doing business in your city, like a business license you need to get?

And finally, it's never too early to start thinking about taxes! Review the requirements for your state and federal tax reporting. You could use an accountant or DIY software like TurboTax -- depending on your needs.

Make a plan. Stick to the plan. File your taxes.

So the bottom line is: registering your business is a big decision, but an exciting one, because you get to define your own path. Where do you see your business going in 5 years? What does success look like?

What infrastructure will you need? It's up to you. Next time, we'll talk about how to get feedback before launching our business, and what to do if our idea is falling flat.

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