



BUSINESS HOW-TO

How to Form Your New ESD Business

United States Edition

To Incorporate or Not To Incorporate

One of the first decisions you'll need to make when starting your ESD business, assuming it will be a for-profit business, is whether or not to incorporate. One of the best reasons to incorporate is to protect your personal assets (money in the bank, a home, other properties, investments, and other valuables), though incorporation is not the only way to do this. Incorporating is relatively inexpensive and, if you keep your personal funds separate from your business funds, your personal assets will be protected from business-related creditors and lawsuits.

If you decide not to incorporate, you will be operating as a sole proprietorship or, if you have a partner, as a partnership. (Note that sole proprietorships and partnerships are the same, for all intents and purposes, in terms of structure and tax classification. The biggest difference is that a sole proprietorship is run by one person, a partnership by more than one person, and each have their own tax forms.) If you will not be incorporating and wish to operate your business under any name other than the legal name of your unincorporated business (your name), you'll need to create a DBA. DBA stands for "doing business as" and is also called a fictitious, assumed, or trade name. Let's say your name is Maria Perez and you want to start an ESD business called Perez Empowerment Self-Defense. You'll need to first search for the name you'd like (we recommend doing this search in your state, county, and city) and then file a DBA form, usually with your county or state. We also recommend that you choose a website name (a URL) and conduct a URL search to ensure that your preferred URL is not already taken.



What About Becoming an LLC?

The first thing to know is that forming an LLC is something you can do whether or not you incorporate. The second thing to know about LLCs is that they do not determine how your business is taxed by the IRS. Taxes are determined by whether or not your business functions as an entity separate from you. In the case of sole proprietorships, for instance, you and the business are the same entity for tax and liability purposes. In the case of LLCs, the LLC is considered a “disregarded entity,” which sounds insulting but really just means that an LLC is a separate legal entity regulated by state law and that the IRS disregards that distinction for tax purposes (the IRS taxes LLCs the way it taxes sole proprietorships and partnerships). Finally, LLCs are afforded the same liability protections enjoyed by corporations—personal assets are protected from business creditors and lawsuits.

How Do I Choose?

There are a few things to consider when deciding whether to form and classify your business as a sole proprietorship or partnership, an S corporation, or an LLC. In weighing tax considerations, you will need to think about state tax rules as well as IRS federal tax rules. Here are some questions to mull over:

How important is it to you that . . .

Your personal assets are protected from your business’s liabilities?

You receive favorable tax treatment?

The process of creating your business is as easy and quick as possible?

The process of running your business is as easy and quick as possible?

You keep startup and ongoing fees to a minimum?



Business Structure Overview

When you form your company, you first file with the state in which you are forming the company. It is here that you designate it as a sole proprietorship, partnership, corporation, or LLC (see [IRS Form 8832](#)). You then file paperwork with the IRS to determine your tax classification (sole proprietorship or C corporation). If you would like to form an S corporation, you have to apply to the IRS.

COMING SOON! Checklists for how to form an S corporation, an LLC, and a sole proprietorship.

Sole Proprietorship

Sole Proprietorship	
Pros	Cons
Taxed at personal not corporate income tax rate.	Personal assets not protected from business debts and lawsuits.
No corporate tax.	Pay and report taxes as self-employed (Schedule C).
No double taxation.	Pay self-employment tax (which is calculated as % of company profits, not salary).
Less red tape setting up & running business.	

For purposes of this article, we will assume that you are forming a sole proprietorship, not a partnership (but the rules, benefits, and drawbacks that apply to sole proprietorships also apply to partnerships).

Organizing your ESD business as a sole proprietorship is probably the easiest and least expensive path to take in terms of setup and ongoing regulations and fees. However, it could go either way on taxes, and there are risks.



The biggest drawback to operating as a sole proprietorship is that your personal assets are not protected from business creditors and lawsuits. This is because, as mentioned above, you and your business are not separate entities, legally speaking.

Whether it's more or less expensive to operate a sole proprietorship or LLC depends on your *personal* finances because, as a sole proprietor, your ESD business revenue will pass through to your personal income tax return. This has advantages and disadvantages.

On the upside, you will be taxed at a personal rather than a corporate income tax rate, and your business will not be subject to a corporate tax. This means that you will avoid "double taxation" (see Terms chart, below, for an explanation of "double taxation"). And if you are trying to avoid red tape and regulatory fees, organizing your ESD business as a sole proprietorship could be the way to go. There is going to be less paperwork involved in setting up your ESD business, and going forward, sole proprietorships (and partnerships) are less regulated than S corporations and LLCs. For example, there is no requirement to have a board of directors, let alone board-approved bylaws or annual meetings and minutes. In addition, fees to set up and run sole proprietorships are lower than for S corporations and LLCs, and your business's accounting may be more straightforward and therefore more affordable.

On the downside, you will have to pay taxes as self-employed (using Schedule C) which means reporting business income and expenses on your personal tax returns. It also means that you will have to pay the more expensive self-employment taxes (100% of Social Security and Medicare) rather than FICA taxes (50% of Social Security and Medicare). In addition, your self-employment tax rate will be calculated as percentage of your business's profits (up to \$142,800 in 2021) rather than as a percentage of your salary alone. Depending on your salary, this can also cost you.

If you decide to organize as a sole proprietorship, we recommend that you create a DBA (DBA stands for "doing business as"). It is very easy to do, just file a form (i.e., fictitious business name statement) with your county or state. When choosing a name for your ESD business, ensure that the name you prefer is not already taken by running a search on both your county (i.e., county registrar office) and state (i.e., secretary of state) websites.

Sole proprietorships file using [IRS Form 1040](#) with [Schedule C](#) and partnerships file using [IRS Form 1065](#) with [Schedule K-1](#) for each partner.



Limited Liability Companies (LLCs)

LLC	
Pros	Cons
Taxed at personal not corporate income tax rate.	More fees to set up and run.
No corporate tax or double taxation.	Pay and report taxes as self-employed (Schedule C).
Less red tape setting up & running business.	Pay self-employment tax (which is calculated as % of company profits, not salary).
Personal assets not protected from business debts and lawsuits.	

When you first form an LLC, it is by default a sole proprietorship or partnership—it won't become a corporation unless you also incorporate. For purposes of this article, we are assuming that you will not incorporate your LLC (but, if you do, the rules of S or C corporations will apply).

The benefits of an LLC include providing a formal business structure for your ESD practice and being easier to establish and run than a corporation (for instance, it's only suggested, not required, that you hold annual meetings and adopt bylaws). In terms of finance, company revenue passes through to your personal tax returns, so you are taxed at a personal rather than corporate tax rate. And because there is no corporate income tax, there is no "double taxation." And unlike a sole proprietorship, an LLC will protect your personal assets from business creditors and lawsuit awards as long as you keep personal and company finances separate.

The disadvantage of forming an LLC is that it will be taxed as a sole proprietorship. This means that you will pay taxes as self-employed and report your ESD business's income and expenses on personal tax returns. As noted in the sole proprietorship section above, you will pay full self-employment rather than FICA taxes (see Terms chart, below), and your self-employment tax rate will be calculated as a percentage of company profits (up to \$142,800 in 2021) rather than as a percentage of your



personal salary alone. On top of that, while LLCs are easier to set up and run than corporations, they can be more costly. For instance, in addition to the setup fees, your LLC will have to pay recurring fees, like the fee to file your annual report. It is also more difficult to attract outside investors as an unincorporated LLC than as a corporation.

Note that each state has its own tax rules, and some states tax the LLC as well as the owner (sometime in the form of a franchise fee).

Bottom line—if you don't want to incorporate but you do want some of the liability and asset protections afforded to corporations, LLCs can be a good option.

Note that whether and how your LLC is taxed at the state level varies from state to state. For instance, some states collect a franchise tax on LLCs, either a flat rate or calculated as a percentage of revenue. Please consult a professional to learn how LLCs are taxed in your state.

To obtain S corp status, here are some forms that might apply to your situation (always note filing deadlines): IRS Form 1040 with Schedule C; IRS Form 1065 with Schedule K-1 (for each partner in a partnership). For IRS guidelines on LLC taxation, see IRS Publication 3402.



S Corporation

S Corporation	
Pros	Cons
Personal assets protected from business debts and lawsuits.	More red tape with start up and running your ESD business.
No federal corporate tax (but check California state rules).	Accounting is more complicated (and therefore more expensive).
No double taxation.	Limited to 100 shareholders.
Paid and taxed as salaried employee, avoid self-employment taxes.	Must be a U.S. citizen or permanent resident.
Pays dividends and distributions.	Shareholders cannot be business entities.
Qualified Business Income deduction (if eligible).	Allowed no more than one class of stock.
Easy to transfer ownership.	Harder to attract investors than with C corp.

S corporations (S corps) are a type of corporation. If you choose to incorporate, you will first create a C corporation (C corp) and then apply to the IRS for S corp status. S corps were created for smaller businesses that want to operate as corporations for the personal liability protections but without some of the tax burdens, much like LLCs. But there are some differences.

There are two primary benefits to operating your ESD business as an S corp—your personal assets will be protected from business liabilities (as with a C corp), but you won't be subject to the same "double taxation" as a C corp. As long as you keep your personal finances separate from business finances, your personal assets will remain protected. Your S corp business will be taxed like a sole proprietorship where company profits pass through to your personal tax returns and you are taxed at a



personal rather than corporate income tax rate. In fact, your business will not be liable for corporate income tax at all and will avoid “double taxation.” All this is very similar to an LLC, but as the owner of an S corp, you can be paid as a salaried employee (as long as your salary is “reasonable” in the eyes of the IRS), thereby avoiding the more expensive self-employment tax and instead paying the less expensive FICA. Another benefit is that you can be paid dividends or distributions if your company is generating those.

Another benefit of running your business as an S corp is that you may be eligible to take a Qualified Business Income deduction of 20% from your share of business income (your income as an employee), in addition to the usual business expense deductions. There are income limits and other restrictions, so not everyone will be eligible.

The biggest drawback to operating your ESD business as an S corp is that starting up and running your business can be a bit more cumbersome and expensive than for a sole proprietorship or LLC due to corporate regulations and restrictions. For instance, you (and your shareholders) must be U.S. citizens or permanent residents of the U.S. Plus, your business is limited to 100 shareholders, and your shareholders cannot be business entities. In addition, your business will be restricted to one class of stock, and even though you’ll be incorporated, it may be harder to attract investors than if you operated your business as a C corp. Also important to consider is that accounting is more complicated for S corps, something that can significantly increase your accountant fees.

Bottom line, S corps are good for protecting personal assets and easier on your taxes than sole proprietorships and LLCs, but there are higher costs and more red tape.

Note that whether and how your S corp is taxed at the state level varies from state to state. For instance, California treats S corps a bit differently—in California, S corps are not treated as pass-through entities and are taxed directly, though at a lower rate than C corps. There’s more to it than that, so please consult a professional to learn how S corps are taxed in your state.

To obtain S corp status, here are some forms that might apply to your situation (always note filing deadlines): [IRS Form 2553](#), [IRS Form 1120-S](#), [Schedule K-1 \(Form 1065\)](#), and [Schedule E \(Form 1040\)](#), and personal return [Form 1040](#) (for all 1040 forms and schedules, [click here](#)).



Terminology

Just a few terms to help better understand the choice between sole proprietorship/partnership, LLC, and S corp.

Terminology	
Business Entity v. Tax Classification	<p>A business entity is a way of describing the way a business is structured. Examples of business entities are sole proprietorships and LLCs.</p> <p>A tax classification determines how a business is taxed. Examples of tax classifications are C corporation, S Corporation, and 501(c)(3) nonprofit.</p> <p>Both carry with them rules and regulations, benefits and burdens.</p>
Sole Proprietorship v. Partnership	<p>A sole proprietorship is a business run by one person whereas a partnership is a business run by more than one person. The rules, benefits, and drawbacks are largely the same and they are taxed the same (though different IRS forms are used for each).</p> <p>Sole proprietorship (and partnership) is a type of tax classification. They are taxed differently than C corps (but not differently than S corps since S corps are taxed as sole proprietorships) and do not afford personal asset protection.</p> <p>Owners of sole proprietorships (and partnerships) are considered self-employed and file IRS Schedule C.</p>
LLC	<p>Type of legal entity that does not, in and of itself, indicate tax classification or treatment. LLCs provide the legal structure of a business. An LLC can be a sole proprietorship or a corporation (which will determine how the LLC is taxed). By default, LLCs are sole proprietorships or partnerships and are taxed as such. However, you can also choose to incorporate your LLC. Note that <u>each state has its own tax rules</u>, and some states tax the LLC (sometime in the form of a franchise fee) as well as the owner(s).</p>
S Corporation v. C Corporation	<p>When you incorporate a for-profit business with a state, you are merely indicating that you will be incorporating, you are not indicating what type of corporation you'll be creating. The IRS will assume that you are forming a C corporation (C corp), the standard kind of corporation. If you would like to form an S corporation (S corp), your business will first incorporate as a C corp with the state and then apply to the IRS for S corp status. C corps have been around forever, while S corps are much newer. S corps were created to accommodate small businesses that want the liability protections but not the tax burdens of corporate status.</p> <p>S corp is a type of tax classification and a type of corporation. To become an S corp, you first incorporate as a C corp with the state in which you are forming your business. Then you apply to the IRS for S corp status.</p> <p>Note that California taxes S corps differently than other states.</p>
DBA	<p>DBA stands for "doing business as." Also called a fictitious, assumed, or trade name. Usually filed with the county or state government.</p>



Terminology

Double Taxation

Where the owner of a C corp business pays personal income tax as an employee of the business and *also* pays corporate income tax on behalf of the corporation as the owner of the business.

FICA v. Self-Employment Taxes

FICA refers to the Social Security and Medicare tax shared by employees and employers, whereas self-employment tax refers to the Social Security and Medicare tax paid solely by sole proprietors, partnerships, and individuals who are self-employed. The total amount received by the federal government is the same, but FICA taxes are paid by both employees and employers, while the full amount of self-employment taxes are paid only by the sole proprietorship, partnership, or self-employed individual.

Company Structures Compared

For purposes of the chart below, we will assume that your LLC will not be incorporated. And for ease of language, we will also assume that you are forming a sole proprietorship rather than a partnership (but remember that the rules, benefits, and drawbacks that apply to sole proprietorships also apply to partnerships).



Company Structures Compared

Structure	Protecting Personal Assets	Tax Implications	Fees & Regulations
Sole proprietorship	<ul style="list-style-type: none"> • Personal assets are not protected from business creditors and lawsuits. 	<ul style="list-style-type: none"> • Company revenue passes through to owner’s personal tax returns, so owner taxed at personal, rather than corporate tax rate. • There is no corporate income tax, so no “double taxation.” • Owner pays taxes as self-employed (Schedule C) which means reporting business income and expenses on personal tax returns. • Owner pays self-employment rather than FICA taxes because self-employed. • Self-employment tax rate calculated as percentage of company profits (up to \$142,800 in 2021) rather than as percentage of owner’s salary alone. • Note that state taxes may also apply. 	<ul style="list-style-type: none"> • Fees to set up and run sole proprietorship are lower than for S corps and LLCs. • Less paperwork involved in setting up your business. • Less regulated than S corps and LLCs (i.e., no requirement to have a board, let alone board-approved bylaws or annual meetings). • Accounting more straightforward. • Recommend that owner create DBA. File form (i.e., fictitious business name statement) with county or state. • Prior to choosing a business name, make sure your preferred name isn’t already taken. Conduct a search of business names on county (i.e., county registrar office) <i>and</i> state (i.e., secretary of state) websites.

Structure	Protecting Personal Assets	Tax Implications	Fees & Regulations
<p>LLC</p> <p><i>*Assume LLC is run as sole proprietorship or partnership rather than as a corporation.</i></p>	<ul style="list-style-type: none"> • LLCs afforded same liability protections as corporation—personal assets are protected from company debts and lawsuits. • To maintain this benefit, keep personal finances separate from company finances, no intermingling. 	<ul style="list-style-type: none"> • LLCs taxed like sole proprietorships so that taxes pass through to business owner. (The IRS term for this is “disregarded entity,” meaning a business that is separate from its owner but which elects to be disregarded as separate from the business owner for federal tax purposes.) • LLC revenue is taxed as personal income. Business owner pays LLC’s taxes on personal tax return using Schedule C. • Business is not subject to corporate income tax, so sole proprietorships avoid “double taxation.” • Owner’s Social Security and Medicare taxes computed as percentage of company profits up to approximately \$142,000 (whereas with S Corp, owner pays these as percentage of owner’s salary). • Note that state taxes may also apply. 	<ul style="list-style-type: none"> • Offer formal business structure, unlike sole proprietorship. • Easier than corporations to set up and run, fewer rules and regulations (i.e., although recommended, not required to hold annual meetings or adopt bylaws). • Less costly than corporations to set up and run, but more costly than sole proprietorship (i.e., fee to file annual report every year). • More difficult for LLCs to attract outside investors than for corporations. • Recommended that owner create DBA by filing appropriate form with county or state (i.e., fictitious business name statement). • Prior to choosing a business name, make sure your preferred name isn’t already taken. Conduct a search of business names on county (i.e., county registrar office) <i>and</i> state (i.e., secretary of state) websites.



Structure	Protecting Personal Assets	Tax Implications	Fees & Regulations
<p>S Corporation</p>	<ul style="list-style-type: none"> • S corps are afforded same liability protections of C corps—personal assets are protected from company debts and lawsuits. To maintain this benefit, keep personal finances separate from company finances, no intermingling. 	<ul style="list-style-type: none"> • S corporations are taxed like sole proprietorships. • Company profits pass through to owners' personal tax returns and owner taxed at personal income tax rate. • This avoids “double taxation” that owner would be subject to in a C corporation. • Owner paid as employee of company and so avoids self-employment (pays FICA rather than self-employment tax and rate is calculated as percentage of owner’s salary (as long as reasonable in the eyes of IRS) rather than as percentage of company profits (up to \$142,800 in 2021). • Owner and other shareholders can be paid in dividends or distributions, as well (relevant dividend/distribution taxes will apply). • With respect to state taxation of S corps, note that they are treated differently in California than other states (more heavily taxed). 	<ul style="list-style-type: none"> • Many regulations control S corps (e.g., adopting bylaws, holding annual board meetings, keeping minutes). • Owners (all shareholders) must be citizens or permanent residents of US. • Limited to 100 shareholders and one class of stock. • Cannot be owned by other businesses, including corporations, LLC, partnerships, and sole proprietorships. • Not as attractive to investors as C corporations. • Fees to establish and manage S corps are higher than for sole proprietorship and some LLCs. • Accounting is more complex, so you may incur higher accounting fees. • To file for S corp status, use IRS Form 2553. Note tax filing deadlines. • Easy to transfer ownership. • Prior to choosing a business name, make sure your preferred name isn't already taken. Conduct a search of business names on county (i.e., county registrar office) <i>and</i> state (i.e., secretary of state) websites.



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