5 Signs You Need to Reconsider Your Sole Proprietor Status

I was chatting with a local business owner and was asked “my business is quite small and I am still running it as a sole proprietor, isn’t that ok? This is a common question for small business CEOs and I will answer this by sharing one of many SCORE resources with you. Nellie Akalp is a serial entrepreneur, small business advocate, speaker and author. She has been named a Top 100 Small Business Influencer by Small Business Trends the last five years and CorpNet.com has been recognized on the Inc. 5000 list of fastest-growing privately-held companies in America in 2015 and 2016. She wrote a SCORE post last week that addresses key considerations important for the CEO that gave me this question.

Although the simplicity and affordability of running a business as a sole proprietorship may have attractive perks, there are reasons why you might benefit from forming an LLC (limited liability company) or corporation instead. How can you recognize that a change may be in order?

1. You're losing sleep over the lack of liability protection. As a sole proprietor, you and your business are considered one and the same entity. That means if you can’t pay down business debt or someone sues your business, your personal assets are at risk.

By forming an LLC or incorporating, your business becomes its own legal entity separate from your personal self. That means your personal property (home, personal bank accounts, retirement account, car, etc.) is protected if your company runs into legal or financial troubles.

2. You need to secure funding. Lending institutions and investors will often require that your business is set up as a formal business structure rather than as a sole proprietorship before they’ll loan you money. If you’re looking to grow and expand your business and need funding to do that, you’ll want to explore forming an LLC or corporation.

3. You want to work with larger clients. If you have your sights set on growing your company by securing contracts with larger businesses, you may find their contracts stipulate your company must operate as an LLC or corporation.
Why do they require this? For one, many professionals view a business that's established as an LLC or corporation as a more reliable, responsible business partner than a sole proprietor. Second, when signing on an LLC or corporation to perform work, there’s no question that the contracted company is not an employee. This is important because the IRS has recently cracked down on companies that improperly classified their employees as “contractors” to avoid paying payroll taxes and providing other benefits.

4. You’re looking for more flexibility with your taxes. With no separation between you (as an individual) and your business, you must report all your business income on your personal tax return when you’re a sole proprietor. That means all of your profits are subject to self-employment taxes (Social Security and Medicare taxes).

But if you form an LLC or corporation and elect S Corporation tax treatment, you might lower your self-employment tax obligation. S Corp status means you only pay self-employment tax on your wages and salaries rather than all of your business profits.

Other tax advantages come with incorporating, too. For example, medical insurance can be a tax deduction and enable you to keep more of your profits in your business. I recommend talking with a CPA or tax advisor for guidance on which business structure will positively affect your tax situation.

5. You want people to know you mean business. The mere visual of having "LLC" or "Inc." after your business name can serve to give your business more clout in the eyes of potential customers, vendors and project partners.

Although seeing either of those sets of three letters behind a company name isn't a reliable measure of capabilities and competency, perception can sometimes make or break business deals. Want to demonstrate to people that you're serious about your business and in it for the long haul? Then consider formally registering your business as an LLC or corporation.

While more involved than setting up shop as a sole proprietorship, completing the paperwork to form an LLC or corporation can be done in only a few hours. It's time well spent considering it will give your business the benefits of personal liability protection, tax treatment options and more credibility.
Before you decide on which business structure will work best in your situation, I encourage you to talk with your SCORE mentor and get guidance from a legal and tax professional.

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