



ESBA

UNDERSTANDING
LEGAL STRUCTURES

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My number one takeaway from this video

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COMPONENTS OF A BUSINESS

Once you've developed who you're serving, what you're offering as a solution and how to deliver results, you'll also need to secure the legal components of entrepreneurship, including:

- Legal structure
- Financial analysis
- Name of entity

COMPONENTS OF A LEGAL STRUCTURE

- Number of owners (e.g., partnership structure)
- Personal liability and business risk
- Tax rates¹
- Incorporation options
- Ownership structure (e.g., sole proprietorship, LLC, C Corporation, S Corporation)

WHY FORM A LEGAL ENTITY²

If you're in business that generates income for you and your family, you need to have a legal entity around you. A legal entity will be a corporation or an LLC. Having a legal entity gives you what [Scott calls “Inside-Out” asset protection.](#)

¹ Tax record and bookkeeping options are in the Tax download.

² **NOTE: You will NOT form your legal structure yet.** Actual legal formation will come under the download 'Securing structure, name and domain' and [after seeking legal counsel.](#)

What is inside-out asset protection

If anything bad happens inside your entity it stays in your entity. A Corporation has been called an ingenious device for obtaining individual profit without individual responsibility.

What does this mean for you

The owners of Corporations and LLC's are not personally liable for the debts or liabilities of the Company. In other words, if you make a profit in your business and purchase a vacation home, a boat, and jewelry these items are not at risk due to activity in your business.

Why is inside-out protection important?

A lawsuit could have been avoided by using the property legal entity.

Most common excuse for not forming a legal entity

An accountant said that it was not yet necessary.

DIFFERENT FORMS OF BUSINESS

There are many different types of legal structures, including:

- ☐ Sole Proprietorship
- ☐ General Partnership
- ☐ Corporation (S-Corp or C-Corp)
- ☐ Limited Liability Company (LLC)
- ☐ Asset Protection Trust

Sole Proprietorship

The simplest form of business entity is a sole proprietorship. There are no formalities with this structure. No filings are required with the state and no fee must be paid. The trade-off for this lack of formality is that the sole proprietorship has few other advantages. Any income is reported on your regular tax return (creating a 7-9 times greater risk of audit) and the organizational form provides no protection from individual liability. This means if you are sued and they win, you pay out of your personal assets.

General Partnership

The most traditional type of partnership is called a general partnership. This type of business entity is also very informal. As with sole proprietorships, no filings are required and no fees must be paid. In fact, a partnership may be found to exist even without a formal or informal agreement between the parties. The essence of a general partnership is that the partners share management and control of the business, as well as expenditures, income, and property. As with sole proprietorships, the partners are taxed on their personal income tax returns, in proportion to their share of the income. General partnerships provide no personal protection from liability.

Corporations

A corporation (sometimes referred to as a C corporation) is a separate and independent legal entity owned by shareholders. Corporations are legal entities and only exist subject to a sponsoring or charter state. The corporation is liable for the actions and debts it incurs, not the shareholders. Corporations are very useful form of business for an entrepreneur.

Corporations consist of the following:

- Shareholders (who may be individuals or other entities)
- Board of Directors (who meet at least annually and elect officers to run the day to day business of the corporation)

Corporation taxes

Corporations are taxed as separate business entities and file their own tax returns unless they have opted to be taxed as Sub-Chapter S Corporations.

Forming a Corporation

Forming a corporation requires filing specific paperwork in the state of incorporation, as well as subsequent legal filings, such as an annual report. Most states also requires corporations to hold annual shareholder meetings. Corporations are taxed, and shareholders are taxed on dividends they earn, as well as earnings received when and if they sell their stock.

Disadvantages to Corporations

- ☐ Only one class of stock is permitted.
- ☐ S corps are limited to a maximum of 100 shareholders.
- ☐ Stockholders types are limited. Stockholders can only include individuals, estates and trusts. Other corporations, partnerships and nonresident aliens cannot own shares of an S corporation.

Limited Liability Company (LLC)

A limited liability company is a hybrid between a corporation and partnership. It provides the limited liability of the corporation and the tax efficiencies or benefits and the operation flexibility of a partnership.

Who owns an LLC

LLCs are owned by "members" instead of "shareholders"

LLC taxes

LLCs are not taxed as a separate business entity. Instead, the profits or losses are "passed through" the company to the members of the LLC. The members then report profits and losses on their personal federal tax returns, just like the owners of a partnership.

Members and company relationship

As with a partnership, the relationship between the members and the company is determined by contract. That contract is called a "company agreement" or "operating agreement."

LLC formation requirements

Forming an LLC requires filing specific paperwork in the state of organization as well as subsequent legal filings, such as an annual reports.

LLCs and asset protection

A domestic asset protection trust (DAPT) is an irrevocable trust established under the special laws of one of the limited number of jurisdictions that allow the settlor of the trust to be a discretionary beneficiary and yet still protect the trust assets from the settlor's creditors. If such a trust were set up under the laws of a non-DAPT jurisdiction, the general rule is that the settlor's creditors can access as much of the trust as can be distributed to the trust settlor.

Why LLC's are most commonly recommended to entrepreneurs

Business owners create businesses to achieve a life goal or dream. Most of those dreams require that you take money home in the form of profit. Forming an LLC helps you do this by having personal asset protection. This is done by a [Separate Legal Entity](#). Like the Corporation, LLC's are separate legal entities. So, LLC's shield the personal assets of their owners.

How does personal asset protection work

If your company has bad debts, banks and other lenders cannot seize your personal property. The only exception is if you signed a personal guarantee to finance your business.

Responsibilities for debt

The owners (members) of LLC's are not personally liable for the debts or liabilities of the Company. In other words, if you make a profit in your business and purchase a vacation home, a boat, and jewelry these items are not a risk due to activity in your business.

Creditor expectations

The best that a creditor can expect is a charging order. A charging order is a court order authorizing a creditor to capture any distributions, payments, or proceeds from an LLC. In other words the creditor can only get what you distribute out as profit. This is very different from the out-and-out attachment or seizure of a judgment debtor's ownership interest like with a Corporation. Corporate stock may be seized and sold at public auction.

Member payment (i.e., distribution or salary)

LLC's that have made a Sub-S election are required to pay the members a reasonable salary for services rendered to the Company.

Seizure of corporate stock

Unlike an LLC membership interest or partnership interest, which is subject to a charging order in many states, corporate stock may be seized and sold at public auction. Stock in a corporation is non-exempt personal property.

Fiduciary Duties

- ☐ Good faith and candor
- ☐ Refrain from self-dealing
- ☐ Care and Loyalty
- ☐ Full disclosure
- ☐ Act with the strictest integrity
- ☐ Fair, honest dealing

Consequences of breaching Fiduciary Duties

Actual Damages

- Lost profits
- Mental anguish
- Exemplary damages

Statutory Fiduciary Duty

The Texas LLC statutes do not specify duties of managers and members, but imply the existence of duties, and managers in a manager-managed LLC and members in a member-managed LLC could expect to be held to fiduciary duties similar to the duties of corporate directors or general partners. Check the rules in your state or [ask Scott](#).

Restrictions on an LLC ownership

There are very few restrictions on LLC ownership. Individuals, trusts, corporations, other LLC's or a combination can own them.

Limitations on an LLC

In a few instances there can be limitations on ownership. One such situation would be a service that requires a specialized license such as doctor or a lawyer. These professionals have to form Professional Limited Liability Companies (PLLC's) and the members must hold that particular license. The operating agreement of an LLC can also limit ownership to a certain family or other specific criteria.

Managing an LLC

An LLC can be run in several different ways:

Member -Managed

A member-managed LLC is most typical. This is appropriate if all the members will certainly actively participate in the actual management and operations of the business. If you are starting a business with one partner, and both of you want to be involved in the management as well as the smaller decisions that affect the LLC every day, then you will probably need to be member-managed. Almost all single-member LLCs are going to be member-managed, at least in the beginning.

Manager-managed

A Manager-managed LLC is most appropriate in situations where one or more of the members are merely investors providing financial help, and are not going to be active in the day-to-day operations.

Or, sometimes one or more members don't have this business acumen to be active in the management, or simply do not strive to be. In any of these situations, a manager-managed LLC enables the members to select managers.

How the selection works

The members can elect one or a number of the members to be professionals, while the remaining members arrive at avoid those management duties. The members can also elect a non-member to be the manager.

Board of Directors managed

While just about all state laws require a corporation to have a board of directors that is elected by the shareholders. This is a way of centralized management. Although an LLC, or perhaps limited liability company, shares some characteristics of a corporation, the requirement for a board of directors is not one. However, most state laws regarding an LLC's management structure are flexible enough an LLC could have a board of directors if LLC members choose.

Flexibility in taxation

One of the biggest advantages to running a business as an LLC is the tax flexibility. The tax implications of LLC differ from those of corporation. LLCs use "pass-through taxation," meaning the LLC will not pay taxes. Income from your business is instead handed down to the company's owners. They claim the earnings or losses on their personal tax returns.

An LLC can be taxed as a Sole proprietorship, partnership or Corporation.

LLC Benefits

- They generally have the benefits of a corporation in terms of limiting the business owners' liability.
- The advantage of an LLC would be the management flexibility it allows, as well as the potential tax benefits.
- LLCs allow a business to achieve the limited personal liability of a corporation as supplied by state law, while being treated being a partnership for purposes of Federal tax laws.
- Operating as a Limited Liability Company also provides owners greater flexibility in determining who manages the organization and what each owner's particular duties are usually in that regard.
- Determining whether any particular business would gain from being structured as a Corporation or possibly a Limited Liability Company is a complex decision. A lawyer who practices business law will help you determine what the possible consequences of each structure would be for your particular business.

Asset protection of the LLC

Business owners concerned about protecting their personal assets from business liabilities often choose to operate their companies as a Limited Liability Company (LLC) or Corporation (usually as an S-Corporation), since these business structures provide what is known as a "liability shield". However, a court can dissolve this liability shield if the proper steps are not taken by the business owner to protect it

Forming an LLC

If you operate an LLC or S-Corporation, be sure you have taken these four important steps to preserve your liability protection:

1. *Go All The Way When You Create Your LLC.* Many entrepreneurs today are going online or to a well meaning CPA and filing a one page form with the Secretary of State to create their LLC and then leaning on it for what Scott calls asset protection:
 - a. File a Custom Certificate of Formation
 - b. Create a Written Operating Agreement
 - c. Sign Organizational Minutes
2. *Do The Right Thing.* Needless to say, as a business owner, integrity is a big thing. Meaning that if you use your business entity to commit serious misconduct or fraud, a court could likely “pierce the veil” and hold you personally liable for business claims. So make sure that when it comes to actions taken on behalf of your business, you’re “doing the right thing”, and are not engaging in any fraudulent or unscrupulous behavior.
3. *Don't Forget Your LLC.* Many entrepreneurs go to all the trouble of setting up an LLC and then leave in the dust as they make their business deals in their personal name. **Only enter into agreements in your LLC Name.**
4. *Keep "Corporate Records".* While the rules for an LLC are less stringent than those for a corporation, you still need an operating agreement, as well as a process for tracking and documenting your business decisions. For those who are considering a Corporate entity, keep in mind that those require you to write company bylaws, hold annual meetings (along with documenting the minutes of those meetings), and write up corporate resolutions.



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