

Sole Proprietorship or LLC

Hi, I'm Dan Smith, of DPs legal counsel, and thanks for watching today.

The question I'm going to be talking about today on this video is whether you should operate your business as a sole proprietor or operate it as an LLC. In other words, should you form a legal entity, or should you just operate your business without a legal entity?

Now, I'm not going to be talking about the pros and cons of a corporation, or an S corporation, or an LLC. I'm going to just assume for this video today, that you're choosing between operating as a sole proprietor--that is with no legal entity--or you're thinking about forming an LLC.

So, what is the main advantage to forming an LLC for your business?

The main advantage is limited liability. You know, the benefit is right in the name of the LLC--a limited liability company--and what that means is this: If your company is sued, you basically have at risk in that lawsuit, the business assets of the LLC, but not your personal assets. It provides you with liability protection because it is considered and is a separate legal entity, separate and apart from you as an individual.

So, for an example, if you were to operate a restaurant and someone got sick at your restaurant from something you prepared, and they sued you.

If you operated as a sole proprietor and you had lots and lots of assets and money in the bank, personally, those personal assets will be at risk when your business is sued. But if you operate your restaurant as an LLC, your personal assets, separate and apart from your business, would not be at risk, only your business assets.

That's the primary reason people set up LLCs--is for liability protection.

In addition to accidents and personal injuries that could occur, there are also contract disputes that could arise and LLCs are also great for liability protection in that event as well.

For example, if you enter into a contract as an LLC with a vendor or another party--some kind of business matter--and a dispute arises and the other party sues you for breach of contract, if you have the LLC in place, and it was the contracting party for you and your business then only your business assets would be at risk in that business dispute.

On the other hand, if you entered into the contract as a sole proprietor--you did not set up an entity--and you had a lawsuit against you for breach of contract, all those personal assets that you have in the bank again, all those things that are different from your business assets would still be at risk on the breach of contract action.

So, liability protection is the main reason, and it's a great reason for people to set up an LLC.

But, what is the disadvantage?

Well, there are several, but they're fairly insignificant except for one.

In Tennessee, an LLC or a corporation, with certain limited exceptions, is subject to the Tennessee Franchise and Excise Tax.

The Franchise Tax and the Excise tax are both taxes on the privilege of being able to do business in Tennessee in the form of a separate entity that provides liability protection, such as an LLC or a corporation.

So if you set up an LLC for your business in Tennessee, you will be subject to the Franchise and Excise Tax.

The Franchise Tax is a tax on essentially the net worth of your business.

The way it's calculated is a percentage of your net worth or the book value of your real property or personal property

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used in your business in Tennessee.

It's 25 cents per \$100 in value. So if you have a business that's worth \$1,000 or has real property and personal property of \$1000, then you would owe \$2.50.

So you can do the math based on that.

The Excise Tax is also a privilege tax but it is essentially an income tax on businesses in Tennessee.

Doesn't apply to sole proprietorships or general partnerships, but it does apply to LLCs and corporations and it is at the rate of 6.5%, and it's based on your business earnings--net business earnings in Tennessee, which is a number that is calculated based on the statute but it's essentially, for purposes of discussion here, very similar to your taxable income for federal tax purposes.

So, as an example, let's say that your net business earnings in Tennessee were \$250,000, 6.5% of that, you can do the math.

I think it's \$16,250. That's a tax that you would have to pay in the State of Tennessee for your Excise Tax.

Now, when you weigh the tax liability in Tennessee versus the ability to have liability protection, you have to kind of make a business judgment what it's worth to you.

It may be that you decide you'll be better off operating as a sole proprietor and simply getting more insurance to cover your liability risk. If you do that, just keep in mind that general liability policies typically won't cover contract disputes, contract breaches, and so you may not be covered in that event. So it's really a weighing of pros and cons.

I would say, in most cases, if you do expect to have some risk of liability in the operation of your business, you're going to be better off having an LLC than operating as a sole proprietor. But you do have to keep in mind that there is that Tennessee Franchise and Excise tax that's lurking out there that you have to take into account.

Alright, I hope that helps.

We'll talk again another time about choosing between an LLC and a corporation or an S corporation, but this should give you something to think about.

And I hope you have a great day.

Thanks.