What is a Legal Entity and Why Create One

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Four topics for consideration when answering the questions, should I and which one?

1. How the company will generate revenue
2. Liability protection
3. Owner's compensation
4. Tax obligations

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A legal entity is a formal business structure, recognized by law, as a separate entity from its owners. This means the business, rather than the person, can enter contracts, own assets, and be held liable for its actions.

There are several types of legal entities, including limited liability companies (LLCs), limited and general partnerships, corporations (including sub-chapter B, S, and C corporations), cooperatives, and non-profit corporations.

It is worth noting that a sole proprietorship holds the same legal status as its owner. It is not separate from its owner.

There are four primary considerations when determining which legal entity to select for your childcare business.

- Liability protection
- How the company generates revenue
- Owner's compensation
- Tax obligations

Liability Protection

Simply creating a legal entity does not eliminate all liability a business' owners may incur, however. Instead, it is often the first in a series of liability shields to separate and protect a business owner from liability.

Childcare providers should consider creating a legal entity because it provides several benefits. First and foremost, it helps protect the provider's personal assets from any liabilities that the business may incur.

For example, if a child is injured while under the provider's care, the legal entity (rather than the provider personally) may be held liable for any damages. This means the provider's personal assets, such as their home or savings account, may not be at risk.

How the Company Generates Revenue

For profit entities, such as LLCs, partnerships, corporations, and some cooperative models derive revenue from the sale of a product or service to a paying customer. This may include contracts with local, state, or public entities. Access to grant funds is limited and often for one-time uses.

Non-profit entities, while also generating revenue through the sale of products or services, may also fund operational expenses through publicly funded grant programs.

Owner's Compensation

Simply put, the legal structure of the company determines how its owner(s) get paid.

For owners of LLCs filing taxes as sole proprietorships with a Schedule C tax form, the owner's income is categorized as an owner's draw. Partnerships file a Schedule K-1 Form 1065.

Owners draws come out of the company's balance sheet equity based on the amount of cash the company has on hand. These draws negatively affect the company's overall net worth. While working for the company, owners are not paid via a W-2. The company does not pay the employee's portion of income taxes.

Owners of corporations, in addition to LLCs filing as S-corporations, are categorized as W-2 wage earners. The company pays two thirds of the owner's income taxes when categorized this way. W-2 wage earners are indicated on a company's income (profit and loss) statement and decrease the company's overall net income. Decreasing a company's overall net income can reduce the company's overall tax burden.

Tax Obligations

Each legal entity type has a different tax reporting obligation. Some tax reporting is done in mid-April when individual tax returns on due. Some tax reporting is done in mid-March. Some tax reporting is done based on the company's calendar year or its fiscal tax year.

For more information on tax obligations, it is recommended to engage a qualified accountant. More information is also available on the Internal Revenue Service (IRS) website at https://www.irs.gov/.

Summary

Lastly, creating a legal entity can help establish credibility and professionalism for the childcare business. This can be particularly important when seeking clients or partnerships with other businesses. It also allows for easier separation of personal and business finances, which can simplify tax reporting and accounting.

There are several options for legal entities when it comes to childcare businesses. Sole proprietorships, while not a legal entity, are simple and inexpensive to set up, but do not provide personal liability protection. Partnerships, LLCs and corporations, on the other hand, do provide some liability protection but have increasingly complex legal requirements and may be more expensive to set up and maintain.

It is important to carefully consider the options and seek professional advice before deciding on which legal entity to establish.

For more, the YouTube channel CrashCourse has this video on the legal entity topic.

- https://www.youtube.com/watch?v=1-xiSOvgNvw

CHART OF COMPARISON

	Sole proprietorship	Limited Liability Company	Limited Liability Partnership	General Partnership	C-Corporation	S-Corporation	B-Corporation	Cooperative	Non-Profit
OWNERSHIP									
Who are the owners?	One person	Depends on tax status as sole proprietor, partnership, or corporation	Unlimited people	Unlimited people	Unlimited people	100	100	User-members (can be other businesses)	Non-profits have no owners. Share of stock are not established at start.
How is the business financed?	Owner investment and retained profit from operations; limited to owners assets and borrowing ability	Owner/Partners' investment and retained profit from operations; limited to owners' contributions and LLC's borrowing abilities; can sell interests to raise capital	Partners' investment and retained profit from operation; limited to owners assets and borrowing abilities; can sell interests to raise capital	Partners' investment and retained profit from operation; limited to owners assets and borrowing abilities; can sell interests to raise capital	Sale of stock and retained profits; limited to owners contributions and corporation borrowing abilities; can sell ingterests to raise capital	Sale of stock and retained profits; limited to owners contributions and corporation borrowing abilities; can sell ingterests to raise capital	Sale of stock and retained profits; limited to owners contributions and corporation borrowing abilities; can sell ingterests to raise capital	Sale of stock/shares and retained profits	Grants, contracts, interest from investments and loan program revenue.
How is ownership transferred?	Privately negotiated	Privately negotiated; current voting partners usually approve new partners	Privately negotiated; current voting partners usually approve new partners	Privately negotiated; current voting partners usually approve new partners	Privately negotiated or publicly traded; if public, anyone with enough money can purchase stock	Privately negotiated; may require corporate approval		Usually highly restricted; transfers to other memebers not typical; new members subject to board approval	Not applicable, as non-profits are not owned by the people who start it.
What is the owner's legal liability?	Unlimited exposure	Limited to investment, except for personal services	Limited to investment	Unlimited	Limited to investment, except for personal services	Limited to investment, except for personal services	Limited if corporate directors make informed decisions in good faith	Limited	Board members of a non-profit have limited liability.
TAXES									
	Self-employment tax; Owner pays income	Depends on tax status as sole proprietor ship,	Self-employment tax; Owner pays income	Self-employment tax; Owner pays income	No self-employment tax because payment for	No self-employment tax because payment for	No self-employment tax because payment for	Co-op pays no corporate taxes on qualified patronage;	Exempt from corporate tax; income taxes are

	tax, pass-through taxation	partnership, or corporation	tax, pass-through taxation	tax, pass-through taxation	services is in the form of wages	services is in the form of wages	services is in the form of wages	Does pay corporate taxes on unallocated net profits, net profits from nonmember business, and equity dividends; members pay individual income tax on cash and deferred patronage refunds and dividends	paid on wages
Tax Year	Same as owner	Depends on tax status as sole proprietorship, partnership, or corporation	Majority interest rules; principal partner rules; or the least aggregate deferral of income rule	Majority interest rules; principal partner rules; or the least aggregate deferral of income rule	Calendar or fiscal year	Calendar year; by election; or business demonstrated business purpose	Calendar or fiscal year	Calendar or fiscal year	Calendar or fiscal year
BENEFITS									
Who receives profits?	Owner	Owner/Partners in proportion to their investment or by agreement	Partners in proportion to their investment or by agreement	Partners in proportion to their investment or by agreement	Stockholders in proportion to investment (stock)	Stockholders in proportion to investment (stock)	Stockholders in proportion to investment (stock)	Members in proportion to their purchases or use of services (patronage)	Earnings are retained
What earnings are possible on invested capital?	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Limited by law in most states; usually at 8%	N/A
Who benefits from equity appreciation?	Proprietor, realized upon sale of business	Owner/Partners, realized on sale of business	Partners, realized on sale of business	Partners, realized on sale of business	Investors, upon sale of stock	Investors, upon sale of stock	Investors, upon sale of stock	Equity does not appreciate	N/A
CONTROL									
Who Votes?	N/A	N/A; Partners	Partners	Partners	Stockholders	Stockholders	Stockholders	Members	Board members

How are votes distributed	N/A	N/A; Partners hold proportional voting rights to investment or by agreement	N/A; Partners hold proportional voting rights to investment or by agreement	N/A; Partners hold proportional voting rights to investment or by agreement	One vote per share of common stock owned. May also issue preferred stock.	Only one class of stock (common); one vote per share	One vote per share of common stock owned. May also issue preferred stock.	One vote per member in most cases	One vote per board member
Who establishes policy?	Owner	Owner/Partners	Partners	Partners	Board of directors elected by a majority vote of owners	Board of directors elected by a majority vote of owners	Board of directors elected by a majority vote of owners	Board of directors elected by a majority vote of owners	Board of directors elected by a majority vote of owners
Who manages the business?	Owner or hired management	Owner/Partners or hired management	All partners	All partners	Hired management	Board of directors or hired management	Hired management	Hired management	Hired management

Sources:

- Principles & Practices in the 21st Century
- 2010 National Association of Tax Professionals
- [Choose a business structure (sba.gov)](#)

For additional assistance and next steps in the planning, launching, and growing your childcare business, contact Zero to Five Montana's Senior Child Care Business Advisor Jason Nitschke at JasonN@ZerotoFive.org.

DISCLAIMER: Staff at Montana Child Care Business Connect and Zero to Five Montana do not provide legal or tax advice. Please consult a qualified professional when making these types of decisions.

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Table 5.1 Comparison of business models in the United States

Topic	Individual (sole) proprietorship	Partnership	Limited liability company	Corporations: Subchapter S	Corporations: Subchapter C	Corporations: Cooperative (Subchapter T)
OWNERSHIP						
Who are the owners?	Individual proprietor	General and limited partners[2]	Usually two or more individuals, but can have one	Minimum of two individuals; maximum of 75	Stockholders (general public and other businesses)	User-members (can be other businesses); minimum of five members in Wisconsin
How is the business financed?	Owner investment and retained profit from operations	Partners' investment and retained profit from operations	Same as partnership	Sale of stock and retained profits	Sale of stock and retained profits	Sale of stock/shares to members and retained profits
How is ownership transferred?	Privately negotiated	Privately negotiated; current voting partners usually approve new partners	Privately negotiated; current voting partners usually approve new partners	Privately negotiated; may require corporate approval	Privately negotiated or publicly traded; if public, anyone with enough money can purchase stock	Usually highly restricted; transfers to other members not typical; new members subject to board approval
What is an individual owner's legal liability?	Unlimited	General = unlimited Limited partnerships = limited	Limited	Limited	Limited	Limited
BENEFITS						
Who receives profits?	Owner	Partners in proportion to investment or by agreement	Same as partnership	Stockholders in proportion to investment (stock)	Stockholders in proportion to investment (stock)	Members in proportion to their purchases or use of services (patronage)
What earnings are possible on invested capital?	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Limited by law in most states; usually at 8%.
Who benefits from equity appreciation?	Proprietor, realized upon sale of business	Partner, realized on sale of business	Partners, upon dissolution of LLC or sale of LLC interest	Investors, upon sale of stock	Investors, upon sale of stock	Equity does not appreciate (except with NGCs and then members benefit)

(continued)

Table 5.1 Comparison of business models in the United States, *continued*

Topic	Individual (sole) proprietorship	Partnership	Limited liability company	Corporations: Subchapter S	Corporations: Subchapter C	Corporations: Cooperative (Subchapter T)
BENEFITS, *continued*						
Who pays income taxes?	Owner at individual rates (pass-through taxation)[3]	Partners at individual rates (pass-through taxation)	Partners at individual rates (pass-through taxation), unless investor is a corporation, in which case corporate taxation applies	Individuals at individual rates (pass through taxation)	Corporation pays at corporate rate; stockholders pay at individual rates on dividends and capital gains (double taxation)	Co-op pays no corporate taxes on qualified patronage refund allocations to members (pass-through taxation), but does pay corporate taxes on unallocated net profits, net profits from nonmember business, and equity dividends; members pay individual income tax on cash and deferred patronage refunds and dividends
CONTROL						
Who votes?	Not applicable	Partners	Partners	Stockholders	Stockholders	Members
How are votes distributed?	Not applicable	Among partners in proportion to investment or by agreement	Same as partnership	Only one class of stock (common). One vote per share	One vote per share of common stock owned. May also issue preferred stock	One vote per member in most cases
Who establishes policy?	Owner	Partners	Partners	Board of directors elected by a majority vote of the owners	Board of directors elected by a majority vote of the owners	Board of directors elected by a majority vote of the owners
Who manages the business?	Owner or hired management	All partners or a general partner in the case of a limited partnership	All partners may participate in management or hired management	Board of directors or hired management	Hired management	Hired management

[1]Subchapter status reflects distinctions in the federal tax code.

[2]A limited partnership may have one or more general partners and one or more limited partners; limited partners are generally restricted from participating in management decisions.

[3]Pass-through taxation is also referred to as single taxation.

Chart of Entity Comparison

	Sole Proprietor	Partnership	C Corporation	S Corporation	LLC
Legal Status	Same entity as owner	Separate entity from owner	Separate entity from owner	Separate entity from owner	Separate entity from owner
Separate Taxable Entity from Owner	No	No	Yes	No	Depends on tax status as sole proprietorship, partnership, or corporation
Ease of Formation	Very easy	Partnership agreement is helpful	Articles of incorporation generally required	Articles of incorporation generally required	Articles of organization generally required
Management	Owner	May be divided among partners	Board of Directors	Board of Directors	Per articles of organization
Continuity of Life	Terminates with death of owner	Cessation of business; ceasing to operate as a partnership; sale or exchange of 50% or more of the profits and capital within a 12-month period; may terminate with death of partner if agreement specifies.	Continuous	Continuous	Per articles of organization
Number of Owners	One	Unlimited	Unlimited	100	Depends on tax status as sole proprietorship, partnership, or corporation
Eligible Owners	Individuals	Unlimited	Unlimited	Some limitations	Depends on tax status as sole proprietorship, partnership, or corporation
Owner Liability	Unlimited exposure	Unlimited if general partner; limited to investment if limited partner	Limited to investment, except for personal services	Limited to investment, except for personal services	Limited to investment, except for personal services
Transferability of Ownership	Only by sale of entire business or creation of a different entity	Can sell all or a portion of partnership interest	Can sell all or a portion of stock	Can sell all or a portion of stock	Per articles of organization; commonly has some limitations
Ability to Raise Capital	Limited to owners assets and borrowing ability	Limited to owners assets and borrowing abilities; can sell interests to raise capital	Limited to owners' contributions and corporation borrowing abilities; can sell interests to raise capital	Limited to owners' contributions and corporation borrowing abilities; can sell interests to raise capital	Limited to owners' contributions and LLC's borrowing abilities; can sell interests to raise capital

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	Sole Proprietor	Partnership	C Corporation	S Corporation	LLC
Ownership Rights	Total	Divided among partners	Divided among shareholders	Divided among shareholders	Divided among members
Tax Year	Same as owner	Majority interest rules; principal partner rules; or the least aggregate deferral of income rule; exceptions may be the business purpose of §444 election	Calendar or fiscal year	Calendar year; §444 election; or business purpose demonstrated	Depends on tax status as sole proprietorship, partnership, or corporation
Allocation of Income	100% to owner	Based on partnership agreement if it has substantial economic reality	100% to corporation	Normally pro-rata based on per share/per day rule	Depends on tax status as sole proprietorship, partnership, or corporation
Tax on Formation if in Control	No gain or loss	Gain to the extent debt relief exceed basis of property transferred	No gain if debt relief does not exceed basis of property transferred and no other assets received by transferee	No gain if debt relief does not exceed basis of property transferred and no other assets received by transferee	Depends on tax status as sole proprietorship, partnership, or corporation
Tax on Formation if Not in Control	Not applicable since always in control	Gain to the extent debt relief exceeds basis of property transferred	Gain or loss as if sold property transferred for the FMV of the stock received	Gain or loss as if sold property transferred for the FMV of the stock received	Depends on tax status as sole proprietorship, partnership, or corporation
Original Basis of Stock if Not in Control	Not applicable since always in control	Basis of property transferred less debt relief	FMV of stock received	FMV of stock received	Depends on tax status as sole proprietorship, partnership, or corporation
Basis Increases from Operations	Additional purchases or cash invested	Increased by profits, additional contributions, and increase in partner's share of debts	Increased by additional investments	Increased by profits and additional contributions	Depends on tax status as sole proprietorship, partnership, or corporation
Basis Decreases from Operations	Normal basis adjustments; depreciation, amortization, etc.	Decreased by losses, deductions, distributions, and decreases in partner's share of debts	Decreased by nontaxable return of capital, if any	Decreased by losses, deductions, and distributions	Depends on tax status as sole proprietorship, partnership, or corporation
Deductibility of Losses	Normal limitations, at-risk, passive	Passed through to partners, normal limitations apply, basis, at risk, passive	Stay at corporate level, not passed through to shareholders	Passed through to shareholders, normal limitations apply, basis, at risk, passive	Depends on tax status as sole proprietorship, partnership, or corporation
Nonliquidating Distributions	100% belongs to owner	Based on partnership agreement	Pro-rata among shares	Rights must be pro-rata among shares	Pro-rata among shares if a corporation; 100% if a sole proprietorship; or based on partnership agreement if a partnership

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	Sole Proprietor	Partnership	C Corporation	S Corporation	LLC
Liquidating Distributions - Owner Level	Not a separate entity; therefore all reported as part of owner's return	Gain if cash, debt forgiveness, and marketable securities exceed basis or if partner receives a disproportionate share of unrealized receivables	Sold stock for value of cash and property received	Sold stock for value of cash and property received	Depends on tax status as sole proprietorship, partnership, or corporation
Worthlessness of Investment	Already has written off or capitalized all investments; loss sale of assets if sold	Capital loss of remainder of basis	Capital loss of remainder of basis; may qualify for §1244 ordinary loss treatment	Capital loss of remainder of basis; may qualify for §1244 ordinary loss treatment	Depends on tax status as sole proprietorship, partnership, or corporation
Charitable Contributions	Generally 50% limitation	Generally 50% limitation at partner level	Generally 10% limitation	Generally 50% limitation at shareholder level	Depends on tax status as sole proprietorship, partnership, or corporation
Alternative Minimum Tax	Applies at individual level	Applies at partner level	Applies at corporate level	Applies at shareholder level	Depends on tax status as sole proprietorship, partnership, or corporation
Death - Basis Adjustments	Basis of assets is generally FMV on the date of death	Basis of partnership interest is generally FMV on the date of death; §754 election available at partnership level	Basis of stock is generally FMV on the date of death	Basis of stock is generally FMV on the date of death	Depends on tax status as sole proprietorship, partnership, or corporation
Self-employment Tax	Yes	Yes if general partner, generally no if limited partner	No, since payment for services is in the form of wages	No, since payment for services is in the form of wages	Depends on tax status as sole proprietorship, partnership, or corporation
Salaries Paid to Family Members	Exempt from FICA for wages paid to children of owner who are under the age of 18; spouse and parents exempt from FUTA	Exempt from FICA for wages paid to children of owner who are under the age of 18 only if all partners are parents of children	No exemption for any family member	No exemption for any family member	Depends on tax status as sole proprietorship, partnership, or corporation
Accounting Method	Any method that clearly reflects income	Any applicable method; cannot use cash method of partnership is a tax shelter or has a corporation as a partner	Any applicable method; cannot use cash if it's a tax shelter, required o use inventories, or has annual gross receipts over certain limits	Any applicable method; cannot use cash if it's a tax shelter, required o use inventories, or has annual gross receipts over certain limits	Depends on tax status as sole proprietorship, partnership, or corporation
Fringe Benefits - Entity Level	Most are nondeductible; may be able to deduct 100% of qualifying health insurance premiums	Most are nondeductible; partner may be able to deduct 100% of qualifying health insurance premiums	Most are deductible	Most are nondeductible; shareholder may be able to deduct 100% of qualifying health insurance premiums	Depends on tax status as sole proprietorship, partnership, or corporation

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	Sole Proprietor	Partnership	C Corporation	S Corporation	LLC
Fringe Benefits - Owner Level	See box above	See box above	Most are tax free	Most are taxable, although may be exempt from FICA if they are nondiscriminatory	Depends on tax status as sole proprietorship, partnership, or corporation
Capital Losses	Deductible by the owner up to capital gains plus $3,000; excess is carried over until death	Passed through to partners with normal limitations applying at partner level	Allowed only to the extent of capital gains. Any net capital loss for the year is carried back three tax years as short-term capital loss then forward five years	Passed through to shareholders with normal limitations applying at shareholder level	Depends on tax status as sole proprietorship, partnership, or corporation
Income Characterization	Treatment depends on income; ordinary income, capital gains/losses, investment income, passive, etc.	Passed through to partners; character is the same as if partner received it directly	Dividend income when reported to shareholder	Passed through to shareholders, character is the same as if shareholder received it directly	Depends on tax status as sole proprietorship, partnership, or corporation
Exempt Income (i.e., municipal bond interest)	Exempt	Passed through to partners; retains character as exempt	Remains exempt for income tax, may be subject to AMT	Passed through to shareholders; retains character as exempt	Depends on tax status as sole proprietorship, partnership, or corporation
Retirement Plans	Any retirement plan, including SEPs, SIMPLEs, Keoghs, solo-401(k)	Any retirement plan, including SEPs, SIMPLEs, Keoghs, 401(k); must be established at partnership level; contributions passed through to partner and deductible by partner	Any retirement plan except Keogh; deductible at corporate level	Any retirement plan except Keogh; deductible at corporate level; must be established at S corporation level	Depends on tax status as sole proprietorship, partnership, or corporation

Note: This chart is intended for informational purposes only and may not include all aspects of tax law. When choosing a business entity, extreme care must be taken to ensure all federal and state laws are being followed.

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