

## Should I Incorporate my Child Care Business?

Learn how to decide what business structure is best for your business and understand your options for incorporation.

### Introduction

When deciding which type of business structure is right for your child care business, you may have many questions. Determining what is best depends on many factors, including your business size, whether you intend to have any employees, and what your financial situation looks like at this time. To help you decide, this guide will walk you through the differences between a sole proprietorship and a corporation and highlight the pros and cons of each structure. Additionally, we will help you to understand the various corporation types that exist and what business structures are most common in child care.

### What is a Sole Proprietorship?

A sole proprietorship is one of the most basic business types. It is also the most inexpensive and simple way to start a business. All that is needed to establish a sole proprietorship is for the single business owner to obtain the necessary licenses and permits. After that, you can start doing business without any additional steps required. Owners of sole proprietorships are considered to be self-employed.

#### **Sole Proprietorship: Tax Identification Number**

Most sole proprietors use their own social security number as the tax identification number for the business. This is a quick and simple way to get your business up and running without having to do any additional paperwork. However, it is recommended you get an Employer Identification Number (EIN) from the Internal Revenue Service. This number functions like a social security number for your business but is an identification number issued by the IRS specifically for your business. The advantage of an EIN is that it will limit the number of documents with your social security number on them, which can help you to keep your personal identification number safe and prevent it from being misused. Further, a sole proprietor must get an EIN if they wish to hire employees and if they want to open a business bank account so having one will prepare you for these potential future steps.

### Sole Proprietorship: Business Name

A sole proprietorship is set up with the owner's full legal name as the business name but you can also establish a "doing business as" (DBA) to use in your operations. This is a name your sole proprietorship can use publicly and is typically set up through your local government. For example, you may have a sole proprietorship using your own name but also use the DBA name "Happy Bear Child Care" in your marketing materials, signs, and other pieces associated with your child care business. Setting up a DBA can simplify how you do your business banking and can allow you to accept payments both to your legal name and to your DBA name. Additionally, creating a DBA can help you to define your business brand which can be useful in your marketing approach.

### Sole Proprietorship: Taxation

Regarding profits, a sole proprietorship is considered a "pass-through" business. That means that the profit from your business, or the money that remains after you pay all your expenses, is included on the Schedule C of your 1040 and will "pass-through" to your personal tax return as your income. Business owners who have a profit on line 31 of their Schedule C are taxed at the self-employment rate of 15.3% and then by their personal income tax rate.

**It's important to remember that as a sole proprietor, you are the business, and the business is you. This means that in terms of taxes and liability, there is no separation between the sole proprietorship and the business owner.** For example, if you have business debt, your personal assets are not protected and they can be legally seized if you were to default on a loan. On the positive side, a sole proprietorship is inexpensive to start and maintain each year, and you have full control over all business decisions.

### Partnerships

A partnership is a business where two or more individuals share ownership. Each person contributes equally in terms of the investments of the business but also shares the profits and losses of the organization in the same way. Because of the nature of the partnership involving shared governance, typically there are very explicit processes to address how to resolve disputes, share profits, and change ownership. Partnerships are usually inexpensive to set up, but they also have shared liability and governance. Like a sole proprietorship, the partners "are" the business- that is the partners are responsible for debt and liabilities.

### Partnership: Taxation

Partnerships are taxed in ways that are similar to a sole proprietorship. They are a "pass-through" business where all profits flow onto the partners' personal taxes, but instead of a Schedule C it comes from a partnership K-1 form.

## What is a corporation?

A corporation is a business that has been incorporated resulting in a separate “corpus,” or body. Where a sole proprietorship is not separate from the business owner in terms of taxes, liability, and debt, a corporation is a legal entity that is separated from you as the owner. There are undoubtedly benefits to this legal separation between business and business owner, though this comes with some additional effort (such as annual filings and a separate tax return) that is needed in setting up the corporation and maintaining it. In terms of liability, your personal property and money are usually protected from outstanding debts of the corporation. In terms of taxes, some corporate structures, like those for the S corporation or nonprofit corporations can provide some tax advantages, which will be discussed in the following section.

## What are the types of corporations?

There are four corporation types that you will most likely consider:

- Nonprofit Corporations
- C Corporations
- S Corporations
- LLCs – Limited Liability Companies

### Nonprofit Corporations

Nonprofit corporations are “charities,” public-serving companies that are not owned by an individual. Instead, they have a board of directors, who are typically not employees, that lead the organization. Nonprofits can be difficult to manage day by day since the director of the corporation will need approval from the board of directors to make key decisions. Additionally, since the organization is not supposed to be operating for the generation of profit, there are several rules about how money must be spent. On the positive side, nonprofits are typically exempt from most federal, state, and local taxes and may be eligible for some government and foundation grants.

The remaining corporation types are **for-profits**, meaning that they are “owned” by people or other corporations and are intended to provide profit for those owners. A sole proprietorship would also be considered for-profit.

### C Corporations

Most of the large companies you see and hear about are C corporations. The C corporation is owned by shareholders. This structure is easier for large enterprises since it allows ownership to be transferred through shares. They are also the most complex in terms of their legal requirements and the most expensive to run in terms of administrative fees and taxes. They also suffer from “double taxation,” that is, the profit from the company is taxed at a corporate rate and then the owners need to pay additional income taxes on it. For most child care businesses,

the additional efforts of a C corporation in terms of paperwork and taxes will likely outweigh the benefits.

## S Corporations

In reaction to the complexities of owning a C corporation, the federal government created a small-business version, called an S corporation. The S corporation is a separate legal entity from you personally (like a C corporation) but is limited in the number of owners. Like a sole proprietorship, the S corporation is a “pass-through” entity, which means that any profit you take out of an S corporation flows into your personal taxes, so it is usually a less complex structure to manage throughout the year and at tax time. The structure also means that the corporation itself is not receiving profits (they flow to your personal taxes); therefore, you typically are not subject to corporate taxation in addition to income taxes.

As an S corporation, you can also pay yourself a reasonable salary as a W-2 employee (which does get taxed as wages) but then any profit above this salary is only subject to income tax (saving you 15.3% in taxes). For example, let’s say you made \$50,000 as a sole proprietor and you are in the 22% income tax bracket. That profit would be taxed at a self-employment rate of 15.3% (\$7,650) and then at the income tax rate of 22% (11,000) for a total tax of \$18,650.

Now, let’s say the same business owner had an S corporation. She determined her reasonable salary was 40% of her income, so \$20,000 will be W-2 income and the remaining \$30,000 will be profit. The \$20,000 will be taxed at the same rate as self-employment, 15.3% (for a total of \$3,060) and then as income at 22% (\$4,400). The other \$30,000 is considered “ordinary income” and only taxed at the 22% rate (\$6,600). The S corporation business owner pays a total of \$14,060, saving \$4,590 compared to the sole proprietor.

## LLCs – Limited Liability Companies

We saved the most typical company classification for last – the limited liability company, or LLC. LLCs usually offer small business owners the greatest ease at start-up, flexibility, and ownership. LLCs can be owned by one or more individuals and are governed first and foremost by your state. This means that they are a state-level corporation, not a federal one. For your federal taxes, you need to let the IRS know how you want to be taxed. That means when you start the LLC, and again each year, you can “choose” which type of corporation you want to be treated as for tax purposes. Note that typically you can only change their election once every five years.

This means that when you begin your business, you can start being taxed the same way as a sole proprietorship when your business is small. As you begin to grow, you can elect to be treated as an S corporation or C corporation. In addition

to having some flexibility around taxation, LLCs typically also cost less to start up and maintain with the state.

Regardless of the type of corporation you are taxed as, with an LLC your personal assets are protected in the same manner as any corporation.

## What type of business structure should I choose?

Generally, child care business owners set up their businesses as sole proprietorships, LLCs, or S corporations, as these tend to be the best fit in the child care industry. So which one is best for your business? The answer depends greatly on the specific circumstances of your business and your current financial situation. However, we can talk broadly about the benefits of each structure.

If you are just starting or are short on revenue and/or time, a sole proprietorship can be a good choice for structure.

However, if you have some time and some degree of cash reserves, forming an LLC can start to give you some benefits, even if you just do it as a single-member LLC, or an LLC that files as a sole proprietorship for tax purposes. Starting up an LLC can be relatively inexpensive (typically under \$1,000 and many people do it themselves for less), as well as to maintain (annual filing fees range from nothing to \$500). In exchange for that investment, you gain additional liability protection – this means that your company, not you personally, would be primarily liable for any adverse actions, such as a lawsuit.

Forming an S corporation can be more costly and time-consuming, and includes the need to file a corporate tax return. However, there can be additional benefits beyond liability protection. For example, an S corporation owner can pay themselves a “reasonable wage” (that is taxed as normal wages) and then treat money above that as a distribution (that is profit) which is taxed as income. The result is a lower tax bill in many cases. The IRS doesn’t define a specific number for “reasonable wages,” but it should match similar pay in your area using job postings or similar sources.

As a rule of thumb, you need to be able to have \$15,000 or more in profit to make the additional costs of an S corporation worthwhile. For example, let’s say you make \$55,000 a year as a sole proprietor, and you become an S corporation. If you find that a reasonable wage is \$22,000 that means the remaining \$33,000 will be a distribution and taxed at your regular income tax rate, saving you the expense of employment or self-employment taxes.

In the example above, the person receiving \$55,000 in income as a sole proprietor would pay around \$20,245 in self-employment and income taxes. However, in the second scenario, having \$22,000 in income and \$33,000 in a distribution they would pay around \$15,466, a savings of \$4,779.

We also want to note you can keep your costs lower with an S corporation by creating an LLC and declaring it as an S corporation for tax purposes. As you know, LLCs have the option to declare how they will be treated come tax time. Since S corporations can pay the owner a

reasonable wage (taxed as normal wages) and then treat profit as a distribution (taxed as a capital gain at your regular income tax rate), this option provides benefits at tax time. Additionally, the creation of an S corporation can be time-consuming and costly, so creating an LLC that declares as an S corporation can give you similar benefits at a lower cost.

### **LLCs are not set in stone.**

One other advantage of an LLC is that you can change how it is treated under tax law. Put simply an LLC that is a single member can later elect to be treated as a C or S corporation and after that can go back to being a single member. To change how your LLC is treated you need to file a Form 2553 with the IRS by March 15 of the given year.

### **What do I do if I need help?**

#### **Contact Our Child Care Team:**

For questions, email [azchildcare@lisc.org](mailto:azchildcare@lisc.org) or leave a message on our help line: (602) 252-6315. A member of our child care team will get back to you as soon as possible.

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