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Entrepreneur

The Skinny on Sole Proprietorships

Protect yourself from the IRS and make your patchwork projects a real business.

By Lydia Dishman | March 15, 2010

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Let's get one thing straight right away: Whether it's a sideline gig or a full-time consulting concern, if you're providing goods or services in exchange for payment, you are running a business. If you started the enterprise yourself--no matter what the reason, or whether you operate from a corner of your bedroom--that makes you an entrepreneur. While you giggle or shake your head at being lumped in with the likes of Oprah Winfrey and Bill Gates, start getting used to the idea that you're part of a business revolution. The [U.S. Census estimates](#) that 10.4 million people are self-employed. That's more than a micro-trend; it's an economic force to be reckoned with.

However, many individuals, especially in this last year of mass layoffs, have put off doing the paperwork required to become a full-fledged enterprise in favor of waiting to "get a real job." In the meantime, patching together project work or pursuing a passion there just wasn't time for while "working for the man" is generating income. Once that begins, no matter how much is on the balance sheet, the IRS can come knocking. So it's best to make things legit.



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Sole Proprietor Startup 101

A sole proprietorship is a business structure owned by one person (and sometimes his or her spouse) that isn't registered with the state as a corporation or a limited liability company (LLC). Says Jason Deshayes, an Albuquerque-based CPA, "Sole proprietorships are easy to set up and require very little legal work, outside of a business license."

Registering your business to comply with any license or permit laws can be as simple as calling your local City Hall and asking how to obtain a business license. It will cost you, and the rates vary based on your municipality's schedule. Once you register, you'll get a Tax ID number. That's helpful for client invoicing--so you don't have to sling your Social Security number around.

Take Care of the Tax Man

Once you've got your license, turn your thoughts to bookkeeping. Kristen Fischer, author of [Creatively Self-Employed](#), says engaging an accountant at this early stage of the game can put you on the road to setting up organized systems to track income and expenses.

"Even if you don't use an accountant in the future, spend the extra money [upfront] and use that person as a resource. Find out what you can deduct and depreciate."

Scott Estill, author of [Tax This! An Insider's Guide to Standing Up to the IRS](#), points out that the U.S. tax code offers numerous deductions for small businesses, such as expenses related to a home office, travel, meals, entertainment, computers, cell phones, and other business items. "The only requirement to qualify as a business is to have a profit motive (as opposed to a hobby, in which profit is not a primary consideration). Estill also notes that a sole proprietor is not required to make any estimated quarterly tax payments until an actual net profit is earned.

"For many small businesses, this will not happen until the second year at the earliest," says Estill. This is because of the operational costs it may take to start. However, once the business is profitable, Estill says a sole proprietors should consult with a tax advisor and make quarterly payments to avoid what could amount to substantial penalties.

Once the systems are in place, Estill says there are plenty of software programs that can help manage bookkeeping. QuickBooks is a good example of a program that offers a range of features from profit-and-loss reports to detailed expense records.

Potential Pitfalls

Though there are tax benefits to being a sole proprietor (no employees = no payroll tax--huzzah!), you are personally liable if a legal situation arises. This is especially important for those providing services like construction and financial consulting.

"If you are dealing with individuals' money that is typically invested in the stock market, this tends to be a very sensitive [and

potentially litigious] issue," says Robert Fuest, principal of [LandorFuest Capital Management](#). "You must understand all of your risks."

Those risks go beyond just upsetting a client. For instance, a default on a debt or other payment can result in a creditor legally coming after your personal property and assets or other possessions.

Fuest advises new business owners to look at their entire financial situation and take into account any plans to grow and include partners and employees. "The LLC offers more flexibility when it comes to operating and more personal protection," says Fuest.

Best Practices

Once your sole proprietorship is up and running, Fischer recommends treating your business like a business, something that those who freelance from a home office would do well to remember. "Be professional at all times and make time for things like marketing and networking."

This includes everything from having professional-looking materials (business cards, letterhead, invoices, etc.), to answering the phone properly and dressing appropriately. Deshayes says this can go a long way toward impressing clients and making them comfortable giving you work.

When purchasing these materials, Deshayes says it's important to keep personal money and business funds separate. "Keep your books clean and avoid comingling funds, which could open you up to legal liability."

Room to Grow

Though there is no mandatory income threshold, Estill uses a guideline of around \$50,000 per year gross as a starting point to consider converting a sole proprietorship to an S corporation (assuming they are not at risk for liabilities--then, forming an LLC would make more sense).

Estill says the primary tax benefit of an S corporation is that the owner controls the payment of employment taxes (via a declaration of salaries or wages). In a sole proprietorship, all net profits are taxed at the self-employment rate, which is currently 15.3 percent on the first \$106,800 of net business income.

That rate remains the same for either structure, but the business owner can save some money with the S corporation. They may draw a salary (let's say half of what they'd declare as net income on a sole proprietorship) and pay the 15.3 percent on that. "The rest of the income flows to your personal tax return on a Schedule K-1, which ends up being subject only to income taxes," observes Deshayes.

There are costs associated with setting up an S corporation, including filing fees and corporate taxes, but Estill says, "The S

corporation can be set up in any of the 50 states with only one shareholder, so it is an ideal business entity for a single-person venture."

Fuest advises looking before you leap, no matter what the structure. "The laws always change, and depending on the size of the business, you could be at an advantage one year and a disadvantage the next. It really comes down to your personal plans for growth."