Eighth edition

Legal Guide for Starting & Running a Small Business

by Attorney Fred S. Steingold

edited by Ilona Bray

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Starting and running a small business—one that's both profitable and emotionally satisfying—is a dream that you share with millions of other Americans. Being an entrepreneur offers rewards of many sorts: the opportunity to spread your wings and use your natural talents, the freedom of being your own boss, the possibility of huge financial success, and more. And in an era when job security is a relic of a bygone era, owning a business means you never have to worry about being fired or outsourced.

Of course, nothing this exciting ever comes without risk. Demographic changes, recessions, changing tastes and styles, new technologies—any of these factors can challenge even the most astute and experienced businessperson. There's no guarantee that any venture will succeed. But the positive side of being self-employed often outweighs the potential risks. That's especially true if you have confidence in your own judgment and abilities. You stand to earn more money than you ever have before—and to achieve a high level of self-fulfillment. In a November 2004 *Wall Street Journal* survey, 86% of small business owners said they'd do it all over again, and 76% said they believe they're better off financially than if they'd worked for another company.

What's more, the existence of risk doesn't mean you're helpless in the hands of the fates. You can greatly increase the chances of success by working hard and planning carefully. In particular, knowing how the law affects your business can help you avoid many costly risks. More and more, the law affects every aspect of a small business operation, from relationships with landlords, customers, and suppliers to dealings with governmental agencies over taxes, licenses, and zoning. That's where this book comes in.

For starters, this book will help you take key preventive measures that will dramatically cut the number of expensive visits you'd otherwise make to a lawyer's office. You'll know exactly where you may be vulnerable to lawsuits so you can wisely take steps to reduce the risks. And you'll know when it makes sense to call in a lawyer or a tax pro for special assistance so that small problems don't turn into huge ones.

This book uses plain English to cover all the major legal issues that a business is likely to face, including:

- Will I be personally liable for business debts?
- How is business income taxed?
- Does it make sense for me to form a corporation? How about an LLC?
- How can I protect my business name?
- Do I need a license or permit?
- What forms do I need to file with the IRS?
- How do I raise money for my business?
- What are the steps in buying an existing business?
- Is buying a franchise a good idea?
- What kind of insurance should I carry?
- How do I negotiate a lease?
- Will zoning affect my home-based business?
- What's the best way to avoid being sued by employees—or former employees?

This book provides easy-to-follow answers to these and dozens of other legal questions so that you can spend your time on what really counts: running a sound and successful business.

A. Is This Book for You?

This book focuses on starting and running a *small* business. Though much of what you learn here will also apply to larger enterprises, this book definitely is not concerned with the sorts of businesses that make headlines in *The Wall Street Journal*. We're focused on readers who fit this profile:

- You're looking to start (or buy) a small retail, service, or manufacturing business—for example, a restaurant or bakery, a dry cleaning establishment, a crafts gallery, an electrical contracting firm, or a modest manufacturing operation.

- You anticipate owning the business yourself, or with one, two, or a handful of other people.
- You'd consider setting up a corporation or LLC if doing so would be legally advantageous.
- You plan to play an active role in running the business—and perhaps even expect that it will provide your main source of income.

Does this sound like you? If it does, then this book has exactly the information you need to take the right legal steps and guard against lawsuits and other unexpected consequences.

B. How This Book Will Help

This book guides you through the many legal concepts and procedures that affect a small business. Here's a preview of what lies ahead.

1. Choosing the Best Legal Entity (Chapters 1 Through 5)

We start with the pros and cons of the types of legal entities used by small businesses—the sole proprietorship, the partnership, the limited liability company (LLC), and the corporation. You'll learn how each type of entity treats your personal liability for business debts. For example, can business creditors or lawsuit plaintiffs seize your house and personal bank accounts if the business falls on hard times? And you'll learn just how each entity gets taxed. For tax reasons, you may decide you'd prefer to have an S corporation rather a C corporation. (If these terms seem like a foreign language to you, don't worry. We'll get to them soon.)

Once you understand the differences between the basic legal entities, and have chosen one for your business, you'll go to a chapter that tells you how to create the entity—the documents you need to prepare and sign and, in some cases, register with a government agency. And if you decide to form a corporation or LLC, you'll find time-tested tips for using the entity to the maximum extent possible to shield your home and other personal assets from business creditors.

If you aren't the only owner of your business, be sure to spend time with Chapter 5, which explains how to lay the groundwork for ownership changes with what's called a "buy-sell agreement."

2. Choosing Your Business and Product Names Wisely (Chapter 6)

You may already have a clever name for your business or product in mind. But don't start using it until you're sure you won't step on the toes of existing businesses. This chapter will explain how to research whether other businesses are using the names you're considering, register and protect the names you choose, obtain an Internet address (URL), and more.

3. Obtaining License and Permits (Chapter 7)

Chances are good that your business needs some sort of license or operating permit, whether from your federal, state, regional, county, or city government. Chapter 7 will alert you to types of businesses or activities that normally need licenses or permits, and explain where to go for details.

4. Meeting the IRS Rules (Chapter 8)

If the only tax return you've ever filed is the familiar Form 1040, you're nowhere near prepared for the complexities of business taxes. But with the help of this book, the task should be easier than you'd expect. You'll learn how to apply for an Employer Identification Number (which your business may need even if it doesn't have employees at first).

You'll find out, too, whether your business must pay income tax to the IRS, or whether you and any other business owners will personally bear the tax burden. In either case, you'll discover which tax forms to file and why. And since business deductions are always a good thing—they reduce the bottom line on which taxes are computed—you'll appreciate learning the ins and outs of deductions and depreciation.

Maybe you've never been audited before—but your luck may run out if you own a small business. The IRS views small businesses as an attractive audit target. So you'll find it comforting to learn how to deal with the IRS if your business does get audited. Knowing what to expect can reduce your anxiety and help you successfully complete the audit process.

5. Raising Money for Your Business (Chapter 9)

We'll cover in detail the two main ways to get money for setting up or expanding your business: loans and equity financing. (Most entrepreneurs prefer, if possible, to take out loans, so they can keep the business ownership all to themselves; equity financing involves shared ownership.) You'll find out where to look for money and how to create legal safeguards so that your interests are adequately protected. And you'll also learn about the protections that lenders and investors might seek for themselves.

Finally, if you think a bank is the only place to get money, you'll be pleased to discover that a number of other excellent sources are available. This is especially important for first-time business owners, given that banks are understandably reluctant to lend money to would-be entrepreneurs with no track record.

6. Alternatives to Starting From Scratch (Chapters 10 and 11)

While this book discusses many aspects of starting a business from scratch, we haven't forgotten that it's not the only way to go. Other options include buying an existing business or buying a franchise.

Buying an existing business is often an attractive choice because someone else has done the hard startup work. And the business has a financial history—you can tell whether it's has been successful so far. If so, you can be reasonably sure that it will continue to be profitable. But you may have to pay more for an existing business, since the seller will want to be rewarded for taking the startup risks.

Buying a franchise can also be tempting—but, as Chapter 11 will explain, you'll need to be aware of many hidden problems. You'll probably be asked to sign a long-term contract with terms that heavily favor the franchisor. Of course, it's true that once in business, you'll get the benefit of the franchisor's advertising and brand name. But offsetting this advantage, you'll be locked into a more-or-less rigid format for running the business—something that a freedom-loving entrepreneur may balk at.

7. Buying Business Insurance (Chapter 12)

Avoiding risk is a major theme of this book—and when it comes to the biggest risks, such as fire, injured customers, or lawsuits stemming from your own negligence, having an insurance policy in place can save you a bundle. On the other hand, you don't need to go hog wild buying insurance policies. This chapter will help you evaluate what insurance you do and don't need, and how to go about getting it at a reasonable price.

8. Finding Space for Your Business (Chapters 13 and 14)

Unless you sit in a coffee shop and conduct a Web-based business from your laptop, you'll probably have to think about where to locate your business. Chapter 13 discusses renting business space. You'll learn how to read the landlord's lease form and negotiate for more favorable terms. You'll be better prepared to avoid hidden costs and arbitrary actions by a landlord.

Chapter 14 discusses the ins and outs of running a business out of your own home. You'll find out how to comply with zoning ordinances, and see how the tax laws let you deduct some repair, utility, and other expenses associated with your home.

9. Hiring and Managing Employees (Chapter 15)

Even if you start out running the business yourself, sooner or later you'll probably need to hire employees. This can be one of the most legally challenging tasks you'll face. Federal and state laws regulate almost every aspect of the employment relationship. You'll need to know about wages and overtime pay, workers compensation, immigration law requirements, and numerous antidiscrimination laws such the Americans with Disabilities Act.

Even if you do everything right, you may eventually have to fire an employee. Termination can be a very delicate matter if you wish to avoid being sued for wrongful discharge. The information in this book will introduce you to safe hiring and firing practices so that you'll sleep better at night.

10. Dealing With Customers (Chapters 16 Through 19)

There's nothing so joyful as watching your first customers walk in the door. And there's nothing so frustrating and frightening as having them fail to pay their bills, sue you out of disgruntlement with your products or services, or complain about you to all their friends. Fortunately, many of these issues can be avoided—or at least prepared for—by developing customer policies that are friendly as well as legally sound. Chapters 16 through 19 will help you do this, with explanations of such issues as advertising, warranties, accepting payment by different methods, and extending credit.

11. Entering Into Contracts (Chapter 20)

Whether you're making agreements with customers or other businesses, chances are you'll want to commit some of these to writing. In this chapter, you'll learn what makes a valid contract, how to write a contract that will hold up legally, and when you can sue someone for breaching your contract.

12. When Trouble Comes (Chapters 21 Through 24)

Despite your best efforts, your business may run into financial trouble. Chapter 21 will help you turn your financially troubled business around, and if that's impossible, sell or close your business. Chapter 22 will teach you how to use tools like mediation or the court system to resolve legal disputes. Because many business disputes involve only a few thousand dollars (not enough to hire a lawyer for) we devote all of Chapter 23 to representing yourself in small claims court. However, if you do need a lawyer, see Chapter 24 on how to find the right one and make the most of your relationship.

C. Nonlegal Matters to Attend To

Dealing effectively with legal matters—the focus of this book—is a key component of running a successful business. But before you start a business or buy one, there are also a number of important practical and financial matters that need your attention. Here, we'll briefly review the most important ones, and direct you to other relevant resources for help.

1. Choose the Right Business for You

Your business should have a solid chance at turning a profit—but it should also suit your particular skills and strengths. It helps to start or buy a business that you know intimately—one that matches your experience, training, talents, and, hopefully, your passions. To put it bluntly, don't open a garden-supply shop unless you have a green thumb and are up to date on the state of the art in gardening products.

Still Tempted to Sell Something You Know Nothing About?

You wouldn't be the first businessperson to attempt a stretch beyond your own knowledge base. Many people have been lured by watching others make quick profits at say, "the latest thing." And some folks have plunged ahead rashly after waking up with a "million-dollar" idea or just a yen to do something new and unusual. You'll see headlines about the people who make it—but these obscure the stories of the thousands of enthusiastic but unprepared dreamers whose businesses crashed and burned.

If you're still inclined to leap into largely unknown territory, at least take steps to expand your knowledge before you proceed. Your best bet is often to become an employee in a similar business—even for free, if no one will pay a novice like you. From that insider's position, you stand to learn about every aspect of the business. And you'll soon find out whether you enjoy that line of work. If not, move on to something else.

Assuming you're thinking of making a business out of something you know and love, the next step is to talk to others in the industry to learn what it takes to run that kind of business. Learn all you can about startup costs, overhead and expenses, and how much revenue you can expect to take in. Maybe you have several interests and are not sure which business would work out the best. You can research the marketplace to see which types of businesses are most needed in your community.

Judge your ability and desire to handle every aspect of the business. If you want to become the millionaire next door, you have to be willing and able to handle many diverse chores—such as dealing with customers, keeping the books, and even flipping the burgers when your employees are out sick. Although employees can ordinarily handle many of the day-to-day operations, you may have to personally pitch in more often than you might imagine. If this is a turnoff, another business may suit you better.

Some businesses require extra caution. For example, there are inherent risks in businesses that use hazardous materials, make edible goods, care for children, sell alcohol, or build or repair buildings or vehicles. But you can usually reduce the risks to manageable proportions by forming a corporation or LLC, and by carrying adequate liability insurance.

2. Do a Break-Even Analysis

No one can tell for sure whether a particular business idea will be profitable. You can, however, make an informed judgment by doing what's called a "break-even analysis." This shows you how much money you'll need to bring in to cover your expenses, even before you make a dime of profit. You don't want to start or buy a business unless you're reasonably sure that sales will far exceed your costs of doing business.

To perform a break-even analysis, you'll have to make educated guesses about your expenses and revenues. This requires some preliminary research. To make the job easier, take advantage of business planning books and software, as well as the free Web resources listed below.

Here are the most important facts and figures you'll need to assemble for your break-even analysis:

- **Fixed costs.** These costs—sometimes called "overhead"—stay pretty much the same from month to month. They include rent, insurance, utilities, and other expenses that must be paid regardless of how much you produce or sell. Be sure to add another 10% to cover unexpected fluctuations in these costs, such as a boost in insurance premiums or the price of natural gas to heat your business premises.
- **Sales revenue.** This is the total amount the business brings in each month or year. Be realistic in figuring the volume of business you can expect. You'll need to specifically identify your customer base, then do some demographic research to find out how many people who fit that profile you can expect to reach and attract.
- **Average gross profit for each sale.** This is how much you earn from each sale after paying the direct costs of the sale. For example, if you pay an average of $200 for each bicycle that you sell at an average price tag of $300, your average gross profit per sale is $100.
- **Average gross profit percentage.** This tells you how much of each dollar of sales income is gross profit. You divide your average gross profit (from above) by the average selling price. In the bicycle example, the gross profit percentage is 66.7% ($200 divided by $300).

Now you're ready to figure out the break-even point. Divide your estimated fixed costs total by your gross profit percentage. This tells you the amount of sales revenue you'll need to bring in just to break even. For example, if your fixed costs are $6,000 a month and your expected profit margin is 66.7%, your break-even point is $9,000 in sales revenue per month ($6,000 divided by .667). This means you must make take in $9,000 each month just to pay your fixed costs and your direct (product) costs. At the break-even point, there's no salary or profit for you.

If your break-even point is higher than your expected revenues, you'll need to figure out whether you can change your plan to make the numbers work better. For example, can you: Find a less expensive source of supplies? Do without an employee? Save rent by doing business out of your home? Sell your product or service at a higher price?

If you can work out a realistic break-even point that gives you reasonable assurance of earning a decent profit, you can move ahead with a more detailed business plan. Otherwise, you'll need to come up with a different business idea.

Want more information on researching and developing your break-even analysis? Check the following Websites:

- *www.businessknowhow.com/startup/break-even.htm*
- *www.toolkit.cch.com/text/P06_7530.asp*
- *www.businesstown.com/accounting/projections-breakeven.asp.*

3. Consider Writing a Business Plan

You may find it useful to capture your thinking about your business in a written business plan. If you need to raise money to start your business, a written plan will make it easier to explain your vision to lenders or investors. And even if you already have enough seed money, a written business plan can be a good idea. Putting your thoughts down on paper can help you fine tune your concept and spot any trouble areas.

Many excellent books are available to guide you, including *How to Write a Business Plan*, by Mike McKeever (Nolo), and *The Successful Business Plan: Secrets and Strategies*, by Rhonda Abrams (The Planning Shop). For software, *Business Plan Pro*, by Palo Alto software, comes very highly rated. Also, several websites offer practical suggestions and provide sample plans. You might start with the U.S. Small Business Administration site at www.sba.gov/starting_business/planning/writingplan.html, where you'll find advice and, through a link, can review dozens of real business plans.

But whatever source you turn to for ideas for writing a business plan, keep in mind that a short, simple plan is usually better than a long, complex one—especially for a small business that's just starting out. Formality can get in the way. One good approach to the task is to imagine that you're sitting across a table from a friend and want to take a few minutes to explain your business idea. What are the key things you'd say? What kind of language would you use? Try to capture that clear, conversational tone in your written plan.

There are many ways to organize your business plan. But however you decide you do it, you'll probably want to cover four main areas.

a. A Description of Your Business

Start with the business name and your Internet domain name, if you already have one. Then specify the products and services you plan to sell, and tell how your business will meet the needs of customers and clients. You can also describe where your business will be physically located—in rented, downtown space, for example, or in your home. It's also important to analyze the competition you'll face and why you think your business will survive and thrive despite it. This part of the plan is also the place to describe any demographic, economic, and industry trends that you believe will help the business get off to a good start.

b. Your Marketing Program

Here, you can set down your thoughts on who your customers and clients will be, and how they'll learn about your new business and be motivated to give it a try. First, you'll need to develop a profile of your typical customer. For example, if you're planning to start a self-storage facility, your customers may be apartment dwellers from nearby apartment complexes who lack sufficient closet space. Or if you're starting a landscaping service, your target clients may be people who are buying homes in new, suburban subdivisions. Once you have a good notion of the kind of customers you'd like to reach, think about the methods you'll use.

It's said that word of mouth is the best way for a business to build a loyal following, but that takes time. With a brand-new business, you'll have to prime the pump. There are lots of ways you might do this. Traditional advertising in newspapers and on radio or television is just the tip of the iceberg.

Among other things, you might consider newsletters; direct mail; a website linked to high-traffic sites; trade show exhibits; billboards; the Yellow Pages; discount coupons; event sponsorship; free classes; telemarketing; and favorable press reports. Many businesses use the sides of their vans and trucks to capture people's attention. (For more on advertising and marketing, see Chapters 16 and 17.)

c. How You'll Operate the Business

A key concern here is the competence of those who will be running the business. Be sure to include your own qualifications and those of any co-owners and managers in any plan that you'll be showing to others. List past business experience and any employment or training that's relevant to your new business. If a small business is organized as a corporation, then most likely the owners will be the board of directors. But if you'll have some outsiders serving on the board, you can name them here and give their qualifications. And consider naming your professional team—a lawyer and accountant whom you may consult from time to time.

You might also mention the number of employees—full-time and part-time—you expect to hire at the beginning, and give some idea of what their jobs will consist of. If you'll rely on independent contractors for some work, you can spell out their duties.

In addition to describing the business's workforce, it's often worth describing other aspects of your business operations, such as any special equipment you'll be using and your arrangements with suppliers. You might also describe any improvements you'll be making to the premises the business will occupy—usually rented space for a new business. If you already have some contracts lined up with customers or clients, that's great because you have a running head start. It makes sense to mention these in your business plan.

For many businesses, order fulfillment and customer service play a major role. Your business plan can explain how your business intends to handle these functions—hopefully in a way that will keep customers happy and coming back for more.

d. The Financial Highlights

Here, you should list your fixed costs and your estimates for other costs, and how much you'll need in startup funds—that is, funds to buy needed equipment, supplies, and inventory, with enough cash left in the till to cover other bills until adequate money starts rolling in (which may take several months). Explain where the startup funds will come from: your own funds on hand, or loans or cash from investors. Be sure to include your break-even analysis, too (see Section 2, above).

Probably the most difficult part of the financial highlights portion of your business plan will be your projections for gross income for the first three years. When you start a business from scratch, this is a largely unknown number. At best you'll be making a rough approximation. It's better to estimate on the low side and be pleasantly surprised if the income exceeds your expectations. If you estimate too high and it turns out there's not enough income to meet expenses, the business will struggle to stay alive and may ultimately fail. To be as accurate as possible in projecting revenues, you'll need to rely on your business acumen, information from multiple industry sources, and perhaps input from an accountant or other business consultant. With careful preparation, you can significantly reduce the risk that your income forecast will be far too high.

Icons

Throughout the book, these icons alert you to certain information.

Fast Track

We use this icon to let you know when you can skip information that may not be relevant to your situation.

Warning

This icon alerts you to potential problems.

Recommended Reading

When you see this icon, a list of additional resources that can assist you follows.

Cross-Reference

This icon refers you to a further discussion of the topic elsewhere in this book.

See an Expert

Lets you know when you need the advice of an attorney or other expert.

Tip

A legal or commonsense tip to help you understand or comply with legal requirements.

Recommended Forms

This icon refers you to a related chapter in Legal Forms for Starting & Running a Small Business, *by Fred S. Steingold (Nolo), which contains legal forms and checklists.* ■

CHAPTER

1

Which Legal Form Is Best for Your Business?

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When you start a business, you must decide on a legal structure for it. Usually you'll choose either a sole proprietorship, a partnership, a limited liability company (LLC), or a corporation. There's no right or wrong choice that fits everyone. Your job is to understand how each legal structure works and then pick the one that best meets your needs.

The best choice isn't always obvious. After reading this chapter, you may decide to seek some guidance from a lawyer or an accountant.

For many small businesses, the best initial choice is either a sole proprietorship or—if more than one owner is involved—a partnership. Either of these structures makes especially good sense in a business where personal liability isn't a big worry—for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money. Sole proprietorships and partnerships are relatively simple and inexpensive to establish and maintain.

Forming an LLC or a corporation is more complicated and costly, but it's worth it for some small businesses. The main feature of LLCs and corporations that attracts small businesses is the limit they provide on their owners' personal liability for business debts and court judgments against the business. Another factor might be income taxes: You can set up an LLC or a corporation in a way that lets you enjoy more favorable tax rates. In certain circumstances, your business may be able to stash away earnings at a relatively low tax rate. In addition, an LLC or corporation may be able to provide a range of fringe benefits to employees (including the owners) and deduct the cost as a business expense.

Given the choice between creating an LLC or a corporation, many small business owners will be better off going the LLC route. For one thing, if your business will have several owners, the LLC can be more flexible than a corporation in the way you can parcel out profits and management duties. Also, setting up and maintaining an LLC can be a bit less complicated and expensive than a corporation. But there may be times a corporation will be more beneficial. For example, because a corporation—unlike other types of business entities—issues stock certificates to its owners, a corporation can be an ideal vehicle if you want to bring in outside investors or reward loyal employees with stock options.

Keep in mind that your initial choice of a business form doesn't have to be permanent. You can start out as sole proprietorship or partnership and, later, if your business grows or the risks of personal liability increase, you can convert your business to an LLC or a corporation.

For some small business owners, a less common type of business structure may be appropriate. *While most small businesses will find at least one good choice among the four basic business formats described above, a handful will have special situations in which a different format is required or at least is desirable. For example, a pair of dentists looking to limit their personal liability may need to set up a professional corporation (PC) or a professional limited liability company (PLLC). A group of real estate investors may find that a limited partnership is the best vehicle for them. These and other special types of business organizations are summarized in Section F at the end of this chapter.*

You may need professional advice in choosing the best entity for your business. *This chapter gives you a great deal of information to assist you in deciding how to best organize your business. Obviously, however, it's impossible to cover every relevant nuance of tax and business law—especially if your business has several owners with different and complex tax situations. And for businesses owned by several people who have different personal tax situations, sorting out the effects of "pass-through" taxation (where partners and most LLC members are taxed on their personal tax returns for their share of business profits and losses) is no picnic, even for seasoned tax pros. The bottom line is that unless your business will start small and have a very simple ownership structure, before you make*

WAYS TO ORGANIZE YOUR BUSINESS

TYPE OF ENTITY	MAIN ADVANTAGES	MAIN DRAWBACKS
Sole Proprietorship **(Section A)**	Simple and inexpensive to create and operate Owner reports profit or loss on his or her personal tax return	Owner personally liable for business debts
General Partnership **(Section B)**	Simple and inexpensive to create and operate Owners (partners) report their share of profit or loss on their personal tax returns	Owners (partners) personally liable for business debts
Limited Partnership **(Section F)**	Limited partners have limited personal liability for business debts as long as they don't participate in management General partners can raise cash without involving outside investors in management of business	General partners personally liable for business debts More expensive to create than general partnership Suitable mainly for companies that invest in real estate
Regular Corporation **(Section C)**	Owners have limited personal liability for business debts Fringe benefits can be deducted as business expense Owners can split corporate profit among owners and corporation, paying lower overall tax rate	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners Separate taxable entity
S Corporation **(Section C)**	Owners have limited personal liability for business debts Owners report their share of corporate profit or loss on their personal tax returns Owners can use corporate loss to offset income from other sources	More expensive to create than partnership or sole proprietorship More paperwork than for a limited liability company, which offers similar advantages Income must be allocated to owners according to their ownership interests Fringe benefits limited for owners who own more than 2% of shares
Professional Corporation **(Section F)**	Owners have no personal liability for malpractice of other owners	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners All owners must belong to the same profession
Nonprofit Corporation **(Section F)**	Corporation doesn't pay income taxes Contributions to charitable corporation are tax-deductible Fringe benefits can be deducted as business expense	Full tax advantages available only to groups organized for charitable, scientific, educational, literary, or religious purposes Property transferred to corporation stays there; if corporation ends, property must go to another nonprofit
Limited Liability Company **(Section D)**	Owners have limited personal liability for business debts even if they participate in management Profit and loss can be allocated differently than ownership interests IRS rules allow LLCs to choose between being taxed as partnership or corporation	More expensive to create than partnership or sole proprietorship State laws for creating LLCs may not reflect latest federal tax changes
Professional Limited Liability Company **(Section F)**	Same advantages as a regular limited liability company Gives state licensed professionals a way to enjoy those advantages	Same as for a regular limited liability company Members must all belong to the same profession
Limited Liability Partnership **(Section F)**	Mostly of interest to partners in old-line professions such as law, medicine, and accounting Owners (partners) aren't personally liable for the malpractice of other partners Owners report their share of profit or loss on their personal tax returns	Unlike a limited liability company or a professional limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders, and landlords Not available in all states Often limited to a short list of professions

your final decision on a business entity, check with a tax advisor after learning about the basic attributes of each type of business structure (from this chapter and Chapters 2, 3, and 4).

A. Sole Proprietorships

The simplest form of business entity is the sole proprietorship. If you choose this legal structure, then legally speaking you and the business are the same. You can continue operating as a sole proprietor as long as you're the only owner of the business.

Establishing a sole proprietorship is cheap and relatively uncomplicated. While you do not have to file articles of incorporation or organization (as you would with a corporation or an LLC), you may have to obtain a business license to do business under state laws or local ordinances. States differ on the amount of licensing required. In California, for example, almost all businesses need a business license, which is available to anyone for a small fee. In other states, business licenses are the exception rather than the rule. But most states do require a sales tax license or permit for all retail businesses. Dealing with these routine licensing requirements generally involves little time or expense. However, many specialized businesses—such as an asbestos removal service or a restaurant that serves liquor—require additional licenses, which may be harder to qualify for. (See Chapter 7 for more on this subject.)

In addition, if you're going to conduct your business under a trade name such as Smith Furniture Store rather than John Smith, you'll have to file an assumed name or fictitious name certificate at a local or state public office. This is so people who deal with your business will know who the real owner is. (See Chapter 6 for more on business names.)

From an income tax standpoint, a sole proprietorship and its owner are treated as a single entity. Business income and business losses are reported on your own federal tax return (Form 1040, Schedule C). If you have a business loss, you may be able to use it to offset income that you receive from other sources. (For more tax basics, see Chapter 8.)

Legal Forms for Starting & Running a Small Business *contains a checklist for starting a sole proprietorship.*

1. Personal Liability

A potential disadvantage of doing business as a sole proprietor is that you have unlimited personal liability on all business debts and court judgments related to your business.

> **EXAMPLE 1:** Lester is the sole proprietor of a small manufacturing business. Believing that his business's prospects look good, he orders $50,000 worth of supplies and uses them up. Unfortunately, there's a sudden drop in demand for his products, and Lester can't sell the items he's produced. When the company that sold Lester the supplies demands payment, he can't pay the bill.
>
> As sole proprietor, Lester is personally liable for this business obligation. This means that the creditor can sue him and go after not only Lester's business assets, but his other property as well. This can include his house, his car, and his personal bank account.

> **EXAMPLE 2:** Shirley is the sole proprietor of a flower shop. One day Roger, one of Shirley's employees, is delivering flowers using a truck owned by the business. Roger strikes and seriously injures a pedestrian. The injured pedestrian sues Roger, claiming that he drove carelessly and caused the accident. The lawsuit names Shirley as a codefendant. After a trial, the jury returns a large verdict against Roger—and Shirley as owner of the business. Shirley is

personally liable to the injured pedestrian. This means the pedestrian can go after all of Shirley's assets, business and personal.

One of the major reasons to form a corporation or a limited liability company (LLC) is that, in theory at least, you'll avoid most personal liability. (But see Chapter 12, Section C, for a discussion of how a good liability insurance policy may be enough protection against personal liability for a sole proprietor.)

2. Income Taxes

As a sole proprietor, you and your business are one entity for income tax purposes. The profits of your business are taxed to you in the year that the business makes them, whether or not you remove the money from the business (called "flow-through" taxation, because the profits "flow through" to the owner's income tax return). You report business profits on Schedule C of Form 1040.

By contrast, if you form an LLC or a corporation, you have a choice of two different types of tax treatment.

- *Flow-Through Taxation.* One choice is to have the IRS tax your LLC or corporation like a sole proprietorship or partnership (discussed above). The owners report their share of LLC or corporate profits on their own tax returns, whether or not the money has been distributed to them.
- *Entity Taxation.* The other choice is to make the business a separate entity for income tax purposes. If you form an LLC and make that choice, the LLC will pay its own taxes on the profits of the LLC. And as a member of the LLC, you won't pay tax on the money earned by the LLC until you receive payments as compensation for services or as dividends. Similarly, if you form a corporation and choose this option, you as a shareholder won't pay tax on the money earned by the corporation until you receive payments as compensation for services or as dividends. The corporation will pay its own taxes on the corporate profits.

In Section E of this chapter, I'll explain the mechanics of choosing between these two methods. For now, just be aware that this tax flexibility of LLCs and corporations offers some tax advantages over a sole proprietorship if you're able to leave some income in the business as "retained earnings." For example, suppose you want to build up a reserve to buy new equipment or your small label-manufacturing company accumulates valuable inventory as it expands. In either case, you might want to leave $50,000 of profits or assets in the business at the end of the year. If you operated as a sole proprietor, those "retained" profits would be taxed on your personal income tax return at your marginal tax rate. But with an LLC or corporation that's taxed as a separate entity, the tax rate will almost certainly be lower.

You can share ownership of your business with your spouse and still maintain its status as a sole proprietorship. *If you choose to do this, in the eyes of the IRS you'll be co-sole proprietors. You can either split the profits from your business if you and your spouse file separate returns (and separate Schedule Cs), or you can put them on your joint Schedule C if you file a joint return. Only a spouse can be a co-sole proprietor. If any other family member shares ownership with you, the business must be organized as a partnership, corporation, or limited liability company.*

3. Fringe Benefits

If you operate your business as a sole proprietorship, tax-sheltered retirement programs are available. A Keogh plan, for example, allows a sole proprietor to salt away a substantial amount of income free of current taxes. So does a one-person 401(k). You can't really do any better by setting up an LLC or a corporation.

A "C" corporation or an LLC that chooses to be taxed as a separate entity does have an advantage when it comes to medical expenses for the owner and his or her spouse and dependents. As a sole proprietor, you are limited as to how much you can deduct for medical expenses on your personal tax return: You can deduct only the amount that exceeds 7.5% of your adjusted gross income for the year. If you form an LLC or a corporation, however, and choose to have it taxed as a separate entity, you can have your business pay *all* of your family's medical expenses (so long as they're not covered by insurance) and then take these amounts as a business deduction. You won't be personally taxed for the value of this employment benefit.

In the past, sole proprietors could deduct only a portion of health insurance premiums for themselves and family members, while LLCs and corporations (if separate taxable entities) could deduct 100%. That sometimes provided a reason to form an LLC or corporation, but no longer. A self-employed person can now deduct 100% of those premiums.

If you form an LLC or a corporation, however, and choose to have it taxed as a separate entity, you can have the business hire you as an employee. The business can pay 100% of your family's health insurance premiums and uncovered medical expenses and then take these amounts as a business deduction; you won't be personally taxed for the value of this employment benefit.

Hiring Your Spouse Can Have Tax Benefits

If you choose to do business as a sole proprietor, there's a way you can deduct more of your family's medical expenses. First, hire your spouse at a reasonable wage. Then, set up a written health benefit plan covering your employees and their families. A sample form is shown below. Your business can then deduct 100% of the medical expenses it pays.

But balance whether such a plan can save you enough money to justify the effort. There may be some expense for setting up the plan and handling the associated paperwork. And remember that your business will be obligated for payroll taxes on your spouse's earnings. (See Chapter 8, Section C, for information on payroll taxes.) But this isn't all bad, since your spouse will become eligible for Social Security benefits in his or her own right, which can be of some value—especially if he or she hasn't already worked long enough to qualify.

If you're audited, the IRS will look closely to make sure your spouse is really an employee and performing needed services for the business.

To learn about how a person qualifies for Social Security benefits, see Social Security, Medicare & Government Pensions*, by Joseph L. Matthews with Dorothy Matthews Berman (Nolo).*

Sample Reimbursement Plan

Sam Jones, a sole proprietor doing business as Jones Consulting Services (the Company), establishes this Health and Accident Plan for the benefit of the Company's employees.

1. *Coverage.* Beginning January 1, 20XX, the Company will reimburse each employee for expenses incurred by the employee for the medical care of the employee and the employee's spouse and dependents, and for premiums for medical, dental, and disability insurance. The medical care covered by this plan is defined in Section 213(d) of the Internal Revenue Code. Dependents are defined in Section 152.
2. *Direct Payment.* The Company may, in its discretion, pay any or all of the expenses directly instead of reimbursing the employee.
3. *Expense Documents.* Before reimbursing an employee or paying an expense directly, the Company may require the employee to submit bills and insurance premium notices.
4. *Other Insurance.* The Company will reimburse an employee or pay bills directly only if the reimbursement or payment is not provided for under any other health and accident or wage continuation plan.
5. *Ending or Changing the Plan.* Although the Company intends to maintain this plan indefinitely, the Company may end or change the plan at any time. This will not, however, affect an employee's right to claim reimbursement for expenses that arose before the plan was ended or changed.

Dated: December __, 20XX

____

Sam Jones, doing business as Jones Consulting Services

4. Routine Business Expenses

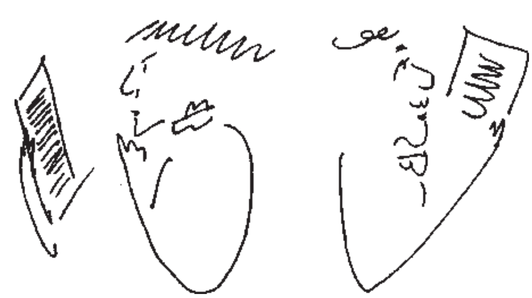
As a sole proprietor, you can deduct day-to-day business expenses the same way an LLC, corporation, or partnership can. Whether it's car expenses, meals, travel, or entertainment, the same rules apply to all of these types of business entities.

You'll need to keep accurate books for your business that are clearly separate from your records of personal expenditures. The IRS has strict rules for tax-deductible business expenses (covered in Chapter 8, Section D), and you need to be able to document those expenses if challenged. One good approach is to keep separate checkbooks for your business and personal expenses—and pay for all of your business expenses out of the business checking account.

But whatever your system, please pay attention to this basic advice: It's simple to keep track of business income and expenses if you keep them separate from the start—and murder if you don't.

B. Partnerships

If two or more people are going to own and operate your business, you must choose between establishing a partnership, a corporation, or a limited liability company (LLC). This section looks at the general partnership, which is the type of partnership that most small businesses will be considering. The limited partnership is described in Section F1, below.



LAW IN THE REAL WORLD
First Things First

Ellen, Mary, and Barbara Kate, librarians all, planned to open an electronic information searching business with an emphasis on information of special interest to women. They would hold on to their daytime jobs until they could determine whether their new business could support all three women.

At a planning meeting to discuss buying personal computers and modems, Ellen said she wanted the business to be run as professionally as possible, which to her meant promptly incorporating or forming an LLC. The discussion about equipment was put off while the three women tried to decide how to organize the legal structure of their business. After several frustrating hours, they agreed to continue the discussion later and to do some research about the organizational options in the meantime.

Before the next meeting, Ellen conferred with a small business advisor who suggested that the women refocus their energy on the computers and modems and getting their business operating, keeping its legal structure as simple as possible. One good way to do this, she suggested, was to form a partnership, using a written partnership agreement. Each partner would contribute $10,000 to buy equipment and contribute roughly equal amounts of labor. Profits would be divided equally.

Later, if the business succeeded and grew, it might make sense to incorporate or form an LLC and consider other issues, like a health plan, pensions, and other benefits. But for now, real professionalism meant getting on with the job—not consuming time and dollars forming an unneeded corporate or LLC entity.

The best way to form a partnership is to draw up and sign a partnership agreement (discussed fully in Chapter 2). Legally, you can have a partnership without a written agreement, in which case you'd be governed entirely by either the Uniform Partnership Act or the Revised Uniform Partnership Act (explained in Chapter 2).

Beyond a written agreement, the paperwork for setting up a partnership is minimal—about on a par with a sole proprietorship. You may have to file a partnership certificate with a public office to register your partnership name, and you may have to obtain a business license or two. The income tax paperwork for a partnership is marginally more complex than that for a sole proprietorship.

1. Personal Liability

As a partner in a general partnership, you face personal liability similar to that of the owner of a sole proprietorship. Your personal assets are at risk in addition to all assets of the partnership. In other words, you have unlimited personal liability on all business debts and court judgments related to your business.

In a partnership, any partner can take actions that legally bind the partnership entity. That means, for example, that if one partner signs a contract on behalf of the partnership, it will be fully enforceable against the partnership and each individual partner, even if the other partners weren't consulted in advance and didn't approve the contract. Also, the partnership is liable, as is each individual partner, for injuries caused by any partner while on partnership business.

EXAMPLE 1: Ted, a partner in Argon Associates, signs a contract on behalf of the partnership that obligates the partnership to pay $50,000 for certain goods and services. Esther and Helen, the other partners, think Ted made a terrible deal. Nevertheless, Argon Associates is bound by Ted's contract even though Esther and Helen didn't sign it.

EXAMPLE 2: Juan is a partner in Universal Contractors. Elroy, one of his partners, causes an accident while using a partnership vehicle. Juan and all the other partners will be financially liable to people injured in the accident if the car isn't covered by adequate insurance. The same would be true if Elroy used his own car while on partnership business.

In both of these situations, the personal assets (home, car, and bank accounts) of each partner will be at stake, in addition to partnership assets. But remember that a partnership can protect against many risks by carrying adequate liability insurance.

2. Partners' Rights and Responsibilities

Each partner is entitled to full information—financial and otherwise—about the affairs of the partnership. Also, the partners have a "fiduciary" relationship to one another. This means that each partner owes the others the highest legal duty of good faith, loyalty, and fairness in everything having to do with the partnership.

EXAMPLE: Wheels & Deals, a partnership, is in the business of selling used cars. No partner is free to open a competing used-car business without the consent of the other partners. This would be an obvious conflict of interest and, as such, would violate the fiduciary duty the partners legally owe to one another.

Unless agreed otherwise, a person can't become a new partner without the consent of all the other partners. However, in larger partnerships, it's common for partners to provide in the partnership agreement that new partners can be admitted with the consent of a certain percentage of the existing partners—75%, for example.

State laws regulating partnerships dictate what occurs if one partner leaves your partnership and you don't have a partnership agreement that provides for what happens. In about half the states, the partnership is automatically dissolved when a partner withdraws or dies; the business is then liquidated. In such a state, it's an excellent idea to put a provision in your partnership agreement that allows the business to continue without interruption, despite the technical dissolution of the partnership. A partnership agreement, for instance, may provide a "buy-sell" provision that calls for a buyout if one of the partners dies or wants to leave the partnership, avoiding a forced liquidation of the business.

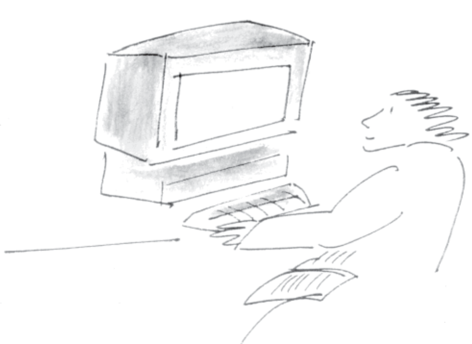
EXAMPLE: Tom, Dick, and Mary are equal partners. They agree in writing that if one of them dies, the other two will buy the deceased partner's interest in the partnership for $50,000 so that the business will continue. (Be aware that often a partnership agreement doesn't fix a precise amount as the buyout price but uses a more complicated formula based on such data as yearly sales, profits, or book value.) To fund this arrangement, the partnership buys life insurance covering each partner in an amount large enough to cover the buyout. If Tom dies first, under the terms of the agreement, his wife and children will receive $50,000 from the partnership to compensate them for the value of Tom's ownership interest in the business. Technically, the remaining partners would operate as a new partnership, but the important point is that the business would keep functioning.

Other states—generally those that have adopted the revised version of the Uniform Partnership Act—follow a slightly different rule. In those states, if your partnership was created to last for a fixed length of time or was created for a specific project, and a partner leaves before the fixed time expires or the project is done, the partnership isn't automatically dissolved. Instead, the remaining partners have the opportunity to continue the existing partnership rather than having to form a new one. But even if your state follows this more flexible approach, you'll still want to use buy-sell provisions to specify how the departing partner—or the family of a partner who's died—gets compensated for his partnership interest.

Chapter 5 discusses buy-sell provisions in greater detail.

3. Income Taxes

In terms of income and losses, the tax picture for a partnership is basically the same as that of a sole proprietorship. A partnership doesn't pay income taxes. It must, however, file an informational return that tells the government how much money the partnership earned or lost during the tax year and how much profit (or loss) belongs to each partner. Each partner uses Schedule E of Form 1040 to report the business profits (or losses) allocated to him or her and then pays income tax on this share, whether or not this income was actually distributed during the tax year. If the partnership loses money, each partner can deduct his or her share of losses for that year from income earned from other sources (subject to some fairly complicated tax basis rules—see "Investment Partnerships," below).



Investment Partnerships

The above analysis assumes that the partner who deducts losses from other income actively participates in the business. If, instead, a partner is a passive investor (as is often the case in partnerships designed to invest in real estate) or receives income from passive sources (such as royalties, rents, or dividends), any loss from the partnership business is treated as a passive loss for that partner. That means that for federal income tax purposes the loss can be deducted only from other passive income—not from ordinary income.

4. Fringe Benefits and Business Expenses

When it comes to retained earnings, tax-sheltered retirement plans, and fringe benefits, a partnership is like a sole proprietorship, and the discussion in Section A3, above, applies to partnerships as well.

Likewise, business expenses can be deducted in the same way for a partnership as for a sole proprietorship; the discussion in Section A4, above, applies here as well.

Put it in writing. *If you go the partnership route, I strongly recommend that the partners sign a written partnership agreement, even though an oral partnership agreement is legal. The human memory is far too fallible to rely on for the details of important business decisions. Chapter 2 contains basic information on how to write a partnership agreement.*

C. Corporations

If you're concerned about limiting your personal liability for business debts, you'll want to consider organizing your business as either a limited liability company (LLC) or a corporation. (Of course, you may have other reasons in addition to limited liability for considering these two business structures.) Since the corporation has a longer legal history, I'll deal with it first, but the LLC—which is covered in Section D—may well be preferable for your particular business, despite its relative newness.

This book deals primarily with the small, privately owned corporation. I'll assume that all of the corporate stock is owned by one person or a few people, and that all shareholders are actively involved in the management of the business—with the possible exception of friends and relatives who have provided seed money in exchange for stock. Because there are many complexities involved in selling stock to the public, I don't discuss public corporations.

The most important feature of a corporation is that, legally, it's a separate entity from the individuals who own or operate it. You may own all the stock of your corporation, and you may be its only employee, but—if you follow sensible organizational and operating procedures—you and your corporation are separate legal entities.

All states have adopted legislation that permits a corporation to be formed by a single incorporator. All states permit a corporate board that has a single director, although the ability to set up a one-person board may depend on the number of shareholders. (See Chapter 3 for more details.) In addition, many states have streamlined the procedures for operating a small corporation, to permit decisions to be made quickly and without needless formalities. For example, in most states, shareholders and directors can take action by unanimous written consent rather than by holding formal meetings, and directors' meetings can be held by telephone.

1. Limited Personal Liability

One of the main advantages of incorporating is that, in most circumstances, it limits your personal liability. If a court judgment is entered against the corporation, you stand to lose only the money that you've invested. Generally, as long as you've acted in your corporate capacity (as an employee, officer, or director) and without the intent to defraud creditors, your home and personal bank accounts and other valuable property can't be touched by a creditor who has won a lawsuit against the corporation.

> **EXAMPLE:** Andrea is the sole shareholder, director, and officer of Market Basket Corporation, which runs a food store. Ronald, a Market Basket employee, drops a case of canned food on a customer's foot. The customer sues and wins a judgment against the business. Only corporate assets are available to pay the damages. Andrea is not personally liable.

Liability for your own acts. *If Andrea herself had dropped the case of cans, the fact that she is a shareholder, officer, and director of the corporation wouldn't protect her from personal liability. She would still be personally liable for the wrongs (called torts, in legal lingo) that she personally commits. So much for theory. In practice, incorporating may not actually give you broad legal protection.*

In the real world, banks and some major corporate creditors often require the personal guarantee of individuals within the corporation. So the limited liability gained from incorporating isn't always as valuable a legal shield as it first seems.

> **EXAMPLE:** Market Basket Corporation borrows $75,000 from a bank. Andrea signs the promissory note as president of the corporation, but the bank also requires her to guarantee the note personally. The corporation runs into financial

difficulties and can't repay the debt. The bank sues and wins a judgment against the business for the unpaid principal plus interest. In collecting on the judgment, the bank can go after Andrea's assets as well as the corporation's property. Incorporation offers no advantage over a sole proprietorship when an owner personally guarantees a loan.

As mentioned in Sections A and B, above, liability insurance can protect against many of the risks of doing business. Because of this, many businesses can structure themselves as sole proprietorships or partnerships without worrying about unlimited personal liability. But if you operate a high-risk business—child care center, chemical supply house, asbestos removal service, or college town bar—and you can't get (or can't afford) liability insurance for some risks that you're concerned about, incorporation may be the wisest choice.

EXAMPLE: Loren is afraid that a clerk at his After Hours beverage store might inadvertently sell liquor to an underaged customer or one who has had too much to drink. If that customer got drunk and hurt someone in a car accident, there might be a lawsuit against the business.

Loren contacts his insurance agent to arrange for coverage, but learns that his liquor store can afford only $50,000 worth of liability insurance. Loren buys the $50,000 worth of insurance, but also forms a corporation—After Hours Inc.—to run the business. Now if an injured person wins a large verdict, at least Loren won't be personally liable for the portion not covered by his insurance.

The lesson of these examples is clear: Before you decide to incorporate your business primarily to limit your personal liability, analyze what your exposure will be if you simply do business as a sole proprietor (or a partner in a partnership).

The limited liability feature of corporations can be valuable, protecting you from personal liability for:

- Debts that you haven't personally guaranteed, including most routine bills for supplies and small items of equipment.
- Injuries suffered by people who are injured by business activities not covered adequately by insurance.

Also, for a business with more than one owner, incorporating can offer a great deal of protection from the misdeeds or bad judgment of your co-owners. In contrast, in a partnership, as noted above, each partner is personally liable for the business-related activities of the other partners.

EXAMPLE: Ted, Mona, and Maureen are partners in Mercury Enterprises. Mona writes a nasty letter about Harold, a former employee, which causes Harold to lose the chance of a good new job. Harold sues for defamation and wins a $60,000 judgment against the partnership. Ted and Maureen are each personally liable to pay the judgment even though Mona wrote the letter.

If Mercury Enterprises had been a corporation, Mona and the corporation would have been liable for the judgment, but Ted and Maureen would not. Ted and Maureen would lose money if the assets of the corporation were seized to pay the judgment, but their own personal assets would be safe.

LAW IN THE REAL WORLD
Going With Your Gut

Several years ago, John took over his dad's rug cleaning business as a sole proprietor. He didn't expect the business to ever grow beyond its status as a small local facility with six employees and $400,000 in annual sales. But grow it did—first to ten, then to 25 employees, operating in four suburban cities and taking in $3.5 million a year.

About this time, John and his wife bought a nice house, put a few dollars in the bank, and finished paying off the promissory note to his dad for the purchase of the business. Things were going so well that John began to worry about what would happen to his personal assets if the business was sued for big bucks. He reviewed his insurance coverage and sensibly increased some of it. He reviewed his operations and improved several systems, including the one for storing, handling, and disposing of toxics. Still, he felt vaguely disquieted.

Finally, even though he couldn't identify any other risks likely to result in a successful lawsuit against his company, John decided to incorporate, to limit his personal liability for the business's debts. He tried to explain his gut feelings of worry to his father, but felt he wasn't quite making sense. The older man interrupted and said, "I think you're trying to say that things have been going so well lately that something is bound to mess up soon. And if they do, you want as much of a legal shield between your personal assets and those of the business as possible."

"Precisely," John said. "But I've already protected myself against all obvious risks, so I can't logically justify a decision to incorporate."

His father replied, "C'mon, son, business decisions are like any other—if your gut tells you to be a little extra careful, go with it. Running a small business means being ready to trust your own intuition."

Payroll taxes. *Limited liability doesn't protect you if you fail to deposit taxes withheld from employees' wages—especially if you have anything to do with making decisions about what bills the corporation pays first. Also, because unpaid withheld taxes aren't dischargeable in bankruptcy, you want to pay these before you pay other debts (most of which can be wiped out in bankruptcy) in case your business goes downhill.*

2. Income Taxes

Federal taxation of corporations is a very complicated topic. Here I deal only with basic concepts.

The federal tax laws distinguish between two types of corporations. A C corporation is treated as a tax-paying entity separate from its investors and it must pay corporate federal income tax. By contrast, a corporation that chooses "S corporation" status doesn't pay federal income tax; instead, income taxes are paid by the corporation's owners.

a. S Corporations

Electing to do business as an S corporation lets you have the limited liability of a corporate shareholder but pay income taxes on the same basis as a sole proprietor or a partner. Among other things, this means that as long as you actively participate in the business of the S corporation, business losses can be used as an offset against your other income—reducing, maybe even eliminating, your tax burden. The corporation itself doesn't pay taxes, but files an informational tax return telling what each shareholder's portion of the corporate income is.

EXAMPLE: Paul decides to start an environmental cleanup business. Because insurance isn't available to cover all of the risks of this business, he forms a corporation called Ecology Action Inc. This limits Paul's personal liability if there's a lawsuit against the corporation for an act not covered by insurance.

Paul is also concerned about taxes. He expects his company to lose money during its first few years; he'd like to claim those losses on his personal tax return to offset income he'll be receiving from consulting and teaching work. He registers with the IRS as an S corporation. Unless he changes that tax status later, his corporation won't pay any federal income tax. Paul will report the corporation's income loss on his own Form 1040 and will be able to use it as an offset against income from other sources.

For many years, if you wanted to limit the personal liability of all owners of your business and have the income and losses reported only on the owners' income tax returns, you would have no choice but to create an S corporation. Today, you can accomplish the same goal by creating a limited liability company (LLC), as explained in Section D, below. Because, in addition, an LLC offers its owners the significant advantage of greater flexibility in allocating profits and losses, it's generally better to structure your business as an LLC than as an S corporation. (But see Section E for a discussion of when it might be better to create an S corporation.)

Should Your Corporation Elect S Corporation Status?

For federal tax purposes, it's often best for a start-up company to elect to be an S corporation rather than a regular corporation. This is so even though recent changes in tax rates have made this decision a bit more complex. Still, to make sure an S corporation is best for you, speak to a knowledgeable accountant or other tax advisor. Also keep in mind that a limited liability company (LLC) may be an even better choice than either type of corporation. (See Sections D and E.)

Starting as an S corporation rather than a regular corporation may be wise for several reasons:

- Because income from an S corporation is taxed at only one level rather than two, your total tax bill will likely be less. (But be aware that the two-tier tax structure for regular corporations can sometimes be an advantage. See the discussion below on how a regular corporation can achieve tax savings through income-splitting.)
- Your business may have an operating loss the first year. With an S corporation, you generally can pass that loss through to your personal income tax return, using it to offset income that you (and your spouse, if you're married) may have from other sources. Of course, if you're expecting a profit rather than a loss—because, for example, you're converting a profitable sole proprietorship or partnership to a corporation—this pass-through for losses won't be an advantage to you.
- Interest you incur to buy S corporation stock is potentially deductible as an investment interest expense.
- When you sell the assets of your S corporation, you may be taxed less on your gain than if you operated the business as a regular corporation (because of the dual taxation structure of corporations).
- Your decision to elect to be an S corporation isn't permanent. If you later find there are tax advantages to being a regular corporation, you can easily drop your S corporation status, but timing is important.

Limits on deductions. *You can deduct S corporation losses on your personal return only to the extent of the money you put into the corporation (to buy stock) and any money you personally loaned to the corporation. Also, if you don't work actively in the S corporation, there are potential problems with claiming losses, because they might be considered losses from passive activities. For the most part, you can use losses from passive activities only to offset income from passive activities. See your tax advisor for technical details.*

Shareholders pay income tax on their share of the corporation's profits regardless of whether they actually received the money or not. If the corporation suffered a loss, shareholders can claim their share of that loss.

> **EXAMPLE:** Assume the same facts as above except that there are two other shareholders in Ecology Action Inc. Paul owns 50% of the stock, and Ellen and Ted each own 25%. Paul would report 50% of the corporation's profit or loss on his personal tax return, and Ellen and Ted would each report 25% on theirs.

Most states follow the federal pattern in taxing S corporations: they don't impose a corporate tax, choosing instead to tax the shareholders for corporate profits. About half a dozen states, however, do tax an S corporation the same as a regular corporation. The tax division of your state treasury department can tell you how S corporations are taxed in your state.

To be treated as an S corporation, all shareholders must sign and file IRS Form 2553. *For more information on this and other requirements for electing S corporation status, see Chapter 8, Section B.*

b. C Corporations

Under federal income tax laws, a C corporation is a separate entity from its shareholders. This means that the corporation pays taxes on any income that's left after business expenses have been paid.

As you saw earlier in this chapter, a sole proprietorship doesn't pay federal income tax as a separate entity; the owner simply reports the business's income or loss on Schedule C of Form 1040 and adds it to (or, in the case of a loss, subtracts it from) the owner's other income. Similarly, a partnership doesn't pay federal income tax; rather, the partnership annually files a form with the IRS to report each partner's share of yearly profit or loss from the partnership business. Each partner then adds his or her share of partnership income to other income reported on his or her personal tax return (the familiar Form 1040) or deducts his or her share of loss. And an S corporation is treated as a sole proprietorship or partnership for federal income tax purposes, depending on the number of owners.

A C corporation is different. It reports its profits on Form 1120 and pays corporate tax on that income. In addition, if the profits are distributed to shareholders in the form of dividends, the shareholders pay tax on the dividends they receive (creating the much-feared "double taxation" scenario).

In practice, however, a C corporation may not have to pay any corporate income tax even though it is a separate taxable entity. Here's how: In most incorporated small businesses, the owners are also employees. They receive salaries and bonuses as compensation for the services they perform for the corporation. The corporation then deducts this "reasonable" compensation as a business expense. In many small corporations, compensation to owner-employees eats up all the potential corporate profits, so there's no taxable income left for the corporation to pay taxes on.

> **EXAMPLE:** Jody forms a one-person catering corporation, Jody Enterprises Ltd. She owns all the stock and is the main person running the

business. The corporation hires her as an employee, with the title of president. The corporation pays her a salary plus bonuses that consume all of the corporation's profits. Jody's salary and bonuses are tax-deductible to the corporation as a corporate business expense. There are no corporate profits to tax. Jody simply pays tax on the income that she receives from the corporation, the same as any other corporate employee.

(1) Tax Savings Through Income Splitting

As an alternative to paying out all the corporate profits in the form of salaries and bonuses, you may want to leave some corporate income in the corporation to finance the growth of your business. You can often save tax dollars this way because, for the first $50,000 of taxable corporate income, the tax rate and actual taxes paid will generally be lower than what you'd pay as an individual.

The federal government taxes the first $50,000 of taxable corporate income at 15%. The next $25,000 is taxed at 25%. Taxable income over $75,000 is taxed at 34% until taxable income reaches $10,000,000—at which point the rate becomes 35%. Additionally, to make larger corporations pay back the benefits of these lower graduated tax rates, corporate taxable incomes between $100,000 and $335,000 are subject to an extra 5% tax. (See the chart in Chapter 8, Section C1d.)

Here's an example of how, with proper planning, a small incorporated business can split income between the corporation and its owners, retaining money in the corporation for expenses and lowering the corporation's tax liability to an amount that's actually less than what would have to be paid by the principals of the same business if it were not incorporated.

EXAMPLE 1: Sally and Randolph run their own incorporated lumber supply company, S & R Wood Inc. One year their sales increase to $1.2 million. After the close of the third quarter, Sally and Randolph learn that S & R Wood is likely to make $110,000 net profit (net taxable corporate income) for the year. They decide to reward themselves and other key employees with moderate raises in pay, give a small year-end bonus to other workers, and buy some needed equipment.

This reduces the company's net taxable income to $40,000—an amount that Sally and Randolph feel is prudent to retain in the corporation for expansion or in case next year's operations are less profitable. Taxes on these retained earnings are paid at the lowest corporate rate, 15%. If Sally and Randy had wanted to take home more money instead of leaving it in the business, they could have increased their salaries and paid taxes at a rate of at least 10% but more probably 25% or 28% or higher, depending on their tax brackets.

Watch out for a double tax trap. *C corporation shareholders (like Sally and Randy) can also decide to take some income in the form of a stock dividend. Doing so, however, will often increase their tax burden because both the corporation and the shareholders will have to pay income tax. Still, in some situations, taking some dividends in place of some salary may make sense—for example, if the corporation is in the 15% bracket and the shareholder is in the 28% (or higher) bracket. This gets complicated, so let a tax pro help you figure it out. Also, be aware that paying dividends won't make sense if you have a Personal Service Corporation (defined in Section F2, below). Such corporations pay a flat 35%.*

EXAMPLE 2: Now assume S & R Wood is not incorporated but instead is operated as a partnership. Now the entire net profits of the business ($110,000 minus the bonuses to workers and deductible expenditures for equipment) are taxed to Sally and Randolph. The result is that the $40,000 (which was retained by the corporation in the above example) is taxed at their individual rate of 25% or 28% or higher rather than the 15% corporate rate.

For a more detailed explanation of how income-splitting can be an advantage to owners of small corporations, see *How to Form Your Own California Corporation*, or *Incorporate Your Business: A 50-State Legal Guide to Forming a Corporation*, both by Anthony Mancuso (Nolo).

The main point to remember is that once your business becomes profitable, doing business as a C corporation allows a degree of flexibility in planning and controlling your federal income taxes that is unavailable to partnerships and sole proprietorships. To determine whether or not favorable corporate tax rates are a compelling reason for your business to incorporate, you'll need to study IRS regulations or go through an analysis with your accountant or other tax advisor.

Tax savings may be a largely theoretical advantage for the person just starting out. If your business is like many start-ups, your main concern will be generating enough income from the business to pay yourself a reasonable wage. Retaining profits in the business will come later. In this situation, the tax advantages of incorporating are illusory.

EXAMPLE: In its first year of operation, Maria's store, The Bookworm, has a profit of $25,000. As the sole proprietor, Maria withdraws the entire $25,000 as her personal salary, which places her in the 15% tax bracket after she subtracts her deductions and personal exemption. It doesn't make sense for Maria to incorporate to take advantage of income-splitting techniques—even if she could get by on say, $20,000 a year, if she left the remaining $5,000 in the corporation, it would be taxed at the 15% corporate tax rate, so her total tax bill would be the same.

Lower Tax Rates Not Available for S Corporations

The lower tax rates for retained earnings don't apply to S corporations, because, as discussed in Subsection a, above, an S corporation does not itself pay taxes on earnings. Individual shareholders in an S corporation pay taxes on their portion of corporate earnings at their personal income tax rates (as if they were partners in a partnership). This is true whether or not those earnings are distributed to them, meaning that even if the shareholders do leave some earnings in the corporation, the shareholders will be taxed on them at their regular tax rates.

(2) Fringe Benefits

The tax rules governing fringe benefits are complicated. Generally, however, if your business will be offering fringe benefits to employees, you can enjoy a tax advantage if you organize as a regular corporation. The business can pay for employee benefits and then take these amounts as business expense deductions. You and the other shareholders who work as employees of your corporation can have the corporation pay for such employee benefits as:

- deferred compensation plans
- group term life insurance
- reimbursement of employee medical expenses that are not covered by insurance
- health and disability insurance.

But the real advantage is how these fringe benefits are treated on your personal tax return. As a shareholder, you won't be personally taxed for the value of this employment benefit. That's because none of the employees of a regular corporation—even if they're owners—have to pay income tax on the value of the fringe benefits they receive. So, for example, your corporation may decide to provide medical insurance for employees and to reimburse employees for uninsured medical payments. The corporation can deduct these payments as a business expense—including the portion paid for the owner-employees of the corporation—and you and the other owner-employees are not taxed on these benefits.

Other types of business entities can also deduct the cost of many fringe benefits as business expenses, but owners who receive these benefits will ordinarily be taxed on their value. That's because the tax laws distinguish between an employee and a self-employed person. The tax laws say that you're a self-employed person—and therefore are taxed on your fringe benefits—if you're a sole proprietor, a partner in a partnership, a member of an LLC that's taxed as a partnership, or an owner of more than 2% of the shares of an S corporation. An owner-employee of a regular corporation, however, isn't classified as a self-employed person. So when it comes to the taxation of fringe benefits, owner-employees of a corporation enjoy a unique advantage.

This favorable tax treatment may seem like a powerful reason to organize your business as a regular corporation. Not so fast. Obviously, there's no benefit unless your business provides these benefits to employees in the first place. And that may be too expensive for some new businesses—especially because many types of employee benefits must be provided on a nondiscriminatory basis to a wide range of employees or to none, and must not be designed to primarily aid the business owner. If you put together a fringe benefit package that favors you and other owner-employees, the IRS will require owners to pay tax on their portion. Few new businesses can afford to carry expensive benefit programs—a cost that typically more than offsets any tax advantage to you as owner of a regular corporation.

Here are some of the IRS ground rules for fringe benefit plans:

- **Medical Reimbursement Plans.** If your business promises to pay those portions of your employees' medical expenses that are not covered by health insurance, your plan can also include the spouse and dependents of each employee. Usually you'll set a limit on the total amount that can be reimbursed during the year; this limit must be the same for all eligible employees. In the typical small business, if you include owner-employees in the plan, your plan must benefit 70% of all employees or at least 80% of all employees who are eligible to participate. You can exclude employees who are under 25, work seasonally or less than 35 hours per week, or have been employed less than three years. As long as you meet these rules, employees—even owner-employees—won't be taxed on reimbursements they receive. If you violate these rules, however, an owner may have to pay tax on all or part of the reimbursements that he or she receives under the plan. (These technical rules apply only to reimbursement of medical expenses—not to employer payment of medical insurance premiums.)
- **Group Life Insurance.** Your business can provide up to $50,000 of group term life insurance tax-free to employees (including yourself) if you meet certain conditions. As an owner-employee of a small corporation, you'll probably be a "key employee" under the tax laws. (A key employee is an officer who is paid more than $130,000 a year, an owner of at least 5% of the company, or an owner of at least 1% of the company who is paid more than $150,000 a year.) If you are a key employee and want to deduct the cost of the insurance from your gross income, your plan must meet special rules: It must benefit at least 70% of all employees, limit the number of key employee participants to 15% of all group participants, or meet other IRS guidelines for "nondiscrimination." All benefits available to participating key employees must be available to all other participating members as well. You can provide different dollar amounts of life insurance to different employees without being "discriminatory" if the amount of coverage is uniformly related to compensation. Also, you can exclude employees who've worked for your company for less than three years.

Clearly, this is technical stuff. Let's say you open a video store and hire a bunch of students to work part time during peak periods, and contract out for bookkeeping services. In such a case, you can set up a medical reimbursement plan without having to worry about covering a whole slew of employees. You could exclude the students because they're under 25 and work less than 35 hours a week. Your bookkeeper, being an independent contractor, wouldn't be an employee and wouldn't have to be covered. So perhaps your plan would cover only yourself and a few full-time employees, plus the families of all covered employees.

(3) Retirement Plans

It used to be that by incorporating you could set up a better tax-sheltered retirement plan than you could get as a sole proprietor, a partner, or a shareholder-employee in an S corporation. There are no longer any significant differences.

3. Attracting Investors

To start and successfully run a small business, you may need more money than you can muster from your own savings or the cash generated by the enterprise. As explained in greater depth in Chapter 9, you have two basic options in raising money from outside sources: borrowing it or getting it from investors. If you expect to seek money from investors—even if they're family members, friends, or business associates—there's a substantial advantage in forming a corporation.

Unlike a lender who, in return for providing money, receives a promise that you'll repay it with interest, an investor becomes a part-owner of the business. While it's possible to form a partnership and make an investor a partner or to form an LLC and make an investor a member, it's often more practical to form a corporation and make the investor a shareholder. That little piece of paper that the corporation issues—the stock certificate—is tangible proof of the shareholder's ownership interest in the business and it's something that most investors have come to expect. Put another way, if you offer an investor a partnership interest or an LLC interest, you're more likely to run into resistance than if you offer him or her stock in a corporation.

Keep in mind that shareholders don't necessarily have to have equal rights to elect the board of directors or to receive dividends. To distinguish between various types of shareholders, you can issue different classes of stock with different rights, for example:

- common, voting shares to the initial owners who will be working in the business
- nonvoting shares for key employees to keep them loyal to the business
- nonvoting preferred shares to outside investors, giving them a preference if dividends are declared or the corporation is sold.

To repeat this key point, the fact that the corporate structure makes it relatively easy to distinguish between different investors by issuing different classes of stock is a real advantage.

Stock options can motivate employees. *Especially for a business that sells stock to the public or plans to do so before long, which allows the market to establish a price for the stock, issuing stock options to employees at a favorable price can be a great way to motivate them. That's because employees who hold options know that if the business is profitable and its stock price goes up, they'll be able to cash in their options at a substantial profit. This can motivate them to help make the business successful. Also, employees who get stock options are often willing to work for a slightly lower salary, making investment capital go farther in the early days of business life.*

Structuring your business as a corporation is not only advantageous but actually essential if—like many small business owners—you dream of someday attracting investors through a public offering. And, fortunately, it's become far easier than it used to be for a small business to do just that without turning to a conventional stock underwriting company. Congress and state legislatures have liberalized laws that enable a small corporation to raise from $1 million to $10 million annually through a relatively easy-to-use procedure called a "limited public offering."

Consider using the Internet to sell shares. *You may decide to market your shares by placing your company's small offering prospectus on the Internet—something now allowed by the Securities and Exchange Commission (SEC), the federal agency that watches over securities laws. If your company creates a website to inform the public about your products and services, you can also use that site to distribute your prospectus and market your shares. Of course, you'll first need to take care of the paperwork required by federal and state securities laws.*

Forming and running a corporation is discussed in more detail in Chapter 3.

Illusory Incorporation Advantages

What, in addition to limited liability and some marginal tax advantages, can you gain by incorporating? In drumming up enthusiasm for incorporating, lawyers and accountants often point to additional supposed benefits—but these advantages are rarely all they're cracked up to be.

Illusory Benefit: Easy Transfer of Corporate Stock If You Sell the Business. The sales pitch is that if you want to sell your interest in the corporation (which may be as much as 100% if you own all of the stock), you simply endorse your stock certificate on the back and turn over the certificate to the new owner. The corporation then issues a new stock certificate in the new owner's name to replace the one that you endorsed.

Reality: There's not much of a market for a small company's stock. And most small business owners go to great lengths to restrict the transferability of their stock. Moreover, in most sales of a corporate business, the corporate assets are transferred rather than the stock. (See Chapter 10.)

Illusory Benefit: Continuity of Business. A corporation continues even if an owner dies or withdraws. (Plus, there may be a buy-sell agreement—perhaps funded by insurance—in which co-owners of the corporation have the right to buy out your inheritors.) Either way, the corporation stays alive, in contrast to sole proprietorships or partnerships, which are automatically dissolved when the owner or a partner dies.

Reality: The death of a principal is traumatic whether you're a sole proprietorship, a partnership, or a corporation. Usually the factors that allow a business to survive are personal and have nothing to do with its formal legal structure. You don't need to incorporate to ensure that your business will continue after your death. A sole proprietor can use a living trust or will to transfer the business to his or her heirs, and partners frequently have insurance-funded buy-sell agreements that allow the remaining partners to continue the business. (See Chapter 5.)

Illusory Benefit: Centralized Management. In corporations with a number of shareholders, management is typically centralized under a board of directors. With a partnership consisting of many partners, management can become fragmented.

Reality: If you are a partner in a partnership, it doesn't take a board of directors to centralize the management; chances are you and the other owners will make all decisions over a cup of coffee.

Conclusion: In weighing pros and cons of incorporation, concentrate on whether you believe you have a real need to limit your personal liability and also on whether you can get substantial tax benefits by retaining some earnings in the corporation and setting up fringe benefit plans. If you conclude that it would be beneficial to form a business entity that offers limited liability, the LLC (discussed in Section D) is often your best choice. And for many new businesses—especially those that won't run up significant debt or expose their owners to the threat of lawsuits—a sole proprietorship or partnership may be a perfectly adequate way to go, keeping in mind that you can always incorporate the business or form an LLC later.

D. Limited Liability Companies

The limited liability company (LLC) is the newest form of business entity. It has enjoyed a meteoric rise in popularity among both entrepreneurs and lawyers—and for good reason. It's often a very attractive alternative to the traditional ways of doing business, which are described in Sections A, B, and C, above.

The state laws controlling how an LLC is created and the federal tax regulations controlling how an LLC is taxed are still evolving. Fortunately, the evolutionary trends are extremely favorable to small businesses. On the formation side, it's becoming simpler and simpler to set up an LLC. On the tax side, LLCs are benefitting from increased flexibility.

For an in-depth discussion of LLCs and step-by-step guidance on creating one: *see* Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo).*

Once you've decided that your business should be organized as an entity that limits your personal liability for business debts, you'll have to weigh the pros and cons of forming an LLC against the pros and cons of forming a corporation. Sometimes, one or the other will clearly emerge as the better choice. Other times, the differences are more subtle—which often means that either will suit your needs equally well. After you've absorbed the information on both legal formats, see Section E for help in choosing between the two.

1. Limited Personal Liability

As with a corporation, all owners of an LLC enjoy limited personal liability. This means that being a member of an LLC doesn't normally expose you personally to legal liability for business debts and court judgments against the business. Generally, if you become an LLC member, you risk only your share of capital paid into the business. You will, however, be responsible for any business debts that you personally guarantee (of course, you can reduce your risk to zero by not doing this) and for any wrongs (torts) that you personally commit (a good insurance policy should help here—see Chapter 12, *Insuring Your Business*).

By contrast, as discussed in Sections A and B above, owners of a sole proprietorship or general partnership have unlimited liability for business debts, as do the general partners in a limited partnership (and limited partners who take part in managing the business—discussed in Section F1, below).

Corporations and LLCs Use Different Language

Although there are many similarities between corporations and LLCs, there are many differences as well—especially when it comes to terminology, as shown in the following chart:

CONCEPT	CORPORATION WORD	LLC WORD
What an owner is called	Shareholder	Member
What an owner owns	Shares of stock	Membership interest
What document creates the entity	Articles of Incorporation (or, in some states, Certificate of Incorporation or Charter)	Articles of Organization
What document spells out internal operating procedures	Bylaws	Operating Agreement

2. Number of Owners

Every state allows an LLC to be formed by just one person. This means that if you plan to be the sole owner of a business and you wish to limit your personal liability, you have a choice of forming a corporation or an LLC.

3. Tax Flexibility

If you create a single-member LLC, it will not be taxed as a separate entity, like a C corporation (see Section C), unless you elect to have it taxed in this manner. Normally, you won't choose corporate-style taxation, preferring to have your single-member LLC report its profits (or losses) on Schedule C of your personal return, just as a sole proprietorship would.

Similarly, if you have an LLC with two or more members, it will be treated as a partnership for tax purposes, with each partner reporting and paying income tax on his or her share of LLC profits unless you elect to have the LLC taxed as a corporation. Again, you normally won't elect to do this, preferring to have your multimember LLC follow the partnership tax route. This means that the LLC will report its income (or loss) on Form 1065, an informational return that notifies the IRS of how much each member earned (or lost). Each member will then report his or her share of profits or losses on her personal Form 1040.

Occasionally, the members of an LLC will conclude that there's an advantage to being taxed like a corporation, with two levels of tax—one at the business entity level (for company profits) and another at the owners' personal income tax level (for salaries and dividends). LLCs that are taxed like corporations are able to split monies between business owners and the business itself, resulting in some situations in a significant overall tax saving. (See Section C2b(1), above, for a discussion of income splitting in the corporate context.)

If, after reviewing all the financial implications—and perhaps seeking the advice of a tax pro—you decide to elect corporation-style taxation, you'll do this by filing IRS Form 8832, *Entity Classification Election*. Where the LLC has two or more members, they can all sign the form or authorize one member or manager to sign.

Electing to have your LLC taxed as a corporation can be advantageous if you want to receive tax-free fringe benefits from the business. *If you follow the usual practice of having pass-through taxation for your LLC—meaning that the business isn't taxed as a separate entity—then as a business owner you'll be taxed on the value of the fringe benefits you receive from the LLC (unlike other employees). A different rule applies if you elect to have your LLC taxed as a corporation. In that situation, as long as you meet the IRS guidelines, you can receive fringe benefits as an owner-employee of the LLC and not have to pay tax on the value of those benefits. (For more on the tax treatment of fringe benefits, see Section C2b(2), above.)*

4. Flexible Management Structure

An LLC member may be an individual or a separate legal entity such as a partnership or corporation that has invested in the LLC. You and the other members jointly run the LLC unless you choose to have it run by a single member, an outside manager, or a management group—which may consist of some members, some nonmembers, or both. If you decide to form an LLC, I recommend that all the members sign an operating agreement that spells out how the business will be managed. Again, the details of how to do this are well covered in *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo).

5. Flexible Distribution of Profits and Losses

The members of an LLC can decide to split up the LLC profits and losses each will receive any way they want. Although it's common to divide LLC profits according to the percentage of the business's assets each member contributed, this isn't legally required.

> **EXAMPLE:** Jim, Janna, Jill, and Jerry—certified personal trainers—form Fit for Life LLC to operate a family fitness center. Each contributes $25,000 to the enterprise. Because Jim, who has a strong business background, has put together the LLC, set up a bookkeeping system, arranged for a bank loan to purchase necessary equipment, and negotiated a very favorable lease at a good location, the owners state in their operating agreement that for the first two years, Jim will receive 40% of the LLC's profits and that Janna, Jill, and Jerry will each receive 20%. After that, they'll share profits equally.

By contrast, rules governing corporate profits and losses are considerably more restrictive. A C corporation can't allocate profits and losses to shareholders; instead, shareholders must receive dividends according to the number of shares they own—if they receive dividends at all. (But it is possible, although more cumbersome, to establish two or more classes of stock, each with different dividend rights.) Similarly, in an S corporation, profits and losses are attributed to the shareholders based on their shares: a shareholder who owns 25% of the shares in an S corporation ordinarily must be allocated 25% of profits and losses—no more and no less. Sometimes, however, corporations can get away from this strict formula by adjusting the salaries of shareholders who work in the business.

The easy flexibility allowed to LLCs in distributing profits and losses permits businesses to be creative and even make distributions to members who have contributed no cash.

> **EXAMPLE:** Howard and Saul run a home repair business organized as an LLC. Howard puts up all the money to needed to buy a van, tools, and supplies and to pay for advertising brochures and radio commercials. Saul, who has little cash but loads of experience in doing home repairs, will contribute future services to the LLC. Although the owners could agree to split profits and losses equally, they decide that Howard will get 60% for the first three years as a way of paying him back for taking the risk of putting up cash.

Starting and operating an LLC is discussed in more detail in Chapter 4.

For forms to use in setting up an LLC: *See* Form Your Own Limited Liability Company, *by Anthony Mancuso (Nolo), and Nolo's* LLC Maker, *an easy-to-use software program that simplifies and automates much of the work of forming an LLC.*

E. Choosing Between a Corporation and an LLC

Let's assume that you've read all the earlier material in this chapter and that you now understand the chief legal, tax, and financial characteristics of the main types of business entities. Let's also assume that you've concluded it would be advantageous to operate your small business through an entity that limits the personal liability of all the owners—even if following this strategy involves a bit more paperwork, complexity, and possible expense.

For the reasons explained earlier in this chapter, you've probably narrowed your choice of entity to either the tried and true corporation or the new and streamlined LLC. Which is better? There's no answer to this question that applies to every business. Nevertheless, some general principles may be helpful.

For the majority of small businesses, the relative simplicity and flexibility of the LLC makes it the better choice. This is especially true if your business will hold property, such as real estate, that's likely to increase in value. That's because C corporations and their shareholders are subject to a double tax (both the corporation and the shareholders are taxed) on the increased value of the property when the property is sold or the corporation is liquidated. By contrast, LLC member-owners avoid this double taxation because the business's tax liabilities are passed through to them; the LLC itself does not pay a tax on its income.

But an LLC isn't always the best choice. Occasionally, other factors may tip the balance toward a corporation. Such factors include the following:

- **You'd like to provide extensive fringe benefits to owner-employees.** Often, when you form a corporation, you expect to be both a shareholder (owner) and an employee. The corporation can, for example, hire you to serve as its chief executive officer and pay you a tax-deductible salary, which, from a tax standpoint, is far better than paying you dividends, which can't be deducted by the corporation as a business expense and therefore wind up being taxed twice (once at the corporate level and once at the personal level). But corporate employees (including employees of a C corporation who are also owners) don't just receive pay—most also receive fringe benefits. These benefits can include the payment of health insurance premiums and direct reimbursement of medical expenses. The corporation can deduct the cost of these benefits and they are not treated as taxable income to the employees. Having your own corporation pay for these fringe benefits and then deduct the cost as a business expense can be an attractive feature of doing business through a regular corporation. These opportunities for you to receive tax-favored fringe benefits are somewhat reduced if you do business as an LLC. Also, a regular corporation may be able to offer slightly better retirement benefits or options under a corporate retirement plan.
- **You want to entice or keep key employees by offering stock options and stock bonus incentives.** Simply put, LLCs don't have stock; corporations do. While it's possible to reward an employee by offering a membership interest in an LLC, the process is awkward and likely to be less attractive to employees. Therefore, if you plan to offer ownership in your business as an employee incentive, it makes sense to incorporate rather than form an LLC.

Choosing Between an LLC and an S Corporation: Self-Employment Taxes Can Tip the Balance

You know that taxes are withheld from employees' paychecks. In 2005, for example, employers must withhold 7.65% of the first $90,000 of an employee's pay for Social Security and Medicare taxes, and 1.45% of earnings above that amount for Medicare taxes. The employer adds an equal amount (to match the employee's share of Social Security and Medicare taxes) and sends these funds to the IRS. The total sent to the IRS is 15.3% on the first $90,000 of wages and 2.9% on earnings above that amount. (See Chapter 8, Section C3.)

You may not be aware that the IRS collects a similar 15.3% tax on the first $90,000 earned by a self-employed person and a 2.9% tax on earnings above that amount for Medicare alone. For this reason, the Social Security and Medicare tax is often referred to as the "self-employment" tax.

For an S corporation, the rules on the self-employment tax are well established: As an S corporation shareholder, you pay the self-employment tax on money you receive as compensation for services—but *not* on profits that automatically pass through to you as a shareholder. For example, if your total share of S corporation income is $100,000 in 2005 and you perform services for the corporation reasonably worth $65,000, you will be taxed 15.3% on the $65,000 but not on the remaining $35,000.

By contrast, the rules for members of an LLC are more complicated, and, for now, somewhat unsettled. Proposed IRS regulations (which Congress has placed on hold) would impose the self-employment tax on your entire share of LLC profits in any of the following situations:

- You participate in the business for more than 500 hours during the LLC's tax year.
- You work in an LLC that provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (no matter how many hours you work).
- You're empowered to sign contracts on behalf of your LLC.

Even though these proposed regulations do not have the force of law, the IRS says it won't challenge you if you use them in determining your liability for self-employment tax. This means that if you don't fall into one of the three categories listed above, you can use the same rules as apply to S corporation shareholders. But if you *do* fall into one of the above categories, you should assume that 100% of your income from the business will be subject to self-employment tax (although the amount that's over the current year's Social Security tax cut-off figure—$90,000 in 2005—will be subject only to Medicare tax).

The point is that, in some cases, an S corporation shareholder may pay less self-employment tax than some LLC members with similar income. You'll need to decide whether these potential tax savings are more important than gaining such LLC advantages as flexibility in management structure and in distributing profits and losses.

F. Special Structures for Special Situations

It's very likely that the best organizational structure for your small business is either a sole proprietorship, partnership, corporation, or LLC. (See Sections A, B, C, and D, above.) There are, however, some situations in which other, less common entities will either offer some tax or other advantage or will be legally required. For instance, you and your tax advisor may decide that selecting a less common structure may be desirable for your business. Your real estate investment group, for example, may find some benefit in creating a limited partnership (described in Section 1, below). Or, you may find that the law in your state *requires* you to select a less common structure for your business; for example, if you're a doctor or an accountant and you want to limit your personal liability, state law may require you to form a professional corporation, a professional LLC, or a limited liability partnership (all of which are described below in Section 2).

1. Limited Partnerships

The kind of partnership covered in Section B, above, is a *general* partnership. It's very different from another form of partnership known as a *limited* partnership, which, in certain circumstances, can combine the best attributes of a partnership and a corporation.

Most limited partnerships are formed to invest in real estate because of tax advantages for those who are passive investors; the passive investor is often able to personally write off depreciation and other real estate deductions. For the majority of other types of small businesses with more than one owner, chances are that forming either a general partnership, a corporation, or an LLC will be the best way to go.

A limited partnership works like this. There must be one or more "general partners" with the same basic rights and responsibilities as in any general partnership, and one or more "limited partners," who are usually passive investors. The big difference between a general partner and a limited partner is that the general partner *is* personally liable for the obligations of the partnership and the limited partner is *not* personally liable for them. The most a limited partner can lose by investing in a limited partnership is the amount that he or she:

- paid or agreed to pay into the partnership as a capital contribution; or
- received from the partnership after it became insolvent.

To maintain this limited liability, a limited partner may not participate in the management of the business, with a very few exceptions. A limited partner who does get actively involved in the management of the business risks losing immunity from personal liability, meaning he or she would have the same legal exposure as a general partner.

The advantage of a limited partnership as a business structure is that it provides a way for business owners to raise money from passive investors (the limited partners) without having either to take in new partners who will be active in the business or to engage in the intricacies of creating a corporation and issuing stock.

> **EXAMPLE:** Anthony and Janice's plan is to buy rundown houses, renovate them, and then sell them at a good profit. All they lack is the cash to make the initial purchases. To solve this problem, they first create a partnership consisting of the two of them. Then they establish a limited partnership, with their own partnership as the general partner, and seek others who are willing to invest for a defined interest in the venture. Anthony and Janice figure that they need $100,000 to get started. They sell ten limited partnership interests at $10,000 each. The limited partners are given the right to a percentage of the profits for a specified number of

years, but they are not liable for any obligations of the partnership.

A general partnership that's been operating for years can also create a limited partnership to finance expansion.

EXAMPLE: Judith and Aretha have been partners in a small picture frame shop for two years. They want to expand into a bigger store in a much better location, where they can stock a large selection of fine art prints as well as frames. To raise money, they create a limited partnership, offering each investor an 8% interest in the total net profits of the store for the next three years as well as the return of the invested capital at the end of that period, in exchange for a $20,000 investment. They sell four limited partnership interests, raising $80,000.

There is a downside to limited partnerships: Doing business as a limited partnership can be at least as costly and complicated as doing business as a corporation. Although limited partnerships don't have to issue stock, state laws typically require that a limited partnership file registration information about the general and limited partners.

Watch out for confusing labels. *Despite the similarity in names, there are major differences between a limited partnership (discussed above) and a limited liability partnership (discussed below). To summarize:*

- *A limited partnership consists of at least one general partner and one or more limited partners. A general partner in a limited partnership is personally liable for all debts of and judgments against the business—regardless of who incurred the debt or other liability. A limited partner is generally not personally liable for any debts or judgments unless he or she actively participates in the business.*
- *A limited liability partnership (LLP) is a special form of general partnership and is usually reserved for professionals such as doctors, lawyers, and accountants. Normally, a partner in an LLP isn't personally liable for the negligent acts of other partners but is liable for his or her own negligence and for other partnership debts.*

2. Choices for Professionals

If you are a professional, such as a doctor, lawyer, or accountant, your choice of business structure may have to take into account certain additional factors. These include your need to avoid group liability, and state laws or rules of professional ethics governing your choices of business structure.

a. Professional Corporations

Laws in every state permit certain professionals to form corporations known as "professional corporations" or "professional service corporations." In many states, people in certain occupations (for example, doctors, lawyers, or accountants) who want to incorporate their practice can do so only through a professional corporation. In some states, some professionals have a choice of incorporating as either a professional corporation or a regular corporation (which can elect to be an S corporation).

The list of professionals eligible to incorporate is different in each state. Usually, though, professionals that must create a professional corporation include:

- accountants
- engineers
- health care professionals such as audiologists, dentists, nurses, opticians, optometrists, pharmacists, physical therapists, physicians, and speech pathologists
- lawyers
- psychologists
- social workers
- veterinarians.

Call your state's corporate filing office (usually the secretary of state or corporation commissioner) to see who is covered in your state.

Typically, a professional corporation must be organized for the sole purpose of rendering professional services and all shareholders must be licensed to render that service. For example, in a medical corporation, all of the shareholders must be licensed physicians.

Professional corporations aren't as popular as they used to be. The main reason for professionals to incorporate—favorable corporate taxation rules—has disappeared. Before 1986, professionals who incorporated could shelter more money from taxes than sole proprietors or partners could. This has all changed. Most professional corporations are now classified as "personal service corporations" by the IRS (see "Personal Service Corporations," below). Because the corporate income of personal service corporations is taxed at a flat rate of 35%, there's no longer any advantage to be gained by the two-tiered tax structure that allows ordinary corporations to save taxes on some retained earnings. Tax laws, however, still give favorable treatment to fringe benefits for corporate employees in professional corporations. (See Section C2b, above.)

Personal Service Corporations

Personal service corporations are defined under federal tax laws and have two basic characteristics:

- the professional employees of the corporation own the stock; and
- the corporation performs services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

The other reason for professionals to consider incorporation is the limitation on personal liability. It's no secret that malpractice verdicts against professionals continue to climb. While incorporating can't protect a professional against liability for his or her negligence, it can protect against liability for the negligence of an associate.

EXAMPLE 1: Dr. Anton and Dr. Bartolo are surgeons who practice as partners. Dr. Bartolo leaves a medical instrument inside a patient, who bleeds to death. The jury returns a $2 million verdict against Dr. Bartolo and the partnership. There is only $1 million in malpractice insurance to cover the judgment. Dr. Anton (along with Dr. Bartolo) would be personally liable for the $1 million not covered by insurance.

EXAMPLE 2: Drs. Anton and Bartolo create a professional corporation. Dr. Bartolo commits the malpractice described in Example 1. Dr. Anton, a corporate employee, would not be personally liable for the portion of the verdict not covered by insurance. Dr. Bartolo, however, would still be personally responsible for the $1 million excess, because he was the one guilty of malpractice. (In some states, Dr. Anton would be free from personal liability only if the professional corporation carried at least the minimum amount of insurance mandated by state law.)

Insurance is a better alternative for most professionals than is the limited liability offered by incorporation. But with malpractice rates soaring for many professionals, it's often hard to afford all the insurance you could possibly need, so forming a professional corporation can be a useful backup.

As an alternative to incorporating, professionals wishing to limit their personal liability should consider forming a professional limited liability company (PLLC) or limited liability partnership (LLP) as described below.

b. Professional Limited Liability Companies

As explained above, licensed professionals are permitted to incorporate but, in most states, they can do so only by forming a special type of corporation—a professional corporation (PC). Similarly, in many states, licensed professionals who wish to form an LLC are required to use a special type of LLC known as a "professional limited liability company" (PLLC).

Lawyers or doctors in a group practice, for example, may find it advantageous to form a PC or PLLC so that each member of the group is legally liable for only his or her malpractice—not the malpractice of other members of the group, as would be the case in a partnership. Members of a PLLC also won't be personally liable for other business debts such as obligations owed to business creditors, lenders, and the landlord.

Typically, state laws require that all members of a PLLC be licensed to practice the same profession—accounting, for example, or engineering.

Especially if the PLLC consists of lawyers, accountants, engineers, doctors, or other health care professionals, state law may require that each member at least carry a specified amount of malpractice insurance or be bonded.

Check the law in your state before setting up a PLLC. *If you're a professional and considering the creation of a PLLC, you need to check your state's statute to learn which professionals can and can't form such an entity. There's wide variation from state to state. (For example, in California, many professionals, such as health professionals, therapists of any type, and architects, cannot form any type of LLC.) If you're a member of a state professional society, its administrator may know the answer, or you can check the statute book at a nearby public library. (See Chapter 24 for information on doing legal research.)*

c. Limited Liability Partnerships

In a few states, laws or professional ethics rulings prevent accounting or law firms from doing business as corporations or LLCs. If you're an accountant or lawyer in such a state and would like some limitation on your personal liability for business obligations, look into forming a limited liability partnership (LLP). Unfortunately, the protection it offers is usually less than you'd get by forming a corporation or LLC—but it's better than nothing.

Available in some but not all states, a limited liability partnership is simply a general partnership whose partners enjoy some protection from personal liability. LLPs are authorized under state statutes and there's a bit of variation from state to state.

Typically a partner in an LLP is personally liable only for his or her own negligence (malpractice) or that of an employee working directly under the partner's supervision; the partner isn't personally liable for the negligence of anyone else in the firm. That's helpful but, as a partner in an LLP, you're still personally liable for a large variety of partnership debts not involving your own negligent acts, for example, obligations owed to business creditors, lenders, and the landlord—regardless of which partner incurred the obligation for the partnership.

EXAMPLE: Hillary, Edgar, and Paula—all certified public accountants—want to form a new firm, but determine that ethics rules in their state prevent them from forming a professional corporation or PLLC. Instead, they form an LLP. Hillary, during a period of disarray in her personal life, messes up big time on a tax return for a major client, who has to pay huge penalties to the IRS. The client sues for malpractice and is awarded a $25,000 judgment. The LLP and Hillary are liable for paying the judgment. Edgar and Paula are not.

During the same period, Hillary also orders $15,000 worth of fancy office furniture, which the LLP can't afford. All three partners are personally liable for the furniture debt. (By contrast, if local ethics rules had allowed the three accountants to organize their accounting firm as a professional corporation or professional limited liability company and they had done so, none of them would be personally liable for the cost of the furniture unless they personally guaranteed payment.)

Check the law in your state before setting up an LLP. *If you're a professional and considering the creation of an LLP, you need to check your state's statute to learn which professionals can and which can't form an LLP, because of the wide variation from state to state. (For example, only architects, accountants, and lawyers can form LLPs in California, where LLPs are referred to as "registered limited liability partnerships," or RLLPs.) If you're a member of a state professional society, its administrator may know the answer, or you can check the statute book at a nearby public library. (See Chapter 24 for information on doing legal research.)*

3. Nonprofit Corporations

Each state permits people to form nonprofit corporations, also known as not-for-profit corporations. The main reason people form these corporations is to get tax-exempt status under the Internal Revenue Code (Section 501(c)(3)). To get tax-exempt status, the corporation must have been formed for religious, charitable, literary, scientific, or educational purposes.

If a corporation is tax-exempt under Section 501(c)(3), not only is it free from paying taxes on its income, but people and organizations who contribute to the nonprofit corporation can take a tax deduction for their contributions. Because many nonprofit organizations rely heavily on grants from public agencies and private foundations to fund their operations, attaining 501(c)(3) status is critical to success.

Tax-exempt status isn't the only benefit available to a nonprofit corporation. The nonprofit label seems to create an altruistic aura around the organization and the people running it. The message is, "We're not in this for the money—we really do love kids (or music or animals)." Also, an organization that plans to do some heavy mailing may be attracted by the cheaper postal rates that nonprofits are charged.

What kinds of groups should consider becoming nonprofit corporations? Here's a partial list:

- child care centers
- shelters for the homeless
- community health care clinics
- museums
- hospitals
- churches, synagogues, mosques, and other places of worship
- schools
- performing arts groups
- conservation groups.

Most nonprofit corporations are run by a board of directors or trustees who are actively involved in the work of the corporation. Officers and employees (some of whom may also serve on the board) usually carry out the day-to-day business of the corporation and often receive salaries.

Keep in mind that if you put assets into a nonprofit corporation, you give up any ownership or proprietary interest in those assets. They must be irrevocably dedicated to the specified nonprofit purposes. If you want to get out of the business, you can't sell it and pocket the cash. If the nonprofit corporation does end, any remaining assets must go to another nonprofit.

This book is addressed primarily to people starting and running a business for profit, so you'll find little here on the peculiarities of nonprofit corporations. If you want to learn about such corporations in greater depth, see How to Form Your Own Nonprofit Corporation, *by Anthony Mancuso (Nolo). That book provides step-by-step instructions for forming a nonprofit corporation in all states.*

4. Cooperatives and Cooperative-Type Organizations

Some people dream of forming a business of true equals—an organization owned and controlled democratically by its members.

These grassroots business organizers often refer to their businesses as a group, collective, or co-op—but these are usually informal rather than legal labels. Everyone who starts a business with others needs to select a legal structure. Generally, this means picking one of the traditional formats described in this chapter: a nonprofit corporation, a partnership, a C corporation, or an LLC. However, some states do have specific laws allowing the formation of a "cooperative corporation." For example, in some states, a consumer "co-op" could be created to manufacture and sell arts and crafts.

If a co-op law exists in your state, it can help make the process of democratic ownership go more smoothly. Otherwise, you'll need to make sure your partnership agreement, corporate bylaws, or LLC operating agreement contains the cooperative features that you and the other members feel are appropriate.

To learn more about cooperative-type organizations and how to start one, visit the website of the National Cooperative Business Association at www.ncba.org. You can order many helpful publications there. Another fine resource is Co-op Incorporation Sourcebook *(Center for Cooperatives, University of California at Davis). It reviews business feasibility and legal requirements for starting a nonagricultural cooperative in California.* ■

CHAPTER

2

Structuring a Partnership Agreement

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11. Resolving Partnership Disputes 2/12

C. Changes in Your Partnership 2/13

There are two kinds of partnership: the general partnership and the limited partnership. This chapter discusses forming the more common kind, general partnerships. See Chapter 1, Section F1, for basic information about limited partnerships.

Features of the General Partnership

Main advantages. Simple and inexpensive to create and operate. Owners (partners) report their share of profit or loss on their personal tax returns.

Main disadvantage. Owners (partners) are personally liable for business debts.

A. Why You Need a Written Agreement

When you form a partnership to run a small business, your partners will probably be family members, close friends, or business associates. You may think it's unnecessary to sign a document with people you know quite well. Experience proves otherwise. No matter how rosy things are at the beginning, every partnership inevitably faces problems over the years. A well-thought-out written agreement will help you preserve the business, as well as your friendships.

You can, however, have a legally valid partnership even without a written partnership agreement. If you don't sign an agreement, the laws of your state will dictate how the partnership is run. That isn't all bad. Every state except Louisiana has adopted either the Uniform Partnership Act (UPA) or the Revised Uniform Partnership Act (RUPA). States have sometimes made slight variations in these laws but there is still a remarkable amount of consistency from state to state.

These state laws solve many common partnership problems in a sensible way. For example, the UPA says that if you don't have an agreement, each partner shares equally in the profits and has an equal voice in management of the business. The UPA goes on to say that partners are not entitled to receive compensation for services they provide to the partnership.

While it's conceivable that the provisions of the UPA are exactly what you and your partners want, partners usually prefer to modify at least some of them. For example, if one partner contributes far more assets than others, that partner may deserve a greater share of the profits. Or you may want to allow one or more partners to receive a salary for their services. Or you may not want each partner to have an equal voice in running the business. Similarly, you may want to include customized provisions on how to value a partner's interest in the business if a partner dies or leaves. In that situation, many partners want to assign some value to the goodwill of the business for tax purposes—something that does not happen automatically under the UPA. With a written partnership agreement, you can tailor your partnership to fit your needs.

There are other benefits to working out the details in a written partnership agreement. You'll focus on issues you might not have thought of—issues about which you and your partners may have different opinions. For example, what if one partner wants compensation beyond a share of the profits to recognize work he or she performs in the evening or on weekends for the partnership? By getting issues out into the open early, you can nip problems in the bud.

Most Partnership Information Is Confidential

The terms of a partnership agreement for a general partnership don't have to be made public. But, in some states, you must file a certificate of partnership, stating the names of the partners, with a county official (such as the county clerk) or state official (such as the secretary of state). (See Chapter 6, Section B3.)

B. An Overview of Your Partnership Agreement

It's up to you and your partners to decide what shape the partnership will take. A lawyer can help you focus on issues and suggest possible solutions, but you and your partners—not the lawyer—must make the basic choices.

This section goes through the clauses that are usually included in a partnership agreement for a small business.

Chapter 2 of *Legal Forms for Starting & Running a Small Business* *contains a sample partnership agreement.*

Where to Find Help With Partnership Agreements

The Partnership Book, by Denis Clifford and Ralph Warner (Nolo). It's the source of the clauses in this chapter, and contains extensive additional material on forming, managing, and ending a partnership.

1. Name and Term

Although many partnerships do business using the last names of the partners, it's both legal and common for a partnership to have one name and to do business under another name. For example, the partnership of Jones, Gold, and Sanchez could decide to do business as Seafood Express. The name Seafood Express would be an assumed name, or fictitious name, which you'd have to register with the appropriate state or county office.

Chapter 6 contains a thorough discussion of business and product names.

Another issue is how long the partnership will last. If you want it to go on indefinitely, include a clause in your partnership agreement like this:

> The partnership shall last until it is dissolved by all the partners or a partner leaves, for any reason, including death.

On the other hand, if you plan to develop a particular piece of real estate or do some other finite task, you might want a clause with a definite date, such as one of the following:

> The partnership shall commence as of the date of this agreement and shall continue for a period of _____ years, at which time it shall be dissolved and its affairs wound up.

or

> The partnership shall continue until _____*[specify an event such as "the completion and sale of The Commercial Office Plaza"]*, at which time the partnership shall be dissolved and its affairs wound up.

2. Purpose

The purpose of the partnership should be broadly stated in plain English. The advantage of a broad statement of partnership purposes is that you have flexibility if the business evolves. Here are two typical purpose clauses:

> The purpose of the partnership is to operate one or more stores for the sale of records, tapes, compact discs, or other related merchandise.

or

> The purpose of the partnership is to operate a bookkeeping and tax preparation service for individual clients and small businesses.

On the other hand, if you're sure you're creating your partnership for a short-term, specific purpose, such as presenting one trade show, it would be appropriate to use a more limited purpose clause, such as this one:

> The purpose of the partnership is to organize and present this year's Builders and Home Improvement Show at the Municipal Convention Center.

3. Contributions

Your partnership agreement should describe the initial contributions that you and your partners will make. Often, each partner contributes cash only.

The amounts of contributions may be equal, but don't have to be. For example, one partner might contribute $5,000 while another contributes $1,000 and a third contributes a pickup truck. If a partner contributes property such as a vehicle, tools, a building, a patent, or a copyright, you need to agree on the value of that property. You can also provide that one of the partners will contribute personal services (perhaps painting the business headquarters) in return for a partnership interest. Keep in mind that a partner can sell, lend, lease, or rent property to the partnership too.

a. Cash Contributions

It's logically neat if each partner contributes an equal amount of cash to a new business. Otherwise, partners who invest more money than the others may feel entitled to a larger voice in making partnership decisions. But in the real world, not all partners are always able to make equal contributions of cash. One way to handle this is to have the partner who contributes more lend the extra amount to the business rather than contribute it outright.

> **EXAMPLE:** Ricardo and Alberta are opening a martial arts training center. Ricardo has just left a job at a corporation and received a handsome severance package. He's willing to put $40,000 into the business. Alberta, on the other hand, is a single mother who wants to start a business precisely because she is short of money. She can raise $10,000. Alberta could contribute $10,000 and Ricardo $40,000, with Ricardo having more say in partnership decisions than Alberta. But an easier and more democratic approach would be for each to contribute $10,000 in cash, with Ricardo lending the partnership the additional $30,000, to be repaid over three years at 10% annual interest.

A basic clause for equal cash contributions reads as follows:

> The initial capital of the partnership shall be a total of $________________. Each partner shall contribute an equal share amounting to $___________ no later than ______________, 20____. Each partner shall own an equal share of the business.

If a partner can't initially contribute the desired amount of cash, another way to handle this problem is to agree that he or she will make payments over time. Here's a sample clause.

> Arthur Feldman shall be a partner upon making an initial contribution of $1,000 to the capital of the partnership. He will subsequently contribute to the partnership capital, and his capital account shall be credited, in the amount of $100 per month beginning July 1, 20__, until he has contributed the sum of $5,000 (including the initial $1,000 payment).

Interest on Partnership Investment: Should partners receive interest on their contributions of capital? Generally, no—after all, the money is already at work building a jointly owned business. But either way you decide this issue, cover it with a specific clause in the partnership agreement.

b. Contributions of Services

Sometimes, a partner's contribution consists wholly or in part of services. In the above example concerning Alberta's contribution to the martial arts training center, another way to handle the disparity in available cash would be for Alberta to agree to work a certain number of hours more than Ricardo at a fixed rate (say $20 per hour) until the contributions were equalized. After that, the partners would work an equal amount of hours each week. If a partner is going to contribute services in return for an interest in the business, this should be spelled out in the partnership agreement.

> **EXAMPLE:** Margaret and Alice form a 50/50 partnership for catering parties. Each will spend equal time on preparing the food and delivering it. Margaret contributes $10,000 to get the business going. Alice agrees to contribute unpaid labor as a bookkeeper and business manager for one year over and above the amount of time she spends on food-related work. Their intention is to equalize the contributions of the partners.

c. Contributions of Property

Some or all of the partners may contribute property as well as, or instead of, cash. A clause covering this possibility might look like this:

> ______________ shall contribute property valued at $______________ consisting of ______________ ______________ by ______________, 20____. [*If the property is difficult to describe, describe it in detail on a separate sheet of paper marked* "Exhibit A" *and add here,* "and more particularly described in Exhibit A, attached to this agreement."]

Getting expert help. *If you're transferring property to your partnership, you may need the assistance of a tax expert. Such contributions raise questions about what tax basis (value) will be assigned to the property being transferred. The IRS looks at tax basis in determining how much profit you've gained when the property is later transferred or sold as well as the amount of losses you can claim on your tax return if the business is not profitable. These tax details are beyond the scope of this book.*

4. Profits, Losses, Draws, and Salaries

How will partners be compensated? The first issue is how you'll divide profits once a year or at the end of some other fixed period. You should also determine whether any partners can receive an early draw against their share of the profits—that is, be paid a portion of profits sooner than other partners. This might be appropriate if one partner is coming into the partnership with less savings than the others and is counting on partnership income for living expenses.

You'll also need to decide whether any partners will receive a salary for work done in the business in addition to draws on their share of profits. If equal partners will all work a roughly equal number of hours, there's no need to pay salaries; an equal division of profits with or without a draw should be adequate. But if one partner will work more hours than the others, paying that partner a salary may be sensible. Or you could give the harder-working partner a larger share of the profits. If salaries are paid, they're a normal business expense and don't come out of profits.

If profits are shared equally, the following clause would be appropriate:

> The partners will share all profits equally, and they will be distributed [*monthly, yearly, etc.*]. All losses of the partnership will also be shared equally.

On the other hand, if profits and losses will be shared unequally, here are some sample clauses to consider:

> Partnership profits and losses will be shared among the partners as follows:

Name	Percentage
____________________________	__________
____________________________	__________
____________________________	__________
____________________________	__________

or

> Partnership profits and losses shall be shared among the partners as follows:

Name	% of Profits	% of Losses
____________	________	________
____________	________	________
____________	________	________

or

> Partnership profits and losses shall be shared by the partners in the same proportion as their contributions of capital bear to each other.

A draw is an advance of anticipated profits paid to a partner or partners. It's easiest if draws are to be made by all partners. But if you want to authorize draws for only certain partners, a clause like the following is appropriate:

> Partners _____________________ and _________________ are entitled to draws from expected partnership profits. The amount of each draw will be determined by a vote of the partners. The draws shall be [*monthly or on any other kind of schedule that you agree to*].

You may also want to provide for the partnership to retain some profits in the business for new equipment, expansion, or employee bonuses. Here's a sample clause:

> In determining the amount of profits available for distribution, allowance will be made for the fact that some money must remain undistributed and available as working capital as determined by [*for example, "all partners" or "a majority of partners"*].

Even though profits are reinvested, you and the other partners are taxed on your shares of them at your individual rates. (Chapter 1, Section C2b, discusses how a regular corporation may afford tax advantages over a partnership when a business has retained earnings.)

The Authority of Partners

Do you want each partner to be able to make decisions that bind the partnership in the normal operation of its business? Or do you want some limitations—for example, that large contracts or purchases must be approved in advance by a majority of the partners? You can address this issue in your partnership agreement. But remember that while a limitation on a partner's authority is binding among the partners themselves, it doesn't necessarily limit liability to outsiders who deal with the partner.

EXAMPLE: Peggy, Roger, and Lisa run a bookkeeping and billing service for several doctors, dentists, and clinics. Peggy, who is a computer whiz, believes that there's no such thing as too much electronic equipment. So in the partnership agreement, a clause provides that any purchase of equipment requires the approval of at least two of the partners. Peggy buys three notebook computers, two laser printers, and assorted modems and fax machines for the partnership, without approval. The partnership and each partner are liable for the $12,000 bill, even though the partners limited liability among themselves. When Peggy purchased the equipment, the computer store didn't know what was in the partnership agreement—the usual case. And Peggy appeared to have authority to bind the partnership. The other partners, however, will have a legal claim against Peggy because she exceeded her authority under the partnership agreement.

LAW IN THE REAL WORLD
A Profitable Experience

Jan and Mike discussed forming a partnership to open a desktop publishing service aimed at helping small businesses design brochures, flyers, and other promotional material. The idea of sharing the work and profits 50-50 appealed to both of them. There was only one major hang-up: The partnership agreement form they looked at provided for profits to be divided at the end of the year. This was okay with Mike, who had received a generous severance package from a former job, but not for Jan, who was trying to put her daughter through college and had no financial cushion.

Recognizing their different circumstances, Jan and Mike agreed Jan would be allowed to take a monthly draw against her share of anticipated partnership profits of $3,000. And because they realized a new business needs all the cash it can get its hands on, Mike would wait and take the same amount at the end of the year. Then Mike and Jan would split any additional profits.

To guard against the possibility that Jan's draw would use up more than half of the profits and shortchange Mike, the partners, after checking the tax consequences with their tax advisor, also agreed that any amount Jan received over her 50% share would be considered a personal loan from the partnership, to be repaid out of her share of future years' profits.

5. Management Responsibilities

It's wise to pin down the basic way you'll operate the business. Commonly, in small business partnerships, all partners are involved in management and supervision, justifying a clause like the following:

> All partners shall be actively involved and materially participate in the management of operation of the partnership business.

You can go further if you want every partner to have a veto power:

> All partnership decisions must be made by the unanimous agreement of all partners.

Some small business partnerships distinguish between major and minor decisions, allowing a single partner to make a minor decision but requiring unanimity for major ones. If you decide to go down this road, you have to figure out how to define a major decision. The distinction between major and minor decisions—especially purchases or the undertaking of obligations—is often based on a dollar amount. A clause like this one would be appropriate:

> All major decisions of the partnership business must be made by a unanimous decision of all partners. Minor business decisions may be made by an individual partner. Major decisions are defined as all purchases and contracts over $5,000 [*or other definition of major decisions*].

If you want to provide for unequal management powers, here are some clauses to consider:

> Each partner shall participate in the management of the business. In exercising the powers of management, each partner's vote shall be in proportion to his or her interest in the partnership's capital.

or

> In the management, control, and direction of the business, the partners shall have the following percentages of voting power:
>
> Name Percentage

Name	Percentage
______________________	__________
______________________	__________
______________________	__________
______________________	__________

If the partners are going to contribute different types of skills, you may also want to state that in your partnership agreement. And while it may seem unnecessary to list the hours to be worked, you may avoid possible problems through a clause such as the following:

> Except for vacations, holidays, and times of illness, each partner will work __________ hours per week on partnership business.

Consider a clause on leaves of absence or sabbaticals. How much time off is allowed? And what happens to a partner's right to receive pay or profits while on leave?

Other financial matters to be dealt with in the partnership agreement may include the following:

- May partners borrow money on behalf of the partnership? Is there a dollar limit on how much a partner can borrow on behalf of the partnership without the prior consent of all partners?
- Are expense accounts authorized? If so, is there a limit on the amount?
- How many signatures are required on partnership checks and to withdraw money from the partnership bank account?
- How many weeks of paid or unpaid vacation each year are partners entitled to?

6. Partners' Outside Business Activities

A key partnership question is whether or not any partner can engage in outside business. In some instances, they must, at least at first, because the partnership business income isn't enough to live on. If a partner can engage in outside business, what types are permitted? You wouldn't want a partner to directly compete with the partnership. That would be a conflict of interest. But how do you define direct competition? If the partners are running a restaurant, can one of the partners own a catering business? Or work in a delicatessen? There are at least four different approaches to this issue. You can:

- Allow partners to engage in one or more other businesses except for those that directly compete with the partnership business.
- Allow partners to engage in other businesses without any other restrictions.
- List permitted activities.
- Prohibit partners from participating in any other business.

Here's an example of the first approach:

> Any partner may engage in one or more other businesses as well as the business of the partnership, but only to the extent that this activity does not directly and materially interfere with the business of the partnership and does not conflict with the time commitments or other obligations of that partner to the partnership under this agreement. Neither the partnership nor any other partner shall have any right to any income or profit derived by a partner from any outside business activity permitted under this section.

LAW IN THE REAL WORLD
Outside Interests

When Ted M. and Ted Y. formed a partnership and opened a bookstore (yup, they called it Two Teds), they didn't expect to make much, if any, money right away. According to their business plan, it would take two to three years for the store to be solidly profitable. In the meantime, both men would have to hold down second jobs. This led to a serious problem. Both men already worked in the book business (Ted M. managed a secondhand book shop, and Ted Y. was a sales rep for a large publisher) and wanted to avoid any hint of a conflict of interest between their personal and partnership interests.

Ted Y. explained his store plans to the publisher he worked for, who agreed to reduce his sales territory and let him work three days per week. (Ted Y. also promised to work 30 hours at Two Teds.) Because selling books to stores and selling them to the public aren't competitive operations, it was easy for the Teds to agree in writing as part of their partnership agreement that Ted Y.'s job didn't amount to a conflict of interest with the partnership.

Ted M.'s situation was tougher. No matter how much they thought about it, managing one store while owning part of another in the same city reeked of possible conflicts of interest. To solve this, it was decided that Ted M. would quit managing the other store. Initially, at least, he would work 55 hours per week at Two Teds and be paid a reasonable salary for the 25 hours per week he worked more than Ted Y.

7. Departure of a Partner—Buyouts

Now we're getting into one of the most essential—but complicated—areas of a partnership agreement: what you'll do if one of the partners voluntarily leaves, becomes disabled, or dies. These things are not easy to think about when you're caught up in the excitement of starting a new business. Still, it's risky to postpone facing them. Sooner or later the partnership will change and fundamental issues will come up. A partner may want to leave for any number of reasons—such as to start another business or to move to another part of the country. Or maybe a partner will retire or die. Can the departing partner sell his or her interest? Do the remaining partners or partner have the right to buy it? How is the purchase price determined?

If one partner quits or dies, most partnership agreements very sensibly require a departing partner to give the remaining partners the chance to buy out his or her share and continue the business before selling or transferring it to outsiders. Here's a sample "right of first refusal" clause designed to accomplish this:

> If any partner leaves the partnership, for whatever reason, whether he or she quits, withdraws, is expelled, retires, or dies, or becomes mentally or physically incapacitated or unable to fully function as a partner, he or she, or (in the case of a deceased partner) his or her estate, shall be obligated to sell his or her interest in the partnership to the remaining partners, who may buy that interest under the terms and conditions set forth in this agreement.

This option protects the remaining partners. But what if the departing partner has found a buyer who is willing to pay a hefty price for that partnership interest? Some partnerships don't compel a departing partner to take a lower price (as predetermined in the partnership agreement) than he or she would get from a bona fide outside buyer; their partnership agreements provide that the existing partners must pay the market price for the departing partner's share. Either way you resolve this issue, you should spell out your solution in the partnership agreement.

Here's a different approach:

> If the remaining partners do not purchase the departing partner's share of the business under the terms provided in this agreement within _____ days after the departing partner leaves, the entire business of the partnership shall be put up for sale and listed with an appropriate sales agent or broker.

a. Valuing a Partner's Share

One major issue in a buy-out clause is how you'll set the worth of the business—and the value of a partner's share. Let's look at some specific valuation methods.

The *asset valuation method* is based on the current net worth of the business (assets minus liabilities). As of the date the departing partner leaves, the net worth of all partnership assets is calculated and all outstanding business debts are deducted to determine net worth. Because goodwill isn't a tangible asset, it's not counted. The departing partner receives his or her ownership percentage of this amount, under whatever payout terms you agreed on.

The *book valuation method* is a variation of the asset valuation method. You calculate the value of all partnership assets and liabilities as they're set forth in the partnership accounting books, which basically means the acquisition cost. Because book value doesn't cover goodwill, in a successful business it has little relation to what the business is really worth. Furthermore, the acquisition cost of property is unlikely to be its current worth.

The *set-dollar method* involves an agreement by the partners in advance that if one partner departs from the partnership, the others will buy out his or her share for a preestablished price. Before adopting this method, be aware that the price selected may be arbitrary. Even if accurate for the present time, the worth of the business may fluctuate, making a predetermined value out of date. You might consider having the partners unanimously establish a value in writing for the partnership each year.

A *post-departure appraisal* means that you agree to have an independent appraiser determine the worth of the partnership when a partner departs. It sounds good in principle, but because many small businesses aren't amenable to precise valuation, even in the hands of an expert appraiser, it can lead to bitter arguments later.

The *capitalization of earnings method* determines what the business is worth based on what it earns. Unless there's an open market to set a price, the best estimate of what a business is worth often depends on its earning capacity. This method works best with a business that's been around for several years. First you need to measure the earnings of the business for a year or more. Then you must agree on a multiplier (often two to five) which, in effect, takes into consideration the fact that a buyer hopes to reap profits in future years. Finally, you multiply the earnings by your multiplier to arrive at a value. But how do you establish the multiplier? Often one is already loosely established in a particular industry. A consultant or trade magazine may tell you that profitable dry cleaning businesses are often sold on the basis of multiplying profits by a certain number. Be aware that this sort of information is at best an estimate, which can change by industry, individual business, and year. If you decide to use this method of valuing your business, you'll need expert advice.

You may want to have a different buyout price depending on when or why a partner departs. For example, a partner who leaves during the initial stages of a business (say, the first one or two years) may be entitled only to the balance in his or her capital account. After that initial period, the departing partner's interest could be calculated by a method that more accurately reflects the actual operation and success of the business.

You could also have varying formulas depending on why the partner leaves. For example, there might be one formula if the partner becomes disabled, retires over age 65, or dies, and another formula if the partner leaves under other circumstances.

b. Payments to Departing Partners

Your partnership agreement should provide for a payment schedule if there's a buyout. Otherwise, the departing partner would have the right to collect for the full value of his or her interest promptly. This could become a serious problem if a partner dies, since the deceased partner's family would likely insist on exercising this right.

Your decision on payment terms has a close relationship to the method you use for determining the buyout price. If the remaining partners can pay the price over a number of years, they're usually willing to pay a higher buyout price than if they must pay all the cash the day a partner leaves.

One of the best ways to finance the buyout of a partner's interest is through insurance. If a partner dies, the proceeds from the partnership-financed insurance policy are used to pay off his or her share, and partnership operating income doesn't have to be used. Many profitable partnerships buy insurance against each partner's serious illness, incapacity, or death. This can be a sensible way of obtaining money to pay off a deceased partner's interest; a term policy, which is relatively cheap, is especially good.

8. Continuity of the Partnership

If a partnership has more than two members, the remaining partners usually want to continue the business as a partnership when a partner leaves. Here's a clause that you can use to assure the continuation of a partnership:

> In the case of a partner's death, permanent disability, retirement, voluntary withdrawal, or expulsion from a partnership, the partnership shall not dissolve or terminate, but its business shall continue without interruption and without any break in continuity. On the disability, retirement, withdrawal, expulsion, or death of any partner, the others shall not liquidate or wind up the affairs of the partnership, but shall continue to conduct the partnership under the terms of this agreement.

9. Noncompetition of Departing Partner

Another issue relating to a partner who leaves the partnership is future competition. You may want to prohibit the departing partner from competing against your firm. This may include the protection of your trade secrets and customer lists.

Legally, this is a touchy area. Forbidding a partner from engaging in his or her usual way of earning a living is a drastic act, and courts often refuse to enforce unfairly restrictive terms. To be legal, a noncompetition agreement normally must be reasonably limited in both time and geographical area and be otherwise fair. State laws vary in regard to noncompetition clauses, and it's not always possible to tell whether or not a judge will enforce one. If you're determined to include a noncompetition clause in your agreement, it makes sense to see a lawyer familiar with small business concerns.

This sample clause will give you an idea of how these clauses are often drafted:

> On the voluntary withdrawal, permanent disability, retirement, or expulsion of any partner, that partner shall not carry on a business the same as or similar to the business of the partnership within the [*describe area*] for a period of [*time period you've agreed on*].

10. Control of Partnership Name

A business name can be valuable. The partnership agreement should spell out what happens to it if a partner leaves. There are a number of ways to handle this, including a clause stating that the partnership continues to own the name, that one partner owns the name, that control of the name will be decided on at a later date, or, finally, that in the event of dissolution, the partnership business name will be owned by a majority of the former partners.

11. Resolving Partnership Disputes

Suppose there's a serious disagreement between the partners and you can't resolve it by personal discussions and negotiations. You may find yourself in court, which is a costly, time-consuming, and emotionally draining way to deal with the dispute. Fortunately, there's a way around litigation as a means of resolving disputes. You can provide in your partnership agreement for mediation or arbitration or both. These subjects are treated in more depth in Chapter 22. Please read that discussion if you're not fully familiar with these methods.

Here's an example of a mediation clause:

> Any dispute arising out of this agreement or the partnership business will be resolved by mediation, if possible. The partners pledge to cooperate fully and fairly with the mediator in an attempt to reach a mutually satisfactory compromise to a dispute. The mediator will be ________________________. If any partner to a dispute feels it cannot be resolved by the

> partners themselves, he or she shall so notify the other partners and the mediator in writing. Mediation will commence within ____ days of the Notice of Request for Mediation. The cost of mediation will be shared equally by all partners to the dispute.

To protect yourselves should mediation fail, you can follow up with an arbitration clause that takes over if a dispute can't be mediated to the satisfaction of the parties. The partners are bound by the arbitrator's decision, which can be enforced in court.

See Chapter 22, Sections B and C, for additional mediation and arbitration clauses.

If you include both mediation and arbitration clauses in your partnership agreement, you need to decide whether the mediator and arbitrator should be the same person. If you have the same person playing both roles, you don't run the risk of having to present the case twice—first to the mediator and then, if mediation fails, to the arbitrator. On the other hand, the person who has ultimate power to make a decision as an arbitrator may be less effective as a mediator.

C. Changes in Your Partnership

As your business changes, your partnership agreement will have to change, too. For example, the addition of a new partner requires revision of at least the clauses listing the partners' names and those covering contributions and distribution of profits.

Even if you admit no new partners, the growth of your business may require you to change your agreement. You and your partners may decide to run your expanded business differently than the original business. Or maybe more cash is required, and the partners decide that their contributions should be in proportions different from those originally agreed to.

Any time you make a significant change in the structure or operation of your business, you should change the partnership agreement to reflect it.

The owners of most small partnerships specify that the partnership agreement may be amended only by the written consent of all partners. But you can create any amendment clause you choose. For example, you could specify that the agreement can be amended by vote of 51% of the partners or by 51% of the capital accounts.

At some point, your partnership may well decide to add another partner. You may need a new partner's contribution of cash or skills, or you may want to retain a key employee by making him or her a partner. Because a partnership technically is dissolved when a new partner joins it, it's helpful to include a clause in your partnership agreement such as the following one:

> Admission of a new partner shall not cause dissolution of the underlying partnership business, which will be continued by the new partnership entity. ■

CHAPTER

3

Creating a Corporation

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Chapter 1 introduced the basic business entities—the sole proprietorship, the partnership, the limited liability company, and the corporation. This chapter tells you more about setting up a corporation. We'll start with the structure of a corporation, including the roles of the key players: the incorporators, shareholders, directors, officers, and employees. Then we'll look at corporate finance—how you get money into the corporation and how you take it out. Next we'll walk step by step through the procedures for setting up a corporation. Finally, we'll examine some sound corporate business practices.

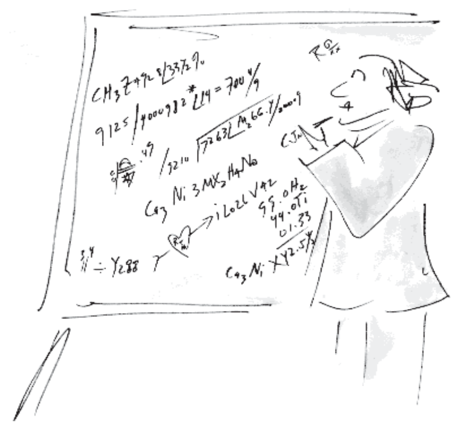
The material in this chapter applies to most, but not all, new corporations. Generally, this material will apply to you if your proposed corporation fits the following profile:

- A relatively small number of people—about ten or fewer—will own the corporate stock.
- All or most of the owners will participate directly in managing and running the business; investors who don't directly participate will generally be limited to friends or family members.
- All of the owners will live in the state in which you form your corporation and conduct your business.

Lawyers often call a small corporation that fits this profile a "closely held corporation." We'll borrow this term in its most general, nontechnical sense.

Classifying your corporation at the outset is important because if you're a closely held corporation and sell stock to only a few friends or family members, normally you'll be exempt from all but the most routine requirements of federal and state securities laws.

But if you sell stock in your corporation to outside investors—people who won't help run the business or aren't closely tied to people who are—you must comply with those laws. So if you want to sell stock to a wider range of people, especially if any of them live in a different state, you'll need to learn more about the requirements of the securities laws. In many states, there are generous exemptions that allow sales of stock to as many as 35 investors without complicated paperwork. But because this is such a technical area and laws vary from state to state, you should seek legal advice from a lawyer knowledgeable about securities laws before you offer stock to outsiders.



A. The Structure of a Corporation

Corporations are controlled primarily by state, not federal, law. This means that 50 different sets of rules cover how corporations are created. Terminology differs from state to state. For example, most states use the term "articles of incorporation" to refer to the basic document creating the corporation, but some states (including Connecticut, Delaware, New Jersey, New York, and Oklahoma) use the term "certificate of incorporation." Tennessee calls it a "charter," and Massachusetts uses the term "articles of organization." Fortunately, the similarities in corporate procedure outweigh the differences, so most of what you find in this chapter will apply to your own situation. Nevertheless, watch out for the differences.

People involved in a corporation traditionally play different legal roles: incorporator, shareholder, director, officer, employee. We'll look at those roles here. But, in virtually every state, there's a way that you can set up a corporation in which one or two people play all roles.

LAW IN THE REAL WORLD
Keeping a Hand in the Business

Anne opened a small business providing customized bookkeeping software for manicurists. For several years she struggled financially as she tried to convince small nail shops that buying her computerized system would ultimately be far cheaper than keeping records in a shoe box. Finally, when a trade magazine gave her system a rave review, business took off. Suddenly Anne found herself hiring employees, upgrading and customizing her software, and greatly increasing her marketing activities.

Anne soon realized that she couldn't do it all herself. Her key employees were increasingly critical to her success. To help ensure their loyalty and hard work, Anne decided to give them an ownership interest in the business. She accomplished this by forming a closely held corporation, Digital Nail Inc. Initially Anne owned 100% of the stock, but under the terms of a shareholders' agreement, half a dozen or so key employees receive stock each year.

Although Anne will always remain the majority owner, over time each longtime employee will gain a significant share. If an employee leaves the company, his or her stock will have to be sold back to Digital Nail at its book (asset) value—considerably less than its market value (assuming the business continued to prosper and was sold or went public). In short, not only does Anne's plan give key employees a stake in the success of the company, it provides a powerful incentive for them to stick with Digital Nail.

1. Incorporators

The incorporators (called the promoters in some states) do the preparatory work. This may include bringing together the people and the money to create the corporation. It always includes preparing and filing the articles of incorporation—the formal incorporation document that is filed with a state office such as the secretary of state. Although several people can serve as incorporators and sign the articles of incorporation, only one incorporator is required by law. Once the articles of incorporation are filed, the incorporator's job is nearly done. The only things that remain to be done are to select the first board of directors and to adopt the corporate bylaws (although, in some states, bylaws may be adopted by the directors).

2. Shareholders

The shareholders own the stock of the corporation. One person can own 100% of the stock. Among the things that only shareholders can do are these:

- Elect directors (although the initial board of directors is usually selected by the incorporator or promoter)
- Amend bylaws
- Approve the sale of all or substantially all of the corporate assets
- Approve mergers and reorganizations
- Amend the articles of incorporation
- Remove directors
- Dissolve the corporation.

State laws typically require that the shareholders hold an annual meeting. However, in many states, a "consent action" or "consent resolution"—a document signed by all of the shareholders—can be used in place of a formal meeting.

For the corporation to elect S corporation status under federal tax laws, all shareholders must sign the election form that's filed with the IRS. (For more on this, see Section F, Step 12.)

3. Directors

The directors manage the corporation and make major policy decisions. Among other things, the directors authorize the issuance of stock; decide on whether to mortgage, sell, or lease real estate; and elect the corporate officers. Directors may hold regular or special meetings (or both). However, in many states, it's simpler and just as effective for the directors to take actions by signing a document called a "consent resolution" or "consent action."

The incorporators or shareholders decide how many directors the corporation will have. The number of directors is usually stated in the articles of incorporation or in the corporate bylaws. Most states specifically permit corporations to have just one director. In the remaining states, the requirement is that there be at least three directors, but there's an exception for corporations with fewer than three shareholders. If there are only two shareholders, the corporation can operate with two directors; if there's only one shareholder, the corporation needs only one director.

> **EXAMPLE 1:** Anita, Barry, and Clint create a corporation in Michigan. They choose Anita to be the sole director. They can do this because the law in Michigan—as in many other states—permits a corporation to function with a single director regardless of the number of shareholders.

> **EXAMPLE 2:** Dustin, Erwin, and Faye create a corporation in California. They would like Dustin to be the sole director, but California law requires them to have at least three directors if there are three or more shareholders; they can have a single director only if the corporation has a single shareholder. Therefore, Dustin, Erwin, and Faye create a three-person board of directors and appoint themselves to those positions.

4. Officers

The officers are normally responsible for the day-to-day operation of the corporation. State laws usually require that the corporation have at least a president, a secretary, and a treasurer. The president is usually the chief operating officer of the corporation. The secretary is responsible for the corporate records. The treasurer, of course, is responsible for the corporate finances, although it's common to hand day-to-day duties to a bookkeeper. The corporation can have other officers—such as a vice president—as well. In most states, one person can hold all of the required offices.

> **EXAMPLE:** Abdul forms a Texas corporation. He provides for the two corporate offices—president and secretary—that are required by Texas law. He appoints himself to both offices. This is legal in Texas and in most other states.

5. Employees

Employees work for the corporation in return for compensation. In the small corporations we're considering in this chapter, the owners (shareholders) are usually also employees of the corporation.

It's through your salary and other compensation as a corporate employee that you'll receive most of your financial benefits from the business. Often the person who runs the business day-to-day gets the most compensation. This may or may not be the president.

6. How It All Fits Together

If you're new to all of this, the numerous components of a corporation may seem unduly complicated for a small business. Fortunately, it all fits together quite smoothly and easily.

> **EXAMPLE:** Al, Bev, and Carla decide to form a corporation to run a fitness center. Their plan is to invest $10,000 apiece and be equal owners. Since state law requires only one person to sign the papers setting up the corporation, Bev signs the Articles of Incorporation for ABC Fitness Center Inc. and sends them to the secretary of state's office along with the filing fee. Bev is the *incorporator*.
>
> Next, Bev adopts bylaws for the corporation calling for a three-person Board of Directors. She elects herself, Al, and Carla to serve as the first *directors*. The three of them then elect Bev to be the president, Al to be the secretary, and Carla to be the treasurer—so the three of them are then the *officers* of the corporation.
>
> When Al, Bev, and Carla each pay $10,000 into the corporate bank account, they each receive a stock certificate for 10,000 shares of corporate stock; at that moment, they become shareholders.
>
> All three are active in running the business, working 50 hours a week and receiving a salary. Al and Bev, who have experience as personal trainers, take charge of training customers and supervising a small staff of other workers. Carla, who studied business in college, looks after the finances—billing customers, marketing, ordering supplies. So in addition to their other roles in the corporation, Al, Bev, and Carla are employees.

B. Financing Your Corporation

It doesn't take an MBA degree to grasp the fundamentals of corporate finance in the typical small business. Assets come into the corporation in two forms: equity and debt. Let's look at each.

1. Funding Your Corporation With Equity

Basically, equity means shareholders contribute cash, valuable property, or services to the company in exchange for stock in the company. The number of shares issued is somewhat arbitrary, but the customary practice in some places is for new corporations to issue one share for each dollar invested.

The most common way to pay for stock is with cash. For example, you may put $5,000 into the company in return for 5,000 shares of corporate stock. But money isn't the only thing that you can invest in a company in return for stock. You may also transfer physical assets, such as real estate or equipment, or a copyright, patent, or trademark. Or you may receive stock in return for past services to the corporation.

Check before you transfer property for stock. *Before you transfer property to your corporation in exchange for stock, check with your tax advisor. If you receive stock for property that has increased in value since you bought it, you may owe taxes.*

In some states, you can receive stock in return for promising to perform services to the corporation, or in return for a promissory note. In other words, you might receive 5,000 shares of stock in return for your promise to work for the corporation for 200 hours or to pay the corporation $5,000 six months later. Not all states, however, permit stock to be issued based on a promise of future services or money, so check the rules of your state.

2. Funding Your Corporation With Debt

The other major way to fund a corporation is through debt—that is, by borrowing money. But you should know that if your corporation borrows from a bank or other outside lender, the lender will probably expect you to personally guarantee to repay the debt should the business be unable to.

Lending money to the corporation. *Until fairly recently, it was quite common for shareholders in some new corporations to lend money to the corporation or transfer assets from an existing sole proprietorship in exchange for a promissory note from the corporation. Shareholders gained tax benefits by dividing their initial investment between debt (represented by promissory notes) and equity (represented by stock certificates). Changes in the tax laws, however, have eliminated the shareholder loan as a viable option for purchasing equity in a new corporation.*

3. Leasing Property to the Corporation

Sometimes you'll want to retain ownership of property being used by the corporation. For example, maybe you own a garage or other small building your company will occupy. With real estate, it's usually better, from a tax standpoint, to have your corporation lease the property from you rather than to transfer the property to the corporation.

> **EXAMPLE:** Nino forms New Age Innovators Inc. to develop some practical new technologies for the plumbing industry. He plans to work out of his garage. He leases the garage to his corporation for $500 a month. On his own personal Form 1040, Nino will report the rent as income and will deduct interest expense (for the mortgage on the building) and depreciation. On its corporate tax return, New Age Innovators Inc. will deduct its rent payments and operating expenses for the garage.

If you lease property to the corporation, have the directors adopt a board resolution approving a lease. Then have the corporation sign the lease as tenant with you, of course, as the landlord. This will be helpful in establishing the existence of a lease if the arrangements are questioned by the IRS.

C. Compensating Yourself

I've just discussed how you put money into the corporation. Now let's get to the fun part—how you take it out.

1. Salary and Bonuses

As a corporate employee, you can receive a reasonable salary plus bonuses which, for tax purposes, are lumped in with salary. (Many corporate owners prefer to pay themselves conservative salaries and then to reward themselves with a year-end bonus if it makes sense economically.) Salaries and bonuses are treated as business expenses of the corporation, which means that the corporation owes no tax on what it pays you. You, in turn, report what you receive as income on your personal income tax return just as you would if you worked for any other employer. The IRS has rules on how much salary is appropriate—the primary one is that the salary must be reasonable. This is a pretty loose standard and, as a practical matter, doesn't affect most small business people, because their businesses can't afford to pay them the sort of stratospheric salaries the IRS might consider unreasonable.

2. Interest on Loans to the Corporation

If you lend money or property to the corporation when it's underway in exchange for a promissory note, you'll receive interest on your loans. Hopefully, the corporation will repay you the principal amount of the loans as well. But you'll have to pay tax only on the interest you receive—not on the principal portion.

Minimum interest. *Any loan between a corporation and an employee or stockholder for more than $10,000 must carry a minimum interest rate. The rate is based on U.S. Treasury Bill rates. The loan type also determines whether other requirements must be met. Check with your tax advisor for details.*

3. Fringe Benefits

Another way to profit from your investment in the corporation is through fringe benefits. For example, your corporation may purchase health insurance for employees and set up a plan under which the corporation reimburses employees for medical expenses not covered by insurance. Health insurance premiums and medical reimbursements paid by the corporation are tax-deductible business expenses for the corporation—and aren't taxable to the employee as personal income. By contrast, if you were to pay for medical expenses with no corporate help, only a limited amount would be tax-deductible on your personal income tax return.

S Corporations Note. S corporations are treated differently under the tax laws. Fringe benefits for an owner-employee who owns more than 2% of the stock of an S corporation are not given this favorable tax treatment.

4. Dividends

You've probably heard about corporate dividends paid to shareholders. This is another way that funds can be removed from a corporation for the benefit of its owners. Perhaps surprisingly, it is rarely done in a small corporation. Because the corporation can't deduct dividends as a business expense, dividends add up to double taxation. (This doesn't apply to S corporations; see Chapter 1, Section C.) The corporation is subject to tax on money paid as dividends, and then the shareholder is taxed a second time. To avoid this double taxation, it's much better to take money out of the corporation through the means previously discussed.

D. Do You Need a Lawyer to Incorporate?

It's possible to form your own corporation without professional help. Every day, many entrepreneurs do exactly that by using an incorporation kit. If you're inclined to go this route, check out *How to Form Your Own California Corporation* or *Incorporate Your Business: A 50-State Legal Guide to Forming a Corporation,* both by Anthony Mancuso (Nolo). These books provide information about incorporating, even if you decide not to do it yourself.

The obvious motivating factor for setting up a corporation on your own is to save on legal fees, which can range from $1,000 to $2,000 or more, depending on where you live. But be aware that there's a tradeoff: you're subjecting yourself to bureaucratic hassles and, unless you do your homework carefully, possible errors. The paper-filing phase, by itself, isn't all that difficult. But tax and legal liability problems may not be obvious to the do-it-yourselfer. And if you plan to issue stock to other than a few people who will work in the business or are close friends and relatives, securities laws can be troublesome.

Still, dollars are often precious to people just starting out in business, and you may decide that it's worthwhile to attempt to form your corporation by yourself. If you choose that route, it's a good idea to have a lawyer experienced with small businesses look over the final documents before you file them. (Chapter 24 discusses finding, hiring, and working with a lawyer.) You should be able to find a lawyer willing to do this at a fraction of the cost of having the lawyer handle the matter from beginning to end.

Beware of securities law. *If you'll have a number of shareholders—especially people who won't be working in the business and who are not close relatives living in your state—consult a lawyer to see that you're in compliance with federal and state securities regulations. (See Section E, below.) While most small businesses are considered to be closely held corporations and exempt from these potentially complicated regulations, it's worth spending a few bucks to find out for sure. Anthony Mancuso's how-to-incorporate books, mentioned above, discuss this issue in detail.*

E. Overview of Incorporation Procedures

While there are differences from state to state, the basic procedures that you or your lawyer will follow in creating a corporation are these:

- Prepare and file the articles of incorporation
- Select a board of directors
- Adopt bylaws
- Elect officers
- Issue stock
- Decide whether or not you want to elect S corporation tax status.

In a moment, we'll walk through the incorporation process. Before we do, let's look at one additional step to consider before starting to incorporate: a preincorporation agreement. It may be unnecessary if you're planning a one-person corporation or if your corporation consists only of family members. Similarly, a preincorporation agreement is less necessary if you and your associates are incorporating an existing business or if you've done business together before. However, if you're going into business with relative strangers, putting your agreement in written form will help you avoid disputes later or, if an argument does arise, will provide a basis for resolving it through arbitration or litigation. (See Chapter 22.) Your written agreement should include these key points:

- the name of the corporation
- its purpose
- how much stock each person will buy and how he or she will pay for it
- what loans each person will make to the corporation and the terms of repayment
- what offices (president, vice president, secretary, treasurer) each person will hold
- what compensation each of you will receive
- what expense accounts each of you will have
- what fringe benefits will be available.

If the corporation is going to lease real estate or other property from one of the owners, the agreement can also outline the terms of that transaction.

Another major topic to cover in either a preincorporation agreement or a separate buy-sell agreement is what happens if a shareholder wants to retire from the corporation or gets sick or dies or just wants to sell his or her stock. Will the corporation or the remaining shareholders be obligated to buy the stock? How will the price be set? Can the stock be sold to outsiders?

These are difficult and important issues—and it's much better to think them through and arrive at a written agreement at the beginning of the corporation's life rather than wait until a crisis arises. If you don't have an agreement in place, you risk the pain of personal and business discord, and possibly even expensive, disruptive litigation.

I cover buy-sell agreements more in Chapter 5. *Also, you can easily put together a solid agreement covering shareholder issues if you consult* Business Buyout Agreements: A Step-by-Step Guide*, by Anthony Mancuso & Bethany Laurence (Nolo).*

Chapter 2 of *Legal Forms for Starting & Running a Small Business* contains a preincorporation agreement.

Where to incorporate—beware the Delaware myth. *Many people are sold on the notion that there's something magical about incorporating in Delaware. The reality is that the best state to incorporate in is the state where your headquarters is located. For the vast majority of small business corporations, that means the state where you live. If you incorporate in Delaware you'll still have to register as an out-of-state corporation to do business in your own state.*

F. Twelve Basic Steps to Incorporate

The following outline will help you understand how to go about forming a corporation for your small business. The procedure for incorporating is similar—but not identical—in every state.

Step 1. Choose a Name

In Chapter 6, you'll find more detail about selecting a business name. But here are a few basics about naming a corporation.

In most states, to alert the public to your corporate status you must include certain words in your corporate name, such as *Incorporated*, *Corporation*, *Company*, or *Limited*, or the abbreviations *Inc.*, *Corp., Co.,* or *Ltd*. And there are certain words you can't use in your name; for example, in California, the words *National, United States,* and *Federal* are prohibited. In New York, you need the approval of a department of state government to use the words *Benefit, Council, Educational,* or *Housing* in your corporate name.

The quickest way to learn what words are required or prohibited in your state is to call or write to the office where you file the articles of incorporation—usually the secretary of state or corporation commissioner's office. In the few states where they're unwilling to help you, the best approach (short of calling your lawyer) is to go to a law library and check the state statute ("code") sections dealing with corporations. For more on law libraries, see Chapter 24, Section D. Because you'll probably want to consult these laws frequently, you may want to buy a set from the state or a private publisher.

Most states will reject a corporation name that's the same as one already on file or one that's confusingly similar to the name of an existing corporation. But even if the Secretary of State accepts your corporate name (or tells you it's available in a prefiling name reservation procedure), this doesn't guarantee your legal right to use it. An unincorporated business may already be using it as its trade name, or a business may be using it as a trademark or service mark to identify products or services. In short, as is discussed in Chapter 6, there is a good deal more to do to check out the availability of a particular name.

Before you file your corporate papers, check with your state's corporate filing office. Generally they can make a preliminary check and tell you if the name is available. If you expect some delay before the papers are actually filed, find out whether your state permits you to reserve a name. Many will reserve a name for you for a month or more.

What happens if you've got your heart set on a name but find that it's too similar to one already in use? One approach is to change it slightly. Most state's name records are computerized, and often a fairly small modification will turn rejection to approval. Or you can ask the owners of the other business to let you use the similar name. In many states you can use such a name if you get the written consent of the corporation that was established earlier.

In many states, a corporation can do business under an assumed or fictitious name. For example, if you incorporate as Miller Manufacturing Company but want to market some of your products under a more specific business name, you can simply file an assumed name certificate for Miller Appliances. Some states require that you file this paper at the same state office where you filed the articles of incorporation (such as the secretary of state's office). In other states, you file your fictitious or assumed name certificate in the counties where your company does business. And some states require that you also publish notice of your assumed or fictitious name in a newspaper.

Using your corporate name as a trademark. *If you plan to use your corporate name as a trademark or service mark for products or services, you won't want a name that's very similar to someone else's. As explained further in Chapter 6, even if your name were approved by your corporate filing office, it might infringe the other user's trademark or service mark.*

Step 2. Prepare and File Articles of Incorporation

As noted above, in some states articles of incorporation are called certificates of incorporation, charters, or articles of association. Here I'll stick with the term "articles of incorporation."

In many states, the secretary of state can give you a printed form for the articles of incorporation; all you have to do is fill in some blank spaces. In other states, you must prepare the articles of incorporation from scratch.

Below is an example of articles of incorporation for a California corporation.

SAMPLE ARTICLES OF INCORPORATION

ARTICLES OF INCORPORATION
OF

____

ONE: The name of this corporation is ______________________________

TWO: The purpose of this corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business, or the practice of a profession permitted to be incorporated by the California Corporation Code.

THREE: The name and address in this state of the corporation's initial agent for the service of process is:

____

____

FOUR: This corporation is authorized to issue only one class of shares of stock which shall be designated common stock. The total number of shares it is authorized to issue is _______ shares.

FIVE: The names and addresses of the persons who are appointed to act as the initial directors of this corporation are:

Name	Address
______________________	______________________________
______________________	______________________________
______________________	______________________________
______________________	______________________________
______________________	______________________________

SIX: The liability of the directors of the corporation for monetary damages shall be eliminated to the fullest extent permissible under California law.

SEVEN: The corporation is authorized to indemnify the directors and officers of the corporation to the fullest extent permissible under California law.

IN WITNESS WHEREOF, the undersigned, being all the persons named above as the initial directors, have executed these Articles of Incorporation.

Dated: ______________________ ______________________________

____

____

____

____

The undersigned, being all the persons named above as the intial directors, declare that they are the persons who executed the foregoing Articles of Incorporation, which execution is their act and deed.

Dated: ______________________ ______________________________

____

____

____

____

While details vary from state to state, the typical articles of incorporation include:

- the corporation's name
- its purpose
- the name of the "initial agent for service of process" (sometimes called a registered agent or resident agent)
- the number of shares authorized
- the names and addresses of the incorporators.

The purpose clause may seem confusing—it's as if you're being asked to define what your business will do until the end of time. Fortunately, this isn't necessary, because the statutes in many states allow you to use very general language, such as: "The purposes of this corporation shall be to engage in any lawful act or activity for which corporations may be organized under the business corporation law."

If such a statement is permitted in your state, it's usually best not to be any more specific. This leaves you free to change the nature of your business without amending the articles of incorporation. It also helps you avoid questions of whether you're acting beyond the scope of your stated purpose if you go into a new business.

Most states require you to designate somebody as a resident agent or registered agent in the articles of incorporation. This is the person who is authorized to receive official notices and lawsuit papers. Normally, you designate the corporate president as this person. If you change the person named or if there's a new address, you need to notify the secretary of state's office by filing a proper form.

It may take a few weeks for your articles of incorporation to be processed by the secretary of state's office. If you need quicker action, check to see if expedited handling is available. In some states, you can file your articles of incorporation in person and have the filing process completed within a day. Sometimes, articles of incorporation sent by UPS, Federal Express, or other overnight means are treated as in-person filings and given expedited treatment.

If you need to sign contracts, such as a lease, even before the corporation has been formed, it's a good idea to state in the contract that you're acting on behalf of a corporation to be formed and that the contract is subject to ratification by the board of directors of the new corporation. Then, if for some reason the corporation is never formed or if the directors fail to ratify the document, you're free from personal liability. Here is sample language for such a lease.

> Landlord acknowledges that Martin Green is signing this lease on behalf of XYZ Corporation (a corporation to be formed) and that this lease is subject to ratification by the corporation's Board of Directors. If the corporation is not formed or if the Board of Directors fails to ratify this lease within 30 days of the present date, this lease will be void. In no event will Martin Green have any personal liability under this lease.

If this approach is not acceptable to the person with whom you're contracting, another possibility is to sign the contract in your own name—thereby assuming personal liability temporarily—but to specifically reserve the right to assign it to the corporation later, as in the sample that follows.

Incorporation Fees

Each state imposes a fee or a combination of fees for incorporating. Some states also require an initial tax payment. The total amounts vary widely, from $50 to $1,000. To find out your state's fees, call the corporate filing office (usually a branch of the governor's office in your state capital). In some states the information is also available online: try exploring your state's website via www.50states.com. (Click on the name of your state, then, when an information screen pops up, click on the large box containing your state's name to be taken to your state's own government website.)

Landlord grants to Martin Green the right to assign this lease to XYZ Corporation, a corporation to be formed. Upon Landlord's receipt of written notice that such assignment has been made, Martin Green will automatically be released from any personal liability under this lease.

Step 3. Elect the First Board of Directors

In some states, initial directors are designated in the articles of incorporation. In other states, the incorporator or incorporators choose the first board of directors. If this is the practice in your state, be sure to document the appointment of directors with a statement or certificate signed by the incorporators. This statement or certificate, which will be inserted into your corporate record book, may look something like the one below.

SAMPLE DESIGNATION OF DIRECTORS BY INCORPORATOR

ACTION BY INCORPORATOR
OF XYZ CORPORATION

The Incorporator of XYZ Corporation, a Pennsylvania corporation, designates the following people to serve as the initial Board of Directors of the Corporation:

Joyce Barker
Lloyd Epstein
Norton Phillips

Dated:____________________ ____

Joyce Barker, Incorporator

Step 4. Adopt Bylaws

The corporate bylaws contain much more detail than the articles of incorporation. They spell out the rights and powers of the shareholders, directors, and officers of the corporation.

Typically the bylaws state the time and place for the annual meeting of shareholders, how much notice of the meeting is given, and what constitutes a quorum. There are also provisions for special meetings to consider issues so important they can't wait for the next annual meeting and a statement about what actions the shareholders can take by written consent without a formal meeting. Bylaws provide how many directors there are, how they're elected, what their powers are, and if and how they're compensated. Titles of the corporate officers (generally, a president, secretary and treasurer) are listed in the bylaws.

The bylaws may also cover matters such as who is authorized to sign contracts, who has the right to inspect corporate books and records (and under what conditions), the fiscal year of the corporation, and how the bylaws can be amended.

In a few states the incorporators must adopt the bylaws; in others, the directors must adopt them. And in still other states, you can choose between the two methods. If the incorporators adopt the bylaws, be sure to document this in a signed statement or certificate. If the directors adopt the bylaws (see below), reflect this action in your minutes of the first directors' meeting; or, if you don't hold a meeting, in a written consent resolution of the directors.

Chapter 2 of *Legal Forms for Starting & Running a Small Business* contains sample bylaws.

Step 5. Hold a Directors' Meeting

The directors must do a number of things at the beginning to get the corporation on the right track. Historically, corporations have recorded these actions in a document called "minutes of first meeting of the board of directors." These minutes were written in language reflecting a formal parliamentary procedure that really doesn't match the less formal style of most small businesses.

Fortunately, in most states, there's a streamlined method for accomplishing this. You or your lawyer can prepare a consent form to be signed by the board of directors such as the one below.

SAMPLE CONSENT FORM FOR DIRECTORS

XYZ Corporation consent of the board of directors

The directors of XYZ Corporation consent to the following:

1. BYLAWS: The attached bylaws shall be the bylaws of the corporation.

2. OFFICERS: The following people are elected to serve as officers of the corporation for the next year, or until their successors are elected:

   President:____
   Secretary:____
   Treasurer:____

3. ISSUANCE OF STOCK CERTIFICATES: The President and Secretary are authorized and directed to issue stock certificates in the following amounts upon receipt of payment from the designated shareholders:

Name	Number of Shares	Amount to be Paid
1. ____________________________	________	________
2. ____________________________	________	________
3. ____________________________	________	________

4. LEASE: The President is authorized and directed to enter into a three-year lease of space in The Village Green on the terms set out in the attached memorandum.

Dated:____________,20__________________________________
Director #1

Dated:____________,20__________________________________
Director #2

Dated:____________,20__________________________________
Director #3

What actions should the board of directors take at its first meeting, either in formal minutes or through a consent resolution? The following are typical:

- adopt bylaws
- designate corporate officers
- approve the form of stock certificate
- adopt the first fiscal year
- authorize issuance of stock
- approve lease
- approve employment contracts
- adopt a shareholders' agreement (buy-sell agreement—see Chapter 5).

Step 6. Set Up a Corporate Bank Account

Remember, your corporation is a legal entity separate from its shareholders, directors, and officers. For that reason, the corporation needs its own bank account so that its finances can clearly be kept separate.

If you're incorporating an existing business that already has a bank account, I recommend that you start fresh and set up a new bank account for the corporation. The bank will ask for a corporate board of directors' resolution authorizing the new account and an Employer's ID Number. (Employer's ID Numbers are discussed in Chapter 8, Section A.)

If you decide to simply continue the old account, do the following:

- Find out the bank's procedures for changing a sole proprietorship or partnership account into a corporate account. Most likely, the bank will want your directors to adopt a specific resolution, using language the bank will supply. The bank will want to see your articles of incorporation and a copy of the banking resolution. You'll also be asked to provide your Employer's Identification Number (issued by the IRS). You may not have this immediately, and the bank will probably let you start using the account for the corporation if you assure them that you've applied for the ID number.
- Keep detailed records showing exactly how much money was in the account when it was changed over to the corporation. Also keep track of any checks that were written by your existing business but haven't cleared yet. These checks should be treated as expenses of the unincorporated business and deducted from the amount considered transferred to the corporation. Preparing and retaining these records will save you headaches a year or two down the road when you try to figure out exactly what was transferred to the corporation.

Step 7. Issue Stock

The corporation should issue a stock certificate to each shareholder. The certificate is evidence of the shareholder's ownership interest in the corporation. Filling out the stock certificate is simple. Your main legal concern is whether you need to do anything to comply with federal or state securities laws.

Federal securities laws are administered by the Securities and Exchange Commission (SEC). In addition, each state has its own law regulating the sale of securities, intended to protect passive investors—people who put money into a corporation but are not active in the day-to-day operations of the business.

The bad news is that both the federal and state requirements are very complicated. The good news is that, as discussed earlier, the typical small corporation—consisting solely of investors who are actively involved in the day-to-day operation of the company, and often their close relatives—is completely exempt from the complicated requirements. Nevertheless, some paperwork may be involved. For example, it's frequently advisable to give a "shareholder representation letter" to each prospective shareholder, even though it isn't strictly required under the state's securities laws. The letter gives you a way to confirm the purchaser's reasons for believing the transaction is exempt from the state's securities laws.

EXAMPLE: Edgewater Inc. has been formed to build and operate a restaurant on the shore of a scenic lake. Chester, a wealthy investor who has been a partner in three major deals with Todd, the president of Edgewater Inc., is going to invest $75,000 in the new corporation and receive 75,000 shares of stock. To qualify a stock purchase as exempt under the state's "limited offering exemption," the purchaser must be one of the following: an insider shareholder (a director, officer, or promoter of the corporation); someone who's had a preexisting business or personal relationship with the corporation or one of its officers; or a "sophisticated investor." (Sophisticated investors are those who, because of their business or financial experience, are in a good position to protect their interests when buying stock in a new corporation.) Chester qualifies as both a sophisticated investor and one who's had a preexisting business relationship with the corporate president. Todd prepares a shareholder representation letter reciting these facts for Chester to sign.

Californians can obtain sample shareholder representation letters and reliable information on how to prepare them for their corporation (as well as blank stock certificates), from *How to Form Your Own California Corporation,* by Anthony Mancuso (Nolo).

Before you issue a stock certificate, make sure that the corporation has actually received payment for the shares. For example, if the shares are being purchased for cash, the corporation should receive the money before issuing the shares. If the corporation is issuing the stock in return for a promise of future payment by the shareholder (a practice allowed in some states but not others), the corporation should have in its possession a promissory note from the shareholder. If property is being transferred to the corporation in exchange for stock, the person transferring the property should sign a bill of sale for the property at the same time the corporate shares are issued.

Step 8. Complete Any Initial Financial Transactions

Tie up any other loose ends relating to the financing of the corporation. As noted earlier, your corporation may borrow some of its startup money from friends, relatives, or other lenders. The corporation should issue written promissory notes as evidence that loans have been made. In addition, if you're leasing a building or equipment to the corporation, sign a lease.

Step 9. Set Up a Corporate Record Book

You can create a corporate record book in an ordinary loose-leaf binder. A more official looking way to do it is to buy a corporate record book from Nolo or a local stationer. These usually come with stock certificates and an embossed corporate seal.

The main items that you'll keep in the corporate record book are the articles of incorporation, the bylaws, the minutes of meetings (or consent resolutions), and the stock certificate stubs or ledger sheets showing who received the stock certificates and when. In many small corporations, shareholders prefer the convenience of simply leaving the completed stock certificates in the corporate record book even though each shareholder is, of course, entitled to possession of his or her certificate.

Step 10. Follow Through on State Government Requirements

Your state may require that you file documents in addition to the articles of incorporation. For example, in New York, you need to file a stock registration certificate certifying that you "keep a place for the sale, transfer, or delivery of your corporate stock" at a certain address (normally your corporate offices). In California, you need to file a notice of stock transaction within 15 days after your first sale of stock and "an annual statement of domestic stock corporation" within 90 days after you file your articles of incorporation. To learn about requirements in your state, contact your corporate filing office.

Step 11. Comply With the Bulk Sales Act

If shareholders transfer assets of an existing business to the new corporation in return for stock, there may be some special requirements. Six states—California, Georgia, Indiana, Maryland, Virginia, and Wisconsin—have bulk sales laws designed to prevent business owners from secretly transferring their business assets to another company to avoid paying creditors. These laws apply mainly to retail, wholesale, and manufacturing businesses. Basically, bulk sales laws require you to notify creditors that the assets of the business are being transferred.

Fortunately, state laws usually provide for some exemption or shortcuts when the assets are being transferred to a new corporation that will be taking over and continuing an existing business. A key element generally is that your new corporation agrees to take over the business debts of the existing company. If you're forming a corporation to take over and continue a business formerly run as a sole proprietorship or partnership, compliance with the bulk sales law should be relatively easy.

Step 12. File S Corporation Election

As discussed in some detail in Chapter 1, an S corporation is simply a corporation that decides to be taxed as a partnership. That is, it's not a separate tax entity like a regular corporation. Instead, the profits and losses of the corporation flow through to the individual shareholders who report them on their individual tax returns.

For purposes of incorporating under state law, the procedure is the same whether you're a regular corporation or an S corporation. But to become an S corporation, you need to file a form with the IRS. This is Form 2553, *Election by a Small Business Corporation*. All of the shareholders must sign this form.

If you want to have S corporation status during the first tax year that your corporation exists, you need to file the election form before the 15th day of the third month of your tax year. In other words, you have a two-and-a-half month window during which you can file the election. When does your tax year start? For a new corporation, your tax year starts when your corporation (1) has shareholders, (2) acquires assets, or (3) begins doing business, whichever happens first. If you miss the deadline, you have to wait until the next tax year to file the election form.

G. After You Incorporate

This chapter concentrates on steps you need to take to form your corporation. What must you do after incorporating? Obviously, you need to comply with federal and state tax filing rules. (See Chapter 8.) Your business may also need to get business licenses and permits. (See Chapter 7.) And it's smart to buy insurance before you begin doing business. (See Chapter 12.)

In addition, corporations must file an annual report with the state's corporate filing office. Typically this is a form sent to you by the corporate filing office which requires you to update information about corporate officers and location. Simply fill it out and return it with the necessary fee. If you forget to send the form back, your corporation may face fines and penalties and may even be automatically dissolved.

H. Safe Business Practices for Your Corporation

Last week you were the sole proprietor of a catering business you called Feasts On The Go. Today you own all the stock of a new corporation, Feasts On The Go, Inc. In addition, you're the corporation's director, president, secretary, and treasurer.

Or maybe last week you and Emily were partners in a used record shop called Around Again. Today you each own 50% of the stock in a new corporation called Second Time Around, Incorporated, which is running the old partnership business. Emily's the president, you're the secretary-treasurer.

What has changed? On a day-to-day level, not much. You still show up at the same place each day and do the same kind of work you did before you incorporated. In fact, your before- and after-incorporation lives will probably be so similar that it will be easy to forget the fact that you're now working for a corporation that is a separate legal entity.

But forgetting can be risky. If you're careless about maintaining the separation between the corporation and yourself, you can jeopardize your tax benefits or your freedom from personal liability—the main reasons to incorporate in the first place. While it's rare for a judge to disregard a corporation and impose personal liability on a shareholder, it does happen. When it does, it's almost always in a small corporation where the owners have allowed the line between the corporation and the shareholders to get very fuzzy or disappear.

Also, the IRS has the power to decide that a corporation is a sham if you fail to maintain it as a separate legal entity. Consider the following actual case:

> For 15 years, Walter Otto ran an export-import business in San Francisco. Then he incorporated his business. He filed articles of incorporation with the California Secretary of State for "Otto Sales Company Inc." Next he invested $50 in the corporation. A few years later, the business became insolvent. A salesman sued for unpaid commissions, naming both the corporation and Walter as defendants. After a trial, the judge ordered Walter himself to pay the salesman over $18,000. Doing business through a corporation didn't protect Walter from personal liability.

What Did Walter Do Wrong? Several things:

- He never issued any stock certificates to himself or anyone else.
- He contributed only $50 to the corporation as his "equity" in the business. (For more on equity and how to structure the financial side of a corporation, see Section B, above.)
- He continued to use the same sales contracts that he used before he incorporated. These contracts said "W.E. Otto" at the top. At the bottom (for seller's signature), the contracts said: "W.E. Otto, by ____________________________, Sellers."

In the judge's view, Walter formed the corporation solely for his personal convenience and did not treat it as a real entity. So the judge "pierced the corporate veil" to make Walter personally liable for the debt. *Shafford v. Otto Sales Company,* 308 P.2d 428 (Cal. App. 1957).

Here are two more cases in which the owners of small corporations were found personally liable:

- J.C. Chou formed Oriental Fireworks Inc., a corporation that grossed from $230,000 to $400,000 annually. Its assets, however, never exceeded $13,000, and the company never bought liability insurance. Gregory Rice was seriously injured by fireworks distributed by the corporation. He sued and was awarded $432,000. Since the corporation lacked funds to pay the judgment—and didn't carry insurance—the court ruled that J.C. was personally liable.

J.C.'s Main Mistake: Failing to provide even minimally adequate funds to the corporation (in legal lingo, failing to adequately capitalize the corporation) or to carry proper insurance. *Rice v. Oriental Fireworks Co.,* 707 P.2d 1250 (Or. App. 1985).

- Dusty Schmidt and Terry Ulven were partners in a business called Western Oregon Christmas Trees. At Christmas time, the partnership rented tents from the Salem Tent and Awning Company to display their trees. Later, Dusty and Terry formed a corporation—Western Oregon Christmas Trees Inc. They continued to rent tents from Salem but didn't sign rental agreements or checks as corporate officers. When several tents were destroyed by a storm, Salem sued the corporation and was awarded a judgment of $12,500. The court ruled that Dusty and Terry also were personally liable for the judgment.
  Dusty's and Terry's Main Foul-ups: Dusty and Terry made a $2,000 down payment on the tents using a check from their previous partnership—not from the corporation. Also, the pair commingled (mixed together) personal and corporate assets and failed to keep corporate records. *Salem Tent & Awning v. Schmidt,* 719 P.2d 899 (Or. App. 1986).

Even though these cases had unhappy endings for the owners of the small corporations, doing business as a corporation isn't all that dangerous. There are several simple steps you can take to preserve your corporate status so that you don't have to lie awake nights worrying about personal liability. These steps are not time-consuming—and they make good business sense.

1. Put Adequate Capital Into Your Corporation

Put in enough money and other assets to meet your foreseeable business requirements. The amount, of course, varies from business to business. What's reasonable to start a video store that requires a considerable inventory of films, a retail location, and several employees may be vastly different than what's reasonable to start a typing service, which may need little more than a personal computer, printer, modem, and copy and fax machines. See if you can get a recommendation from your accountant or someone in the same business.

2. Insure Against Obvious Risks

Try to determine whether there's a substantial risk of customers or others being injured because of your business. If so, it's wise to obtain a reasonable amount of coverage. (See Chapter 12 for more on insurance.) There have been some cases—not many—in which a judge has felt that the failure of owners of a small corporation to buy insurance that was reasonably available was so reckless that it was a factor in disregarding the corporation and holding its owners personally liable.

> **EXAMPLE:** Eunice owns all the stock in a corporation called Roadside Enterprises Inc. The corporation sells and installs tires. It's obvious that an improperly installed tire can cause a serious accident. What if a Roadside employee forgets to tighten the lugs on a newly installed tire and the tire falls off, causing the driver to swerve into a tree? If the driver is killed, his or her family will probably sue Roadside. And if the corporation doesn't have reasonable insurance coverage (and hasn't set up a reasonable reserve fund), a judge could rule that Eunice has some personal liability—even though she wasn't even at the tire store when the employee was inattentive.

Basically, it's a matter of exercising reasonable business judgment. If your business involves the risk of injury and you can buy liability insurance at a reasonable price, I recommend that you do so. On the other hand, if affordable insurance isn't available—an unfortunate reality in some industries today—it's highly unlikely that a judge would find fault with the owners of the corporation for not insuring against the risks.

3. Observe Corporate Formalities

Another way to protect yourself from the possibility that your corporation could be disregarded by a court is to always take it seriously yourself. Issue stock certificates to the shareholders before your corporation starts doing business. Keep a corporate record book containing your articles of incorporation, stock records, bylaws, and minutes of shareholders' and directors' meetings. Comply with state law requirements that you hold annual meetings of shareholders or act by signed consent actions or resolutions. Either way you should document all actions taken, such as election of officers for the next year.

Conference Calls. If it's not convenient for all the directors to meet at the same place, many states allow them to participate through a conference call. Follow up by documenting the telephone meeting in writing as soon as possible and sending a copy to each director.

Keep in mind that the annual meetings are minimum requirements. While it's not necessary or appropriate to write up minutes or consent actions for every conference you have with your colleagues, if you take significant corporate actions during the year, it's wise to document them through minutes of a special meeting or a consent action form. Keep the minutes and consent actions in your corporate record book.

Here are some types of business activities that you should document with minutes of a directors' meeting or a signed consent action form signed by the directors:

- authorizing corporate bank accounts and designating who is eligible to sign checks and withdraw funds
- determining salaries and bonuses of officers
- contributing to pension and profit-sharing plans
- acquiring another business
- borrowing money
- entering into major contracts
- buying, selling, or leasing real estate
- adopting or amending employee fringe benefits plans
- applying for trademark registration.

Chapter 3 of *Legal Forms for Starting & Running a Small Business* contains various forms for running your corporation.

4. Separate Your Personal Finances From the Corporation's

The corporation needs its own bank account. (See Section F, Step 6.) Don't use the corporate bank account to pay your personal expenses. Get salary checks on a regular basis from the corporation (deducting employee withholding taxes); deposit the checks in your personal account; and then pay your own bills.

If you use personal funds to pay business expenses—for example, you pick up a ream of typing paper while you're out for lunch—you can have the corporation reimburse you, but be sure the corporation keeps the receipt for the paper to justify the payment as a proper business expense.

To further preserve the distinction between you and the corporation, document all transactions as if you were strangers. If the corporation leases property from you, sign a lease. If the corporation borrows money from you, get a promissory note. If you sell property to the corporation or use your property to buy stock, sign a bill of sale or other legal document formally transferring legal title to the corporation.

5. Use the Correct Corporate Name

Suppose the name of your corporation is The A.B. Smith Fitness Store Inc. Use that full business name in all your business dealings—on your stationery, business cards, and phone book listings, on your signs, in catalogues, and on the Internet. Be careful not to use a different or abbreviated version (such as Smith Fitness Center) unless you file an assumed name certificate or fictitious name certificate as permitted by state law. (For more on corporate names, see Section F and Chapter 6.)

6. Sign Documents as a Corporate Officer

In correspondence and on checks, sign your name as William Jones, President, along with the full name of your corporation, rather than just William Jones. This makes it clear to those who deal with you that you're acting as an agent or employee of the corporation and not as an individual. Follow this practice on any other documents you sign, such as contracts, order forms, and promissory notes.

SAMPLE SIGNATURE OF CORPORATE OFFICER

JONES BAKERY INC.

By:____________________________________

William Jones, President

In some cases, you may have to sign the contract or promissory note personally as a guarantor. For example, banks usually won't lend money to a small corporation without the personal guarantees of the principals, and some extra-cautious landlords may insist on similar guarantees for leases. But even if you have to accept personal liability for some corporate obligations, it's better to do this as a guarantor than as the main signer. The reason: The guarantee provides further evidence that you and the corporation are separate legal entities.

7. Assign Existing Business Contracts to the Corporation

If you incorporate an existing business (such as a sole proprietorship or a partnership), the old business may have contracts still in effect, which the corporation will take over. For example, maybe the prior business leased space and the lease still has a year to go. Or maybe you're a computer consultant and, as a sole proprietor, you'd just gotten started on a contract to design customized billing software for a medical clinic.

It's usually a good idea to formally transfer these contracts to the corporation. Generally, unless the contract expressly prohibits an assignment, you're free to transfer it to your corporation without getting the consent of the other party.

But bear this in mind: Unless you get that consent and a release of personal liability, or unless your contract already specifically permits you to assign it to a new corporation and be free from personal liability, you're still going to be legally responsible for performance of the contract. This means that the landlord can turn to you if the corporation doesn't pay the rent, and the medical clinic can hold you personally responsible if you don't deliver the software you promised.

Important tax note. *If your corporation will derive income from passive sources, such as rents, royalties, or dividends, or from the performance of personal services, get professional tax advice before you transfer contracts to the corporation. A transfer could lead to a personal holding company penalty—which could be quite substantial.*

To assign a contract, prepare a short document called "Assignment of Lease" or "Assignment of Computer Consultation Contract." A sample is shown below. Have the corporation agree to accept the assignment and to carry out the terms of the contract. From a business and legal standpoint, it makes sense to continue your business through a single entity—the corporation—rather than to do business simultaneously as a sole proprietor and as an employee of your corporation. Putting your eggs in one basket reduces the chances of blurring the distinction between the corporation and your personal business interests.

SAMPLE ASSIGNMENT OF CONTRACT

ASSIGNMENT OF RENOVATION CONTRACT

In consideration of the sum of $________, receipt of which is acknowledged, Cecil Hardwick (d/b/a Hardwick Construction) assigns to Hardwick Building Company (a Nevada Corporation) all of his rights, duties, and obligations under his contract with Plaza Building Associates dated _______________, 20____, concerning the renovation of the Plaza Building.

Hardwick Building Company accepts this assignment and accepts all of Cecil Hardwick's duties under the assigned contract.

Dated:_____________, 20___

ASSIGNOR:	ASSIGNEE:
	Hardwick Building Company, A Nevada Corporation
________________________________	By: ________________________________
Cecil Hardwick d/b/a Hardwick Construction	Cecil Hardwick President

***The Corporate Minutes Book*, by Anthony Mancuso (Nolo),** *shows how to hold and document necessary corporate meetings, and includes all forms on CD-ROM.* ■

CHAPTER

4

Creating a Limited Liability Company

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Chapter 1 introduced the basic business entities—the sole proprietorship, the partnership, the limited liability company (LLC), and the corporation. This chapter tells you more about setting up an LLC.

As explained in Chapter 1, an LLC is often the best choice if you want to limit your personal liability as the owner of a small business. (Having limited liability means that being a member of an LLC doesn't normally expose you to legal liability for business debts and court judgments against the business.)

While forming a corporation will also give you and your co-owners (if you have any) limited liability, the structure of a corporation is somewhat more complicated than an LLC's. In even the smallest corporation, for example, you have a three-level organizational structure consisting of shareholders, a board of directors, and corporate officers.

It's true that the same people can fill all of these roles—in fact, in a one-person corporation, a single individual can do it all. But keeping track of what corporate hat you're wearing can be challenging when you have more pressing business matters to think about. And with an LLC, you may be able to avoid some of the legal and tax paperwork associated with a corporation. For example, an LLC needn't worry about getting signatures on stock subscriptions or issuing stock certificates or drawing up board of directors' resolutions—although an LLC whose members prefer a higher degree of formality are certainly free to issue membership certificates and to document all major company decisions. (See Section H8.)

And when it comes to taxes, a one-member LLC that prefers pass-through taxation (as in a sole proprietorship) rather than corporate-style taxation can remain what the IRS calls a "disregarded entity"—which means the LLC itself needn't file any tax documents at all.

In addition to requiring less paperwork, an LLC can be far more streamlined and flexible than a corporation. LLC owners can run their business with much less formality. For instance, the owners of an LLC (known as members) jointly manage the LLC (although they can instead designate one or more managers to manage it if they want to impose a separate level of management). And in most states, LLCs don't have to hold annual meetings of the members (although they can hold them if they choose). Finally, as discussed in Chapter 1, Section D, LLCs have the flexibility to choose to be taxed as corporations or as partnerships.

The paperwork requirements and legal rules governing LLCs are based on state laws. While these laws vary somewhat from state to state, LLCs do enjoy a surprising amount of consistency around the country. This chapter is based on the LLC state laws that are typical in most states. As you go through this chapter, you should keep in mind that the rules and practices for LLCs in your state may have some quirks that aren't covered here. It's your job to make sure that you're following the law in your state for creating an LLC.

For comprehensive information and guidance on setting up an LLC: *Consult* Form Your Own Limited Liability Company, *by Anthony Mancuso (Nolo). Among other things, the book contains complete details on preparing your LLC articles of organization and LLC operating agreement. The book also contains a CD-ROM to help you prepare these documents. Also, Nolo's* LLC Maker *software, by Anthony Mancuso, walks you through the process of creating an LLC.*

A. Number of Members Required

Every state lets you form an LLC that has just one member.

B. Management of an LLC

As with any company, at least one person has to be in charge of managing the day-to-day business. In most states, unless you appoint one or more members or nonmembers to manage the LLC, you and all the other members are automatically responsible for managing the business. This is called "member-management." If you choose the other option and do appoint one or more people to manage the LLC, it's called "manager-management."

Chances are that your LLC will choose member-management rather than manager-management. That's because you probably won't want or need a separate level of management.

> **EXAMPLE:** Joyce, Phil, and Nora form Cyber Networking LLC, a small consulting firm. All three members are experienced computer experts who actively work in the business and participate equally in running it. They meet weekly to review new project proposals and to decide whether or not to take on the new work. They are all member managers. Nothing could be simpler.

There are situations, however, in which a manager-managed LLC is the better way to go. This is most likely to be the case if you have passive investors who will feel more comfortable if the LLC appoints an active managing member (or perhaps several managing members) whose duties are explicitly defined.

> **EXAMPLE:** Terry, Bill, and Chester form Wheel Wellness LLC, a bicycle repair business, built around Chester's years of experience in repairing exotic bikes. Terry and Bill contribute most of the money but, knowing little about bicycle repair, stay out of running of the business. Chester contributes a small amount of money to the LLC but his main contribution is his skill. Since Terry and Bill are passive investors, they agree that Chester will manage the company—but they carefully spell out his duties in the operating agreement so he knows what decisions require input from the investors. All three are happy with their manager-managed LLC in which the lines of authority are clearly defined.

If your LLC chooses to designate managers, you'll need to specify this choice either in your articles of organization or your operating agreement (see below), depending on your state law.

C. Financing an LLC

Assets come into an LLC in two forms: equity and debt. Let's look at each.

1. Capital Contributions (Equity)

Ordinarily, you and the other LLC members will make an initial financial contribution to the business. In return, you'll each get a percentage (capital) interest in the LLC. Among other things, this capital interest determines the portion of the LLC assets each of you is entitled to receive if the business is dissolved or sold. Also, this percentage is frequently used to determine how profits and losses will be allocated while the business is in operation.

Under most state statutes, your capital contributions can consist of cash, property, or services—or the promise to provide any of these in the future.

You may need to comply with securities laws. *If an LLC membership is considered a "security," you'll need to register it at the federal or state level unless it's exempt from registration. Unfortunately, the rules for when LLC memberships are securities and when they're not haven't been well defined yet. Generally, if a member relies on his or her own efforts to make a profit—that is, the member actively engages in managing or working for the business—the interest probably won't be considered a security. It follows that most LLCs don't have to reg-*

ister before selling membership interests. If, however, a member relies on someone else's effort—that is, a member is a passive investor—that member's interest is probably a security, and must be registered.

Because the law on whether LLC interests are securities is in flux, you may want to see an experienced business lawyer before you sell membership interests in your LLC to people who won't be active in the day-to-day business. You may want to make sure that the membership interests are not considered securities or, if they are, that they're exempt from government registration.

Normally, a capital investment in an LLC is tax-free. You and the other members don't pay tax on the membership interests you receive, and the LLC doesn't pay tax on the cash or property it accepts in exchange. The tax effects of paying capital into an LLC are deferred until a later time; as an LLC member, you'll be taxed on any profit you make when you sell your interest or you dissolve the business.

> **EXAMPLE:** Wendy makes a capital contribution of $10,000 to her new pet supply business, Puppy Love LLC. As the sole member, she receives a 100% capital interest in the business. She pays no tax at this time. Five years later when Wendy sells the business and receives $50,000 after all expenses are paid, she pays tax on the $40,000 profit.

Attracting Financing for Your LLC

In the past, corporations sometimes had an edge over other business forms in attracting investment capital because the corporate stock structure easily accommodates the issuance of shares to investors. These days, however, a growing number of venture capitalists are investing in LLCs because LLCs can be taxed as corporations or partnerships and they offer flexibility in how they're managed.

For example, you can give majority voting power to a venture capital group in return for investing in your LLC. You simply amend your LLC operating agreement and issue voting membership interests to the group. What's more, if your LLC elects to be taxed like a partnership, the profits allocated to the investor-members won't be taxed twice (as corporate dividends are), but will pass through the LLC to the investors. They'll then report and pay taxes on the profits on their individual income tax returns.

2. Loans (Debt)

To supplement capital contributions, LLCs often borrow funds from time to time from their members or a member's family or friends. These loans help to increase the LLC's cash reserves or cover operational expenses. The money your LLC borrows isn't treated as business income—after all, it has to be paid back. As a result, neither the LLC nor the members pay tax on it.

These insider loans can benefit both the LLC and the lender. A loan payable with interest can result in an immediate investment return to the lender if repayments are made in monthly installments.

EXAMPLE: Phil's mother lends $10,000 to Phil's one-person LLC. The interest rate is set at 8%—less than Phil would pay to a bank but more than Phil's mother would earn from a government bond. The loan is repayable in monthly installments of principal and interest over a five-year period. Phil's mother receives a return on her money whether or not the LLC turns a profit in any given month or year.

To avoid IRS problems, your LLC should pay a lending member or other insider a commercially reasonable rate of interest—a rate that's close to what a bank would charge. When the LLC makes payments on the loan to the lending member, that member reports the interest payments received from the LLC on his or her individual income tax return, and pays taxes on them at the individual income tax rate.

Of course, the repayment of principal by the LLC to the lending member is simply a return of loan proceeds, and isn't taxable income. The LLC deducts the interest payments that it makes to the lending member as a business expense. These deductions reduce the net profit of the LLC, which in turn reduces the profits allocated and taxed to members at the end of its tax year.

D. Compensating Members

We've looked at how money gets put into an LLC. Now let's get to the fun part and look at how you take money out. We'll assume that your LLC has chosen the usual course and opted for partnership-style rather than corporate-style taxation (discussed in Chapter 1, and in Section G4, below).

LLC management can choose to pay active members a regular salary or a share of LLC profits. (If a member is inactive, the LLC can pay that member only a share of the profits—see directly below). If the LLC does choose to pay an active member a salary, the salary must be reasonable in light of the services performed by the member—the IRS has rules on what an LLC can pay to its members as salaries and what must be paid out as profits (see IRS Publication 535, Chapter 2).

A salary paid in return for the performance of services (one that is not tied to net income of the LLC) is classified as a "guaranteed payment." A guaranteed payment is taxed as ordinary income to the member, and the LLC will deduct it as a business expense before the net LLC income available for distribution to all members is computed.

EXAMPLE: Will and Peter each have 50% ownership interests in their home repair business, Fixer Upper LLC. Will works half time in the business and receives guaranteed payments (a salary) of $30,000 annually for his services. Peter works full time and receives guaranteed payments of $60,000 annually. During the year, the LLC earns $100,000 and has no expenses other than Will and Peter's salaries. After paying the salaries to the two members, the LLC is left with a $10,000 profit. That profit is allocated 50/50 between Will and Peter at the end of the year.

Now suppose you don't receive a "salary" for your services in the form of guaranteed payments during the year (or that you're an inactive member). In that case, your earnings are tied entirely to the net income of the LLC. An LLC's profits and losses are allocated to its members at the end of the LLC's tax year, according to the allocations in the LLC operating agreement.

Typically, the share of profits and losses allocated to each member is based on each member's percentage, or capital, interest in the LLC. So, going back to the above example, if Will and Peter didn't receive guaranteed payments for their services, the LLC's $100,000 profit would be allocated equally between them at the end of the tax year. The capital accounts of both Will and Peter would be credited with $50,000.

Sometimes members decide, and state in their operating agreement, that one or more members may receive what's called a "draw"—a periodic payment against future LLC profits. In this case, members do not have to wait until the end of the LLC's tax year to take profits from the LLC. Each member takes a draw each month or quarter; that draw, or distribution of future profit, is subtracted from the member's capital account. When profits are allocated to each member at the end of the LLC tax year, the member's capital account balance goes back up.

In tax lingo, profits that are allocated to an LLC member are known as the member's "distributive share." An LLC member must pay income tax on his or her distributive share whether it's actually distributed to the member or retained in the LLC coffers.

Self-Employment Taxes for LLC Members

As mentioned in Chapter 1, the IRS collects a 15.3% "self-employment" tax on the first $90,000 earned by a self-employed person and a 2.9% tax on earnings above that amount for Medicare alone. While owners of S corporations do not have to pay the self-employment tax on the profits passed through the corporation to them, according to proposed IRS regulations (which Congress has placed on hold), as an LLC member you would have to pay self-employment tax not only on money you receive as compensation for services, but also on all profits passed through the LLC to you, in the following situations:

- You participate in the business for more than 500 hours during the LLC's tax year.
- You work in an LLC that provides professional services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting (no matter how many hours you work).
- You're empowered to sign contracts on behalf of your LLC.

The IRS says it won't challenge you if you use the proposed regulations to determine your liability for self-employment tax. If you fall into one of the three categories listed above, 100% of your income from the LLC will be subject to self-employment tax. Otherwise, you can apply the S corporation rules described at the end of Chapter 1.

E. Choosing a Name

Your LLC name will have to comply with state legal requirements. This usually means including an LLC designator such as "Limited Liability Company" or "Limited Company" in the LLC name. Many states allow abbreviations such as LLC or LC.

> **EXAMPLE:** You choose Andover Services as the name of your business. Depending on the state in which you're located, one or more of the following may be appropriate ways to indicate that your business is an LLC:
>
> - Andover Services Limited Liability Company
> - Andover Services L.L.C.
> - Andover Services LLC
> - Andover Services Limited Liability Co.
> - Andover Services Ltd. Liability Co.
> - Andover Services Limited Company
> - Andover Services Ltd. Co.
> - Andover Services L.C.
> - Andover Services LC.

You'll need to put the name of your LLC in the articles of organization that you'll file with your state's LLC filing office. If you pick a name that's already on file for an LLC in your state, your articles of organization will be rejected. The same thing will occur if your proposed name is not identical to but simply too close to one that's already on file. Some states will also cross-check your proposed name against names on file for existing corporations or limited partnerships.

By planning ahead, you'll avoid the annoying setback of having to choose another name. In many states, if you call the LLC filing office, the clerk will make an instant computer check and let you know if there's a name conflict. A few states will ask you to request the information in writing.

Name availability check is only preliminary. *Until you've reserved an LLC name (as explained below) or filed your LLC articles of organization and had your filing accepted, your* *proposed name isn't yours to use. The information on name availability that you receive by phone or in response to a written request for a name check is just preliminary. Until you definitely have the name reserved or filed and accepted, don't spend money on business stationery, signs, or advertising using the proposed name.*

Be aware that even if your name is accepted by the LLC filing office, you may not have the full legal right to use that name to identify your products or services. The LLC filing office looks only at whether the name meets the requirements of the state LLC law and whether it's already in use by another LLC in the state. Some states will cross-check your proposed name against names on file for existing corporations or limited partnerships, but many will not even do that.

And, of course, legal conflicts may arise from other sources. Most important—especially if you'll use your name as a trademark or service mark to identify your goods or services—you'll need to make sure your proposed name isn't the same as or very similar to another well-known business name or trademark—Starbucks, Intel, or Borders, for example (see Chapter 6). If it is, the owner of the famous name will insist that you drop it; if you don't, the name owner will very likely go to court and win. To avoid this complication, you may want to do a national name search—and perhaps register your name as a trademark or service mark if the name is clear for your use.

To learn more about trademark law in general and name searches in particular (including how you can do a simple name search yourself): *Read* Trademark: Legal Care for Your Business & Product Name, *by Stephen Elias (Nolo).*

Suppose your LLC name is available but you're not quite ready to file your articles of organization. In most states, you can reserve the name for 30 to 120 days by paying a small filing fee. Many states have a preprinted form you can use for this purpose. After reserving a name, if you file your articles of organization within the reservation period, the name will be accepted by the LLC filing office.

You're not locked into your business name forever. *Your business can use a name that's different from the name used in your articles of organization. You can even use several alternative names. However, to use one or more alternatives with legal safety (in other words, to preserve the benefits of limited liability), you'll have to register each name as an "assumed" or "fictitious business name" at the state or county level or both. For more on this subject, see Chapter 6, Section B. It's also possible to change the name of your LLC by filing amended articles of organization.*

F. Paperwork for Setting Up an LLC

Setting up an LLC is simple. Typically, you must complete just two basic legal documents—the articles of organization (also called "articles of formation" or a "certificate of formation" in some states) and the operating agreement (called "regulations" in a few states).

Additional form for corporate-style taxation. *In the somewhat unusual event that you want to have your LLC taxed as a corporation, you'll also need to file a form with the IRS; it's IRS Form 8832,* Entity Classification Election. *See Section G4, below.*

1. Articles of Organization

In most states, preparing your articles of organization is surprisingly simple—especially if your LLC is a typical small business consisting of a handful of owners. Most states provide a printed form for the articles of organization; just fill in the blanks, sign the form, and file it with the LLC filing office. The task is made even easier in the states that include instructions for filling in the blanks.

Other states don't provide the actual articles of organization form but do furnish something almost as convenient: sample articles with instructions. You can prepare your own articles of incorporation by following the format and contents of the sample.

If your state is one of the few that provides neither fill-in-the-blank forms nor sample forms with instructions, you'll need to check your state's LLC statute to learn what to put into the articles of organization.

For step-by-step instructions on preparing articles of organization and other organizational documents for your LLC: *Consult* Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo).*

Typically, your articles of organization will not need to include anything more than the following information:

- *The name of your LLC.* (See Section E, above, for more on picking a name.)
- *The name and address of your LLC's initial registered agent and office.* You'll probably name one of your members as your registered agent—the person who receives official correspondence relating to the LLC and who gets served with lawsuit papers if someone sues the business. You'll generally use the LLC's business location or the registered agent's home as the registered office address.
- *Statement of purpose.* In most states, you don't need to describe your business activity—a general statement of purpose will suffice. Example: "Purpose: To engage in any lawful business for which limited liability companies may be organized in this state."
- *Type of management.* You usually need to say whether your LLC will be member-managed or manager-managed. The difference between the two is explained in Section B, above. In most states, if you don't specify the type of management, your LLC will be managed by all the members (that is, member-managed). Typically, you'll also need to give the names and addresses of your initial members and, for manager-managed LLCs, your initial managers. (Note: In some states, the type of management is specified in the operating agreement rather than the articles.)
- *Principal place of business.* You'll give the address of your main business location. For most small businesses, it's also the only location.
- *Duration of the LLC.* In many states, your articles must specify how long your LLC will be active. You may be able to choose between a "perpetual" (unlimited) duration or a specific number of years. Some states put an upper limit on the number of years you can choose—30 or 50 years, for example. These statutory limits should cause no problem because when the time is up, you or your LLC successors can extend the life of the business for another long term of years.
- *Signatures of people forming the LLC.* Usually, state law allows one person to sign the articles as the organizer of the LLC. But if your LLC is member-managed, you'll probably choose to have all the initial members sign the articles of organization to give everyone a sense of participation.

After preparing your articles, you file them with your state's LLC filing office—usually the secretary of state, located in your state's capital city. In a few states, before or after you file your articles of organization, you may need to put a legal notice in a local newspaper stating your intention to form an LLC.

There may be special requirements for licensed professionals. *In many states, if you're a licensed professional, you'll need to comply with additional rules for starting an LLC. For example, you may have to file special articles of organization for a professional LLC, and you may have to end your LLC name with special words or initials such as "Professional Limited Liability Company" or "PLLC." In a few states, such as California, many types of professionals, such as accountants, doctors, and physical therapists, to name a few, are not allowed to form LLCs. For more on professional LLCs, see Chapter 1, Section F2b.*

2. Operating Agreement

Once you've filed your LLC articles of organization with your state's LLC filing office and the document has been accepted, you're officially in business. But if you have more than one member, don't overlook another important piece of LLC paperwork: the operating agreement.

Although you can usually omit this document for a one-person LLC (except see "Ask your tax advisor about allocating goodwill payments in your operating agreement," below), it's very important to have one if your LLC has two or more members.

Ask your tax advisor about allocating goodwill payments in your operating agreement. *If you plan to sell your LLC membership interest in the future, you may wish to specifically provide in your LLC operating agreement that part of the buyout price includes a reasonable payment for the selling member's share of the business's goodwill. (Goodwill is an intangible factor—often based on brand recognition or business reputation—that makes a business worth more than just the value of its physical assets.) You're probably aware that it's better to have income taxed as a capital gain rather than as ordinary income. By including such a goodwill allocation in an operating agreement, you ensure that the portion of the buyout price attributed to goodwill will be treated as a capital asset. This will save the selling member from having to pay tax on it at the higher, ordinary income tax rates. For this reason, if you set up a one-person LLC, you may want to create an operating agreement just for the purpose of making a goodwill allocation. See your tax advisor, as this is a complicated area of business tax law.*

The operating agreement serves a function similar to partnership agreements (Chapter 2) and corporate bylaws (Chapter 3). It sets the rules for how the owners will run th(9business and it defines their rights and responsibilities, such as the members' voting power and right to profits.

In a typical operating agreement for a member-managed LLC, provisions covering the following subjects are usually included:

- *Capital provisions.* One of the most important parts of an operating agreement sets forth how much money or property each member will contribute to the LLC and what additional contributions may later be required.
- *How a member's percentage interest is determined.* The operating agreement should state how members' percentage (capital) interests are computed. Typically a member's percentage interest will be based on how a member's capital account compares to the total of all

members' capital accounts. So if Ed has $25,000 in his capital account and the total of all capital accounts is $100,000, then Ed's percentage interest is 25%.

Capital Accounts Explained

In bookkeeping speak, a member's capital account represents the current value of that member's percentage of ownership interest.

When an LLC member contributes cash or property to the LLC, the member's capital account is credited with the cash amount or fair market value of the property contributed. Later, when profits are allocated at the end of the LLC tax year, the member's capital account balance goes up (the business owes the member this money); as distributions of profits are made, the capital account balance goes down (the business no longer owes this money to the member).

The capital account balance is also the amount of LLC assets that a member expects to be paid if the company is liquidated and split up among the members (assuming there's sufficient cash or other assets left after all creditors have been paid).

- *Type of management.* Your agreement may need to specify whether your LLC will be member-managed or manager-managed. Most small LLCs will opt for member-management, and in the majority of states, if you don't specify your choice, the law says that your LLC will be managed by all the members (that is, member-managed). Typically, you'll also need to give the names and addresses of your initial members and, for manager-managed LLCs, your initial managers. (Note: In most states, you can elect the type of management either in your articles or your operating agreement.)
- *Membership voting.* Your agreement should also specify how issues will be voted on and decided. In the case of a member-managed LLC, you'll probably want a simple majority (51%) of membership interests to decide most issues, but you can also provide for a larger majority (two-thirds, for example) to decide some matters. You can also provide for per capita voting, where one member is given one vote.
- *Profits and losses.* Explain how profits and losses will be allocated to members. Typically, it will be on the basis of each member's percentage (capital) interest in the LLC.
- *Distribution of money.* You may decide to put language in your operating agreement spelling out who will decide if and when LLC profits will be distributed to members. For example, you might provide that all members must agree on a distribution or, perhaps, tfy4 a majority of members can make that decision.
- *Tax election.* As noted above, an LLC is taxed as a partnership unless it elects to be taxed as a corporation. It's a good idea to state in your operating agreement how the LLC will be taxed initially.
- *Transfer of a membership interest.* Your operating agreement should say how a member can withdraw from the business and whether a member can transfer his or her interest in the LLC to someone else.
- *Addition of new members.* Explain whether new members will be allowed into the LLC and how—that is, by a simple majority, a larger majority, or a unanimous vote.
- *Buy-sell provisions.* Chapter 5 covers the important subject of what happens if a member dies, moves away, gets sick, or simply wants to get out of the business. Can the LLC force the departing member to sell her interest to them? How will the interest of a departing member be valued? While you can cover

these issues in a separate buy-sell agreement, it makes better sense for LLC members to deal with them in the operating agreement.

- *Other businesses.* Your operating agreement can provide, for example, that members are free to own interests in or work for other businesses that don't compete with the business of the LLC.

As mentioned above, most small businesses that operate as LLCs will prefer to have the business member-managed rather than manager-managed. If your business chooses the less popular manager-managed option, you'll need a special section in your operating agreement dealing with how managers are selected and replaced, and what authority they have.

For excellent guidance on preparing your LLC operating agreement: *Consult* Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo). It contains complete details for preparing an LLC operating agreement whether your LLC is member-managed or manager-managed. The CD that accompanies the book makes the task even easier.*

Have a lawyer review your operating agreement. *If you prepare your own operating agreement, it's a good idea to have an experienced small-business lawyer look it over before you and the other members sign it. That will help assure that the provisions are internally consistent and that you haven't made any technical errors that can cause legal, tax, or financial problems later. A lawyer's fees for reviewing the operating agreement should be a fraction of what they would be if the lawyer drafted the document from scratch.*

G. After You Form Your LLC

Once your LLC articles of organization have been accepted by your state's LLC filing office and you've signed an LLC operating agreement dealing with such important issues as managing the business, allocating profits and losses, and transferring membership interests, you're ready to start doing business. However, there are a few additional actions that are either legally required or worth considering to put your new company on a sound footing.

1. Set Up an LLC Bank Account

Remember, your LLC is a legal entity separate from its members and managers. For this reason, your LLC needs its own bank account so that its finances can clearly be kept separate.

If you're creating an LLC out of an existing business that already has a bank account—for example, your sole proprietorship or partnership business is now going to be run as an LLC—start fresh by opening a new bank account for the LLC. The bank may ask for a copy of your articles of organization and your Employer Identification Number (EIN), which is issued by the IRS. (EINs are discussed in Chapter 8, Section A.)

If you decide to simply continue the old account, you'll need to check with your bank to learn their procedures for moving a bank account from a prior business to a new legal entity. Again, the bank will probably want to see your articles of organization and your EIN. You need to keep detailed records showing exactly how much money was in the account when it was changed over to the LLC. Also, keep track of checks that were written by your prior business but haven't cleared yet. These checks should be treated as expenses of the prior business and deducted from the amount considered transferred to the LLC. If you don't prepare and retain these records, you can wind up with one big headache a few years from now when you try to reconstruct exactly what you transferred to the LLC.

2. Complete Any Initial Financial Transactions

Tie up any other loose ends relating to the financing of the LLC. For example, make sure that the members deposit their initial contributions of cash into the LLC bank account. If a member transfers property—computer equipment, for example—to the LLC in exchange for a membership interest, the member should sign a bill of sale confirming the transfer of property to the LLC.

And if your LLC is borrowing startup money from friends, relatives, or its members, be sure to issue promissory notes from the LLC stating the interest rate and other terms of repayment.

Finally, if you or another member will be leasing space to the LLC, prepare a lease as if the landlord were a complete outsider.

3. Comply With the Bulk Sales Law

If members are transferring assets from a preexisting business to the new LLC in exchange for membership interests in the company, you may need to comply with your state's bulk sales law. These laws, currently on the books in six states (California, Georgia, Indiana, Maryland, Virginia, and wisconsin), apply mainly to retail, wholesale, and manufacturing businesses. They are intended to prevent business owners from secretly transferring their business assets to another company to avoid paying creditors. Typically, under these laws, you have to notify creditors that the assets of the business are being transferred.

While the details of bulk sales laws differ somewhat from state to state, these laws usually have an exemption or shortcut that applies when you transfer assets from an existing business to a new LLC that will continue the business. Typically, to qualify, your LLC needs to agree in writing to take over the business debts of the existing company.

4. Inform the IRS If Your LLC Chooses Corporate Taxation

An LLC is normally taxed as a partnership (explained in Chapter 1, Section D). This means that for federal income tax purposes, the LLC itself does not pay a tax on its income. Profits or losses pass through to the individual members, who include their share of LLC profits or deduct their share of LLC losses on their personal tax returns. This is the route that the members of most LLCs prefer. If that's what you want to do, you don't have to let the IRS know. You'll automatically be treated as a partnership for federal income tax purposes.

The other tax option is to have your LLC treated as a corporation for tax purposes. Your tax advisor may recommend this if you expect your LLC profits will be substantial and the members are prepared to leave some of the profits in the business. The funds can be used in a later year, for example, to pay for a new building or the purchase of additional equipment. With corporate tax treatment, the income retained in the LLC is taxed at lower corporate tax rates (15% and 25% for taxable net income up to $75,000), instead of the top individual tax rates of 35% and 38.6% that might apply to income allocated to members of an LLC that has elected partnership-style taxation.

If your members want to have your LLC taxed as a corporation, the LLC will need to file IRS Form 8832, *Entity Classification Election*, within 75 days of the formation of the company. Otherwise, you'll have to wait until a later tax year to make the change.

For more on complying with federal and state tax filing rules, see Chapter 8.

H. Safe Business Practices for Your LLC

In a small LLC consisting of just one member or a few members, it's sometimes hard to keep in the front of your mind the fact that the LLC is a separate legal entity from you and the other members. You and your business are not the same. In the eyes of the law, you are an agent of the LLC. For example, when you sign contracts and other documents, you're signing them (or should be signing them) on behalf of the LLC and not as an individual.

Remembering this distinction between you and your LLC can seem especially burdensome if you've done business in the past as a sole proprietorship or partnership and have just changed over to an LLC. On the day-to-day level, it's really business as usual and, in many respects, nothing at all has changed. Yet, if you want to get the maximum protection from personal liability for debts of the business, you need to carefully observe the legal distinction between yourself and your LLC. Fortunately, as you'll see shortly, that task isn't as tough as you may think.

The reason it's so important to always treat the LLC as a separate entity is that if you don't, a judge may decide that you're personally liable for a business debt or that you have to pay a lawsuit judgment out of your personal assets. It's becoming clear that in cases involving LLCs, judges will follow the same rules that they apply to corporations and will hold LLC owners personally liable for business debts if the owners haven't respected entity formalities. (See Chapter 3, Section H, for some examples of what courts have done when corporations have been sloppy.)

So if you ignore the fact that your business is organized as an LLC, and you operate it more like a sole proprietorship or a partnership, you will needlessly face the risk of personal liability. It follows that many of the precautions that I recommend for protecting corporate shareholders from personal liability should help to shield LLC members.

1. Put Adequate Capital Into Your LLC

Put enough money and other assets into your business to meet business expenses that are likely to come up. If you don't, and there's a lawsuit, a judge may rule that the LLC is a sham—that it really isn't a separate entity from its owners—in which case you and the other members may be personally liable.

Each business has different financial needs. You can often legally fund a small home-based business such as a computer consulting operation on a shoestring. But opening a pizza restaurant would require considerably more money, since you'd need to lease space, outfit a kitchen and dining area, and hire employees. Your accountant should be able to recommend a reasonable level of funding for your LLC.

2. Insure Against Obvious Risks

Think carefully about whether there's a substantial risk of customers or others getting hurt because of your business. If so, it's a good idea to buy a reasonable amount of liability insurance coverage. (See Chapter 12 for more on insurance.)

In a few cases, judges have felt that the owners of a small corporation were acting recklessly because the corporation didn't buy liability insurance that was reasonably available. This recklessness played a part in the judges' decisions to hold the owners personally liable to people injured by the corporations' employees or products. It's likely the same principle will be applied to LLCs. So if liability insurance is available at a reasonable price, see to it that your LLC gets the proper coverage.

3. Separate Your Personal Finances From Your LLC's Finances

The LLC needs its own bank account (see Section G1). Don't use that account to pay your personal expenses. If you receive checks from the LLC for salaries or draws (see Section D, above), deposit the checks in your personal account and then pay your personal bills from that account.

If you use personal funds to pay business expenses—for example, you pick up a business book on the way home from work—you can have the LLC reimburse you. Be sure the LLC keeps a receipt for your purchase of the book to justify deducting the cost as a proper business expense.

To further separate you and other members from the LLC, document all transactions as if you were strangers. If the LLC leases a building from you, sign a lease. If the LLC borrows money from you, get a promissory note. If you sell equipment to the LLC, sign a bill of sale to formally transfer legal ownership to the LLC.

4. Use the Official LLC Name

Suppose the name of your LLC is Kitchen & Bath Designers LLC. Use that full business name in all your business dealing—on your stationery, business cards, and phone book listings, on your signs, in catalogues, and on the Internet. Don't use a different name or abbreviation (such as Kitchen & Bath Designers, without the letters LLC) unless you file an assumed name certificate or fictitious name certificate as permitted by state law. For more on LLC names, see Section E, above, and Chapter 6.

5. Sign Documents as an LLC Member or Manager

In correspondence and on checks, sign your name as Paula Smith, Member, or Paula Smith, Manager, along with the full name of your LLC, rather than just Paula Smith. This makes it clear to those who deal with you that you're acting as an agent or employee of the LLC and not as an individual. Follow this practice on any other documents you sign, such as contracts, order forms, and promissory notes.

SAMPLE SIGNATURE OF LLC MEMBER OR MANAGER

Whole Grain Bakery LLC
By: ______________________
Paula Smith, Member

OR

Whole Grain Bakery LLC

By: ______________________
Paula Smith, Manager

In some cases you may have to personally sign an LLC document or promissory note as a guarantor. For example, a bank typically won't lend money to a small LLC unless the members personally guarantee repayment, and a super-cautious landlord may want you to guarantee the lease. But even if you have to accept personal liability for some LLC obligations, it's better to do this as a guarantor than as the main signer. The reason: The guarantee serves as further evidence that you and the LLC are separate legal entities.

6. File Annual State LLC Reports

In most states, you're required to file a one-page annual report on a form available from the LLC filing office. Usually, the form is automatically mailed to you. You'll have to pay a small filing fee in the range of $10 to $50—although the fee is higher in a few states. To avoid losing your legal status as an LLC and your protection from personal liability, it's important that you complete the form and return it along with the filing fee to the appropriate state office.

7. Assign Existing Business Contracts to Your LLC

If you've been doing business as a sole proprietorship or partnership and are now switching over to an LLC, you may have some ongoing contracts that you'd like the LLC to take over. For example, maybe your sole proprietorship signed a five-year lease for business space and there are still two years left to go under the lease. Or maybe the partnership you established for your lawn maintenance business has several contracts in force to service the lawns of major businesses in a local research park.

It makes sense to transfer these contracts to your LLC. You usually can do this without getting the consent of the other party to the contract, unless the contract specifically prohibits an assignment. But be aware that if you do assign a contract to your LLC, you'll still be personally liable for complying with it. There are basically only two situations in which this isn't true. The first is when the other party consents in writing to release you from liability. The second is when the contract contains language allowing you to assign it to a new LLC or corporation and be free from personal liability.

Unless you fall into one of these two exceptions, the landlord in the first example will be able to turn to you for the rent if the LLC doesn't pay it. Or in the second example, the businesses that contracted for your lawn maintenance services will be able to hold you personally responsible if your LLC doesn't perform and the businesses have to pay a higher price to get the work done by someone else.

Tax rules on passive investments are tricky. *If your LLC will receive income from passive sources (rents, royalties, or dividends, for example) or from the performance of personal services, get professional advice before transferring contracts to the LLC. A transfer could lead to a personal holding company penalty—which could be quite substantial.*

SAMPLE ASSIGNMENT OF CONTRACT

Assignment of Contract

In consideration of the sum of $_____, receipt of which is acknowledged, WordSmith Associates (an Indiana partnership) assigns to WordSmith Media Consultants LLC (an Indiana limited liability company) all of its rights and duties under the contract with Smoke Stack Industries, Inc., dated _____________, 20__, for advertising, marketing, and public relations services.

WordSmith Media Consultants LLC accepts this assignment and accepts all of WordSmith Associates' duties under the assigned contract.

Dated: ______________, 20__

ASSIGNOR:	ASSIGNEE:
WordSmith Associates,	WordSmith Media Consultants LLC,
An Indiana Partnership	An Indiana Limited Liability Company
By:________________	By: _________________
Cynthia Cardone	Cynthia Cardone
Partner	Member

8. Record Keeping

If someone goes to court and asks the judge to disregard your LLC and hold you personally liable, you may be able to bolster your position if you can produce a record book that shows you've consistently treated the LLC as a separate legal entity.

This is clearly the case when someone seeks to get behind a corporation and hold the owners (shareholders) personally liable. (See Chapter 3, Section H.) That's because by law and tradition, corporations are expected to observe a number of formalities such as holding annual meetings and documenting meetings of the board of directors. The paperwork requirements for an LLC are minimal compared with those for a corporation. Still, you may want to hold periodic meetings and document important LLC decisions—especially if you have more than two or three members.

Depending on the degree of formality you choose for running your LLC, I recommend that you keep an LLC record book containing important paperwork, such as:

- the articles of organization
- the operating agreement
- a membership register listing the names and addresses of your members
- a membership transfer ledger showing the dates of any transfers of membership interests by a member
- membership certificates and stubs (if your LLC decides to issue certificates to members), and
- minutes of LLC meetings and written consent forms (if your LLC decides to hold formal meetings or to get written membership approvals for certain LLC decisions—see discussion directly below).

Even if your LLC has decided to proceed with a minimum amount of formal paperwork, you should consider documenting the members' approval of the most significant LLC actions, including:

- authorizing LLC bank accounts and designating who's eligible to sign checks and withdraw funds
- borrowing money, from a bank or from an LLC member
- amending the articles of organization or the operating agreement
- entering into major contracts
- buying, selling, or leasing real estate
- electing corporate-style taxation or a tax year other than a calendar year
- authorizing distributions of profits to members
- admitting new members
- authorizing the LLC purchase of the interest of a departing member.

By staying on top of this simple paperwork, you'll have a paper trail of important LLC decisions that will help satisfy courts, the IRS, and others that you've attended to all the legal and tax niceties and that you've treated the LLC as a separate legal entity.

Your Limited Liability Company: An Operating Manual, *by Anthony Mancuso (Nolo), explains ongoing record keeping requirements and provides minutes, written consent forms, and resolutions for a multitude of business decisions.* ■

CHAPTER

5

Preparing for Ownership Changes With a Buy-Sell Agreement

A. Major Benefits of Adopting a Buy-Sell Agreement 5/3
   1. Controlling Who Can Own an Interest in Your Company 5/3
   2. Providing a Guaranteed Buyer for Your Ownership Interest 5/5
   3. Setting a Fair Price and Providing a Workable Method for a Buyout 5/6
B. Where to Put Your Buy-Sell Provisions 5/7
   1. Corporations 5/7
   2. LLCs and Partnerships 5/8
C. When to Create a Buy-Sell Agreement 5/8

If you're in business with others, there's a good chance that there will be ownership changes as the years go by. That's true whether you organize your business as a partnership, a limited liability company (LLC), or a corporation. Ownership changes may be the last thing you want to think about when the business is brand-new. However, the fact is that many things can happen down the road—or maybe only a few steps away—to affect the ownership of your business. For example, you or a co-owner may:

- decide to move out of state to pursue a new line of work
- become physically or mentally disabled—or even die
- seek to buy out a co-owner's interest in the business, or
- want to sell to an outsider.

What happens then? Will the transition proceed smoothly and fairly? Or will there be discord and, possibly, lawsuits? The answer may depend on how well you've planned for the future. Without careful planning, the business itself may be in jeopardy. In an extreme case, all the time and money that you and the other owners have put into the venture may evaporate as the business falls apart.

Certainly, during the sunny, optimistic days when you're putting the business together, it's hard to focus on disruptive changes that you may face in the future. And it's equally difficult to do so when the business is humming merrily along. But planning ahead can save all involved from a ton of grief.

Most businesses with two or more owners should put together a buy-sell agreement. This principle applies regardless of the legal format you've chosen for your business. Partners in a partnership, shareholders in a corporation, and members of an LLC will all benefit from well-drafted buy-sell provisions.

First, let's get our terms straight. When I use the term buy-sell agreement, I'm not talking about a contract in which you promise to buy an outsider's business or an outsider promises to buy yours; that's a separate topic, covered in depth in Chapter 10. The buy-sell agreement we're looking at here is a binding contract among the owners of your business that controls the buying and selling of ownership interests in that business. When a co-owner is thinking about selling or giving away his or her interest, a good buy-sell agreement steps in to give the continuing owners some control over the transaction. Often, the agreement will regulate who can buy the departing owner's interest and at what price, or sometimes whether the co-owner can sell at all.

Importantly, a buy-sell agreement helps assure that you and your co-owners aren't forced to work with strangers or other people you won't get along with. It can also help assure that if a co-owner leaves the business, that person will receive a reasonable sum in exchange for his or her ownership interest—or if a co-owner dies, that the heirs will be paid fairly.

Typically a buy-sell agreement also gives the business and its continuing owners a chance to buy out an owner who's stopped working for the business or has died. This eliminates the possibility that active owners will be forced to share profits with an inactive owner or an unsuitable new owner. Some buy-sell agreements also say that if an owner dies, the surviving owners can force the deceased owner's estate representative or inheritors to sell back the deceased owner's interest to the company or to its surviving owners. Similar provisions may apply when an owner decides to retire after a certain period of time, or becomes disabled and can't actively participate in the business.

This chapter simply introduces you to the important concept of buy-sell agreements. *For comprehensive coverage of the subject and precise guidance on how to develop your own agreement, be sure to consult* Buy-Sell Agreement Handbook: Plan Ahead for Changes in the Ownership of Your Business, *by Anthony Mancuso and Bethany K. Laurence (Nolo). The book comes with a CD-ROM and a worksheet to walk you through the process.*

Check your agreement with an expert. *With the help of the comprehensive book and disk recommended above, you should be able to craft a respectable buy-sell agreement. However, as authors Mancuso and Laurence wisely note, even their book can't provide the depth of advice—especially in the tax and estate-planning realm—that a buy-sell or financial planner or tax expert can provide. And of course, their book can't customize an agreement for you that suits exactly your company's and each owner's individual needs. So if you do draft your own buy-sell agreement, be sure to take it to a small business tax or legal advisor before putting your finalized agreement into action.*

A. Major Benefits of Adopting a Buy-Sell Agreement

If you *don't* have a buy-sell agreement, here are some things that can happen:

- You may be forced to work with and share control of the company with an inexperienced or untrustworthy stranger who buys the interest of a departing owner.
- You may be forced to work with the spouse or other family member of a deceased or divorced owner. While this might work out just fine, there's also a substantial possibility that the family member will lack the necessary business skills or the right personal qualities for working with you and the other co-owners.
- If you leave the company or die, you or your survivors may be stuck with a small business interest that no outsider wants to buy—and for which no insider will give you a decent price.
- You and your co-owners may argue with a departing co-owner or the inheritors of that co-owner over what price should be paid for the interest that's changing hands. This can cause an angry deadlock that can wreak havoc on your business operations.

Now let's see how a buy-sell agreement can help your business avoid these situations.

1. Controlling Who Can Own an Interest in Your Company

An outsider who gains an ownership interest can disrupt the smooth flow of your business—especially in the case of major management decisions that require unanimous approval of the owners. Consider this example:

> **EXAMPLE 1:** Joe and Cindy form a small corporation. Each receives 50% of the corporate stock. They don't foresee problems down the road so they don't bother with a buy-sell agreement. A few years later, Joe and Cindy have a serious disagreement over how to expand the business. To avoid further hassles, Joe sells his shares to Albert, whom Cindy has never met before. The two quickly reach an impasse on management issues and the business comes to a standstill.

A buy-sell agreement can prevent this from happening, by giving the owners the power to prevent outsiders from buying in. Sometimes this is accomplished by giving the remaining owner or owners the opportunity to meet any outsider's offer for an interest in the company. This type of provision is called a "Right of First Refusal." To better understand its purpose, see what happens if Joe and Cindy had a buy-sell agreement:

> **EXAMPLE 2:** Joe and Cindy form a small corporation—and they wisely create a buy-sell agreement to deal with what happens if one of them wants to leave the business. A few years later

when they disagree on how to expand, Joe decides to sell his shares. Albert offers to buy the shares for $10 each. The Right-of-First-Refusal provision in their buy-sell agreement requires Joe to offer the shares to Cindy at the same price. Rather than share control of the business with a stranger, Cindy buys Joe's shares. The business continues to run smoothly and prospers.

A buy-sell agreement can also give the surviving owners the power to purchase the interest of an owner who's died if the surviving owners don't want the inheritors of the deceased owner to become co-owners of the business.

Who Doesn't Need a Buy-Sell Agreement?

Although a buy-sell agreement can benefit most small businesses, there are situations where one isn't essential.

You're the 100% owner of the business. If you have a one-person business, obviously you won't have much interest in an agreement that controls who may own interests in the company, since you can do that yourself. But consider the possibility that you may want to plan for the future by agreeing to sell the business to a valuable employee who is willing and able to take it over. In that situation, you might decide to sign a buy-sell agreement with the employee. This will assure the employee that he or she will be taking over some day, and you'll know that you or your inheritors will receive payment when ownership of the company is transferred to the employee upon your death.

You own the business with your spouse. If you've been married a long time and have a good, solid marriage, you probably won't need a buy-sell agreement. It's unlikely that either of you will want to leave the company unless you both do. And if one of you dies, the other one probably will inherit the ownership interest. On the other hand, if you haven't been married long, or your future with your spouse is unsure, a buy-sell agreement can make sense.

You own the business with one of your children. If you plan to transfer part or all of your business to your child, a buy-sell agreement isn't required. You can arrange the transfer through a regular contract or your will or a trust. But even here, you may want to sign a buy-sell agreement. It's always possible, for example, that your child will die or want to leave the business before you do. A buy-sell agreement can address this and other possibilities.

2. Providing a Guaranteed Buyer for Your Ownership Interest

As we've seen, a buy-sell agreement can protect your company by making sure that an outsider does not disrupt the business by becoming an owner without the approval of the owners. But a buy-sell agreement can also help you individually if you ever reach the point where you want or need to sell your ownership interest.

Obviously, it can be quite difficult to sell a less-than-100% share of a small business. There may be no market at all for a minority interest. A person interested in buying into a small business will normally not find it attractive to be in business with strangers and to have very little say in how the business is managed. This lack of a true market for your interest can be a problem for you and your family. The time may come when you want to leave the business but your co-owners may be unwilling to pay you a fair price for your interest. If that happens, you may be stuck with a share of the company you can't sell. The same thing can happen if your heirs inherit your piece of the company.

> **EXAMPLE:** Norm, Betty, and Phil form a small corporation, each receiving one third of the shares. They neglect to sign a buy-sell agreement. Three years later, Norm dies unexpectedly. His wife and two children inherit his shares. They'd like to sell the shares to raise money for college and other living expenses but can't find an outside buyer. Knowing this, Betty and Phil buy Norm's shares for a pittance, leaving Norm's family in dire economic straits.

A good buy-sell agreement can avoid an unfortunate outcome like this by requiring the company or the remaining owners to pay a fair price if your inheritors want to sell your interest in the business. You accomplish this by putting a "Right-to-Force-a-Sale" provision in your buy-sell agreement, which requires the company or the continuing owners to buy you out if you die, and sometimes under other circumstances. (The agreement can also provide that the company purchase life insurance on its owners, to fund the future purchase of a deceased owner's interest.) This can protect you and your inheritors from taking a financial hit if the company or continuing owners refuse to buy your interest at a fair price or from becoming embroiled in bruising negotiations over what will happen to your ownership interest.

Let's see how a buy-sell agreement could have changed the grim outcome for Norm's family in the above example.

> **EXAMPLE:** Norm, Betty, and Phil form a small corporation, each receiving one third of the shares. Wisely, they sign a buy-sell agreement containing a Right-to-Force-a-Sale clause, which kicks in if one of them dies. The clause requires the surviving owners to buy the interest of an owner who's died, assuming the estate representative, trustee, or inheritors want to sell it.
>
> Three years later, Norm dies unexpectedly. His wife, as representative of his estate, invokes the Right-to-Force-a-Sale clause. Since the agreement required the purchase of life insurance policies on each owner, Betty and Phil can easily buy out Norm's shares at the price in the agreement by using the insurance proceeds. Norm's wife spends the money for college expenses for the children and for other living expenses.

A buy-sell agreement can also require the company or remaining owners to buy your interest in other situations as well. For instance, you may want to retire or stop working, or you may become mentally or physically disabled. If you don't have a buy-sell agreement in these situations, there's no guarantee that you'll get a fair price for your business interest.

3. Setting a Fair Price and Providing a Workable Method for a Buyout

A well-prepared buy-sell agreement can set a price for interests in the business—or a formula for setting a price. This can eliminate lengthy disputes and unpleasant lawsuits about the value of an owner's interest. Equally important, the agreement can provide a mechanism for how the departing owner (or his or her family members) will be paid. Having to come up with a lump-sum payment for a departing owner's interest, for example, may create financial stress for the company or the remaining owners. As a solution, a buy-sell agreement may provide for payments to be made in installments over a number of years. Or maybe the payments will come from life or disability insurance that the company buys for each owner.

Be forewarned that figuring out a fair price in advance of a buyout scenario is no easy task. You and the other owners will be trying to arrive at a price that, years from now, will represent the true value of the company. You can't know today if your business will prosper in the years ahead or struggle to make a profit. And since there's no public market for small business interests, it's hard to make comparisons with interests in similar businesses—not that such information would be of great help anyway. Each industry and small business is different; comparative data from other companies has limited value. Still, picking a fair price—or a formula for setting the price—is essential if the buy-sell agreement is to do its job.

There are five basic methods for setting a buyout price—all of which are explained clearly and in great depth in *How to Create a Buy-Sell Agreement & Control the Destiny of Your Small Business,* by Anthony J. Mancuso and Bethany K. Laurence (Nolo). Typically, you'll set a price for the business as a whole—or a formula for determining that price, and the interest of an owner will usually be a percentage of that price. For example, if the entire business is worth $500,000, the interest of a 25% owner will be worth $125,000 for buy-out purposes. Let's briefly look at the most common methods for valuing a company for purposes of a buyout:

a. Valuation Method 1—Agreeing on a Fixed Price in Advance

Using this method, you simply agree on a price for the business as a whole and put that number in your buy-sell agreement. This agreed-value or fixed-price method is simple and certain. However, it's hard to pick a price that will reflect the value of the business throughout its life—the price you decide on today can quickly become outdated. So if you use this method, you will want to provide that the number will be updated each year.

b. Valuation Method 2—Book Value

The book value of a company is generally its assets minus its liabilities as shown on the company's most recent year-end balance sheet. Because the book value is basically a snapshot of the company's finances on a given day, it doesn't give information about the profitability of the business. Also, book value may not reflect assets such as customer goodwill that reflect the profit-making ability of the company. Compared to other formulas for determining value, the book value method usually results in the most conservative (lowest) value for a business.

c. Valuation Method 3—Multiple of Book Value

If a small business has been up and running for several years, its real value is probably greater than its book value. The multiple-of-book-value method takes into account intangible assets that add to the worth of the business—assets such as goodwill, patents, copyrights, brand names, and trade names.

You might decide that the price of the business should be, for example, two times its book value or three times its book value.

d. Valuation Method 4—Capitalization of Earnings

This method is best suited to established companies, since it measures the value of a business by its past profits. If your company is just starting out or hasn't been around very long, you can't use this method because you have no earnings history.

But after your company has produced a good profit for several years, you may want to shift over to this method. Here's how it works. You first determine the company's annual earnings, or profit, by subtracting the cost of doing business from gross revenues. Next you multiply the earnings by a number called a multiplier. The number you choose should depend, to some degree, on your company's industry and also on prevailing interest rates. Generally, you'll apply the multiplier to your company's average annual earnings for a "base earning period" of three years or longer.

e. Valuation Method 5—Appraisal Method

Your buy-sell agreement can simply provide that at the time of a buy-out, a professional business appraiser will establish the value of the business. Actually, you may want to provide for two appraisers. Typically, as part of the buy-out process, the buyer (usually the company or remaining owners) and the seller (for instance, the departing owner or the representative of a deceased owner's estate) each choose an appraiser to value the company. If they come up with the same price, that value is used. If they come up with close prices, the parties may be able to negotiate and agree on a price. But if the two appraisers are far apart on the price, the agreement may require them to choose a third appraiser who will set the price. A drawback is that the appraisal method can be costly and time-consuming.

B. Where to Put Your Buy-Sell Provisions

You may be wondering what kind of document should hold your buy-sell provisions. Basically, you need to choose between putting the provisions in a separate buy-sell agreement and adding them to another document that may already be in existence—for example, your corporate bylaws, your LLC operating agreement, or your partnership agreement. Here are my recommendations.

1. Corporations

If you do business as a corporation, you can add your buy-sell provisions to your organizational documents—either your articles of incorporation or, more likely, your bylaws. Or, you can adopt a separate agreement, often called a shareholders' agreement in the corporate context. I believe that the latter approach—adopting a distinct agreement—is best. You're emphasizing the importance of these provisions, so that an owner can't later claim surprise when another owner asserts the terms.

If you follow this recommendation, it's a very good idea to refer to the separate buy-sell agreement in the bylaws. This can help head off a legal challenge by someone looking for a legal way to escape from the buy-sell terms.

Whichever approach you take, make sure your buy-sell provisions don't conflict with the existing provisions of your articles of incorporation or bylaws. You may want a lawyer to help you with this consistency check.

To make sure that potential buyers of your corporate stock as well as potential creditors know about the buy-sell agreement, add language to each stock certificate stating that the share is subject to the terms of a shareholders agreement. This statement is called a stock certificate *legend*.

2. LLCs and Partnerships

For a partnership—whether general or limited—the partnership agreement is the primary (and, usually, only) agreement among the business owners. Similarly, for an LLC, the operating agreement is the primary agreement between owners. So for partnerships and LLCs, I recommend that you place your buy-sell provisions in the partnership or LLC operating agreement itself. You'll want to make sure, of course, that the buy-sell terms mesh well with the other provisions of the agreement. A lawyer can help with this chore.

Perform a Consistency Check on Your Buy-Sell Provisions

Whether you adopt your buy-sell provisions as part of a separate agreement or add them to your bylaws, partnership agreement (discussed in Chapter 2), or LLC operating agreement (discussed in Chapter 4), make sure they do not conflict with the current provisions of those organizational documents.

Mostly, you want to check to make sure an existing provision in one of those documents does not prohibit, or impose addition rules on, any of the buy-sell provisions that you're adding. For example, if your partnership agreement prohibits the transfer of ownership interests to outsiders, but the buy-sell provision you want to use allows an owner to sell to an outside buyer under certain circumstances, you will want to amend your partnership agreement to delete the restriction on transfers.

Prevent legal termination of partnerships and LLCs. *One area that partnerships and LLCs need to cover in their buy-sell provisions is what happens to the company when an owner leaves (sells out, retires, or dies). Some state laws say that the partnership or LLC automatically dissolves when an owners leaves unless the partnership agreement or LLC operating agreement says otherwise or unless the remaining owners vote to continue the company within 90 days. If the owners don't vote to continue the company in that period of time, the company is considered dissolved and must file dissolution papers with the state. To avoid risking the future of the partnership or LLC and having to take a vote after an owner leaves, as part of your buy-sell provisions state that the partnership or LLC continues without a vote of the owners when an owner leaves the company.*

C. When to Create a Buy-Sell Agreement

The key to a successful buy-sell agreement is coming up with a reasonable plan early on, before anyone knows who will be most affected by it. At the outset, when you're just getting started, your concerns and those of the other owners will be roughly the same because no one knows who will be the first to leave. Because at that early point no one wants to sell out, everyone has the same interest in crafting an agreement that's fair to everyone.

With a brand-new business, you and your co-owners can start by putting together a very simple buy-sell agreement. You can concentrate on giving your company or continuing owners the right to buy a selling or departing owner's interest at a fair price, or a price to be set according to a simple formula such as book or appraised value.

After you've been in business a few years, you may want to come up with a more complex agreement. The same holds true if your business's assets have become quite valuable or there's a concern about limiting estate taxes. While it's always a good idea to have a small-business lawyer look over your buy-sell agreement before it's final, it's especially important to get a lawyer's help in creating a more sophisticated agreement. ■

CHAPTER

6

Naming Your Business and Products

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Trademark Terminology

Trademark: A word, phrase, design, or symbol that identifies a product brand—such as Compaq computers, Nike shoes, Kodak cameras, Xerox photocopiers, and Marathon gasoline.

Service Mark: A word, phrase, design, or symbol that identifies the provider of a service—such as Burger King (fast foods), Roto-Rooter (sewer-drain service), Kinko's (copy centers), and Blockbuster (video rentals).

Mark: Sometimes used to refer to both a *trademark* and a *service mark,* because the terms are nearly, but not completely, interchangeable.

Corporate Name: The name of a corporation as registered with one or more states. *Examples:* Time Inc.; Sony Corporation. The corporate name refers to the corporation only, and not to any product or services it offers.

Trade Name or Business Name: The name used to identify a business, as distinct from the product or service it offers. It may be the same as the product or service name; for example, Sony Corporation sells electronic equipment under the Sony trademark; McDonald's Corporation uses the service mark McDonald's on its fast-food service. Or the trade name or business name may be different—for example, General Motors Corporation sells cars under the Buick trademark.

Assumed Name or Fictitious Name: A business name different from the owner's name. *Example:* Laura does business as Coffee Express. Partnerships and (in many states) corporations may also use assumed or fictitious names. In most places, you must register a fictitious name. (See Section B3.)

Federal Trademark Register: A list of all trademarks and service marks registered with the federal government. To be accepted, a trademark or service mark must be distinctive and not confusingly similar to an existing mark. All states maintain trademark registers too, and some maintain service mark registers; preexisting federal trademark rights have priority.

Naming your business and products may not be as simple as it first appears. For one thing, you need to comply with legal procedures mandated by state law. If you incorporate, for example, or form a limited liability company, you must choose a corporate or LLC name acceptable to your state's business filing office. And all businesses—corporations, LLCs, partnerships, and sole proprietorships—must comply with laws dealing with the registration and possible publication of assumed names or fictitious names. (See Section B.)

Other legal procedures having to do with business names are not mandatory, but it nevertheless makes good sense to follow them. For example, before using a cool-sounding name—especially one that will also be used to identify your products and services—it's extremely smart to find out whether someone else already has rights to the name and, as a result, can legally limit how you use it or tell you not to use it at all. This normally involves at least two steps. To avoid a claim of unfair competition, your first step is to do a local name search to make sure that no local business in your field uses a similar name. Don't start Jimmy's French Laundry if there's already a Jenny's French Laundry a few miles away.

Step two involves making sure you gain maximum protection for your trademarks or service marks—names you'll use to identify your products or services. Especially if you're looking for comprehensive protection for a trademark or service mark, you'll want to first carefully check and then register the mark under federal and state trademark laws. (See Sections C, D, and E.)

Just how much effort and expense should you sensibly invest in protecting the name of your business, product, or service? The answer depends on many factors, such as: the size of your business, the size of the market that you'll operate in, the type of product or service, and your expectations for growth and expansion.

As a general rule, the more customers your business will reach, the more you need to be sure you have the exclusive right to use your chosen name within your business or product niche. For example, if you're starting a local computer repair service, you won't need as much business name protection as if you were planning to sell a new line of low-fat salad dressings in all 50 states. But be aware that because of the Internet and other electronic communication methods, the number of small businesses that compete with one another is rapidly growing, meaning the need to do in-depth name searches and to consider the implications of trademark law is also rapidly growing.

Business Names and Trademarks: They Are Not the Same

Legally, there are two main types of business names:

- the formal name of the business, called its trade name (Apple Computer Inc., for example), and
- the names that a business uses to market its products or services, called trademarks and service marks (Macintosh brand computer, for example).

Use of either type of business name can raise legal issues, but the most serious lawsuits tend to focus on the trademarks and service marks a business uses to market its products or services.

By being the first to use and register a trademark or service mark, a business can prevent another business from using the same or very similar mark. Laws that protect the integrity of trademarks and service marks are intended to prevent consumers from being unfairly confused about the source of products and services. A buyer should be able to rely on the fact that the source of a computer bearing the trademark "Macintosh" is Apple Computer Inc., which has registered Macintosh as a trademark.

Obviously, if you're choosing a name to use as a trademark or service mark, you need to conduct a full search to make sure no other business is already using that name as a trademark or service mark. What may be less obvious is that you need to make exactly the same kind of search if you plan to use your business name to identify your goods or services—as when Ford Motor Company markets cars under the brand name (trademark) Ford.

For a thorough discussion of business names: *See* Trademark: Legal Care for Your Business & Product Name*, by Stephen Elias (Nolo). That book discusses in great depth how to choose a legally protectable name and offers step-by-step instructions on how to file a federal trademark registration. Also check out the Nolo website (www.nolo.com) where you'll find extensive legal information on patents, copyrights, and trademarks.*

A. Business Names: An Overview

Complying with the few mandatory legal procedures for naming your small business is relatively simple. (See Section B.) For some very small, local businesses, meeting these requirements and doing nothing more may be adequate.

> **EXAMPLE:** Jeff wants to start a local word processing service called "Speedy Typing for All." He'll be a sole proprietor. Since his is a small, unincorporated local business, he is probably safe enough if he registers the name as an assumed or fictitious name. In most states, he will register it at the county level, but some states require registration at the state level and also require publishing the name in a newspaper. (See Section B for more on assumed and fictitious names.) Jeff probably doesn't need to spend time and money to register the name as a state trademark or service mark. With a descriptive name and a small local business, there's little likelihood that the customers of any other business would be misled, so there's not much to protect. However, Jeff should check to be sure there are no other word processing services in his area using the same or a very similar name. If there are, Jeff should change his name or risk a claim of unfair competition. If Jeff wants to go the extra legal mile, he should check his state's Trademark Register and the Federal Register to see if other "Speedy Typing" businesses are registered. (See Section F for how to do a trademark search.)

Until quite recently, a wide range of local businesses—small retail stores, repair services, and craft studios, for example—didn't need to worry about registering a trademark or service mark. And to avoid possible claims that they were unfairly using another business's name, they could feel relatively secure if they checked for possible name conflicts in state and local business directories and Yellow Pages with no need to do a more formal state or federal trademark search.

But today, the rules of the game are dramatically different. The reason is that in the world of the Internet, mail order, and rapidly growing national chains, the idea of "local" isn't what it used to be. Today, even modest-sized businesses must consider taking name protection steps that used to be the sole concern of larger, more expansive enterprises. For example, you might think you have no problem if you're choosing a name for a shoe store in a small town. Think again. If you happen to pick a name that's similar to a shoe store that sells on the Internet, you are very likely to be accused of trademark infringement and probably forced to change your business name, even though the online store's headquarters is located 2,500 miles away.

Doing Business on the World Wide Web

Like many other business owners, you may decide to operate a website. If so, you'll need to select a domain name—a unique address that computers understand and customers can use to find you. The issues involved in choosing a domain name range from getting your hands on an available one to avoiding trademark lawsuits based on your choice of name.

A good domain name should be memorable, clever, and easily spelled. Unfortunately, many of the best names are already taken. To see if the name you have in mind has been registered, go to www.networksolutions.com. This site allows you to search for a particular name. For example, if you are starting a speed typing business, you might check "speedy.com." If you find that speedy.com is already taken, the www.networksolutions.com website allows you to peruse other possibilities. After you enter relevant keywords (such as quick, speedy, and typing), you'll get a list of related names that are still up for grabs.

Once you've found an available name, you'll need to make sure it doesn't conflict with someone else's trademark. If your choice will cause customer confusion between your company and another, you're safer choosing another name. This is true even if the other business is halfway across the country. Once you've established a Web presence, you are in competition with businesses around the globe, and must address trademark issues equally broadly. A generic name such as "coffee.com" will keep you safest from lawsuits, but will also leave you unable to argue that other businesses cannot legally use a very similar business or domain name—you'll need to strike a balance.

After you've chosen an appropriate domain name, you can register it online with a service such as Network Solutions, at the website mentioned above. Some businesses register under more than one name, or register common misspellings of their names.

Courts are still grappling with the issues surrounding domain names and trademark law, and there's much more to know than I can cover here. For detailed and up-to-date information on choosing and registering domain names, as well as avoiding domain name conflicts, check out Nolo's free Internet Law Center at www.nolo.com. Also read *Domain Names: How to Choose & Protect a Great Name for Your Website*, by Stephen Elias and Patricia Gima (Nolo).

These days, about the only time you might be able to ignore thinking about trademarks and service marks is if you have a tiny, local business that uses your own name—or a very common name—to market goods and services locally. In short, if you plan to sell services using your own name (Harvey Walker Roof Repair) or if yours will be a one-person, home-based business such as a graphic design service (A+ Design), you're not likely to have a trademark problem.

But if your business is just a little bigger, such as a large camping equipment store (Wilderness Outfitters), or sells goods or services beyond a very local or industry-specific niche (Lamps.com Online Lamp Store), you really should take time to understand the basics of trademark law (Sections C, D, and E)—and conduct a name search to see if someone else in your field is already using your proposed name (Section F).

The reason to be absolutely sure you have the legal right to use your chosen business name is simple: You don't want to invest time and money in signs, stationery, and ads for your business and then get a nasty letter from a large company that claims a right to the name you're using and threatens you with a trademark infringement lawsuit. Just defending such a case in federal court can cost you upwards of $100,000, meaning that even if you're sure that you're in the legal right, you'll probably wind up changing your name just to duck the lawsuit—no fun, given the investment you've already made.

If you decide that you want the protection of federal or state trademark registration: *See* Trademark: Legal Care for Your Business & Product Name*, by Stephen Elias (Nolo). You can probably handle the registration process yourself, but if you prefer to use a lawyer, the book will make you better able to take advantage of your lawyer's assistance.*

Relying on a State-Filing Search May Not Be Adequate

When you form a corporation or LLC, the state filing office will check to see whether your proposed business name is the same as or confusingly similar to one already on file. If so, your name will be rejected. But just because your name is accepted by the state filing office doesn't mean your business name is safe to use. That's because these offices don't check state or federal *trademark* registers. In short, even though a name may be available in your state to identify your business, you may run into costly trademark infringement problems if you also use it to identify your products and services.

> **EXAMPLE:** Tony and Lars form a corporation that will design state-of-the-art sound systems for restaurants and jazz clubs. Their name—The Ears Have It Inc.—has been cleared by the secretary of state for their state. Can they now safely use this name as a service mark to market their services? No. When the secretary of state cleared the corporate name, it simply meant that the name didn't duplicate the name of another corporation in that state. Another company may have already been using the name as a trademark or service mark. This wouldn't show up in the secretary of state's corporate name records.
>
> Since Tony and Lars are hoping to market their services in several states, they (or a name search company they hire) should do a thorough search, including checking federal and state trademark registers. If they don't, they may inadvertently find themselves in conflict with a company that's already using the name. If they find that their proposed name is clear, they should think about registering it as a federal trademark or service mark.

B. Mandatory Name Procedures

As mentioned, there are name-related legal tasks that every business must attend to.

1. Corporations

Part of the process of creating a corporation is choosing a corporate name. Most states require certain words or abbreviations in your corporate name, so the public can recognize that your business is a corporation. This puts them on notice that, in general, you're not personally liable for debts of the corporation. (See Chapter 1 regarding limitations on the liability of corporate shareholders.)

Each state has its own laws dealing with what words you must include in your corporate name, so check your own state's statute. Most states will send you an information packet along with a sample printed form for the articles of incorporation. Typically, the state will require one of the following in your official corporate name: *Incorporated*, *Corporation*, *Company*, or *Limited*, or the abbreviations *Inc.*, *Corp.*, *Co.*, or *Ltd*. If the name doesn't include one of the required terms, the state won't accept your corporate filing.

The law in your state will also likely list some words that can't be included in your corporate name or that can be used by only certain types of businesses.

Words That Are Typically Limited or Prohibited

Bank, banking, co-operative, engineering, trust, National, Federal, United States, insurance, acceptance, guaranty, pharmacy, credit union, medical, architect, indemnity, thrift, certified accountant, Olympic, surveyor.

This is by no means a complete list. For example, in New York you need the approval of a department of state government to use the words *Benefit*, *Council,* or *Housing* in your corporate name.

To learn about the prohibited or limited words in your state, start by calling the office where you file the articles of incorporation. This is usually the secretary of state or the corporate commissioner's office. If they can't or won't tell you, go to a law library or to Nolo's online legal research center (www.nolo.com) and look up the statute sections dealing with corporations.

Building Your Reference Library

Consider buying a copy of your state's corporation statutes; it will be handy for answering other legal questions as well. Of course, a lawyer can also let you know about your state's corporate name requirements.

Most states will reject a corporation name that's the same as one already on file or that's confusingly similar to the name of an existing corporation. If this happens to you and you've really got your heart set on the name you've picked out, there may be a way to get around the rejection. One approach is to change the name slightly or add something to it. Even a relatively small change may result in approval of the name.

Or in some states, you can use a similar (but not identical) name if the prior holder of the name consents in writing. The document in which the other company gives its consent will have to be filed with the office that accepts corporate filings. Obviously, you're most likely to get cooperation from the other corporation if your business involves a completely different product or service.

> **EXAMPLE:** Country Squire Inc. sells wood-burning stoves in the southern part of the state. It consents in writing to the use of the name "Country Squire Inn Inc." by a new corporation that will run a bed-and-breakfast in the northern part of the state. With the consent on file, the state corporations commissioner accepts the Country Squire Inn Inc. incorporation papers.

To avoid filing your corporate papers and then receiving word three weeks later that your name has been rejected, in many states you can call the government office that receives incorporation papers and ask whether your proposed name is available. They may give you preliminary clearance by phone if the records show that no other corporation in your state is using the same or a similar name.

Watch how you use the name. *The fact that the state filing office accepts your corporate name doesn't assure that you have the exclusive right to use the name in your state. An unincorporated business may already be using it as its trade name in your state. Or another business—whether incorporated in your state or elsewhere—may be using the name as a trademark or service mark. Depending on the situation, the prior use often gives the user the right to legally prevent your use of the name if your use of the name would be likely to confuse customers. It's always prudent to check further to avoid conflicts with other users. (See Section F for how to conduct a name search. For how to protect a name as a trademark or service mark, see Section C.)*

If you expect some delay between the time you choose a name and the time you file your incorporation papers, find out if your state lets you reserve your preferred corporate name. Many states allow you to tie up a corporate name for two to four months by simply filing a form and paying a small fee.

2. Limited Liability Companies

The procedures for LLC names are very similar to the procedures for corporate names. When you prepare the Articles of Organization for your LLC, you'll need to include its name. If the proposed name—or one similar to it—is already in use by another LLC on file with the LLC filing office, your Articles of Organization will be sent back to you unfiled. To avoid this inconvenience, it's wise to check the availability of the name before you file the Articles.

Your LLC will have to include certain words or abbreviations that let people know its legal status. Examples include:

- Limited Liability Company
- Limited Company
- Ltd. Liability Co.
- L.L.C.
- LLC.

The list of words and abbreviations varies a bit from state to state, so check the law in your state to learn all the possibilities.

Here's a shortcut for picking a required LLC designator: *Ending your LLC name with the words "Limited Liability Company" will meet the name requirements of all states except Florida and Iowa; in those two states, "Limited Company" or "L.C." is required.*

As with a corporation, your state law may prohibit you from using certain words in your LLC name—words, for example, that refer to banking, insurance, trust, or financial services. And again, as with a corporation, your state filing office won't accept your proposed LLC name if it's the same as or very similar to an LLC name that's already on file. Your state may also cross-check the name against the names of non-LLC entities—such as corporations and limited partnerships—that are required to register with the state. Your name will be rejected if it's too close to one of these.

For an in-depth discussion of choosing a name for your LLC: *See Form Your Own Limited Liability Company, by Anthony Mancuso (Nolo).*

3. Assumed and Fictitious Names

Sole proprietors sometimes choose to do business under names different from their own names, and partnerships usually select a partnership name other than the full names of all partners. Corporations and limited liability companies may also decide to do business under names different from their official corporate names. Depending on state law, these adopted business names will legally be called "assumed names" or "fictitious names." If your business uses such a name, you probably must register it.

a. Sole Proprietorships and Partnerships

If you're planning to do business as a sole proprietor or partnership, in most states you're required to file an assumed name or fictitious name certificate with the designated public office—usually at the county level—before you start doing business. Generally, there's a printed form for you to fill out, and you'll probably have to pay a small filing fee. In some states, the registration is good for a limited period, such as five years, and must be renewed. State law may also require that you publish notice of your business name in a local newspaper.

States require you to file the certificate for a simple reason: It lets members of the public know who is behind the name. If you don't register your assumed or fictitious name, you can have both legal and practical problems. For one thing, in many states, you may not be able to sue on a contract made or other transaction done under the business name. And in some states, you may be fined. In a number of states you can't open a bank account in the name of your business without filing.

Terminology

Some people refer to an assumed name or a fictitious name as a "DBA." That's short for "doing business as"—for example, Albert White doing business as Al's Cabinet Shop. On legal documents such as contracts and lawsuits, this may appear as: Albert White d/b/a Al's Cabinet Shop.

b. Corporations and LLCs

Most corporations and limited liability companies operate under their corporate or LLC name, which is of course on file with their state filing office. If, however, a corporation or LLC decides to do business under a different name, many states require it to file an assumed or fictitious name registration. This involves completing a simple form and sending it to the state filing office with a modest filing fee.

> **EXAMPLE:** Miracle Widget Manufacturing Company, a corporation, wants to do parts of its business under the name "Widco" and other parts under the name "Industrial Innovators." In many states, it will have to register both of these names as assumed or fictitious names.

It's important to use your correct corporate or LLC name, since this makes it more difficult for anyone to claim that your business entity is a sham (believe it or not, lawyers call this "piercing the corporate veil") and impose personal liability on you. (See Chapter 3 for more on corporate liability.) If you're going to do business under a name that deviates from the official name on your Articles of Incorporation or LLC Articles of Organization, it's essential that the name be properly registered. That way, you won't jeopardize the immunity from personal liability that's part of your reason for having a corporation or LLC.

If your state doesn't allow a corporation or LLC to register an assumed or fictitious name, there may be an easy way to reach this same end while complying with state rules. You can use a preferred business name in conjunction with your official corporate or LLC name.

> **EXAMPLE:** Contemporary Home Furnishings LLC is established in a state that doesn't allow registration of assumed or fictitious names. The company wishes to operate a lamp store called "Bright Lights." It does this by calling the lamp store "BRIGHT LIGHTS" and then in smaller print adding "a division of Contemporary Home Furnishings LLC" or by saying "BRIGHT LIGHTS, owned and operated by Contemporary Furnishings LLC."

This puts everyone on notice that the business isn't a sole proprietorship or partnership—so you continue to enjoy the benefits of limited personal liability.

When it comes to products and services, a corporation or LLC is completely free to use names that are unrelated to its corporate or LLC name (as long as these names don't infringe someone else's trademark, of course). In fact, this is common. Apple Computers, for example, sells products under the name Macintosh, and the Ford Motor Company sells Taurus automobiles.

C. Trademarks and Service Marks

A trademark or service mark consists of two parts. In reverse order, they are:

- The noun that specifies what kind of product or service you're talking about. *Examples*: automobile; health plan.
- The word or words that function as an adjective to identify a product or service as being different from all others. *Examples:* Buick automobile; Saab automobile; Blue Shield health plan; Kaiser health plan.

Think of these as the first and last names of products and services. The last name identifies the group; the first name uniquely specifies a member of that group. As such, the trademark is used as a proper adjective and is always capitalized.

Trademark law is the main tool that businesses use to protect the symbols and words that identify the origin of services and products. The basic premise is that the first user of a distinctive (that is, creative or unusual) name or symbol gets the exclusive right to use it. If you're the first user, you can make that right easier to enforce if you register the name or symbol with the federal trademark agency. The principal purpose of registration is to protect rights that already existed because you used the mark first. But registration can also confer other rights. For example, if you're using an unregistered mark without knowing that someone else used it first, federal registration can give you priority in areas outside the first user's market territory. The twin goals of trademark law are:

- to prevent businesses from getting a free ride off the creativity of others in naming and distinguishing services and products, and
- to prevent customers from being confused by names that are misleadingly similar.

From a legal protection standpoint, the best trademarks are coined words, such as Kodak or Yuban, or arbitrary words such as Arrow for shirts or Camel for cigarettes, which have nothing to do with the product. Nearly as good are suggestive trademarks—ones that hint at some aspect of the product. For example, Talon suggests the gripping power of a zipper.

Trademarks that consist of creative, unusual, or otherwise memorable terms are called "distinctive" and "strong." If you're the first to use such a name or symbol, you can legally stop others from using it in most situations.

Trademarks that consist of ordinary terms are called "weak," and competitors are free to use them. Merely descriptive words (such as Easy Clean for a cleanser) generally are not legally protectable. These weak marks can, however, become strong if they acquire a secondary meaning through prolonged usage. If that happens, they may be federally registered and may also be protected under the law of unfair competition if there's a local conflict with a similar mark. (See Section E, below.)

You can't acquire any rights in the name of the product itself; this is called a generic name. This means you can't adopt Bicycle or Refrigerator as your trademark for your version of those products. You can use the words as *part* of a distinctive name.

The law doesn't allow a business to claim the exclusive right to use descriptive words and generic names because competitors also need to describe their products. If you could tie up key words for your own exclusive use, your competitors would be unduly restricted in describing their goods. Also, descriptive terms aren't particularly memorable and don't further the purpose of trademarks and service marks.

D. Strong and Weak Trademarks

As noted earlier, with very few exceptions, only strong trademarks or service marks have the full protection of federal and state trademark laws. Remember, too, that trademark laws don't automatically protect a business name (the name of your company); to be considered a mark, a business name must be used to identify a product or service in the marketplace.

A trademark is considered weak when others can use it (or something similar) on products or services that don't compete directly with yours. Most ordinary trademarks are weak. *Examples:* Liquor Barn, Cuts Deluxe, Charlie's Auto Parts, 10-Minute Lube.

A trademark is considered legally strong when others can't use it or anything similar on related goods or services. There are two kinds of strong trademarks: ones that contain distinctive terms and ones that contain ordinary terms that have acquired distinctiveness through use.

1. Distinctive Terms

Distinctive trademarks are memorable, evocative, unique, or somehow surprising—for example, 7-Up, Lycra, or Cherokee apparel. The words themselves have little or no descriptive function; they serve to set the product or service off from others.

So if you're naming a service or product and want a strong mark, try for a name that is either unusual or used in an unusual way. A judge is likely to treat a distinctive name as a trademark or service mark and protect it from use by others—unless someone else has used a similar trademark on the same type of product or service first.

> **EXAMPLE:** "Buick" distinguishes a line of cars from others, and the name means nothing apart from its trademark use. It's a distinctive name. Conversely, "Dependable Dry Cleaners" merely tells you something about the business; it doesn't help you distinguish it from rivals who might also advertise their services as reliable or efficient. So the name would probably not qualify for trademark or service mark protection unless it had been in use for a long time and developed a sizable following—that is, a secondary meaning.

2. Ordinary Words

Generic terms can't be protected by trademark law; original and distinctive words can be protected. But what about other words used to identify products and services—ordinary words that are neither generic nor distinctive? This category covers place names (Downtown Barbers), surnames (Harris Sales), words that describe the product or service (Slim-Fast Diet Food) and words of praise (Tip-Top Pet Shop). Ordinary words receive limited legal protection as trademarks. It's more difficult to keep others from using them or something similar.

Even a weak trademark can acquire limited protection under unfair competition laws. For example, an ordinary name (a weak trademark) can be protected from someone else using the name in a confusing way. The law of unfair competition is generally based on state law (statutes and judge-made law) that supplements federal and state trademark laws. Owners of weak and unregistered names can get some relief from a rival's use of the identical name on the identical product or service in a competing market.

Weak trademarks can become strong ones through long use and extensive public familiarity with the mark. A trademark that starts out being ordinary or otherwise weak (like Dependable Cleaners) can sometimes, over time and through use, become identified in the public's mind with a specific product or service. When that happens, it can be transformed into a strong trademark.

> **EXAMPLE:** Chap Stick brand of lip balm was originally a weak trademark. It simply described the condition the product was designed to cure: chapped lips. But it became strong as advertising and word of mouth helped the public develop a clear association between the name and a specific product. Over time, the name developed distinctiveness based on familiarity rather than any quality inherent in the name.

Lawyers describe a trademark that has become distinctive over time as one that has acquired a "secondary meaning." McDonald's is another good example of a weak mark that developed a secondary meaning over the years—and now qualifies for broad protection.

E. How to Protect Your Trademark

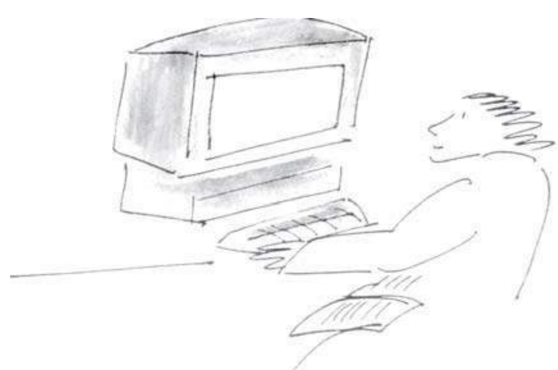
What do the words aspirin, escalator, cellophane, and shredded wheat have in common? They are all former trademarks that have entered our language as product names. These words have lost their status as trademarks and are now generic terms. Other examples of former trademarks include harmonica, linoleum, raisin bran, thermos, and milk of magnesia. In each of these cases, a business lost its exclusive right to use a valuable trademark.

Here are some steps that your business can take to prevent this from happening to your trademark.

- Use your trademark as a proper adjective that describes your product. You'll notice that ads refer to a Xerox copier, Jell-O gelatin, and Band-Aid adhesive strips. If people continue to use the words Xerox, Jell-O and Band-Aid alone, these marks can easily go the way of other trademarks like nylon, mimeograph, and yo-yo.
- Always capitalize the first letter of your trademark. And at some place on each ad or package, say specifically that the trademark is owned by your company.
- If your trademark has been placed on the federal trademark register, consistently give notice of that fact by using the ® symbol. If a trademark isn't federally registered or is registered only by a state, you may use the letters "TM" or "SM" to give notice of your claims. You may not use ® unless your mark is in fact on the federal register.
- Take prompt legal action if other businesses use your trademark without permission. A trademark may become weakened or even generic if others use it to describe their prod-

ucts and you do nothing about it. You or your lawyer should send a letter by certified mail (return receipt requested) demanding that the infringement cease. If your demand is ignored, be prepared to go to court to seek an injunction—but first do a careful cost/benefit analysis to satisfy yourself that it's worth the expense.

- If you discover that a newspaper or TV program has improperly used your trademark, send them a letter. Keep a copy in your records as proof that you have consistently enforced your trademark rights.



F. Name Searches

There are compelling business and legal reasons to conduct a name search before you lock in the name of your business. As noted above, this is especially true if you choose an unusual or unique business name that will also be used to identify your products—Z Pop Inc., for example, will sell a new carbonated drink called Z. If someone else in your field is already using this name and may even have registered it as a state or federal trademark or service mark, you will really be an infringer if you start to use it (based on the fact that customers really are likely to be confused as to the source of two businesses' services and products). In such circumstances you can be forced to give up the name.

1. Conducting Your Search

Here are some self-help search techniques to see if others are using a business name like the one you have in mind:

- *Check state and county records where business names are filed.* To avoid a claim that you're unfairly competing with another local business by using their name, start with the records of your state's office where corporations and LLCs are registered—usually the secretary of state or corporations commissioner—as well as the state office (if any) that maintains a list of assumed or fictitious names for corporations, LLCs, partnerships, and sole proprietorships. In addition, if assumed or fictitious names are filed at the county or local level, check the lists for the counties and localities in which you plan to do business now or in the foreseeable future.
- *Check business directories and trade sources.* These include the phone books of all major metropolitan areas, general business directories, and trade magazines for your industry. A reference librarian should be able to help you. Also, take a look at all online search engines such as Google, Yahoo!, AltaVista, and Excite to see if anyone is using your name.
- *Check trademarks and service marks registered in your state.* The office that registers trademarks and service marks in your state should be able to tell you by phone if another business has registered a name that's the same as or close to the one you're thinking about. In some states, you may have to request the information in writing and pay a small fee for the search. It makes better sense, however, to mount an even broader search, checking on state registrations nationwide—a task made simple by using a computer database (see below).
- *Check the federal trademark register.* Since goods and services are widely marketed over

the Internet as well as through mail-order catalogues these days, your small business—even though you think it's local—may find itself competing with national companies. It makes sense to make sure you're not infringing on a trademark or service mark that's been federally registered. A large public library or special business and government library near you should carry the federal trademark register, which contains trademark and service mark names arranged by categories of goods and services. Check it for potential conflicts with your name. Also check the *Official Gazette* for the most recent filings.

Performing a full search of all registered and unregistered trademark sources involves time, effort, and some cost. Also, since there is considerable skill involved in doing an in-depth search, it often makes sense to engage professional help. But fortunately, there are three different levels of searches and a small, local business can often get by with a somewhat shallower search. The three levels are:

1. **A direct hit federal register search,** which compares your mark with identical or very similar federally registered (and pending) marks in one or more trademark classes. This is the quickest, cheapest, and most bare-bones type search. A direct hit search is especially helpful when you're trying to choose among several potential names or trademarks and want to narrow the field by discovering and eliminating obviously unavailable names or marks.
2. **An analytical search,** which compares your mark with all registered and pending marks (federal and state) that sound or look like your mark. The search also covers marks that mean the same thing or in some other way might lead to customers' confusion between them and your mark. This deeper type of search is more expensive and time-consuming than a direct hit search.
3. **A comprehensive trademark search,** which hunts for all possibly relevant unregistered marks as well as for federal and state registered (and pending) trademarks. Because of its depth and breadth, this type of search is the trickiest to do well and, as a result, the most expensive and time-consuming.

For many businesses, especially those that plan to operate regionally or nationally, a direct hit search is only the first step to clearing a business name. If the proposed name is distinctive, a more thorough search—at least an analytical search—will be appropriate.

EXAMPLE: Jamie is considering Geoscan as the name of her new company. She does a direct hit search and finds that no one else has registered that name. That's reassuring. But since Jamie plans to do business nationwide, she decides that she can't rely entirely on the direct hit search and needs to dig deeper.

Jamie has chosen a fairly distinctive name, so she is wise to take further steps. If your proposed name is less distinctive (a "weak" mark), or your business is small and local and you can live with the possibility that an undiscovered prior user will surface later, a direct hit search may suffice. A search firm can do a direct hit search for a reasonable fee. Or you can do the search yourself by using the federal government's trademark database, called TESS (for Trademark Electronic Search Service). You'll find it at the website of the U.S. Patent and Trademark Office, www.uspto.gov. On the left side of the home page under Trademarks, click "Search." To use TESS, you enter the business name you're interested in. The database will tell you if someone else is using the name, and if so, will give you the owner's name, the date of registration or application, and the goods or services it represents.

A deeper, analytical search looks for synonyms, phonetic equivalents, alternative spellings, anagrams (rearrangements of letters), and other similarities that may create a potential conflict.

EXAMPLE: Jamie embarks on an analytical search. She starts out by looking at the marks that immediately surround Geoscan alphabetically (it turns out that Geoport and Geoscope have been registered). Then she checks out all the marks ending in -scan and all marks with the sounds -eo or -osc in the middle. She also searches for all the synonyms she can think of (earthspan), and then anagrams (scanoge, canesog) and alternative spellings (gioscan, jeoscan, geoskan). This gives her a better idea of potential conflicts.

It's essential to perform this deeper search if you want to make sure your business name or mark isn't likely to be challenged as being confusingly similar to, or evocative of, an existing name or mark. While in theory it's possible for you to do an analytical search using the TESS database, I recommend you use another Internet resource, SAEGIS by Thomson & Thomson at www.saegis.com. True, even here, there's a considerable learning curve—and you will have to pay some fees. But the SAEGIS search engine is simply better suited to analytical searching than TESS.

Often, it's wise to go beyond a direct hit search *and* an analytical search. If you have a small, local business, you should, in addition to a direct hit search, check the Yellow Pages, newspapers, trade and product journals, and any other source that might show that another business is using the same or a similar name or mark locally.

If your business elects to do a more comprehensive search, you'd include not only an analytical search of registered and pending trademarks, but also an examination of Yellow Pages, trade directories, the Internet, product catalogues, and other industry sources. Because most disputes about names and marks are resolved in favor of the first actual user, you need to discover any actual use of the proposed name—whether or not it's officially registered.

Consider hiring a search firm. *You can reliably do a direct hit search yourself, but for an analytical or comprehensive search, a search firm is likely to produce more reliable results. It may be well worth the cost—especially if you have a strong and distinctive mark and will be investing heavily in promoting your products or services under that mark.*

Search firms—which, unlike lawyers, don't offer legal advice—generally charge as follows:

- *direct hit search (for identical marks)—from $30 to $100 per mark searched*
- *analytical federally registered trademark search (for similar or related marks)—from $85 to $300 per trademark*
- *common law search (for unregistered marks)—from $100 to $200 per mark searched*
- *comprehensive search (combining analytical federal, state and common law)—between $185 and $500 per mark searched.*

The ranges of rates reflect variations in search coverage, the type of report you get, the experience of the searchers, and economies of scale. Be on the lookout for firms that advertise an unusually low price to draw you in, but then add on charges so the overall cost becomes excessive. Shop sensibly to determine the true cost.

2. Analyzing Your Search Results

So now you've done your search, whether by hiring a search firm or performing the search yourself, and you have the results in hand. What do the results mean?

There are a few things you should look for when you read through the names that were found in your search. First, did your search turn up any names that are identical to the one you are using or plan to use?

Finding an identical name should make you pause, but doesn't automatically mean that you must scrap plans to use it. If the identical name is being used for a very different product or service from the one you are producing or plan to produce, then you have good reason to move forward with your plans to use the name and register it as a trademark or service mark. For example, just because a plumbing business in Coos, Oregon, calls itself Z-Pop doesn't mean you, in Arizona, can't use Z-Pop as the brand name for your soda pop. That plumbing business in Oregon is not your competitor and your use of Z-Pop for your soda pop will not likely confuse customers into thinking that your soda pop is related to that plumbing business.

On the other hand, if you find an identical name being used on an identical or closely related product or service, such as another soda pop product, then you really should consider choosing a different name. Even if the company using the name seems like a local outfit in a faraway place, it could have plans to expand its territory.

The second thing you should look out for is an identical (or very similar) name that is linked to a very famous company or product. This situation is often referred to, in trademark lingo, as dilution. Dilution occurs when a brand name has become so famous (like Coke) that not even noncompeting products or services can use the name. If it turns out that the mark you've had your eye on is famous and highly marketed, don't touch it. Let it go. Find another name.

Finally, the third thing you should look for is a name that is very similar to the name you want to use. If you find a similar name *and* it is being used to market the same type of product or service that you are planning to create or offer, then you should seriously consider choosing a different name. How close is close? That is a very tricky issue and is often a matter of considerable subjectivity on the part of trademark examiners and the PTO. If you're not sure and really want to use the name, consider hiring an attorney specializing in trademark law for the sole purpose of helping you decide whether the two names are too close for comfort.

We've given you a few guidelines for evaluating your search results, but there is more to evaluating competing names than what we can provide in this chapter. If you think your situation is more complex, please consult the recommended book below.

For more information on conducting a thorough national search and on how to evaluate competing marks: *See* Trademark: Legal Care for Your Business & Product Name*, by Stephen Elias (Nolo).* ■

CHAPTER

7

Licenses and Permits

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You'll probably need a license or permit—maybe several—for your business. In some locations, every business needs a basic business license. But whether or not that is required, your business may need one or more specialized licenses. This is especially likely if you serve or sell food, liquor, or firearms, work with hazardous materials, or discharge any materials into the air or water.

There are licensing and permit requirements at all levels of government—federal, state, regional, county, and city. It's not always easy to discover exactly what licenses and permits you'll need. But it's very important. You should thoroughly research this issue before you start a business, complete the purchase of a business, change locations, or remodel or expand your operation. If you don't, you may face huge expenses and hassles.

In a worst-case situation, you could be prevented from operating your planned business at a particular location—but still be obligated to pay rent or a mortgage. For example, what if you sign a five-year lease for business space and then discover that the location isn't zoned properly for your business? What if you buy a restaurant and then find out that the liquor license isn't transferable? Or suppose you rent or buy business space thinking that you can afford to remodel or expand it, without realizing that remodeling means you must comply with all current ordinances? You might have to pay for $15,000 worth of improvements to comply with the federal Americans with Disabilities Act (ADA) or $10,000 for a state-of-the-art waste disposal system.

Here are several examples that illustrate the types of licenses and permits many businesses need:

- Misook plans to open a new restaurant. Before doing so, she needs a permit from the department of building and safety for remodeling work and a license from the health department approving the kitchen equipment and ventilation system. She also needs a sign permit and approval of her customer and employee parking facilities from the city planning department. Finally, she has to get a sales tax license; even though in her state sit-down meals are not taxed, she must collect and report sales tax for take-out orders and miscellaneous items such as cookbooks.
- Leisure Time Enterprises, a partnership, buys a liquor store that also sells state lottery tickets. In addition to obtaining a basic business license issued by the city, the partners must have the state-issued alcoholic beverage license transferred to them. They also have to apply to the state lottery bureau for a transfer of the lottery license and to the state treasury department for a sales tax license.
- Electronic Assembly Inc., a corporation that assembles electronic components for manufacturers of stereo equipment, must obtain a conditional use permit from the planning and zoning board in order to conduct its "light manufacturing operation" in a commercial district. The company also needs clearance from a tri-county environmental agency concerned about possible air pollution and disposal of toxic chemicals. In addition, the new elevator must be inspected and approved by the state department of labor.
- Peaches and Cream, a new disco, has to get fire department clearance for its exit system and also must comply with the city's parking ordinance—which practically speaking means negotiating with the planning department for the number of off-street parking spaces the disco will provide for customers. The club also needs a liquor license from the state liquor control commission, a cabaret license from the city council, and a sales tax license.
- Glenda needs an occupational license from the state department of cosmetology before she can open up her beauty shop. Because she carries a line of shampoos, conditioners, and make-up, she needs a sales tax permit as well. In addition, because she's extending the front of her shop three feet into the front set-back area, she needs a variance from the zon-

ing board of appeals. Finally, because she's in an "historic preservation area," her sign must be approved by the local planning board.

If zoning requirements are too restrictive, you might decide to avoid the hassle and move somewhere you don't have to fight City Hall for the right to do business. Similarly, if building codes require extensive—and expensive—remodeling to bring an older building up to current standards, you might want to look for newer space that already complies with building and safety laws.

Each state has its own system of licensing as does each unit of local government. Obviously, it's impossible to provide a comprehensive list of every permit and license in the United States. Fortunately, I can give you some general principles and a positive approach to help you learn about and comply with the licensing requirements that affect your business.

Double check license and permit rules. *When you investigate the type of licenses and permits you need for your business, check directly with the appropriate governmental agencies. Never rely on the fact that an existing business similar to yours didn't need a license or had to meet only minimal building code requirements. Laws and ordinances are amended frequently—generally to impose more stringent requirements. Often an existing business is allowed to continue under the old rules, but new businesses must meet the higher standards. Similarly, for obvious reasons, don't rely on the advice of real estate agents, business brokers, the seller of a business, or anyone else with a financial interest in having a deal go through.*

The Purposes of Licenses and Permits

Governments require licenses and permits for two basic reasons. One is to raise money; the whole point behind some licenses or permits is to levy a tax on doing business. In a way, these are the easiest to comply with—you pay your money and get your license.

The other basic purpose behind licenses and permits is to protect public health and safety and, increasingly, aesthetics. A sign ordinance that dictates the size and placement of a business sign or an environmental regulation that prohibits you from releasing sulphur dioxide into the atmosphere are two of many possible examples. Complying with regulatory ordinances can often be far more difficult than complying with those designed simply to raise money.

A. Federal Registrations and Licenses

Small businesses don't have to worry about federal permits and licenses, but all businesses must know about federal tax registrations.

1. Tax Registrations

On the federal level, there are two tax registrations that you should know about. The first is the application for an Employer Identification Number (Form SS-4), which should be filed by every business. The form is available online at www.irs.gov. If you're a sole proprietor, you may use your own Social Security number rather than a separate Employer Identification Number, but I generally recommend that even sole proprietors obtain an Employer Identification Number—especially if they plan to hire employees or retain independent contractors. It's one good way to keep your business and personal affairs separate. Employer Identification Numbers are covered in Chapter 8.

The second federal registration requirement applies if your business is a corporation and you want to elect status as an S corporation. In that case, you need to file Form 2553 (*Election by a Small Business Corporation*; also available at www.irs.gov). S corporations are discussed in Chapter 1, Section C2, and Chapter 3, Section A2; the requirements for filing Form 2553 are discussed in Chapter 8, Section B.

2. Federal Licenses and Permits

The federal government doesn't require permits from most small businesses, but it does get into the act when certain business activities or products are involved. Below is a list of the business operations most likely to need a federal license or permit, along with the name of the federal agency to contact.

Business	Agency to Contact
Investments advisors	Securities and Exchange Commission
Ground transportation business such as a trucking company operating as a common carrier	Federal Motor Carrier Safety Administration
Preparation of meat products	Food and Drug Administration
Production of drugs	Food and Drug Administration
Making tobacco products or alcohol, or making or dealing in firearms	Bureau of Alcohol, Tobacco, and Firearms of the U.S. Treasury Department

B. State Requirements

It may take a little effort to discover which business permits and licenses your state requires. Fortunately, small-business assistance agencies set up in every U.S. state can help you cut through the bureaucratic thicket. (See Appendix A.) Most offer free or inexpensive publications that list the required state registrations, licenses, and permits. Often the information is available online at the agency website.

Beyond contacting these general purpose agencies, it's wise to call all state agencies that might regulate your business and ask what they require. In addition, you can often get valuable information from the state chamber of commerce and from trade associations or professional groups serving your business, profession, or industry.

1. Licensing of Occupations and Professions

It should come as no surprise that states require licensing of people practicing the traditional professions, such as lawyers, physicians, dentists, accountants, psychologists, nurses, pharmacists, architects, and professional engineers. Most states also require licenses for people engaged in a broad range of other occupations. The list varies from state to state but typically includes such people as barbers, auto mechanics, bill collectors, private investigators, building contractors, cosmetologists, funeral directors, pest control specialists, real estate agents, tax preparers, and insurance agents. Since you can't always guess the occupations for which licenses are needed, you'll need to inquire.

Some licenses are taken out by the business entity (for example, your partnership or corporation), while others must be issued to the individuals who work in the business. For example, licensing laws for professionals—including lawyers, doctors, accountants, and architects—tend to place requirements on individual professionals rather than on the partnership or professional corporation that is the business entity.

The procedures vary, but to get a license for a profession or occupation, you'll probably have to show evidence of training in the field, and you may have to pass a written examination. Sometimes you must practice your trade or profession under the supervision of a more experienced person before you can become fully licensed.

For example, a real estate agent usually must work under the supervision of a licensed broker for several years before the agent is eligible to become a broker. Usually there's a formal application process, which may involve a background check. A license may be good for only a limited period, after which time there may be retesting before the license can be renewed. License laws for some occupations and professions require evidence of continuing education, usually in the form of short professional seminars.

2. Tax Registration

In all but the few states that still assess no taxes on income, chances are you'll have to register under your state's income tax laws in much the same way that you do under the federal laws. The state agency in charge (such as the treasury department or the department of revenue) can tell you what registrations are necessary. In addition, if you're engaging in retail sales, you may need to register for or obtain a sales tax license. There may also be registrations for other business taxes.

3. Employer-Employee Matters

As an employer, you may have to register with your state's department of labor or with agencies administering the laws on unemployment compensation and workers' compensation. As explained in more detail in Chapter 15, workers' compensation is a method of paying the medical bills and lost wages of employees injured in the course of their employment—regardless of who is at fault. Some state laws allow a business to be self-insured under some circumstances, but for most small businesses this isn't practical, so you'll have to carry workers' compensation insurance.

In addition, if your state has its own version of the federal Occupational Safety and Health Act (OSHA), your business may need to meet certain state-mandated requirements to protect your employees in the workplace.

Finally, a number of tax requirements relate to a business that has employees or works with independent contractors. For example, you'll need to get Employer ID Numbers from both the IRS and state tax authorities. And you'll have to withhold income taxes and Social Security taxes from the paychecks of employees, and report the figures to both the employee and the government.

With independent contractors, you need to report income annually on a Form 1099 which goes to the independent contractor and the government. For more on taxation, see Chapter 8. For more on employees and independent contractors, see Chapter 15.

4. Licensing Based on Products Sold

Some licenses for businesses are based on the type of products sold. For example, there often are special licenses for businesses that sell liquor, food, lottery tickets, gasoline, or firearms.

5. Environmental Regulations

Governmental regulation of environmental concerns continues to expand. As the owner of a small business, you may have to deal with regulators at the state or regional (multicounty) level. It's unlikely that you'll become involved with environmental regulations at the federal level.

Here are several activities that affect the environment and may require a special permit.

- *Emissions into the air for an incinerator, boiler, or other facility.* For example, if you're going to be venting your dry cleaning equipment into the outside air, you may need a permit.
- *Discharge of wastewater to surface or ground water.* For example, you may need a discharge permit if byproducts from manufacturing are being disposed of in a nearby pond. And you may need a storage permit if materials that you store on your site could contaminate ground or surface water.
- *Handling of hazardous waste.* If your business has any connection with hazardous waste, it's likely that the environmental agency will require you to at least maintain accurate records concerning the waste. You may need special disposal permits as well. Environmental regulations may also require you to register underground storage tanks holding gasoline, oil, or other chemicals. And if there's an underground tank on your business site that's no longer being used, you may be required to remove it.

Permits aren't just for big factories. *At first glance, the above list might suggest that only manufacturers or owners of large businesses need to worry about environmental regulations. Not so. Many small businesses need to obtain permits, or at least become informed about what they must do to avoid contaminating the environment. For example, if you create and sell leaded glass windows, you need to know whether you can dump your lead-laced wastewater down the nearby storm sewer or need a permit for some other means of disposal. Similarly, dry cleaners, photo processors, and others need to know the rules for handling and disposing of the hazardous substances used in their work.*

C. Regional Requirements

Increasingly, some environmental concerns are being addressed by regional (multicounty) agencies rather than by an arm of the state or local government. If so, you may need a permit or license from that regional body.

1. Environmental Regulations

In many areas, control of air pollution is now handled by a regional (multicounty or state) agency that issues permits and monitors compliance. For example, in northern California, the Bay Area Air Quality Control District covers at least seven counties. A regional body with environmental responsibilities may also have jurisdiction over wastewater discharge or the storage or disposal of hazardous materials.

2. Water Usage

Questions affecting the use of water by a small business are usually dealt with at the local (city or county) level, but some issues may fall within the jurisdiction of a regional authority. For example, if your business is in a semirural area and plans to draw its water from a well rather than the public water supply, a regional health authority may test the purity of the water before you're allowed to use it. In scarce-water areas, a regional water management body may have authority to decide whether or not you may install a well or use an existing one.

Similarly, while regulation of septic systems typically is left to local health departments, in some areas permits may be under the control of a regional body.

D. Local Requirements

On the local level, begin by asking city and county officials about license and permit requirements for your business. A few larger cities that hope to attract economic growth may have a centralized office that provides this information. Otherwise, the city and county officials most likely to be of help are as follows:

- city or county clerk
- building and safety department
- health department
- planning (zoning) department
- tax offices (for example, tax assessor or treasurer)
- fire department
- police department
- public works department.

Nonofficial but often extremely helpful resources include local chambers of commerce, trade associations, contractors who have experience in building or remodeling commercial space, and people who have businesses like yours. You can also consult a lawyer who's familiar with small businesses similar to yours.

1. Local Property Taxes

Your city may impose a property tax on the furniture, fixtures, and equipment that your business owns. If so, you may be required by law to file a list of that property with city tax officials, along with cost and depreciation information. You may have to update this information annually. Sometimes there's also a tax on inventory—which leads many retail businesses to run a stock reduction sale a few weeks before the inventory-taking date mandated by the tax law.

2. Other Local Taxes

Some cities, especially larger ones, tax gross receipts and income. Check with the city treasurer for registration and filing requirements.

3. Health and Environmental Permits

If your business involves food preparation or sales, you'll need a license or permit from the local health department. The health ordinances may require regular inspections as well.

Whether you run a sit-down or a fast-food restaurant or a catering establishment, you can expect the health department to take a keen interest in the type of cooking equipment you use, the adequacy of the refrigeration system, and many other features of the business that can affect the health of your customers.

You may also run into health department regulations if you receive water from a well rather than a public water supply. In small towns or semirural areas, health departments routinely test well water for purity.

Also, where septic systems are used for sanitary sewer disposal, the health department supervises the installation of new septic systems to make sure that there's no health hazard. (As noted in Section

C, in some areas these matters are handled by regional rather than local authorities.)

Increasingly, local health departments are getting involved in environmental duties, including such things as radon tests and asbestos removal. Many other environmental problems, however, such as air and water quality, are still dealt with mainly at the state and regional level.

4. Crowd Control

If your business deals with large numbers of customers, you may need licenses or permits from the fire or police departments. These agencies are concerned about overcrowding and the ability of people to leave the premises in case there's an emergency.

The role of the fire department may overlap with that of the building and safety department in prescribing the number of exit doors, the hardware on those doors, the lighting to be used, and the maintenance of clear paths to the exits. The fire department will also be concerned about combustible materials used or stored on your business premises.

5. Building Codes

For anything but the most minor renovation (such as putting in track lighting or installing shelves), you're likely to need a permit—maybe several—from the building and safety department that enforces building ordinances and codes. Often, separate permits are issued for separate parts of a construction or remodeling project, including permits for electrical, plumbing, and mechanical (heating and ventilating) work. If you don't have experience in these areas, you may need a licensed contractor to help you discover the requirements for your construction or remodeling project.

Building codes are amended frequently, and each revision seems to put new restrictions and requirements on the building owner. Municipalities often exempt existing businesses from laying out money to retrofit their premises—at least for major items such as elevators, heating and ventilating systems, and overhead sprinkler systems. This is sometimes called "grandfathering"—slang for not imposing new rules retroactively.

Grandfathering can create surprises. You may look at space in an older building and figure that you'll have no problems in doing business there because the current business owner or the one who just vacated the premises didn't. But the prior occupant may have had the benefit of grandfathering language which didn't require him or her to bring the space up to the level of the current codes. A change in occupancy or ownership may end the benefits of grandfathering, and a new occupant or owner may be required to make extensive improvements.

An experienced contractor can help you determine the building and safety requirements that apply to a particular space—for example, a code section mandating that railings on outside stairs be 36 inches high.

If You Build or Remodel

For any building or remodeling project, it's essential that you learn the applicable rules. If your city uses all or part of the Uniform Building Code, get a copy of it.

Other municipal ordinances may be administered by the building and safety department or by another unit of local government. There's no uniformity in how the responsibility for administering these other ordinances is assigned. A large municipality or county might have several separate departments to act as the enforcing agency. A smaller city or county would probably leave everything to the building and safety department.

6. Zoning Ordinances

Before you sign a lease, you absolutely need to know that the space is properly zoned for your usage. If it's not, it's best to make the lease contingent on your getting the property rezoned or getting a variance or conditional use permit—whatever it takes under the ordinance to make it possible for you to do business there without being hassled by the city or county.

In some communities, you must get a zoning compliance permit before you start your business at a given location. Other communities simply wait for someone to complain before zoning compliance gets looked at. Keep in mind that by applying for a construction permit for remodeling or by filing tax information with the municipality, you may trigger an investigation of zoning compliance.

Zoning laws may also regulate off-street parking, water and air quality, and waste disposal, and the size, construction, and placement of signs. In some communities, historic district restrictions may keep you from modifying the exterior of a building or even changing the paint color without permission from a board of administrators.

Years ago, people tried to argue in court that such regulation of aesthetics wasn't a proper governmental function—that it wasn't related to the protection of the public health and safety. However, a carefully drawn ordinance seeking to preserve the special appeal of a historic district will very likely survive a legal challenge. So if you look at space in one of these protected neighborhoods, be prepared to suspend your freedom of choice and place the destiny of at least the exterior of the building in the hands of a panel of administrators.

In Chapter 14, dealing with home-based businesses, you'll find a discussion of zoning ordinances as they relate to businesses in the home. Take the time to review Chapter 14, Sections A and B, because zoning restrictions apply to all businesses.

E. How to Deal With Local Building and Zoning Officials

There's a certain amount of administrative discretion under building codes and zoning ordinances—enough, certainly, that it can help greatly to have the administrators on your side. Here are some ideas for accomplishing this.

1. Seek Support From the Business Community

If you employ local people and will contribute positively to the economy, it may pay to make contact with city or county business development officials or even the chamber of commerce. If they see your business as an asset and don't want you to locate in the next city, they may be helpful in steering you through the building and safety department and may even advocate on your behalf before zoning and planning officials.

Trade associations and merchants' associations may also come to your aid if you need building and safety officials to decide in your favor in areas in which they have some administrative discretion. Finally, contractors, lawyers, and others who are familiar with the system and the personalities often know how to get things done and can be helpful to you.

2. Appealing an Adverse Ruling

The decision of a zoning or building official isn't necessarily final. If you get an adverse decision from the local Planning Commission, for example, you may be able to have a board of zoning adjustment or board of appeals interpret the zoning ordinance in a way that's favorable to you. Alternatively, you may be able to obtain a variance (a special exception to a zoning law) if a strict interpretation of the ordinance causes a hardship. In some cases, you can get a conditional use permit, which lets you use the property in question for your kind of business as long as you meet certain conditions set down by the administrative panel.

In dealing with administrators and especially with appeals boards, it's important to have the support of neighbors and others in your community. A favorable petition signed by most other businesses in your immediate area or oral expressions of support from half a dozen neighbors can make the difference between success and failure at an administrative hearing.

Conversely, if objectors are numerous and adamant, you may not get what you're after. So if you sense opposition developing from those living or doing business nearby, try to resolve your differences before you get to a public hearing—even if it means you must make compromises on the details of your proposal.

LAW IN THE REAL WORLD
Strategic Planning Pays Off

Shelby, owner of Small Universe Books, is delighted to learn that the drugstore next door is going out of business. He immediately seeks to buy or sign a long-term lease for the building so he can expand his profitable business. The future looks rosy.

Not so fast. Shelby learns that for his new business use of the building, he'll have to supply eight parking spaces to get a permit. Doing this in his desperately crowded neighborhood is totally impossible at anything approaching an affordable price.

Instead of giving up, Shelby asks the city planning commission for a variance to waive the parking spaces rule. A public hearing is scheduled. Shelby knows he has to put on a persuasive case, so he:

- Calls hundreds of local writers, publishers, critics, educators, and book lovers to pack the hearing room and testify that an expanded book store will be a great community resource.
- Documents the prohibitive cost of buying or leasing the required parking spaces.
- Offers to validate parking at a lot four blocks away, just outside the worst of the congested area.
- Hires an architect who determines that a heavily used, nearby public garage can accommodate 20 more cars if the parking spaces are striped differently.
- Offers to pay for the restriping.

Shelby gets the variance.

3. Going to Court

Every day, hundreds if not thousands of interpretations and applications of building and zoning laws are worked out through negotiation with administrators and through administrative appeals. But if these channels fail, it's possible in many instances to go to court. This can be very expensive and time-consuming. What good is it if you win your battle for a permit to remodel your premises but you waste two years getting to that point?

Still, there are times when what you're seeking is so valuable and your chances of success are so great that you can afford both the time and money to get a definitive ruling from the courts. And in some instances, you can get a court to consider your dispute fairly quickly.

If, for example, you submitted plans to the city that complied with all building and safety codes, and the building official refused to issue a building permit unless you agreed to put in some additional improvements you believe are not required by the ordinance, you could quickly go to court asking for an order of "mandamus." Your argument would be that the administrator wasn't following the law.

Before you consider court action, however, get as much information as you can about the cost of litigation, how long it will take (you can win in the trial court, but the city might decide to appeal), and the likelihood of your ultimate success. This is a specialized corner of the law, so you're going to need someone who's had experience in the field—and there may not be that many to choose from in any given location. Look for a lawyer who's represented a similar business in a dispute with the city or someone who formerly worked as a city attorney and knows all the ins and outs of the local ordinances. ■

CHAPTER

8

Tax Basics for the Small Business

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No matter whether your business is organized as a sole proprietorship, partnership, corporation, or limited liability company, you've automatically got a silent partner: Uncle Sam. The federal tax laws make this unavoidable. To guard against interest and penalties, you need to know what tax forms to file and when to file them. And to succeed in business, you need at least a basic, working knowledge of the tax system.

On a more positive note, by being aware of the fine points of the tax laws, you can often legally save a bundle of money—not to mention aggravation. For example, having a clear picture of what the IRS regards as a proper business expense will allow you to take deductions that otherwise might not occur to you.

Get detailed information. *The tax laws are vast and complicated, and you'll surely need much more information than you'll find in this chapter. Here I just hit the high points; it's up to you to deepen your knowledge. A good starting place is the IRS website at www.irs.gov.*

In addition to what you learn from books and other publications, you may have to hire a bookkeeper and an accountant. If you're operating a one-person word processing business out of your home, you may be able to keep your books and do your taxes with no professional help at all—or perhaps get help just the first time you file your annual tax return, to make sure you've correctly completed Schedules C (*Profit or Loss From Business*) and SE (*Self-Employment Tax*). On the other hand, if you've formed a corporation that's operating a good-sized dry-cleaning shop with eight employees, you may want an accountant to help set up your books and to prepare—or at least review—your business tax returns each year. And you may find that employing a part-time bookkeeper not only results in your records being well kept, but also frees you for more important tasks.

A word of caution about one other possible source of assistance: IRS employees. Most of them are hardworking and well-meaning, but their training and supervision are often inadequate. Unfortunately, it's common to receive poor oral advice in answer to questions. And if the advice proves to be so inaccurate that it results in your being assessed interest and penalties, the fact that you got it from an IRS employee won't get you off the hook. In short, it's often cheaper in the long run to rely on the advice of an experienced small business accountant than on a free oral opinion from the IRS.

State Taxes. In addition to federal taxes, you need to be aware of your state's tax scheme, which may include an income tax structured along the same lines as the federal version or one that has some major differences. Before you begin your business, contact your state's taxing authority to get detailed information. You'll also find helpful links at www.statetaxcentral.com.

A. Employer Identification Number

Even if your business has no employees, you must get an Employer Identification Number (EIN) from the IRS when you start a business that you've set up as:

- a partnership
- an S corporation
- a C corporation
- a limited liability company (LLC) with two or more members, or
- a single-member LLC that you've chosen to have taxed as corporation.

Technically, if you're a sole proprietor or the sole member of a limited liability company (LLC) that is not being taxed as a corporation (see Chapter 1, Section D) and you have no employees, you can use your personal Social Security number instead of an EIN. But even in those situations, it's a good business practice to get an EIN to differentiate cleanly between your personal and business finances.

You'll need your EIN before you file a tax return or make a tax deposit. In some cases, a bank will require you to have an EIN before you can open a business bank account.

APPLICATION FOR EMPLOYER IDENTIFICATION NUMBER

Form **SS-4** (Rev. December 2001) Department of the Treasury Internal Revenue Service

Application for Employer Identification Number

(For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.)

▶ **See separate instructions for each line.** ▶ **Keep a copy for your records.**

EIN

OMB No. 1545-0003

Type or print clearly.

1 Legal name of entity (or individual) for whom the EIN is being requested
Alpha Bean Cromwell

2 Trade name of business (if different from name on line 1)
ABCD Plumbing

3 Executor, trustee, "care of" name

4a Mailing address (room, apt., suite no. and street, or P.O. box)
1234 Rooter Place

5a Street address (if different) (Do not enter a P.O. box.)

4b City, state, and ZIP code
Nowheresville, CA 95555

5b City, state, and ZIP code

6 County and state where principal business is located
Somewheres County, California

7a Name of principal officer, general partner, grantor, owner, or trustor
Alpha Bean Cromwell

7b SSN, ITIN, or EIN

8a **Type of entity** (check only one box)
- ☒ Sole proprietor (SSN) 555 55 5555
- ☐ Partnership
- ☐ Corporation (enter form number to be filed) ▶
- ☐ Personal service corp.
- ☐ Church or church-controlled organization
- ☐ Other nonprofit organization (specify) ▶
- ☐ Other (specify) ▶
- ☐ Estate (SSN of decedent)
- ☐ Plan administrator (SSN)
- ☐ Trust (SSN of grantor)
- ☐ National Guard
- ☐ Farmers' cooperative
- ☐ REMIC
- ☐ State/local government
- ☐ Federal government/military
- ☐ Indian tribal governments/enterprises

Group Exemption Number (GEN) ▶

8b If a corporation, name the state or foreign country (if applicable) where incorporated | State | Foreign country

9 **Reason for applying** (check only one box)
- ☒ Started new business (specify type) ▶
- ☐ Hired employees (Check the box and see line 12.)
- ☐ Compliance with IRS withholding regulations
- ☐ Other (specify) ▶
- ☐ Banking purpose (specify purpose) ▶
- ☐ Changed type of organization (specify new type) ▶
- ☐ Purchased going business
- ☐ Created a trust (specify type) ▶
- ☐ Created a pension plan (specify type) ▶

10 Date business started or acquired (month, day, year)
01/01/05

11 Closing month of accounting year
December

12 First date wages or annuities were paid or will be paid (month, day, year). **Note:** *If applicant is a withholding agent, enter date income will first be paid to nonresident alien. (month, day, year)* ▶

13 Highest number of employees expected in the next 12 months. **Note:** *If the applicant does not expect to have any employees during the period, enter "-0-."* ▶

Agricultural	Household	Other

14 Check **one** box that best describes the principal activity of your business.
- ☐ Health care & social assistance
- ☐ Wholesale-agent/broker
- ☐ Construction
- ☐ Rental & leasing
- ☐ Transportation & warehousing
- ☐ Accommodation & food service
- ☐ Wholesale-other
- ☐ Retail
- ☐ Real estate
- ☐ Manufacturing
- ☐ Finance & insurance
- ☐ Other (specify)

15 Indicate principal line of merchandise sold; specific construction work done; products produced; or services provided.

16a Has the applicant ever applied for an employer identification number for this or any other business? ☐ **Yes** ☒ **No**
Note: *If "Yes," please complete lines 16b and 16c.*

16b If you checked "Yes" on line 16a, give applicant's legal name and trade name shown on prior application if different from line 1 or 2 above.
Legal name ▶ Trade name ▶

16c Approximate date when, and city and state where, the application was filed. Enter previous employer identification number if known.
Approximate date when filed (mo., day, year) | City and state where filed | Previous EIN

Third Party Designee

Complete this section **only** if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.

Designee's name

Designee's telephone number (include area code)
(510) 555-5555

Address and ZIP code

Designee's fax number (include area code)
(510) 666-6666

Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.

Name and title (type or print clearly) ▶

Applicant's telephone number (include area code)
( )

Applicant's fax number (include area code)
( )

Signature ▶ *Alpha Bean Cromwell* Date ▶ 1/1/05

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 16055N Form **SS-4** (Rev. 12-2001)

1. How to Apply

To get an EIN, file Form SS-4, *Application for Employer Identification Number*.

The form isn't difficult to fill out if you follow the IRS instructions. Nevertheless, a few pointers may help.

Space 1. Insert your official corporate name if you're a corporation or your official company name if you're a limited liability company. If you're a partnership, use the partnership name shown in your partnership agreement. If you're a sole proprietor, insert your full name—the name you use on your personal tax return.

Space 11. Here you're asked to state the closing month of your business accounting year. Your answer, however, isn't binding. You make your binding election of a fiscal year-end on the first federal income tax return that you file for the business.

Sole proprietors, partnerships, S corporations, personal service corporations (see Chapter 1, Section F2a), and limited liability companies are generally required to use a calendar year—that is, a year ending December 31—for tax purposes. Personal service corporations have two basic characteristics:

- the professional employees of the corporation own the stock, and
- the corporation performs its services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

To use a tax year other than a calendar year, an S corporation must demonstrate to the IRS that there is a substantial business reason to do so, such as the seasonal nature of the business. Basically, the IRS wants to make sure that permitting you to claim a tax year other than the calendar year won't substantially distort your income.

See IRS Publication 589, *Tax Information on S Corporations,* and *IRS Publication 538,* Business Purpose Tax Year, *for details.*

A regular corporation that's not a personal service corporation is freer to choose a fiscal year. Most small businesses find that where there's a choice, the calendar year is the most convenient way to proceed. Sometimes, however, there are tax planning reasons for a business owner to choose a different tax year for the business.

> **EXAMPLE 1:** Radcraft Inc., a regular corporation, selects the calendar year for its fiscal year. In December 2003 it pays a $30,000 bonus to Jill, the president and sole shareholder. The bonus is included on Jill's 2003 income tax return, and tax on the bonus is due in April 2004.

> **EXAMPLE 2:** Jill selects a fiscal year of February 1 through January 31 for Radcraft Inc. (On Form SS-4, she lists January in space 11 for the closing month of the corporation's accounting year.) In January 2004, the corporation pays Jill a $30,000 bonus. The bonus is included in Jill's 2004 income tax return. The tax on the bonus isn't due until April 2005—although Jill must keep track of it when computing her quarterly estimates in 2004.

An accountant or other experienced tax advisor *can help you decide whether or not you and your corporation can realize a tax advantage by using a tax year other than a calendar year.*

Space 12. The IRS will send you computer-generated payroll tax forms based on your answer to this question.

Space 13. These numbers can be estimated. It's usually best to estimate on the low side.

Space 17a. This question refers to the business, not the owner. Normally, a partnership, corporation, or limited liability company has only one Employer Identification Number (EIN). A sole proprietor may have several businesses, each with a separate number.

After filling out the form, there are four ways to obtain the number.

- *By mail.* If you have enough lead time, you can mail Form SS-4 to the IRS and wait for the number to be mailed to you, which will take about four weeks.
- *By phone.* To get a Form SS-4 processed more quickly, use the TELE-TIN system operated by the IRS. Complete Form SS-4 and, before you mail it, phone in the information to the IRS at the phone number for your region. Phone numbers are listed in the form's instruction sheet. An IRS employee assigns an EIN, which you'll then insert in the upper-right corner of the form before sending it to the IRS.
- *Online.* The IRS has made it a snap to get your EIN online. Go to www.irs.gov. Click "Businesses," then "Employer ID Numbers," then "apply online." (You'll also find full instructions at the IRS site for completing the form—instructions that will be useful even if you prefer to fill out and file a paper form.)
- *By fax.* You can fax your Form SS-4. To obtain the fax number, inquire at the IRS office where you pick up your Form SS-4. You'll get your EIN in a day or two. This is slower than the phone method but it avoids the frustration of repeated calling because the TELE-TIN voice line is tied up.

Use your EIN on all business tax returns, checks, and other documents you send to the IRS. Your state taxing authority may also require your EIN on state tax forms.

2. When to Get a New Number

If your S corporation chooses to change to a regular corporation—or your C corporation chooses to change to an S corporation—it doesn't need a new EIN; the one you already have is still sufficient. However, you'll need to get a new EIN if any of these changes occur in your business:

- You incorporate your sole proprietorship or partnership.
- You convert your sole proprietorship or partnership to a limited liability company.
- Your sole proprietorship takes in partners and begins operating as a partnership.
- Your partnership is taken over by one of the partners and begins operating as a sole proprietorship.
- Your corporation changes to a partnership or to a sole proprietorship.
- You purchase or inherit an existing business that you'll operate as a sole proprietorship.
- You represent an estate that operates a business after the owner's death.
- You terminate an old partnership and begin a new one.

Filing Form SS-4 for an LLC

The IRS has some special rules applicable to LLCs completing Form SS-4, as follows:

- You have a single-member LLC, and you plan to run it as if you were a sole proprietor (using Schedule C to report business income). Your LLC won't need an Employer Identification Number (EIN). Therefore, you probably shouldn't file Form SS-4. Your name and Social Security number will normally be all you need to use for tax purposes. But if your LLC will have employees, you can, if you wish, get an EIN for the LLC for reporting and paying employment taxes. You can also get an EIN for nontax reasons (such as a state requirement) or simply as a bookkeeping preference. If you do decide to get an EIN for the LLC, check the "Other" box in space 8a and write in: "Disregarded Entity—Sole Proprietorship."
- You have a multimember LLC, and you plan to run it as if you were a partnership (using Form 1065 to report business income). You should apply for an EIN and, in space 8a, check the "Partnership" box.
- You have either a single-member or a multimember LLC, and you plan to run it as a C Corporation. You should apply for an EIN and, in space 8a, check the "Corporation" box. Then, below the "form number" line, write in "Single-Member" or "Multimember." Also be sure to file Form 8832 to elect corporate tax status, as explained in Chapter 4, Section G4.

B. Becoming an S Corporation

Many corporations derive tax benefits from electing S corporation status. The difference between a C corporation, which is a separate tax entity from its shareholders, and an S corporation, whose income is reported on the owners' tax returns, is described in some detail in Chapter 1. If you're not thoroughly familiar with this material, please reread it before going on.

To become an S corporation, all shareholders must sign and file IRS Form 2553 (*Election by a Small Business Corporation*) with the IRS by the 15th day of the third month of the tax year to which the election is to apply.

> **EXAMPLE:** Nancy, Jerry, and Agnes form a corporation, Phoenix Ventures Inc. They start to do business on September 1, 2004 and, like most businesses, use the calendar year for accounting and tax purposes. Their 2004 tax year will be a short one: September 1 through December 31. To obtain S corporation status for that first tax year, they need to file Form 2553 by November 15, 2004, which is the 15th day of the third month of that tax year. If they miss that deadline, their corporation won't qualify for S corporation status in 2004. But if they file Form 2553 by March 15, 2005 their corporation will get S corporation status for 2005.

A number of technical rules govern which corporations can elect to become S corporations. Your corporation must meet these requirements:

- It must be a "domestic" corporation—one that's organized under U.S. federal or state law.
- It must have only one class of stock.

- It must have no more than 100 shareholders.
- It must have as shareholders only individuals, estates, and certain trusts. Partnerships and corporations can't be shareholders in an S corporation.
- It can't have any shareholder who is a nonresident alien.

There are other technical rules, but the vast majority of new, small corporations may become S corporations if they choose to do so.

To elect S corporation status, you need the consent of all shareholders. Unless yours is a one-person corporation, you should agree on this election before you form your corporation.

An S corporation election doesn't have to be permanent. You can start out as an S corporation and then, after a few years, revoke your S corporation status and be taxed as a regular corporation. If you terminate your status as an S corporation, generally you'll have to wait five years until you can again become an S corporation—although you may be able to get permission from the IRS to shorten this waiting period.

Once the shareholders file a Form 2553, the corporation continues to be an S corporation each year until the shareholders revoke that status or it's terminated under IRS rules. What terminates S corporation status? For one thing, ceasing to qualify as an S corporation. For example, your corporation would no longer qualify if it had more than 75 shareholders or if you or another shareholder transferred some of your stock to a partnership.

C. Business Taxes in General

Three main categories of federal business taxes may apply to your business:

- income tax
- employment taxes
- self-employment tax.

This section looks briefly at each of these tax categories. Get IRS Publication 509, *Tax Calendars,* to see when to file returns and make tax payments. It's updated annually.

Excise Taxes. In addition to the three main business taxes, the federal government imposes excise taxes on a few specialized transactions and products. These taxes almost never are of concern to small businesses. To see whether your business is affected, see IRS Publication 334, *Tax Guide for Small Business.*

1. Income Tax

You must file an annual federal tax return reporting your business income. Below is a list of the forms to use.

Business Income Tax Forms

Type of Legal Entity	Form
Sole Proprietorship	Schedule C (Form 1040)
Partnership	Form 1065
Regular Corporation	Form 1120 or 1120-A
Single Member LLC	Schedule C (Form 1040)
S Corporation	Form 1120-S
Multimember LLC	Form 1065, 1120 or 1120-A

a. Sole Proprietorship

If you're a sole proprietor, your business itself doesn't pay income tax. You report your business income (or loss) on Schedule C, and file it with Form 1040. Your Schedule C income (or loss) is added to (or subtracted from) the other income you report on your personal Form 1040. If you have more than one business, file a separate Schedule C for each business.

b. Partnership

A partnership Form 1065 is an informational tax return telling the IRS how much each partner earned. The partnership doesn't pay tax on this income. Each partner reports his or her share of income (or loss) on Schedule E, *Supplemental Income and Loss*, and files it with Form 1040.

This Schedule E amount is added to (or subtracted from) the other income the partner reports on Form 1040. In other words, a partner's income is treated like a sole proprietor's income on Form 1040: It's listed in a separate schedule and then blended with other income listed on the first page of the 1040.

Passive losses. *Losses from passive partnership activities—such as real estate investments or royalties, in which the partnership plays the role of a passive investor—can usually be taken as a credit only against income from other passive activities. This is explained in greater detail in IRS Publication 925.*

c. S Corporation

The S corporation itself doesn't pay income tax. Form 1120-S filed by an S corporation is an informational return telling the IRS how much each shareholder earned. As a shareholder, you report your portion of income or loss on Schedule E and file it with Form 1040. Then you add that income to (or subtract a loss from) your other 1040 income.

d. C Corporation

A C corporation reports its income or loss on Form 1120 or 1120-A and pays a tax if there is income. But in many small corporations, the shareholders are employees who receive all profits of the business in the form of salaries and bonuses, which are tax-deductible by the corporation as a business expense. In that situation, the corporation would have no taxable income.

Not all small corporations, however, are able to pay out their income in the form of salaries and bonuses. If they don't, they must pay a corporate income tax.

EXAMPLE: Jenny and her twin sister Janet are the sole shareholders in Neptune Corporation, which manufactures swimming pool supplies. In the second year of their corporate existence, to encourage growth, Jenny and Janet decide to pay themselves minimal salaries and to plow most of the corporate income into inventory and the purchase of rehabilitated but serviceable equipment. The money that the corporation puts into inventory and equipment isn't available for distribution to Jenny and Janet; moreover, most of that money isn't a currently deductible business expense, so it is taxed at corporate income tax rates. (The equipment will be capitalized; depreciation deductions will be spread over several years.)

Tax Rates on Taxable Corporate Income

Income Over	But Not Over	Tax Rate
$0	$50,000	15%
$50,000	$75,000	25%
$75,000	$100,000	34%
$100,000	$335,000	39%
$335,000	$10,000,000	34%
$10,000,000	$15,000,000	35%
$15,000,000	$18,333,333	38%
Over $18,333,333		35%

Note: Personal service corporations are subject to a flat tax of 35% regardless of the amount of income.

If you have a C corporation that expects to have taxable income, your corporation needs to make periodic deposits of its estimated income taxes. And if you're an employee of your C corporation (as is almost always the case with an owner of a small business corporation), taxes and Social Security payments must be withheld from your paychecks.

e. Limited Liability Company

A single-member LLC is normally taxed as a sole proprietorship, meaning that you'll report the income (or loss) on Schedule C and file it with Form 1040. The bottom line will be added to (or subtracted from) the other income you report on Form 1040.

An LLC that has two or more members, unless the owners choose to have the business taxed as a corporation, will be taxed as a partnership (tax liability passes through to the LLC members) and will use Form 1065—an informational return that tells the IRS how much each member earned. The LLC doesn't pay tax on its income but, as with a partnership, each member reports his or her share of income (or loss) on Schedule E, *Supplemental Income and Loss*, which is filed with Form 1040. This Schedule E amount is added to (or subtracted from) the other income the member reports on Form 1040.

An LLC that chooses to be taxed as a corporation will use Form 1120 or 1120-A. See Subsection d, above, for a discussion of corporate taxes.

New Tax Break for Manufacturing Businesses

Beginning in 2005, a manufacturing business can take an attractive deduction—and one that will get even better as it is phased in year by year. The tax law definition of manufacturing is broad enough to include income from farming and construction, but not from restaurants. Once the deduction takes full effect, you'll be able to deduct 9% of the lesser of:

- the business's production activities income, or
- its taxable income for a taxable year.

The deduction, however, can't be larger than 50% of your company's W-2 wages for the taxable year. In most cases this is the same as 50% of your company's payroll.

If your company is eligible, it can claim a 3% deduction in 2005 and 2006, and a 6% deduction from 2007 through 2009. In 2010, the full 9% deduction will kick in. The deduction applies to a wide range of entities—including sole proprietorships, partnerships, LLCs, C corporations, and S corporations.

Because this is a particularly complex area of tax law, you should talk to a tax pro to see how this tax break applies to your business.

2. Federal Payroll Taxes

There are several types of employment-related taxes the federal government exacts from businesses.

a. Federal Income Tax Withholding (FIT)

You must withhold income taxes from employees' paychecks based on:

- the employee's filing status (single, married, or married but withholding at the higher single rate)
- the number of dependents (withholding allowances) declared by the employee, and
- the size of the employee's salary.

Each employee should give you a signed Form W-4 stating his or her withholding allowance. Save these forms. You needn't send them to the IRS unless the employee:

- claims more than ten allowances, or
- claims to be exempt from withholding and also normally earns more than $200 a week.

Use the tables in Circular E (referenced below) to figure out how much income tax to withhold.

- **IRS Publication 15, Circular E, *Employer's Tax Guide,*** *published by the IRS, explains employment-related taxes clearly and in great detail. Updated whenever the tax rates change, Circular E is available at all IRS offices (or at www.irs.gov) and is mailed automatically to all businesses with an EIN.*
- *IRS Publication 334,* Tax Guide for Small Business*, and if you're just getting started, IRS Publication 583,* Starting a Business and Keeping Records*, are well worth reading. These publications are free from your local IRS office or can be obtained by calling the main IRS number: 800-829-3676, or by going to www.irs.gov.*
- Tax Savvy for Small Business, *by Frederick W. Daily (Nolo). An excellent guide to all the tax problems small businesses face. The audit material alone is well worth the price of the book.*
- Small-Time Operator, *by Bernard Kamoroff (Bell Springs Publishing), is a clearly written book that covers not only taxes but also many other practical aspects of doing business, including bookkeeping.*
- U.S. Master Tax Guide *(CCH, Inc.), is updated annually and available in law libraries, business school libraries, and the reference departments of major public libraries. It features in-depth explanations of tax complexities.*
- The Kiplinger Tax Letter, *published by the Kiplinger Washington Editors, is a biweekly newsletter that does an excellent job of keeping you up-to-date on what's happening in the tax field. The breezy—some would say breathless—style is fun to read. Go to www.kiplinger.com or call 800-544-0155.*

Also, there is software that handles payroll, including tax computations. Look into QuickPay, OneWrite, *and* Peachtree.

b. Social Security Tax (FICA)

You must withhold the employee's share of the Social Security tax and Medicare tax from the employee's pay. And you must also pay the employer's share. The amounts to be withheld are listed in the most current edition of Circular E. For 2005, for example, the employer and the employee are each required to pay 7.65% on the first $90,000 of the employee's annual wages; the 7.65% figure is the sum of the 6.2% Social Security tax and the 1.45% Medicare tax. There is no Social Security tax on the portion of the employee's annual wages that exceeds $90,000—only the Medicare tax; the employer and the employee each pay the 1.45% Medicare tax on the excess amount. The rates and the cutoff point for the Social Security tax change annually.

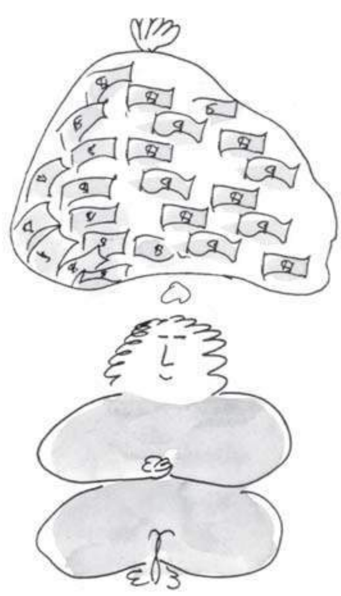
Withholding From an Owner's Paycheck

Money you earn from your corporation—whether it's an S or a C corporation—isn't limited to dividends you receive as a shareholder. If you perform substantial services for your corporation, you're considered an employee for tax purposes. This means you must complete and submit a Form W-4 to the corporation the same as any other employee, and the corporation must withhold income taxes and your share of Social Security and Medicare taxes from your paychecks.

These requirements may seem burdensome, but if you're an employee of a C corporation the time you spend completing the paperwork is well worth it because the money you take out as an employee is taxed only once rather than twice. (See Chapter 1, Section C2.)

c. Federal Unemployment Tax (FUTA)

Finally, you must report and pay the federal unemployment tax (FUTA). The employer is responsible for paying this tax; it's not withheld from the employee's pay. The FUTA rate through 2007 is 6.2% of the first $7,000 of the employee's wages for the year. Employers are given a credit for participating in state unemployment programs. The credit reduces the FUTA rate to 0.8% for most employers—which translates into $56 for an employee earning $7,000 or more per year.



Use Form 940 or 940EZ to report federal unemployment tax. Sole proprietorships and partnerships don't pay the FUTA on the owners' compensation.

d. Periodic Deposits

You must periodically deposit the withheld income tax and the employer's and employee's shares of Social Security and Medicare taxes at an authorized financial institution—usually a bank. The IRS sends you coupons to use in making these deposits. It also provides instructions on how often you're required to deposit these funds, which depends on the size of your payroll and amounts due; a typical small business makes monthly deposits.

Deposit taxes on time. *Be sure to withhold taxes as required by the tax laws—and to deposit those taxes on time. There are substantial penalties if you don't. And if you're an owner of a small business and personally involved in its management, you can be held personally liable for these taxes and the additional penalties, even if the business has the funds to pay them. If your business suddenly runs into financial trouble, put the withheld taxes at the top of the list for payment. If that means not paying suppliers and others, so be it. The debts of the other creditors can be wiped out in bankruptcy if the business continues to go downhill. Not so with the withheld taxes. You can remain personally liable for these amounts even if the business goes through bankruptcy. However, passive investors—for example, those who merely own corporate shares and play no role in making business decisions—face very little risk of being personally liable for the taxes.*

Get a copy of IRS Publication 509, *Tax Calendars,* *to see when to file returns and make tax payments. It's available from your local IRS office, by calling the main IRS number: 800-829-3676, or by going to www.irs.gov. The publication is updated annually.*

Payroll Taxes Made Easy

If you're overwhelmed by the requirements for calculating payroll taxes and the fine points of when and where to pay them, you can pay a bank or payroll service to do the work for you. A reputable payroll tax service that offers a tax notification service will calculate the correct amount due, produce the checks to pay the employees and the taxes, and notify you when the taxes are due.

One big advantage of a payroll service over a bank is that the bank will normally withhold the amount of the tax from your account when the payroll is done, even though the tax isn't due yet. That means the bank, not you, gets the use of the money for a while. If your payroll service offers tax notification, it will prepare the checks and tell you when they must be deposited. Depending on how often you must make payments, that can give you the use of the money an extra month or more.

At the end of each quarter, the payroll service will produce your quarterly payroll tax returns and instruct you about how to file them. At the end of the year, the service will also prepare W-2 forms and federal and state transmittal forms.

Payroll services can be cost-effective as compared to the hours it will take to handle your own tax reporting (even for very small businesses). But when you look for one, it pays to shop around. Avoid services that charge setup fees—basically, a fee for putting your information into its computer—or extra fees to prepare W-2 forms or quarterly and annual tax returns.

3. Self-Employment Tax

The self-employment tax applies to income you receive from actively working in your business—but not as an employee of that business. Technically, it's not an employment tax, but it's so closely related that you should be aware of it to fully understand employment taxes.

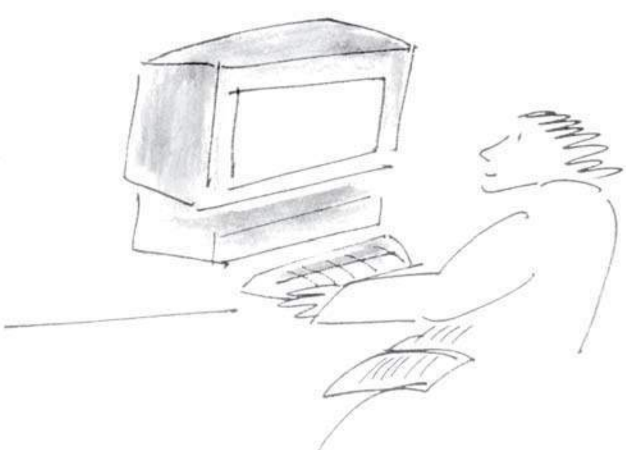
If you're a sole proprietor or a partner (or an LLC member, probably—see note below), you must pay the federal self-employment tax in addition to regular income tax. The self-employment tax is equal to the employer's and employee's portion of the Social Security and Medicare taxes that you and your employer would pay on your compensation if you received it as an employee.

Compute this tax each year on Schedule SE, which you then attach to your personal Form 1040. Add the self-employment tax to the income tax that you owe. For example, in 2005, the self-employment tax is set at 15.3% on earnings up to $90,000 and 2.9% on earnings over $90,000. The tax law lightens the burden of the self-employment tax somewhat by allowing you to deduct one-half of this tax in computing your adjusted gross income. You take the deduction on the first page of your federal tax return.

You may not owe the full self-employment tax on all of your business earnings. If you have income from another job that's subject to withholding—common for people just getting started in business—the income from your other job will reduce the tax base for your self-employment tax. So in computing your self-employment for 2005, for example, you'd reduce the $90,000 figure to reflect any of your job earnings that were subject to employer withholding.

EXAMPLE: Morton works ¾ time as a chemistry instructor at a local college, where he receives an annual salary of $60,000. He also does consulting, as a sole proprietor, for several chemical companies and earns an additional $40,000 a year after expenses. The $60,000 salary at the college—which is subject to withholding by the employer—is used to reduce the $90,000 cap on income that's subject to the 15.3% self-employment tax. So Morton computes the tax at the rate of 15.3% on $30,000 of his consulting business income ($90,000 less $60,000 = $30,000). On the remaining portion—$10,000 ($40,000 less $30,000 = $10,000)—he computes the tax at the rate of 2.9%.

LLC members may have to pay self-employment tax. *As explained in Chapter 1 and Chapter 4, Section D, LLC members may have to pay self-employment tax on all income they receive from the LLC, whether in the form of salary or allocations of profit.*



Computing Your Estimated Taxes

Many taxpayers receive income from sources other than paychecks—for example, from investments and royalties. These taxpayers often owe surprising amounts of income taxes on April 15. Sometimes, that's because they had no employer to withhold income tax during the year. Other times, it's because even though there was an employer, the amounts withheld were insufficient to cover the taxpayer's non-employment income.

As you may know, the IRS doesn't want you to wait until April 15 to pay. Instead, the IRS requires you to pay your taxes in advance in quarterly estimated installments if not enough is being withheld from your salary to cover your full income tax bill. Every year, the IRS provides guidelines on how you can avoid interest and penalties for paying too little in estimated tax. For tax year 2004, for example, you would have avoided interest and penalties by paying 90% of your 2004 tax bill in advance, or an amount equal to 100% of your 2003 tax bill (or 110% of your 2003 tax bill if your adjusted gross income was over $150,000).

In figuring out what your tax bill will be and whether you need to pay any quarterly installments of estimated taxes, don't overlook the self-employment tax that is added to your regular income tax on your Form 1040 as part of your tax obligation. Make sure your quarterly installments are large enough to cover your self-employment tax as well as your usual income tax.

For more on this subject, see IRS Publication 505, *Tax Withholding and Estimated Tax,* available at the nearest IRS office or by going to www.irs.gov.

D. Business Deductions

Of all the federal taxes that may affect a small business, income tax is the one that business owners are most concerned about. The general formula is that you first figure out your gross profit—your gross receipts or sales less returns and allowances and the cost of goods sold. Then you subtract your other business expenses to find the net income or loss of your business. For an in-depth analysis of what business expenses can be deducted, see IRS Publication 535, *Business Expenses*.

In this section, we'll look at common categories of deductible business expenses.

Home-Based Businesses. If you have a home-based business, you'll find special tax pointers in Chapter 14.

1. IRS Guidelines for Business Deductions

The IRS has broad, general guidelines for what constitutes deductible expenses. For example, to be deductible, a business expense must be ordinary and necessary—something that's common in your type of business, trade, or profession. If you have an expense that's partly for business and partly personal, you must separate the personal from the business part. Only the business part is deductible.

So much for generalities. Here's a partial list of the kinds of expenses that your business can normally deduct:

- advertising
- bad debts
- car and truck expenses
- commissions and fees
- conventions and trade shows
- depreciation on property owned by the business (discussed in Section 2, below)
- employee benefit programs
- insurance
- interest
- legal, accounting, and other professional services
- office expenses
- pension and profit-sharing plans
- rent
- repairs to and maintenance of business premises and equipment
- supplies
- taxes and licenses
- trade publications
- travel, meals, and entertainment
- utilities
- wages.

This list isn't all-inclusive. You can also deduct any other expenses that you believe—and can convince the IRS—are ordinary and necessary business expenses.

Now let's look at the rules affecting a number of specific expenses (deductions) in more depth.

2. Depreciation

If you buy equipment or machinery that has a useful life longer than one year, the IRS generally won't let you deduct the full cost in the year you buy it. Instead, you deduct a portion each year over the term of the item's useful life by using depreciation.

Depreciation is the loss in the value of the property over the time the property is used—including wear and tear, age, and obsolence. IRS tables list the useful life of various types of equipment and machinery for the purpose of depreciation.

You don't need to depreciate inexpensive items. *Exceptions are made for inexpensive items for which the cost of detailed record keeping would be prohibitive. For example, your $75 desktop calculator may last for five years but you'd undoubtedly be allowed to deduct its entire cost in the year you buy it. You'd probably treat it as part of your office supplies.*

You may choose one of two methods—straight-line or accelerated—for figuring depreciation.

a. Straight-Line Depreciation

The straight-line method means that you deduct an equal amount each year over the projected life of the asset. Actually, that's a bit of an over-simplification; something called the "half-year convention" makes things slightly more complicated. That rule allows only a half-year's worth of depreciation to be deducted in the first year.

> **EXAMPLE:** Norbert buys a $1,000 fax machine in 2005 that can be depreciated over five years according to the IRS table. Under a strict application of the straight-line depreciation method, he'd deduct $200 each year for five years. But the half-year convention allows him to deduct only a half year's worth of depreciation—$100—the first year. So Norbert would deduct $100 the first year; $200 a year for the next four years; and the final $100 in the sixth year.

(Exceptions to the half-year rule are explained in IRS Publication 946, *How to Depreciate Property*.)

b. Accelerated Depreciation

Another method of depreciating assets—accelerated depreciation—is also available. Most small businesses will want to use the accelerated depreciation tables instead of the straight-line method. It allows them to write off a large amount of the purchase price in the years immediately following the purchase of the machinery or equipment. That, of course, makes the tax savings available sooner.

c. Immediate Write-Offs

Another tax rule—one especially helpful to small businesses—lets you get around the depreciation rules to a great extent. You can, if you choose, write off up to $102,000 of depreciable assets in the year of purchase. This figure will be adjusted annually for inflation in 2005 and future years. You can, if you choose, write off up to $100,000 of depreciable assets in the year of purchase.

> **EXAMPLE:** Bertha buys an $8,000 computer in 2005. Ordinarily, she'd have to use IRS depreciation tables and spread the cost over several years. But she has the option of deducting the cost all at once in the year 2005. This is known as a Section 179 capital-expense election.

There are a few important limitations to this deduction. The first, which doesn't affect many businesses that are just starting out, applies if you purchase more than $410,000 in depreciable assets in one year. If you do, the maximum amount you can deduct as a Section 179 capital-expense deduction is reduced, dollar for dollar, by the amount you exceed $410,000. For example, if you spend $415,000 on depreciable assets, you can write off—as an expense deduction—only $97,000 ($102,000 less $5,000). This $410,000 threshhold will be adjusted for inflation in 2005 and future years.

Second, the amount you write off can't exceed the total taxable income that your business received in that year. You may, however, carry forward any disallowed part of this write-off so that you get some tax benefit in future years.

Any depreciable assets that you don't write off under Section 179 can be depreciated and written off under the straight-line or accelearated methods of depreciation, above.

For further explanation of this complicated area: *See* Tax Savvy for Small Business*, by Frederick W. Daily (Nolo).*

To Take Business Deductions, You Need a Business

The tax laws don't allow you to take business deductions for a hobby. Sometimes, however, the line between a business and a hobby can get fuzzy. This can happen if your small business is more a labor of love than a dependable source of income. Let's say you're a chiropractor but your real passion is growing orchids. Occasionally, you sell your orchids to friends and neighbors. You can't possibly get rich doing this, but you are intrigued by the possibility of deducting the cost of your plant materials, gardening equipment, fertilizer, plant-related magazine subscriptions, and the expenses of attending an orchid-growers convention. Can you legitimately deduct these items? Maybe—or maybe not.

The answer lies in whether you're profit motivated. To test for a profit motive, the IRS relies mainly on a simple "3-of-5" test. If your business makes a profit in any three out of five consecutive years, you're presumed to have a profit motive. That's true even if during the profitable year the profit was only $1. If you don't pass the "3-of-5" test, you may still be able to convince the IRS that you have a profit motive—but the going will be tougher. You'll have to use your ingenuity to establish that you have a real business. Some things that may help: Business cards, letterhead, well-kept books, a separate bank account, a separate phone line, business licenses and permits, and expenses for marketing.

3. Employees' Pay

You can deduct salaries, wages, and other forms of pay that you give to employees as long as you meet certain IRS tests listed below. If you're both an employee and a shareholder of your business, your own salary must meet the same tests for deductibility as salaries paid to any other executive or employee.

For a salary to be deductible, you must show that:

- The payments are ordinary and necessary expenses directly connected with your business.
- The payments are reasonable. Fortunately, you have broad discretion to decide what's reasonable. Short of a scam—such as paying a huge salary to a spouse or relative who does little or no work—the IRS will almost always accept your notion of what's reasonable pay.
- The payments are for services actually performed.

If you use the cash method of accounting (very common among small businesses), you can deduct salaries and wages only for the year in which they were paid. However, you can deduct employee taxes your business withheld in the year your business withheld them; you can't deduct (until paid to the government) the employer's matching portion of these taxes. Businesses using the accrual method have more latitude as to when they can deduct salaries and payroll taxes.

You can also deduct bonuses you pay to employees if they're intended as additional payment for services and not as gifts; most bonuses qualify for deduction. If your business distributes cash, gift certificates, or similar items of easily convertible cash value, the value of such items is considered additional wages or salary regardless of the amount. If a bonus is considered as part of an employee's wages or salary, it's subject to employment taxes and withholding rules.

Certain noncash bonuses that *are* intended as gifts are deductible if they are less than $25 per person per year.

EXAMPLE: To promote employee goodwill, Pebblestone Partnership distributes turkeys, hams, and other items of nominal value at holidays. The value of these items isn't considered salaries or wages, but the partnership can deduct their cost as a business expense.

4. Employee Benefits

A number of employee benefits can be deducted, including:

- health and dental insurance
- group term life insurance
- moving expenses
- qualified employee benefit plans, including profit-sharing plans, stock bonus plans, and money purchase pension plans
- employee benefit plans that allow employees to choose among two or more benefits consisting of cash and qualified benefits.

If your business can afford these benefits, not only are they tax deductible by your business, but they are not taxed to the employee.

While these benefits sound attractive, there are two serious drawbacks. First, many small businesses—particularly those just starting out—can't afford them. Second, plans that mainly benefit the owners of the business are not tax-deductible. (See Chapter 1, Section C2b(2), for a more thorough discussion.)

5. Meals, Entertainment, and Travel

To be treated as a business deduction, travel expenses need to be ordinary and necessary in your type of business. Basically, these are any reasonable expenses you incur while traveling for business. You (or your business) can't deduct expenses for personal or vacation purposes, or any part of business expenses that is lavish or extravagant.

(And deductible travel expenses don't include expenses for entertainment such as sports events and concerts.)

But if you're on the kind of tight travel and entertainment budget common to most small business people, you won't have to worry about this last restriction. Here are examples of deductible travel expenses:

- air, rail, and bus transportation while traveling on business
- operating and maintaining your own car for business (see Section 6 for more on car expenses).
- taxi fares or other costs of transportation between the airport or station and your hotel, from one customer to another, or from one place of business to another
- baggage charges and transportation costs for sample and display material
- meals and lodging while traveling on business
- cleaning and laundry expenses
- telephone and fax expenses
- public stenographers' fees
- tips incidental to any of these expenses.

You cannot deduct expenses for transportation while you're not traveling. The IRS says that you're traveling away from home if (1) your duties require you to be away from the general area of your tax home substantially longer than an ordinary day's work, and (2) you need to get sleep or rest to meet the demands of your work. (Napping in your car doesn't count.) Generally, your "tax home" is your main place of business regardless of where your family home is.

If a trip is entirely for business, you can deduct all of your ordinary and necessary travel expenses. If your trip was primarily personal, you can't deduct any travel expenses—even if you did some business at your destination.

What if your trip was primarily for business but you took a vacation-like side trip? Then you need to allocate your expenses; see IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, for instructions. The IRS does give you one break; if you legitimately need to fly somewhere for business, you can write off the entire plane fare, even though you stay over for pleasure after your business is completed.

Meal and entertainment expenses have special rules and restrictions. You can generally deduct only 50% of your business-related meal and entertainment expenses. In addition, the IRS may disallow extravagant and excessive expenses.

But short of fraud or obvious gross excess, the IRS doesn't monitor where you go for your business meals. So in practice, for most small business people, 50% of all business-related meal expenses are deductible. As an employer, this 50% limit applies to your business even if you reimburse your employees for 100% of their meal and entertainment expenses.

If you're a sole proprietor, deduct the allowable portion of your own business travel, meals, and entertainment expenses on Schedule C of your Form 1040. Use Schedule C to also report the expenses that you reimburse or directly pay your employees. (Consult IRS Publication 463 for an in-depth treatment of this subject.)

If you're a partner or a shareholder of a corporation in which you play an active management role, it's usually best to have your partnership or corporation reimburse you for your business-related travel and entertainment expenses. The business can then deduct these amounts to the extent allowed by law.

Excessive expenses may trigger an audit. *Your overall travel and entertainment budget may result in a tax audit if these expenses are out of proportion to what the IRS thinks is reasonable, given your type of business and income. For most honest small business people, this isn't usually a problem unless they have some extraordinary need to travel.*

> **EXAMPLE:** *Ben starts a marble importing business and spends his first year visiting 200 prominent architects and interior designers from coast to coast to introduce his business. His high travel expense triggers an audit, but Ben is able to show that these trips were necessary to get his business off the ground.*

If you are audited, you'll need to show the IRS complete and accurate records of your travel and entertainment expenses, including actual receipts. Also, since you need to tie each trip and meal to a specific business purpose, it makes good sense to keep a log stating the purpose. Otherwise, if challenged, you may have trouble recalling the details.

6. Automobile Expenses

If you use your car for business, you may be able to deduct some or all of your car expenses. Deductible items include:

- gas
- oil
- tolls
- tires
- garage rent
- lease fees
- rental fees
- parking fees
- repairs
- licenses
- depreciation.

The following discussion assumes you use your car more than 50% for business. Special rules apply if you use your car 50% or less for business. For complete information about deductions for your car, again see IRS Publication 463.

If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. (This rule applies to all items you use for both business and personal use.) The miles you put on your car driving from your home to your main place of business are considered to be commuting miles—a personal use, not deductible. The same thing applies to fees you pay to park your car at your place of business.

EXAMPLE: Tricia has a catering business that requires her to call on customers. She drives 20,000 miles during the year: 12,000 for business and 8,000 for personal use (including her daily trips from home to her shop). She can claim only 60% of the cost of operating her car as a business expense (12,000 divided by 20,000). The coins she fed the parking meter in front of her shop each day would be a personal (commuting) expense and not deductible; fees paid for parking while calling on customers would, however, be deductible.

What about depreciation? As with other business assets, you can deduct the cost of a car (but only the portion used for business), but you must spread the deductions over several years. IRS depreciation tables have special schedules for cars. These schedules are updated periodically. For example, if you placed a car in service in 2004 and used it 50% or less for business, your first-year deduction was limited to $2,960 times the percentage of business use. If you used the car more than 50% for business, the maximum first-year depreciation was $10,610.

Depreciation for Employees' Cars. If your employees use their cars in their work, they can't take a depreciation deduction unless this use is for your convenience as their employer and you require it as a condition of employment.

If you don't want to keep track of your car expenses and you want to avoid the complexity of the depreciation rules, the IRS offers a second method for deducting car expenses. You can use the standard mileage rate for your business usage. In 2005, the rate is 40.5 cents per mile. The rate changes periodically, so check IRS publications for the latest figure.

If you're going to use the standard mileage rate, you must start by using it in the year you begin using the car for business. If you don't use the standard mileage rate that first year, you can't use it for that car later on. If you use the standard mileage rate, you can also deduct tolls and parking fees that were paid while on business.

If you take a deduction for car expenses, you must file Form 4562 with your tax return. If you give an employee a car for business and personal use, the employee must report as income the value of the personal usage. For example, an employee who keeps a company car at home and drives to and from work must report that commuting usage—and any other personal usage—as income.

If you lease rather than own your car, you can deduct the part of each lease payment that's for your business use of the car. If you use your leased car 60% for business, you can deduct 60% of each lease payment. You can't deduct any payments you make to buy the car even if the payments are called lease payments. A lease with an option to buy may be a lease or a purchase contract, depending on its wording.

Keep accurate records of your car usage so that if you're challenged by the IRS, you can demonstrate the extent of your business use. The best procedure is to keep a daily log in your glove compartment to record the following about each business trip:

- date
- destination
- mileage
- business purpose.

E. Tax Audits

As a small business owner, you're three times more likely to be audited by the IRS than a regular employee-taxpayer would be. If you're audited, you have the burden of proving that your tax return is accurate. In over 80% of audits, the taxpayer winds up owing more taxes—usually because of poor record keeping rather than dishonesty.

If your business is facing an audit: *You'll get excellent guidance from* Tax Savvy for Small Business, *by Frederick W. Daily (Nolo)—which is the source of much of the material in this section. The* Tax Savvy *book goes through the audit process step by step and in great depth. And if, as* *commonly happens, the business audit turns into a personal audit as well, refer to* Stand Up to the IRS, *which is also by Frederick W. Daily (Nolo).*

1. How the IRS Audits a Small Business

The IRS conducts two kinds of audits of small businesses and their owners: *office* audits and *field* audits. There's a difference not only in where the audit is held, but also in the intensity of the process.

If you're a sole proprietor and gross less than $100,000 per year, the IRS is likely to ask you to come to their office for the audit. Usually an office audit lasts from two to four hours, and a typical business taxpayer is hit for additional taxes averaging about $4,000.

If you have a partnership or corporation, or a sole proprietorship that grosses over $100,000 a year, the IRS will probably order a field audit. The process will be much more intensive than an office audit. Field auditors—called revenue agents—are much better trained in accounting than are IRS office tax auditors. The average amount owed by a business after going through a field audit is over $17,000, including additional tax, penalty, and interest.

An IRS field audit may be conducted at your business place, but doesn't have to be. If your business premises are very small, you might point out that having the audit conducted there would interfere with your operations. Ask that the audit be held elsewhere—at the IRS office, for example. Or if you plan to be represented by a tax professional—a lawyer or accountant with tax experience—you can request that the audit be conducted at the professional's office.

Even though you have the right to have an audit conducted elsewhere, an auditor has the power to enter your business if it's open to the public. But an auditor can't go into a private area—such as a storeroom or your private office—unless you consent. But if you have nothing to hide, there's no reason to raise suspicions by denying access. Offer the IRS auditor a complete tour.

If you have a home office, you don't have to let an auditor into your home unless there's a court order. But if you refuse entry, your home office depreciation or rental expense will probably be disallowed because you haven't proven you had a home office.

2. The IRS Inquiry

Wherever the audit is conducted, the auditor will want to see the business records you used to prepare the tax returns. This can include check registers, bank statements, canceled checks, receipts, invoices, and a formal set of books.

To get still more financial information about you and your business, an auditor can require records from your tax preparer, banks, suppliers, customers, and others.

3. Hiring a Tax Professional

Many small business owners can handle a run of the mill IRS office audit without professional representation. Often it's sensible to do this, since the cost of hiring professional help may be more than the IRS is likely to bill you. However, if you fear that some serious irregularity may come to light—perhaps you've taken a huge deduction and can't produce a receipt or canceled check to verify it—consult with a tax professional before the audit.

When it comes to a field audit, where more money will almost surely be at stake, it's usually wise to bring in a tax professional from the outset. The IRS uses experienced auditors to conduct field audits, so you may be overmatched if questions come up about your documents or interpretations of the tax law.

4. Preparing for Your Audit

Thoroughly review the tax return that's going to be audited.

Make sure you can explain how you came up with the figures. Identify problem areas, such as how you reported particular items of income or expense.

Then find all the records you need to substantiate your tax return and organize them logically and clearly for the auditor. Among the items to gather up for the audit are:

- bank statements, canceled checks, and receipts
- electronic records—for example, charge card statements
- books and records—which can range from a formal set of books to cash register tapes
- appointment books, logs, and diaries
- car records, and
- travel and entertainment records.

If records are missing, you may still be able to prove a deduction by offering an oral explanation or by reconstructing records in writing. Business-related expenses of less than $25 each don't require substantiation.

Neatness counts. *It can be tempting to dump a pile of receipts on the table and require the auditor to search through them. This is one temptation you'll want to avoid. Neatness helps build credibility with the auditor who, when presented with well-maintained records, may even give you the benefit of the doubt on questionable items.*

5. What Auditors Look For

In auditing your business, the IRS will try to determine if you

- failed to report all of your business sales or receipts (income)
- skimmed cash from the business
- wrote off personal living costs—family travel, for example—as business expenses
- failed to file payroll tax returns on time or to make the required deposits, or
- improperly classified some workers as independent contractors rather than employees.

This isn't a complete list—just the things the IRS auditor will most likely scrutinize.

Be prepared for an analysis of your bank accounts. Office auditors don't always take the time to do this, but field auditors do. This consists of adding up all the deposits in all your business bank accounts to see if the total is more than your reported income. The auditor will also want to see all of your personal account records to learn if the amounts deposited are consistent with your business cash flow.

It's smart to review your bank accounts in advance to try to spot and be able to explain deposits that weren't income and therefore weren't reported on your tax return—loan proceeds, for example, or proceeds from the sale of assets (other than the capital gain portion), transfers from other accounts, inheritances, gifts, or money held for relatives.

After confirming that your income figures are accurate, turn to your business expenses. The tax law makes you prove that your deductions were legitimate; the IRS doesn't have to disprove them. Be especially careful to have good documentation for deductions you took for travel and entertainment, a home office, thefts, bad debts, depreciation, and car expenses—all prime targets during an IRS probe.

If you can't produce thorough records to back up your deductions, don't despair. You may be able to reconstruct the missing documents. For guidance on how to do this, see *Tax Savvy for Small Business,* by Frederick W. Daily (Nolo).

6. How to Behave at an Audit

Keep small talk to a minimum. An auditor is trained to listen for clues about your lifestyle—which may not seem affordable on your reported income. Raising suspicions in an auditor's mind can prolong the agony of an audit.

If you're asked a direct question, try to answer "yes" or "no." Don't over-explain or answer questions that weren't asked. If you don't have a ready answer, it's OK to say, "I don't know" or "I'll get back to you on that," or "I'll have to check with my accountant." Often the auditor will let it go. At the very least, you've bought some time, which can work to your advantage.

Most auditors are businesslike, but now and then you run into one who's impolite, hostile—or maybe is just having a bad day. You're entitled to courteous treatment from IRS auditors. If your auditor gets out of line, mention your right to courteous treatment and politely ask the auditor to lighten up. If that doesn't work, ask to speak to the auditor's manager and describe the unfair treatment you're receiving.

It's all right to ask for time out. *You can stop or recess an audit for just about any good reason—for a few minutes to go to the bathroom or eat lunch, or for the day because you feel ill or need to confer with a tax professional. If you ask for a recess, the auditor may find it more convenient to resume the audit in a week or two—giving you time to regroup or get professional advice.*

7. How to Negotiate With an Auditor

As Fred Daily explains in much greater depth in *Tax Savvy for Small Business* (Nolo), there's often room to bargain during the audit process—despite the official line that IRS auditors don't negotiate.

One approach is to suggest that a disputed item be resolved by applying a percentage figure. Suppose you claimed the costs of a trip as a business deduction. The auditor, believing it was a personal trip, wants to disallow the deduction. You might say: "Perhaps, in fairness, the trip can be seen as being both for business and pleasure. How about agreeing that 70% of the expenses were for business and 30% for pleasure?" This may work. On the other hand, IRS auditors are instructed not to talk about compromising the dollars—so you may not get as far by using a more direct approach and proposing, for example, to pay $5,000 to settle a $10,000 IRS claim.

Another tactic in negotiating is to take the offensive. An audit isn't a one-way street. Auditors must make adjustments in your favor when you're legally entitled to one. Maybe you missed a deduction or were overly conservative on your return. When the auditor's review has been completed, bring up the items that entitle you to an adjustment in your favor. This can help offset the amounts the auditor claims you owe. ■

CHAPTER

9

Raising Money for Your Business

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To succeed in business, you'll need money to get started and to keep afloat until you become profitable—and, assuming you're successful, you'll probably need more money to expand than you can generate internally. How much you'll need and when you'll need it will depend on the nature of the business. However, unless you have a good-sized nest egg put aside or are starting a tiny, home-based business on a shoestring, finding money to finance your new enterprise is likely to be a major concern.

Fortunately, there are many places to look for startup funds. If one source doesn't pan out, you can try another and then another.

And there's no requirement that you get all your money from a single source. Often, you can tap a combination of sources—for example, savings, loans, and equity investments—to provide the needed funds. In this chapter, we'll look at all of these sources—and the legal rules that apply.

Watch your pennies. *Although you may be chomping at the bit to get your new business going, it can be a mistake to pour in too much money at the beginning. You need time to learn whether the business is viable. Because a fair number of small businesses fail, raising and spending a pile of money for an untested business idea can lead to much grief—especially if you're personally on the hook for borrowed funds. While some small businesses require a great deal of cash or credit up front, my experience is that many others don't. Consider starting as small and cheaply as possible. If your concept works, more funds will become available. If not, you can move on and take advantage of the lessons you've learned—and you won't be burdened with a ton of debts.*

A Business Plan Can Help

Before you start searching for money, it's helpful to write a business plan—a statement that analyzes your proposed business and explains how it will become profitable. *How to Write a Business Plan,* by Mike McKeever (Nolo), offers step-by-step guidance. McKeever suggests that a simple plan include the following elements:

- business description
- your personal business-related accomplishments
- sales revenue forecast
- profit and loss forecast
- capital spending plan, and
- cash flow forecast.

For a more sophisticated plan, McKeever recommends that the following elements be added:

- marketing plan
- future trends
- risks your business faces
- personnel plan
- specific business goals
- your personal financial statement, and
- your personal background—including your strong and weak points.

A major part of your business plan should cover how much money you'll need to get started and how you'll pay it back. Be conservative in projecting income. It may take months before a significant amount of money starts flowing into the business. Obviously, you'll need sufficient funds to carry you through the startup period. A cash flow analysis can help you decide how much money you should start out with so you can weather the lean, early days of the business and give yourself a reasonable chance to find out if the business can turn a profit.

Putting numbers on paper also forces you to focus on where the money will be coming from and how it will flow through your business. This is a valuable reality test for you and—equally important—it's something that lenders and investors will want to look at before shelling out money.

A. Two Types of Outside Financing

If you're starting a small business, chances are that at least part of the initial funding will come from your own pocket—savings, an inheritance, or a severance check you received for taking early retirement. But you may also need to seek money from outside sources, so it's important to understand the two main categories of such funding and the differences between them. One category consists of loans; the other consists of equity investments.

1. Loans

As you know, a loan is based on a simple idea: someone gives you money and you promise to pay it back—usually with interest. Since you must pay back the lender whether your business is a fabulous success or a miserable failure, the entire risk of your new enterprise is placed squarely on your shoulders.

Of course, nothing in business—or in life, for that matter—is without risk. Nevertheless, a commercial lender will be unwilling to lend you money if the odds of your repaying the money look low. And to help keep the risk down, a lender will very likely ask for security for the loan—for example, a mortgage on your house so that the lender can take and sell your house if you don't keep up your loan payments.

But as compared to selling a portion of your business to investors, there's an obvious plus side to borrowing money: If your business succeeds as you hope and you pay back the lender as promised, you reap all future profits. There's no need to share them.

In short, if you're confident about the prospects of your business and you have the opportunity to borrow money, a loan is a more attractive source of money than getting it from an equity investor who will own a piece of your business and receive a share of the profits. Again, the downside is that if the business fails and you've personally guaranteed the loan, you'll have to repay it. By contrast, you don't have to repay equity investors if the business goes under.

Loans are so common that you probably are familiar with the mechanics, but nevertheless it makes sense to review the basics.

a. The Promissory Note

A lender will almost always want you to sign a written promissory note—a paper that says, in effect, "I promise to pay you $XXX plus interest of XX%" and then describes how and when payments are to be made. (See Section C2 for a sample form.) A bank or other commercial lender will use a form with a bit more wording than our form, but the basic idea is always the same.

A friend or relative may be willing to lend you money on a handshake. This is a poor idea for both of you. It's always a better business practice to put the loan in writing—and to state a specific interest rate and repayment plan. Otherwise, you open the door to unfortunate misunderstandings that can unnecessarily chill a great relationship.

Sign only the original of the promissory note. When it's paid off, you're entitled to get it back. You don't want several signed copies floating around that can cast doubt on whether the debt has been fully paid. But you should keep a photocopy of the signed note—marked "COPY"—for your business records.

b. Repayment Plans

If the interest rate on the loan doesn't exceed the maximum rate allowed by your state's usury law, you and the lender are free to work out the terms of repayment.

Typically, a state's usury law will allow a lender to charge a higher rate when lending money for business purposes than for personal reasons—in fact, in several of these state laws, there's no limit at all on the interest rate that can be charged on business loans, as long as the business borrower agrees to the rate in writing.

In a few states, the higher limit or absence of any limit applies only when the business borrower is organized as a corporation. In other states, the higher rates permitted for business borrowers are legal even if the borrower is a sole proprietorship, partnership, or limited liability company.

Check your state usury law. *As a general rule, if your business is a corporation and the terms of repayment are in a promissory note, the lender can safely charge interest of up to 10% per year and not have to worry about the usury law. But because there's so much variation in usury laws from state to state, you or the lender should check the law. Look under interest or usury in the index to your state's statutes. (For more on doing your own legal research, see Chapter 24.)*

Assuming there are no usury law problems, you and the lender can agree on any number of repayment plans. Let's say you borrow $10,000 with interest at the rate of 10% a year. Here are just a few of the repayment possibilities:

- *Lump sum repayment.* You agree, for example, to pay principal and interest in one lump sum at the end of one year. Under this plan, 12 months later you'd pay the lender $10,000 in "principal"—the borrowed amount—plus $1,000 in interest.
- *Periodic interest and lump sum repayment of principal.* You agree, for example, to pay interest only for two years and then interest and principal at the end of the third year. With this type of loan plan—often called a "balloon" loan because of the big payment at the end—you'd pay $1,000 in interest at the end of the first and second years, and then $10,000 in principal and $1,000 in interest at the end of the third year.
- *Periodic payments of principal and interest.* You agree, for example, to repay $2,500 of the principal each year for four years, plus interest at the end of each year. Under this plan, your payments would look like this:
  End of Year One:
  $2,500 principal + $1,000 interest
  End of Year Two:
  $2,500 principal + $750 interest
  End of Year Three:
  $2,500 principal + $500 interest
  End of Year Four:
  $2,500 principal + $250 interest.
- *Amortized payments.* You agree, for example, to make equal monthly payments so that principal and interest are fully paid in five years. Under this plan, you'd consult an amortization table in a book, on computer software, or on the Internet to figure out how much must be paid each month for five years to fully to pay off a $10,000 loan plus the 10% interest. The table would say you'd have to pay $212.48 a month. Each of your payments would consist of both principal and interest. At the beginning of the repayment period, the interest portion of each payment would be large; at the end, it would be small.
- *Amortized payments with a balloon.* You agree, for example, to make equal monthly payments based on a five-year amortization schedule, but to pay off the remaining principal at the end of the third year. Under this plan, you'd pay $212.48 each month for three years. At the end of the third year after making the normal monthly payment, there'd still be $4,604.42 in unpaid principal, so along with your normal payment of $212.48, you'd make a balloon payment to cover the remaining principal.

Avoid loans with prepayment penalties. *Whenever you borrow money, you'd like to be free to reduce or pay off the principal faster than called for in the promissory note if you have the wherewithal to do so, since this reduces or stops the running of interest. In other words, if you have a three-year loan but are able to pay it off by the end of year two, you don't want to pay interest for year three. By law, some states always allow such early repayment and you pay interest only for the time you have the use of the borrowed money. In other states, however, the law allows a lender to charge a penalty (amounting to a portion of the future interest) when a borrower reduces the balance or pays back a loan sooner than called for. Because it seems unfair to have to pay anything for the use of borrowed money except interest for the time the principal is actually in your hands, try to make sure any promissory note you sign says you can prepay any or all of the principal without penalty. If the lender doesn't agree, see if you can negotiate a compromise under which you'll owe a prepayment penalty only if you pay back the loan during a relatively short period, such as six months from the time you borrow the money.*

c. Security

Lenders, with the possible exception of friends or relatives, will probably require you to provide some valuable property—called security or collateral—that they can grab and sell to collect their money if you can't keep up with the loan repayment plan. For example, the lender may seek a second mortgage or deed of trust on your house, or may ask for a security interest or lien on your mutual funds or the equipment, inventory, and accounts receivable of your business. Again, the reason for doing this is if you don't make your payments, the lender can sell the pledged assets (the security) to pay off the loan.

But it's important to realize that a lender isn't limited to using the pledged assets to satisfy the loan. If you don't make good on your repayment commitment, a lender also has the right to sue you.

Typically, a lender will seize pledged assets first and then sue you only if the funds realized from those assets are insufficient to pay off the loan—but that's not a legal requirement. A lender may decide to sue you before using up the pledged assets. If the lender wins the lawsuit and gets a judgment against you, assets you haven't specifically pledged as security are at risk—as is a portion of your future earnings.

In short, before you borrow money—under either a secured or unsecured promissory note—think about what will happen if you run into financial problems.

d. Cosigners and Guarantors

If you lack sufficient assets to pledge as security for a loan, a lender may try other methods to attempt to guarantee that the loan will be prepaid. One is to ask you to get someone who is richer than you to cosign or guarantee the loan. That means the lender will have two people rather than one to collect from if you don't make your payments.

When asking friends or relatives to cosign or guarantee a promissory note, be sure they understand that they're risking their personal assets if you don't repay it.

If you're married, the lender may insist that your spouse cosign the promissory note. Be aware that if your spouse signs, not only are your personal assets at risk, but also those assets that the two of you jointly own—a house, for example, or a bank account. What's more, if your spouse has a job, his or her earnings will be subject to garnishment if the lender sues and gets a judgment against the two of you because the loan isn't repaid as promised.

Community Property States

If you live in a community property state—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin—you'll need to do a bit of research or consult briefly with a business lawyer to learn the legal effect of your spouse cosigning a promissory note. (See Chapter 24.) In researching Wisconsin law, you'd look under marital property, but the concept is the same as community property for all practical purposes.

In a community property state, debts incurred by one spouse are usually the legal responsibility of both—meaning that a couple's community property is at risk if the debt isn't paid.

In addition to community property, you or your spouse may have separate property—which, depending on the law of the particular community property state, is usually property owned by a spouse prior to marriage or acquired after marriage by gift or inheritance. The effect of your spouse cosigning a promissory note for a business loan is to obligate his or her separate property, as well, to repay the loan.

Forming a corporation or LLC may not protect you from personal liability on a loan. *As explained in Chapter 1, a virtue of doing business as a corporation or a limited liability company (LLC) is that corporate shareholders and LLC members aren't personally liable for paying business debts, including loans made by the corporation or LLC. But a small corporation or LLC—especially one just starting up—will find it impossible to borrow money from a bank or other sophisticated lender unless the shareholders or members personally guarantee repayment. And if this guarantee is made, the shareholders or members are just as obligated to repay the loan as if they signed as personal borrowers in the first place. Typically, lenders will continue to require that shareholders or LLC members guarantee repayment of a corporate or LLC loan—at least until the business is well established and has a long record of being profitable.*

2. Equity Investments

Equity investors buy a piece of your business. They become co-owners and share in the fortunes and misfortunes of your business. Like you, they can make or lose a bundle. Generally, if your business does badly or flops, you're under no obligation to pay them back their money.

However, some equity investors would like to have their cake and eat it too; they want you to guarantee some return on their investment even if the business does poorly. Unless you're really desperate for the cash, avoid an investor who wants a guarantee. It's simply too risky a proposition for someone starting or running a small business.

a. Limiting Risk

Because equity investors are co-owners of the business, they may be exposed to personal liability for all business debts unless your business is a corporation, limited partnership, or limited liability company. If you recruit equity investors for what has been your sole proprietorship, your business will now be treated as a general partnership. This means your equity investors will be considered to be general partners, whether or not they take part in running the business. And, as explained in Chapter 1, as far as people outside of the business are concerned—people who are owed money or who have a judgment against the business—general partners are all personally liable for the debts of the partnership.

Equity investors often want to limit their losses to what they put into the business. An investor who puts $10,000 into a business may be prepared to lose the $10,000—but no more. In short, the investor doesn't want to put the rest of his or her assets at risk. The investor will want to avoid being—or being treated as—a general partner.

Fortunately, there are three common ways to organize your business so that you can offer an investor protection from losses beyond the money being invested.

- *Corporation.* Form a corporation and issue stock to the investor. A shareholder who doesn't participate in corporate activities and decision making is virtually free from liability beyond his or her original investment. A shareholder who does help run the company is liable to outsiders for his or her own actions—for example, making slanderous statements or negligently operating a piece of equipment—but isn't liable for corporate debts or the actions of corporate employees.
- *Limited Partnership.* Form a limited partnership and make the investor a limited partner. A limited partner's freedom from liability is similar to that of a shareholder, as long as the limited partner doesn't become actively involved in running the business.
- *Limited Liability Company.* Form a limited liability company and make the investor a member. The investor will be protected in much the same manner as a shareholder or limited partner.

Each of these business formats is described in much greater detail in Chapter 1.

Encourage investors to determine their own degree of risk. *As mentioned, an investor in a business organized as a corporation, limited partnership, or limited liability company usually stands to lose no more than his or her investment. However, state laws must be followed carefully to achieve this result. To avoid having investors accuse you of giving misleading assurances, recommend that they check with their own financial and legal advisors to evaluate whether their investment exposes them to the possibility of incurring additional losses.*

b. Return on Investment

Someone who invests in your business may be willing to face the loss of the entire investment and not insist that you guarantee repayment. But to offset the risk of losing the invested money, the investor may want to receive substantial benefits if the business is successful.

For example, an investor may insist on a generous percentage of the business profits and, to help assure that there are such profits, may seek to put a cap on your salary. The terms are always negotiable—there's no formula for figuring out what's fair to both you and the investor.

Here are just a few possibilities:

- John, a former police detective, decides to start a business to offer security training seminars to midsized manufacturing companies. He forms STS Limited Liability Company and invests $10,000, which is only part of his $20,000 start-up budget. His aunt Paula, recently widowed, invests $10,000 of her inheritance in the company. The STS operating agreement states that John will be in full control of day-to-day operations. John and Paula agree in writing that John will receive a salary of no more than $4,000 a month from STS for the first four years, and that Paula will receive 60% of STS profits during that period. After that, John's salary will be tied to gross receipts, and John and Paula will share profits equally.
- Stella wants to start a travel agency. She approaches Edgar, a friend from college days, who has just sold a screenplay to a major studio and is looking for investment opportunities. They agree that Stella will form a limited partnership and act as the general partner. Edgar will invest $60,000 in the business and become a limited partner. Stella will work for $3,000 a month and use the first profits of the travel agency pay back Edgar's $60,000 investment. After that, the profits will be split 50/50.
- Larry, an experienced carpenter, wants to become a general contractor so he can build cus-

tom homes and do major remodeling jobs. He's able to invest his savings of $30,000 in his new venture, but needs another $20,000 to get started. Larry forms a corporation, Prestige Homes Inc., and invites his friend Brook, who owns a building supply business, to invest $20,000 in return for a 40% interest in Prestige Homes. Brook agrees, on the condition that the new corporation will buy all its lumber and other building materials from Brook's company—and, in addition, pay Brook $5,000 for each home that's built by Prestige Homes. They sign a shareholders' agreement containing those terms.

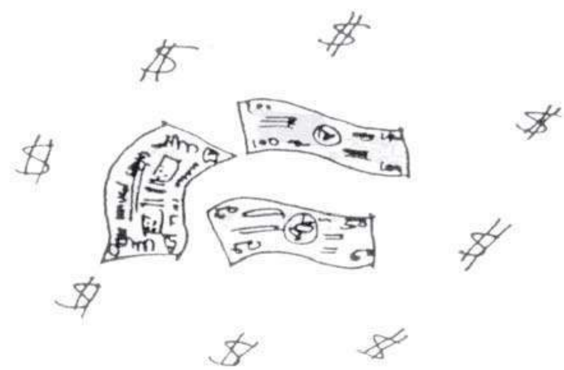
c. Compliance With Securities Regulations

The law treats corporate shares and limited partnership interests as securities. Issuing these securities to investors is regulated by federal and state law. In some cases, an investor's interest in a limited liability company may also come under these laws.

This means that before selling an investor an interest in your business, you'll need to learn more about the requirements of the securities laws. Fortunately, there are generous exemptions that normally allow a small business to provide a limited number of investors an interest in the business without complicated paperwork. Chances are good that your business will be able to qualify for these exemptions.

In the rare cases in which the exemptions won't work for your small business and you have to meet the complex requirements of the securities laws—such as distributing an approved prospectus to potential investors—it's probably too much trouble to do the deal unless a great deal of money is involved.

For a first-rate introduction to securities laws and the exemptions for small businesses: *See* Incorporate Your Business: A 50-State Legal Guide to Forming a Corporation, *or* How to Form Your Own California Corporation, *both by Anthony Mancuso (Nolo).*



B. Thirteen Common Sources of Money

While there are many sources of money for a small business, some are more accessible than others. There are 13 that entrepreneurs tend to rely on most frequently.

1. Salary

"Don't give up your day job." That's the advice commonly given to aspiring actors and musicians—but it's equally applicable to many entrepreneurs who are testing the waters. If you start small enough, you may be able to stay afloat for many months by continuing your full-time job or cutting back to part time. This steady source of income can reduce your need for turning to others for start-up funds and can help keep you solvent if the business doesn't succeed.

2. Personal Savings

Putting your own money into your business is the simplest way to get started or to expand your business. You avoid entanglements with others, keep your business affairs private, and steer clear of possible legal complications.

If your business takes off, you'll own business assets—such as inventory, equipment, and furniture—free of debt, making it easier to borrow money later or bring equity investors into the business.

Your money may come from savings that you've carefully accumulated over the years. Or it may come from a lump sum of money that's available all at once. For example, you may have received an inheritance from a relative or an attractive severance package from a job you've just left. Or perhaps you've sold your house and will be living in a less expensive one or in rented quarters. Investing this money in your own business may yield a bigger return than you could ever expect to receive by investing it in someone else's business.

Try to keep some cash in reserve. *Since no business is risk-free and the cash flow is usually unpredictable, it makes sense not to commit every last dollar to your business. Yes, this can be extremely hard to do. But if you can plan well enough to keep a reasonable amount of cash on hand to cover several months' worth of living expenses and possible medical emergencies, you'll improve your odds of succeeding in business. And you'll receive an added bonus of not having to worry constantly about how to pay personal bills.*

If You're the Beneficiary of a Trust Fund

Another possible source of funds can be a trust fund established on your behalf at the death of a parent, grandparent, or other relative. Often these funds provide the beneficiary with income for a number of years before the trust ends and all remaining funds are turned over to the beneficiary in a lump sum. However, in the meantime, the trustee often has the discretionary power to take additional money out of the trust for a good reason, such as education, health needs, and possibly starting a business.

Since the trustee's discretion will be tied to the specific wording of the trust document, you'll want to start by reading it carefully. But assuming that distributing money for a business venture would qualify as a proper purpose under the trust, you should present your business plan to the trustee. If the trustee agrees that your plan has merit, this can magically free up the cash you're looking for.

3. Equity in Your Home

If you own a home, you may be able to tap into a portion of the equity to raise cash. As you know, equity is the difference between what the home is worth and how much is left on the mortgage. Let's say you bought your home several years ago for $150,000 by paying $30,000 down and getting a $120,000 mortgage. Today, the house would sell for $200,000 and the mortgage balance is down to $100,000. You have $100,000 in equity—some of which you can use to help finance your business.

There are two ways to get your hands on a portion of the equity. One is to get a new, larger mortgage that will pay off the earlier one and still yield some cash. For example, if you get a new mortgage for $160,000—which is 80% of the home's current value and likely to be approved by a conservative lender—you'll have $60,000 after the earlier mortgage balance of $100,000 is paid off.

Unfortunately, the actual amount you'll end up with will be significantly less because the bank will require you to pay some hefty costs for processing the mortgage. These transaction costs typically include an application fee, document preparation fees, closing costs known as points, fees for a personal credit check, an appraisal of the home, and mortgage title insurance.

Plan carefully before applying for a new mortgage. *If your purpose in getting a new mortgage is to raise a relatively small amount of money for your business, make sure you understand all of the costs involved. Obviously, unless it's your only way to raise money, you don't want to plunk down $2,000 in expenses to get your hands on $10,000 that, of course, will also require you to pay interest. Before applying for a mortgage, ask the lender to itemize the costs involved. Also, if you're planning to quit your job or cut back to half-time to run the business, it may be wise to wait until after the mortgage loan has been made—especially if you don't have a spouse or significant other earning a decent income. This is because before approving the new mortgage, the lender will be looking at your ability to repay. Having a steady source of income from a job when you apply for and receive a mortgage loan can help convince the lender to approve the loan.*

The second approach is to apply for a line of credit based on your home equity. The bank will have a second mortgage on your home. Using the assumptions in the example, you may be able to obtain a line of credit for $60,000. Typically, the bank will give you a checkbook that you can use to write checks against the line of credit. Your monthly payment to the bank will depend on how much of the credit line you've used.

Deciding which method to use can be difficult. A line of credit will likely cost less to set up—perhaps there will simply be a $250 upfront fee rather than a few thousand dollars in closing costs for a mortgage—but the interest rate will likely be higher or, if the loan has a variable interest rate, the bank will have the right to increase the interest rate if interest rates in the overall economy rise.

Don't overdo borrowing against your house. *Whichever method you use to borrow against your house, you put your home at risk if you can't meet the repayment schedule. You don't want to lose your house to the lender or be forced to sell under pressure of an imminent foreclosure to save a portion of the equity. So don't borrow more than you absolutely need. Also, take time to figure out how you'll make the mortgage payments if your business is slow to get off the ground or you end up closing it. One good approach is to look for a loan with a long repayment window and, hence, lower monthly payments. If your business does well, you can always repay the loan sooner.*

4. Retirement Savings

If you have money in a retirement savings plan where you work, you may be able to borrow some of that money. As you know, income tax on the money you contribute to an IRS-qualified plan—such as a 401(k) plan—is deferred, allowing your retirement to grow faster.

Check the plan language to see whether loans are allowed for business purposes. If so, you should be able to borrow up to one-half of what you have in the plan—but no more than $50,000. Also check other conditions, such as the maximum term allowed for a loan (typically, five years), the interest rate, and the loan fees. You will have to pay interest on the money you borrow from your plan, but that's not all bad. Because the money you're borrowing is yours, the interest goes back into your plan.

Generally, unless you've reached the age of 59½, you wouldn't be wise to simply take rather than borrow money from the tax-deferred plan. Early withdrawals are subject to a penalty tax. After age

59½, however, IRS rules allow you to withdraw funds without paying a penalty tax.

Don't borrow from an IRA. *Unfortunately, if you borrow money from an Individual Retirement Account (IRA), it will be treated as a withdrawal and you'll have to pay a penalty tax if you're not yet 59 ½ years old.*

5. Credit Cards

You can use your credit cards to help finance your business. Plastic can quickly get you a computer and fax machine—and probably other business equipment and furniture as well. And for expenses such as rent, phone bills, or money to pay employees, you can usually get a cash advance.

Credit cards are a convenient way to arrange for short-term financing because they're so easy to use. Over the long haul, however, they're less attractive—mainly because the interest charges are relatively high, often as much as 20% or more per year. If you're going to succeed in business, you shouldn't need me to tell you not to borrow very much for very long at those rates.

6. Buying on Credit

The companies from which you're buying goods or services may offer favorable credit terms to capture your business. Often this will mean you don't have to pay your bill for 30 or 60 or more days. Or you may be able to spread payments for a purchase over a period of several months with no finance charges as long as you pay each installment on time. And the interest rate that's charged may be substantially lower than that charged by a credit card company.

Don't be discouraged by the fact that the best credit terms usually go to established businesses and that new businesses typically have to pay up front. Credit decisions are somewhat subjective, leaving you room to convince the seller that your new business deserves special consideration.

Especially if you'll need starting inventory, as in the case of a retail store, call suppliers and ask for help. Show them a copy of your credit history and business plan. If they look good and you're persuasive, you may be able to get a fair amount of your inventory on favorable terms.

7. Leasing

If you need equipment—anything from computers and copiers to forklifts and trucks—consider leasing it. True, leasing doesn't put money directly in your hands but, almost as good from a cash flow point of view, it does reduce the amount of cash you'd have to come up with if you were to instead buy the same equipment. And many leases offer you the option to acquire the equipment for a nominal amount when the lease period is over.

Over the long term, leasing usually costs a bit more than buying—but if the cash flow from your business will be tight for a few years, leasing can be an effective way to get the equipment you need now.

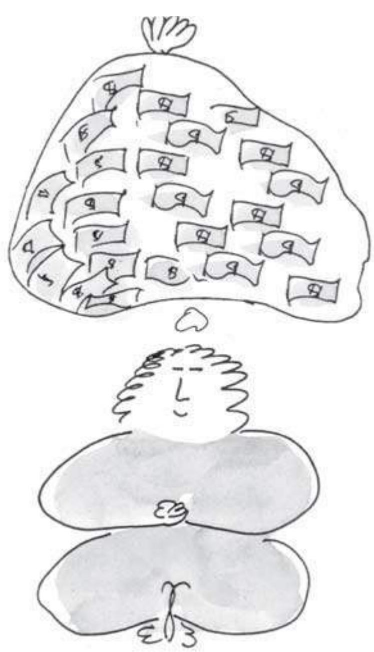
8. Friends, Relatives, and Business Associates

Those close to you can often lend you money or invest in your business. This helps you avoid the hassle of pleading your case to outsiders and enduring extra paperwork and bureaucratic delays—and can be especially valuable if you've been through bankruptcy or had other credit problems that would make borrowing from a commercial lender difficult or impossible.

Some advantages of borrowing money from people you know well are that you may be charged a lower interest rate, may be able to delay paying back money until you're more established, and may be given more flexibility if you get into a jam. But once the loan terms are agreed to, there's one thing that borrowing from friends, relatives, or business associates doesn't do. It doesn't legally diminish your obligation to meet those terms.

In addition, borrowing money from relatives and friends can have a big downside. There's always the possibility that if your business does poorly and those close to you end up losing money, you'll damage a good personal relationship. So in dealing with friends, relatives, and business associates, be extra careful to not only clearly establish the terms of the deal and put it in writing, but also make an extra effort to explain the risks. In short, it's your job to make sure your helpful friend or relative won't suffer a true hardship if you're unable to meet your financial commitments.

Don't borrow from people on fixed incomes. *Don't borrow or accept investment money from folks who can't afford to lose money. It's fine to borrow needed money from your Mom if she's well enough off that lending you $20,000 won't put her in the poorhouse if things go wrong and you can't repay the loan. But if your Mom lives on Social Security, don't borrow her last $10,000 no matter how badly you need it. If you do and your business fails, you'll be about as miserable as it's possible to be.*



Gifts Can Save Taxes

If you're likely to inherit money from a parent or grandparent in the future, it can make sense for them to make a gift now. Why? Because if a family member's estate exceeds a certain amount ($1.5 million in 2005, rising to $2 million in 2006), the excess will be heavily taxed by the federal government when that person dies.

By contrast, up to fairly generous limits, there will be no estate or gift tax on the money the relative gives away while alive. Specifically, an individual can make a gift of up to $11,000 per year per person free of any federal gift or estate tax—and a couple can give twice that amount.

For example, your mother and father can each give $11,000 to you and $11,000 to your spouse—a total of $44,000—in one year. This has the effect of removing this money from their estates with neither a federal estate or gift tax. Obviously, gifts of that size can be a big boost to any small business since there is no worry about the need to repay.

How to promote family harmony. *If your parents give you money for your business, it may make sense for them to make equal gifts to the other children. Or if the parent isn't financially able to do this, he or she can even things out by leaving the other children more in a will or trust. If this is done, the reason for the discrepancy can be explained in the will or trust, or in a separate letter.*

For detailed information on gifts and the tax laws: *See* Plan Your Estate*, by Denis Clifford and Cora Jordan (Nolo).*

9. Supporters

As Mike McKeever points out in *How to Write a Business Plan* (Nolo), many types of businesses have loyal and devoted followers—people who care as much about the business as the owners do. A health food restaurant, a women's bookstore, an import car repair shop, or an art studio, for example, may attract people who are enthusiastic about lending money to or investing in the business because it fits in with their lifestyle or beliefs.

Their decision to participate is driven to some extent by their feelings and is not strictly a business proposition. These people can also be a source of great ideas—ideas that can be as valuable as money—and they'll be happy to share these with you at no charge.

The rules for borrowing from friends and relatives apply here as well. Put repayment terms in writing—and don't accept money from people who can't afford to risk it.

10. Banks

Banks are in the money business, so it's natural to look to them for startup funds. It's hard to predict, however, whether the banks you approach will be willing to lend you money on reasonable terms.

Historically, banks were reluctant to lend substantial sums to a new business, even if the owner was willing to pledge a house or other valuable asset as security for repayment (for example, by giving the bank a second mortgage). Often this reluctance to lend was attributable to the fact that loan officers were looking for an established record of business profitability which, of course, a new business couldn't provide.

Fortunately, that standoffish attitude is starting to crumble. Many banks, in fact, have departments geared especially to the needs of small businesses—and some are even eager to establish a banking relationship with those just getting started. With a little luck, you may be able to locate such an enlightened, small-business-oriented bank in your community. As you might imagine, banks offer their best terms to businesses that appear the least risky and that are likely to maintain sizable deposits as the business grows.

Banks tend to respond more favorably to loan applications when the requested loan has been guaranteed by the Small Business Administration (SBA). Two SBA loan programs are particularly worth a look:

- **Basic 7(a) Loan Program.** If you qualify, the SBA will typically guarantee up to 85% of a loan of $150,000 or less, and up to 75% of a loan above $150,000. You can use the loan proceeds for most sound business purposes, such as working capital, equipment, and buying or renovating a building. You get the loan from a commercial lender, and the SBA supplies the guarantee.
- **Microloans.** These are short-term loans to let you buy inventory, supplies, furniture, fixtures, and equipment. You can borrow up to $35,000, but the average loan is about $10,500. You apply through a local intermediary lender—a nonprofit organization with experience in lending and in giving technical assistance. The funds are provided by the SBA.

Check out the SBA's loan prequalification program. *SBA-affiliated experts are available to analyze your loan application, as long as you're not applying for more than $250,000. The program focuses on your character, credit, experience, and reliability, rather than on your assets. The expert will work with you to strengthen your loan application and improve your chances of qualifying for an SBA loan or guarantee.*

Want more information on SBA loans? *The best starting point is the SBA website, www.sba.gov.*

11. Other Commercial Lenders

If you can't get a bank loan, consider applying to other commercial lenders, such as Allied Capital Corp., the Money Store, or GE Capital. More than one third of the money loaned to small businesses comes from these nonbank sources. They're often less tightfisted than banks and may give more weight to intangible factors like your business vision and personal integrity. You'll be in an especially good position to borrow from a nonbank lender if your loan qualifies for SBA backing.

The Five C's of Credit

Bankers like to speak of the five C's of credit analysis—factors they look at when they evaluate a loan request. When applying to a bank for a loan, be prepared to address these points.

- **Character.** Bankers lend money to borrowers who appear honest and who have a good credit history. Before you apply for a loan, obtain a copy of your credit report and clean up any problems.
- **Capacity.** This is a prediction of the borrower's ability to repay the loan. For a new business, bankers look at the business plan. For an existing business, bankers consider financial statements and industry trends.
- **Collateral.** Bankers generally want a borrower to pledge an asset that can be sold to pay off the loan if the borrower lacks funds.
- **Capital.** The borrower's net worth—the amount by which assets exceed debts—is scrutinized.
- **Conditions.** The current economic climate can influence whether a loan is given and the amount of the loan.

12. Venture Capitalists

There are companies and individuals looking to invest in extraordinary companies that will reward them with large profits. See if your city has a venture capital club which helps introduce new businesses to venture capitalists. If so, get in contact and find out how you can meet potential investors.

Often you'll be afforded a chance to make a short presentation which can make an impression on someone with deep pockets. Your local or state chamber of commerce should be able to direct you to the closest club, or you can check with the instructor of a business school that offers courses in entrepreneurship.

13. The Seller of an Existing Business

If you're buying an existing business, you may be able to negotiate favorable payment terms—which can reduce the amount of cash you have to come up with. You have a number of variables to work with. Try to keep the down payment low and see if the seller will agree to below-market interest rates or will even charge no interest for the first year or two.

Try, too, to extend the payments over as many years as possible. As with a bank loan, you can always pay the debt off early if your business prospers. (For more on buying a business, see Chapter 10.)

C. Document All Money You Receive

In raising money for your business, you should be familiar with the basic paperwork and other legal requirements, a number of which I've already mentioned in this chapter.

Chapter 4 of *Legal Forms for Starting & Running a Small Business* contains several promissory note forms and a security agreement.

1. Gifts

If a family member gives you money for your business, it's smart to put it in writing. Strictly speaking, this isn't a legal requirement, but nevertheless I highly recommend that you do so. For one thing, it can help with taxes. An individual can make a gift each year of up to $11,000 to any number of people. These gifts won't be subject to either the federal estate or gift tax. (See "Gifts Can Save Money," in Section B8.) If the giver states in writing that the money is a gift and not a loan, it will be clear to the IRS that no tax is owed.

A second reason to document the gift is to avoid possible future misunderstandings with other people who eventually inherit from the giver. Incredible as it may seem, brothers and sisters have sometimes gone to court to argue that a sum of money that a parent advanced to one child should be treated not as a gift, but as a loan to be repaid to the estate. And even where siblings haven't resorted to such drastic action, doubts about a parent's intentions can simmer beneath the surface for years, hurting the relationship.

2. Loans Without Security

The way to document a loan is through a promissory note. (See Section A1.)

Banks and other commercial lenders will have their own forms for you to sign. The following forms can be used if you borrow money from a relative or friend.

SAMPLE PROMISSORY NOTE FOR INSTALLMENT PAYMENTS THAT INCLUDE PRINCIPAL AND INTEREST

September 1, 20XX

For value received, I promise to pay to Leo Lender

$10,000 and interest at the rate of 10% per annum on the unpaid balance as follows:

1. I will pay 60 monthly installments of $212.48 each.
2. I will pay the first installment on October 1, 20XX, and a similar installment on the first day of each month after that until principal and interest have been paid in full.
3. Payments will be applied first on interest and then on principal.
4. I will pay the entire amount of principal and interest within five years from the date of this note.
5. I may prepay all or any part of the principal without penalty.
6. If I am more than 10 days late in making any payment, Leo Lender may declare that the entire balance of unpaid principal is due immediately, together with the interest that has accrued.

Bob Borrower

SAMPLE PROMISSORY NOTE FOR ANNUAL INTEREST PAYMENTS AND BALLOON PAYMENT OF PRINCIPAL

September 1, 20XX

For value received, I promise to pay to Leo Lender

$10,000 and interest at the rate of 10% per annum on the unpaid balance as follows:

1. I will pay interest on September 1 each year for five years beginning in 20XX.
2. I will pay the principal five years from the date of this note.
3. I may prepay all or any part of the principal without penalty.
4. If I am more than 10 days late in making any payment, Leo Lender may declare that the principal is due immediately, together with the interest that has accrued.

____

Bob Borrower

SAMPLE PROMISSORY NOTE FOR LUMP SUM REPAYMENT

September 1, 20XX

For value received, I promise to pay to Leo Lender

$10,000 and interest at the rate of 10% per annum on the unpaid balance on [*Insert date when the entire $10,000 plus interest is due*]. I may prepay all or any part of the principal without penalty.

____

Bob Borrower

For additional promissory notes that cover several common transactions: *See* 101 Law Forms for Personal Use (with CD-ROM), *by Robin Leonard and Ralph Warner (Nolo). You'll find promissory notes that can be used for a loan repayable in a lump sum with no interest, a lump sum with interest, installments without interest, installments with interest, a lump sum secured by real or personal property, and installments secured by real or personal property.*

3. Loans With Security

If you're pledging property as security for a loan, you can start with one of the sample forms given in Section C2, above—but the promissory note should also state that it's a secured loan and that additional documents have been prepared and are being signed to fully protect the lender.

Commercial lenders will generally prepare these additional documents. When you're borrowing from a friend or family member, however, and pledging security for the loan, you and the lender will need to follow through on these details.

a. Note Secured by Personal Property

Personal property is property that's not real estate—equipment and inventory, for example. If you're pledging personal property as security, here is sample language to include in a promissory note:

SECURED INTEREST PROVISION

I agree that until the principal and interest owed under this note are paid in full, the note will be secured by a security agreement signed today giving *(lender's name)* a security interest in the equipment, fixtures, inventory, and accounts receivable of the business known as *(name of borrower's business)*.

You should prepare and sign a security agreement that gives the lender the right to take the specified assets if you don't repay your loan as agreed. Also prepare and sign a Uniform Commercial Code Financing Statement—sometimes called Form UCC-1. This form should be available at office supply stores that serve lawyers.

Generally, there will be a statewide office where the lender should file this form. In addition, in many states, the lender should also file a copy at the county office that keeps records of liens on personal property. The form notifies future creditors that the lender is a secured creditor and holds a lien on the listed assets. When you pay off the loan, the lender should release the lien—and, as with real estate liens, the release should be filed at the same public office where the Form UCC-1 was filed.

If you pledge a car or truck, check with the office in your state that handles motor vehicle titles to learn how to record the fact that the lender is obtaining a security interest in the car or truck.

b. Note Secured by Real Estate

Here is sample language to include in a note secured by real estate:

SECURED INTEREST PROVISION

> I agree that until the principal and interest owed under this note are paid in full, the note will be secured by a mortgage [*or deed of trust*] to real estate commonly known as ___(*address or other description*)___, owned by ___(*name*)___ signed on ___(*date*)___ and recorded at ___(*place recorded*)___.

You'll probably need professional help in preparing the mortgage or deed of trust. This is routine stuff for an experienced real estate lawyer, so you should be able to get it done by paying for a half-hour or less of a lawyer's time.

The mortgage or deed of trust will have to be witnessed and notarized, and then get recorded for a small fee at a government office that handles real estate registrations. To learn the name and location of the correct government office, call the county clerk or inquire at a title insurance company.

Be sure the security interest gets canceled. *You don't want to face problems ten years from now when you go to sell the real estate. So when you pay off the loan, don't forget to get a paper signed by the lender that releases or discharges the mortgage or deed of trust. The document, which will need to be witnessed and notarized, must be filed at the same place where the mortgage or deed of trust was filed. Again, you'd be wise to consult briefly with a lawyer or check with a local title insurance company to make sure you're doing this correctly.*

4. Equity Investments

Equity investments in a limited partnership, corporation, or limited liability company are usually treated as securities and may be regulated by federal and state laws. (See Section A2.) It's unlikely that this will be a problem for a small business with just a few owners and investors. Investments in these businesses are usually exempt from the regulations. If that's so in your case, you won't have to deal with the sometimes burdensome paperwork.

If, however, you decide to go public—make a public offering of an interest in your business—then you definitely need to seek detailed legal advice.

Whether or not you must meet special requirements under federal or state laws regulating securities, you should always have a written agreement with an equity investor. The mechanics will depend on the legal structure of your business.

- **Sole Proprietorship.** By definition, a sole proprietorship is owned by just one person. Anyone else who invests in your business and acquires equity in it becomes a co-owner—

which means that, legally, your sole proprietorship is converted into a partnership. It makes sense to sign a partnership agreement outlining your responsibilities and those of the investor (see Chapter 2).

- **Partnership.** An equity investor in a partnership is a partner, so you should amend your partnership agreement to include your new partner and specify the financial relationships. All partners—old and new—should sign it. (Again, see Chapter 2 for help on partnership agreements and consult *The Partnership Book*, by Denis Clifford and Ralph Warner (Nolo).)
- **Limited Partnership.** Assuming that the investor will play a passive role and won't be actively involved in running the business, he or she will be a limited partner. The limited partnership agreement will define how a limited partner gets money from the business. The limited partner will receive a certificate recognizing his or her interest in the limited partnership.
- **Corporation.** The equity investor will be a shareholder. You, the equity investor and all other shareholders should sign a shareholders' agreement—or amend the existing agreement if there is one—to spell out the corporation's obligations to the investor. The corporation should issue a stock certificate in the investor's name.
- **Limited Liability Company.** The equity investor will be a member. You, the equity investor, and all other members of the LLC should sign an operating agreement—or amend the existing operating agreement if there is one. ■

CHAPTER

10

Buying a Business

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For those who would like to own their own business, buying an existing business may be a better approach than starting from scratch. After all, there's something attractive about letting someone else find a location and sign a lease; test the market and develop a customer base; buy furniture, fixtures, equipment, and inventory; hire employees; and perform the countless other chores that go with starting a business. In short, you'll have let someone else prove that the business works.

If you find yourself looking for an existing business to buy, keep an open mind. It's not always possible to buy a business you'll be happy with at a price you can afford. Many people who buy existing businesses do very well, but others, having explored the opportunities and finding nothing to their liking, return to the idea of starting their own business. And some people pay too much money for a poor business or one they may never really enjoy operating.

This chapter first looks at how to find a business to buy. Then it turns to the nuts and bolts of actually buying a business, including how to structure the purchase, what to investigate before closing the deal, and the legal documents needed for a business to change hands.

Selling a Business. This chapter focuses on buying a business, but a seller's concerns are also discussed briefly in Section I.

A. Finding a Business to Buy

Before you look for a business to buy, narrow your field of possible choices. First, decide whether you want to be in a service, manufacturing, wholesale, retail, or food service business. Once you make this choice, consider the specific type of business you're interested in—perhaps a desktop publishing center, a management consulting business, a direct-mail processing business, a dance studio, a flower shop, or a used book store.

Your choice of business should be motivated by the type of work you've done in the past, courses you've taken, special skills you've developed through a hobby, or perhaps just a strong yearning to work in a particular field. It's almost always a mistake to consider buying a business you know little about, no matter how good it looks. For example, if you're confused by mechanical and electronic equipment, buying an auto tune-up shop or a business that installs security systems makes little sense even if the business looks irresistible from a financial point of view.

If you're currently employed by a small business you like, what are the chances of that business becoming available to you? Maybe the current owner wants to retire, is in bad health, is moving out of the city, or is just getting bored. If you know the inner workings of the business and are sure that it's doing well—or at least that it has the potential to flower under your able leadership—that would be an ideal place to start. Failing that, perhaps business associates or friends can provide you with leads to similar businesses that may be available.

Here are some other time-tested ways to search for an available business:

- *Newspaper ads.* This is a traditional starting point and can quickly put you in touch with people who are actively seeking a buyer for their business. Unfortunately, ads are only the tip of the iceberg. Many of the best business opportunities never get into the papers but surface by word of mouth.
- *Professionals who advise small businesses.* Bankers, lawyers, accountants, insurance agents, and real estate brokers who regularly work with small businesses often know about available businesses before they go on the market. Think about who you know who is plugged into this network and get on the phone. A few well-placed phone calls may be enough to identify likely candidates in your area.
- *Business suppliers.* Another great way to tap into the grapevine is to contact the network of suppliers for that business. For example, if you're thinking of opening a flower shop, a

floral wholesaler in your area will probably know who is thinking of retiring or selling out for other reasons.

- *Trade associations.* Almost every business has a local or regional trade association—for example, the Northern California Booksellers Association or the Michigan Pest Control Association. The secretary or a longtime employee of such a group may have heard about a business owner who's thinking of retiring.
- *The direct approach.* If there's a business that you've admired from afar, simply drop in and politely ask if the owner has ever thought about selling. Who knows? Maybe he or she has been thinking about moving to another part of the country or changing to a different type of business. Once in a while, you'll be in the right place at the right time. A long shot? Probably—but you have nothing to lose by trying it.
- *Business brokers.* Finally, there are business brokers—people who earn commissions from business owners who need help finding buyers. As is true in all endeavors, not all business brokers are created equal. A few are honest, ingenious, and hardworking. Many more are adequate but nothing special when it comes to competence, energy, and integrity. More than a few are sleazy, incompetent, and interested almost exclusively in earning a commission. In short, before working with a broker, it pays to carefully check out his or her reputation. Several glowing recommendations from a banker, accountant, or fellow small business person should raise your confidence level. On the other hand, if the feedback you get is lukewarm, look for someone else.

It's foolish to rely on a broker—who gets paid only if the deal goes through—for advice about the quality of the business or the fairness of its price. If you do, he or she is almost sure to paint an unrealistically rosy picture. Also, because the seller typically pays the broker, the broker's loyalty will be to the seller—not to you. Use a broker only to find a business, not to negotiate the purchase price and other terms. See Section G on drafting the documents involved, particularly the purchase agreement.

B. What's the Structure of the Business You Want to Buy?

If you find a business you're interested in, one important question is: What kind of legal entity owns the business—a sole proprietorship, partnership, corporation, or limited liability company (LLC)?

1. Buying From a Sole Proprietor or Partnership

When you buy a business from a sole proprietor or a partnership, you never acquire the old legal structure of the business, only its assets (and possibly its liabilities, depending on how your deal with the seller is structured).

Legally, it's simplest to buy a business from a sole proprietor, because one person owns the business and the assets are in his or her name. Buying from a partnership is almost as simple, although a partnership agreement typically requires the consent of all owners before the business can be sold. If you're dealing with only one partner in a partnership, to avoid disappointment, promptly ask to see the partnership agreement. Then make sure that the person negotiating the deal has received proper authority from the other owners. Beyond that, get a clear understanding early on about whether you'll only be buying the assets of the business, or whether the seller is also trying to get you to assume responsibility for all liabilities.

It's best to avoid assuming business liabilities. *A major issue in buying any business is whether you'll be purchasing only its assets, or if, as part of the deal, you'll also be taking on its liabilities. You'll avoid many potential legal and debt entanglements if you insist on buying the assets only (even if this means you pay a higher price). But whatever you and the seller decide, it's vital that you clearly record your understanding in the purchase documents.*

Changing a business's structure. *A new owner is free to change the legal form of a business. For example, you can buy a business from a sole proprietor and then operate it through a partnership or corporation.*

2. Buying From a Corporation

When you buy a business owned by a corporation, you run into a special problem: figuring out the best way to structure your purchase. You can buy the corporate entity itself (the stock) or you can buy only its assets, leaving the seller still owning the corporation minus the assets you purchased.

In almost any purchase of a business, you'll be much better off buying the assets rather than the corporate stock (but see Subsection c, below). Most sales of small businesses—a whopping 94%—involve the sale of assets rather than corporate stock. Buying assets has four distinct advantages:

- It helps you avoid the liabilities of the existing business.
- It gives you significant tax advantages.
- You can avoid acquiring unwanted assets from the corporation.
- You generally can get a higher tax basis for depreciable assets, which means there's less taxable gain to report if you later sell the assets.

EXAMPLE OF STOCK PURCHASE: Brown Manufacturing Inc. is a small corporation owned by Joseph Brown and his two sons. The company, which makes specialized computer circuit boards, owns a small factory, several machines, raw materials, an inventory of completed items, office furniture and equipment, and two delivery trucks. The corporation owns all of the assets of the business. In a stock purchase, you'd buy 100% of the stock of the corporation from Joseph Brown and his sons. As the new owner, you'd elect yourself (and anyone else you choose) to the board of directors; the board would then typically appoint you to the office of president.

EXAMPLE OF ASSET PURCHASE: You want to buy the business operated by Brown Manufacturing Inc., but instead of buying the corporate stock, you have the corporation sell you all or most of its assets, such as the factory, the machines, the trucks, and several patents and trade secrets associated with circuit board assembly. The seller would continue to own Brown Manufacturing Inc. minus its assets. You would use these assets to run the manufacturing business as a sole proprietorship or partnership (if you have one or more business associates), or perhaps you would choose to place the assets in a new corporation of your own.

Get the Consent of Shareholders When You Purchase Corporate Assets

Remember that a corporation is a separate legal entity from its owners—the shareholders. When you purchase the assets of a small corporation, you want to avoid the possibility of having to deal with disgruntled minority owners. Even though the corporation's bylaws or shareholders' agreement may permit the sale of its assets with the consent of a majority (or more) of the shareholders, it's legally far safer for you if you insist that all shareholders agree with the sale of the corporation's assets. Get this consent in writing by following a two-step process:

- Require that all shareholders sign the purchase contract.
- Ask that all of the corporation's shareholders and directors sign and give you a copy of an official Corporate Resolution Authorizing Sale of Assets.

A big bonus that comes with insisting that all shareholders sign the purchase contract is that they then become personally liable for the warranties and representations in the contract. Without their signatures, should things go wrong, your only recourse would be against the corporation, which by that time would probably be without funds. You can also include language committing each shareholder to any noncompetition clause in the agreement—but as with other noncompete covenants, you must pay the signer something to make the covenant legally binding.

a. Liabilities of the Corporation

If you buy the stock of a corporation, you're buying not only the assets but any liabilities as well. This is fine if there aren't any, but this can be difficult to determine. Maybe the corporation owes federal income taxes that you don't know about or has a huge balance to pay on a bank loan. Or maybe a customer slipped in the entryway of the business three months ago, broke his leg, and is right now visiting a lawyer to prepare a million-dollar lawsuit. Or maybe there's an underground storage tank quietly leaking into the earth below the corporation's main office. Hidden liabilities can surface for injuries caused by defective products, discrimination against employees, or environmental or safety violations, to name but a few.

In addition, the business may have contracts that you don't want to assume. For example, the corporation may have a five-year maintenance contract for service on the computers it owns—and there may be four more years to go, at a rate you consider exorbitant.

You can protect yourself against some unknown liabilities. A good investigation will uncover many (though not all) potential liabilities. And personal warranties from the seller guaranteeing payment of any liabilities not disclosed can give you someone to turn to if unknown or undisclosed liabilities suddenly surface. Insurance may cover some of these risks, such as claims for injuries caused by defective products. But the point remains—if you buy a corporation, it's almost impossible to get 100% protection from its obligations.

In contrast, by buying the assets of the corporation rather than the corporate stock, you can avoid virtually all of these liability problems as long as you notify creditors of your purchase under the terms of your state's bulk sales statute (see Section G10) and you don't lead creditors to believe that you're picking up the liabilities of the corporation.

It's important to realize, however, that under some circumstances, if you continue the business of the prior corporation, you or your new corporation may still be subject to some liabilities incurred by the old corporation even if you only purchase assets. Known in legal lingo as "successor liability," the most common area of concern is product liability—liability to a person injured by a defective product.

This is particularly likely to arise if you buy the assets of a corporation that manufactured a potentially hazardous consumer product and you directly continue the business. Each state has its own legal rules governing what constitutes a sufficient link (often called continuity) between the first manufacturer and the second to hold the second liable. One court ruled that there may be such a link if:

- There is a continuation of the management, personnel, physical location, assets, and general business operations of the selling corporation.
- The selling corporation quickly ceased its ordinary business operations and then liquidated and dissolved.
- The purchasing company assumed the liabilities and obligations of the seller ordinarily necessary for continuing the business operations of the selling corporation.

In addition, depending on state law, a company that's just a continuation of an earlier corporation may be liable for other legal problems of the earlier corporation—for example, a wrongful discharge case brought by an ex-employee—or even for contractual obligations such as a union contract.

The good news is that if you're fully informed about the law in your state, you can usually anticipate any successor liability problems and structure your purchase to avoid them. Or you may be able to buy insurance—often called "tail coverage"—to protect you from the long tail of the old corporation's liabilities.

b. Tax Advantages

You may be able to get several kinds of tax advantages in an asset purchase because you can allocate the purchase price among various assets you buy. As long as this allocation is based on an arm's-length negotiation between you and the seller, it's likely to be upheld by the IRS.

You want to allocate the greater portion of the purchase price to assets you can quickly write off or depreciate on your tax returns. These include things like the inventory of the business, supplies, machinery, equipment and vehicles, furniture, and fixtures.

Normally, you'll also want to assign some value to the seller's noncompetition agreement. The value of the promise not to compete is spread over its duration (often three to five years), and an equal amount is deducted each year.

On the other hand, you'll want to assign minimally reasonable values to assets that can't be deducted as current expenses, depreciated, or amortized. This includes such assets as goodwill, trademarks, customer lists, and trade names. (How to allocate purchase price to different assets you're buying is discussed in Section G.)

In addition, by buying assets rather than corporate stock, you can depreciate assets that the seller has already fully depreciated.

> **EXAMPLE:** Arthur is buying a dry cleaning business. The business has dry cleaning equipment that's ten years old but in excellent condition. The owner has fully depreciated it. Arthur and the seller allocate $30,000 of the purchase price to the equipment. That way, Arthur can start to depreciate it a second time. If Arthur bought the corporate stock, he wouldn't be able to take any depreciation for this equipment.

c. Exceptions: When You Must or Should Purchase Stock

In some situations you may not be able to swing a deal in which you buy only corporate assets. This can occur, for example, if the seller insists on a stock sale—perhaps because he or she believes there's a tax advantage in going this route. If you agree to this, see Subsection d, below, "How to Protect Yourself If You Buy Corporate Stock."

In some limited circumstances where the corporation has a uniquely valuable asset that can't be transferred, it may actually be better to buy the stock of the corporation rather than its assets. For example, the corporation may have tax benefits such as a net operating loss carryover (NOL) that you want to take advantage of. The NOL carryover would be lost if you purchased the assets rather than the corporate stock. Also, if a store had a favorable five-year lease with a five-year option to renew that wasn't freely assignable, that could provide an incentive to you to buy the corporate stock. Or suppose a computer retail business had a hard-to-get distributorship for a particular brand of popular computers. If the distributorship contract couldn't be assigned to you and you weren't sure you could qualify for a similar contract yourself, you might consider buying the corporate stock because the corporation would likely continue to have the rights to be a distributor.

Investigating distributorships. *Even in a stock purchase, you'd want to read the distributorship documents carefully and check with the manufacturer to confirm that the manufacturer didn't reserve the right to cancel the distributorship if the corporate stock changed hands.*

d. How to Protect Yourself If You Buy Corporate Stock

If you do decide to purchase a corporation's stock instead of its assets, protect yourself to the maximum extent possible. Conduct an in-depth investigation of the corporation's financial affairs. Try to get a strong personal guarantee from the shareholders that things are as stated.

You could also get a warranty from the seller that he or she will pay for certain types of problems such as tax liabilities, obligations to former employees, or damage claims by the landlord. Then arrange to pay for the business in installments spread over a number of years. Most liabilities will come to light in the first few years after you purchase the business. If the seller fails to make good on his or her warranty, you can pay for these liabilities and then withhold the amounts from the balance you owe the seller.

Also, as mentioned earlier, insurance may be in place or obtainable to protect against product liability and other personal injury claims.

3. Buying From an LLC

In buying a business from an LLC, you'll have to start by making the same decision as when buying from a corporation: Should you purchase the whole entity (the LLC) or just its assets? In my opinion, you're much better off buying the assets rather than the entity, for the reasons I listed in Section B2, above, "Buying From a Corporation."

Buying the Entity. If you buy the LLC entity, you won't be buying shares of stock as you would with a corporation. An LLC doesn't issue stock. Instead, you'll purchase the membership interests of all the LLC members. By doing so, you'll wind up owning the LLC, which in turn owns the company's assets.

Buying the Assets. If you simply buy the business's assets, the LLC will transfer the assets to you, leaving the current LLC members with ownership of the LLC shell. (The shell is a company without any assets, except possibly your promissory note for the balance of the purchase price.) To avoid possible problems with dissatisfied LLC members, I recommend that you require all members to sign the sales agreement.

C. Gathering Information About a Business

Buying a business takes weeks or months. During that time you'll need to diligently gather information—lots of information—about the business so that you don't get stung on the purchase price or have surprises later about income, expenses, or undisclosed liabilities. Eventually, this information will help you structure a sound sales agreement.

In most small business purchases, the buyer learns everything possible about the business before signing the sales agreement. By contrast, business brokers sometimes advise making a quick formal offer to purchase with a number of contingencies that allow you to terminate the deal if all the facts don't turn out as represented by the seller. I recommend against this approach.

Why invest your time, effort, and money in a complete investigation of the business if the preliminary review of records convinces you that this isn't the business for you or that the price is too high? Better to request early access to financial records that will help you decide whether you're really interested in the business. Then if you're satisfied with the finances you can sign a sales agreement with appropriate contingency clauses or wait until closing (legal lingo for the transfer of the business) to sign.

If you and the seller are strangers to one another, however, the seller may be reluctant to turn over sensitive business information until he or she is confident that you're a serious buyer. The seller may suspect you have some secret plan in mind, like using the information in a competitive business or some other improper purpose. To allay these fears, consider giving the seller a confidentiality letter like the one below.

SAMPLE CONFIDENTIALITY LETTER

Carlos Mendez, President
Mendez Furniture Company Inc.

Dear Mr. Mendez:

As you know, I am looking into the purchase of your furniture business. Our conversations have been helpful but I'm now at the stage where I would like to see your company's financial records, including your tax returns, for the past five years.

I know that the information that I'm requesting is confidential and that improper use of the information could damage your business. Consequently, I will use this confidential information only to help me decide whether I want to purchase your business and the terms of that purchase. I will disclose this confidential information only to my co-investors, my lawyer, and my accountant. I'll make sure that each of these people knows that this information is confidential, and I'll ask them to sign confidentiality agreements before I release the information to them.

If I don't buy your business, I will return all of the confidential information, including any copies, to you and will continue to treat in confidence the information you have disclosed to me.

I look forward to receiving this information.

Sincerely yours,

Suzanne Gerstein

That kind of letter will satisfy many sellers. But a few sellers may prefer a longer, more formal confidentiality agreement drafted by a lawyer. That's okay, but you (and perhaps your lawyer as well) should make sure that the proposed document contains no binding commitment to buy the business. It should be limited to your agreement to treat the information as strictly confidential and use it only to investigate the purchase of the business, and to the other terms set out in the letter. If the proposed agreement goes farther than that, find out why and get legal advice.

Don't be surprised if the seller wants to learn about your own financial status, job, or business history. Remember that most purchases of a small business are usually done on an installment basis, where the seller receives a down payment and payments over a period of time. The seller is interested in your financial stability, your reputation for integrity, and your general business savvy because the seller, in effect, will be extending credit to you.

D. Valuing the Business

Does it sound impossibly demanding to determine a fair purchase price for a business? It's really not—especially if you take the sales price with a grain of salt. Most sellers ask for way too much, and far too many inexperienced buyers don't bargain aggressively enough. Lots of little businesses are worth no more than the fair current value of inventory and equipment. Goodwill, over and above the value of the continuing hard work of the owner, is commonly a myth.

1. What Are You Buying?

Generally, the assets of a business consist of inventory, fixed assets (furniture, fixtures, equipment), and intangible assets (such as a lease, trade name, customer list, and goodwill). The most important factor in establishing the fair market value of these assets is this: Given the realities of the business and the industry in which it operates, what kind of return would a buyer reasonably expect on his or her investment? To arrive at this number, an appraiser will look both at the business's earnings and what similar businesses typically earn.

2. Goodwill Can Be a Myth

Be very careful about what you pay for goodwill—the portion of the purchase price attributed to such intangible factors as the reputation of the business, its location, and the loyalty of its customers. Despite what sellers will almost surely tell you, many small businesses have little or no value beyond the value of the hard assets such as furniture, fixtures, and equipment.

How can this be, if a business earns a good yearly profit? Easy. Most of the profit is commonly attributable to the hard work, clear vision, and good judgment of the owner, not to the inherent value of the business. Think of it this way: Most rug cleaning businesses, hardware stores, print shops, and restaurants don't make a substantial profit. Those that do are usually run by uniquely talented people. When these people move on, many of those businesses quickly lose their luster.

> **EXAMPLE:** Joe and Monte own Caretti Brothers, a highly successful produce store that they've operated for 20 years. They sell the business to Anna Marie, who pays $200,000, including $100,000 for goodwill. Anna Marie continues to run the business as Caretti Brothers and does her best to preserve the store's distinctive atmosphere. Nevertheless, in her first year she earns only one-third the profits generated by the former owners.
>
> Unhappily, she realizes that Joe and Monte succeeded because customers valued their extroverted personalities and their rare ability to select only the freshest and tastiest tomatoes and grapefruit. Too late, she understands that she should have paid little or nothing for goodwill, which was largely personal to the Carettis and couldn't be transferred to her.

Goodwill isn't always a myth. Some profitable businesses—usually those that have been established for years and have strong name recognition—are worth significantly more than the value of their tangible assets, because they have a good reputation. Even if the owner retires or sells out, this reputation will continue to bring in business.

Unfortunately, deciding that a business has goodwill is easier than deciding how much. One approach is for buyer and seller to try to agree on a multiplier—the number by which earnings (or sometimes sales) must be multiplied to determine the value of the business.

Where does the multiplier come from? In some industries, there are rough norms. For example, certain types of businesses typically sell for five times earnings, while other often sell for ten or more. Construction companies, retail stores, and restaurants are examples of businesses where you can often obtain standard multipliers from business evaluators or appraisers who specialize in that industry.

Be critical of all multipliers. *Never accept a multiplier without loads of caution. The facts of a particular business, the state of the local economy, and industry trends change so quickly that last year's sensible multiplier can be completely off base this year.*

3. Evaluating the Business's Financial Health

To properly evaluate the business, ask for access to the following documents:

- tax returns, profit and loss statements, and balance sheets for the last five years
- loan documents, if you're going to assume any obligations of the business
- papers relating to specific assets; for example, the lease if you're taking over seller's space or title documents if you're purchasing the seller's building
- patents, trademarks, copyrights, and licenses
- documents that relate to lawsuits, administrative proceedings, and claims against the corporation
- all accountants' reports, including compilation reports, reviews and audit reports. (See "Types

of Accountants' Reports," below.) A full-fledged audit report is the best, but not all small businesses have one available. Whatever type report the business has, specifically ask for a list of all assets and the depreciation schedules.

In addition, if you're purchasing corporate stock, ask for:

- corporate contracts with major suppliers, as well as contracts obligating the corporation to deliver goods or services
- employment agreements, union contracts, and any other documents concerning wage levels and fringe benefit obligations.

Types of Accountants' Reports

Reports from Certified Public Accountants come in three basic varieties:

Compiled. The CPA compiles the balance sheet of the company and the related statements of income and retained earnings and cash flows for a specified year. The compilation simply presents, in the form of a financial statement, the information gathered by the owners of the company. The accountant doesn't audit or review the information or offer an opinion about it.

Reviewed. The CPA goes a step farther by asking questions of company personnel and analyzing the financial data presented by the owners. Short of a full-scale audit, the CPA certifies only that he or she isn't aware of any material modifications that should be made to the financial statements to conform to generally accepted accounting principles.

Audited. Here, the CPA examines, on a test basis, evidence supporting the amounts and disclosures in the financial statements. For example, the CPA may visit the warehouse to see if it really contains the inventory that's claimed. Also, the accountant assesses the accounting principles used by the owners and evaluates the overall financial statement. If everything is in order, the CPA signs an opinion that the financial statements are accurate and maintained in conformity with generally accepted accounting principles.

Once the books are in your hands, have an experienced small business accountant study them. You and your accountant should look especially hard at the years before the last one. It's relatively easy for a business owner to pump up earnings and depress expenses for a year or two, so assume that the results for the last year at least have been manipulated.

Tips for spotting exaggerated earnings: *One way to see if earnings have been exaggerated is to see if there are fewer employees now than previously—almost any business can operate shorthanded for a limited time. Also, check to see whether equipment maintenance or replacement has been deferred by comparing maintenance and replacement costs for the last year with those of the years before.*

4. Expert Help

Consider hiring an experienced appraiser to appraise the business as a whole as well as the individual assets. Check references and be sure the person you pick understands the type of business you are entering.

For example, if you're thinking of buying a traditional typesetting business, work with someone who thoroughly understands the mostly negative implications that the rapid improvement of desktop publishing techniques holds for this business. Appraisals do cost money, but it's money well spent if it saves you from overpaying for the business.

Where can you turn for an accurate assessment of the value of a business? Here are three suggestions:

- Consult a member of the American Society of Appraisers who specializes in business valuations. For a list of such appraisers, call 800-ASA-VALU or visit www.appraisers.org.
- Check with a respected firm of certified public accountants. Many CPA firms offer business valuation services.
- Seek guidance from an experienced business broker. But use caution. Brokers are best at making deals. They often lack the technical training needed for placing a value on a business.

E. Other Items to Investigate

Now let's look at some other items that are worth investigating before you close on the purchase of a business.

1. Title to Assets

If real estate is included in the sale, ask to see the deed and the title insurance policy. The title should be rechecked to make sure no new encumbrances appear, and the title insurance policy will need to be updated. Also ask to see ownership documents for any cars and trucks.

It's a good idea to check with the appropriate county or state offices to see if there are liens on any of the vehicles or other equipment or merchandise. Lenders who have taken a security interest in the business or suppliers who have extended credit may have filed a UCC (Uniform Commercial Code) financing statement with the appropriate state agency to record the fact that they have a security interest in some assets of the business.

Any bank lending officer, small business lawyer, or accountant should be able to tell you where and how to check in your state.

2. Litigation

Ask to see copies of any lawsuit papers and letters from any people threatening lawsuits. Also check with the court clerk in the main counties in which business is conducted. What you're looking for are actual or threatened lawsuits involving injuries or claimed breaches of contract.

This type of investigation is particularly important when you're buying the stock of a corporation, but you may also turn up information that will be valuable to an asset purchase. For example, if the business manufactures or distributes aluminum stepladders, finding product liability lawsuits pending will help you determine whether the ladders are safe or need to be redesigned. Also, remember that in a few circumstances even those who purchase assets of a corporation may be held liable for the existing business's liabilities. (See Section B2.)

3. Warranties and Guarantees

If you buy the stock of a corporation, you want to know what types of warranties the corporation has extended to its customers so you can anticipate claims. For example, if you buy a business that writes customized computer software, you'll want to know what promises have been made should bugs be discovered in already-installed programs.

4. Workers' Compensation Claims and Unemployment Claims

Check with the workers' compensation insurance carrier to learn the claims history of the business and current insurance rates. Also check with the state office handling unemployment affairs to learn what rate is currently applied to the payroll of the business. These facts will be primarily of concern if you're planning to purchase the stock of a corporation, because they'll indicate how much you'll probably have to pay for workers' compensation insurance or unemployment coverage. But in some states, even purchasers of corporate assets may have their future workers' compensation insurance rates affected if it looks like the new business is simply a continuation of the old one.

5. Employee Contracts and Benefits

This is a concern primarily if you're buying the stock of a corporation and will be subject to its contracts. However, if you intend to keep the same employees, you need this information for other purchases as well so that you'll know the employees' expectations when they come to work for your new business entity. They won't be happy campers if you offer them less pay or benefits than they're currently getting.

If it's a concern, ask the seller for permission to talk to key employees to see if they'll stick with you after you buy the business. (Strictly speaking, permission isn't required, but being polite helps bring about a smooth transition.)

6. Maintenance of Trade Secrets

Not every business has trade secrets, but if the one you're purchasing does—and those secrets are a valuable asset for which you're paying—you want to be sure they've been properly safeguarded. Ask what the business has done to protect its trade secrets and other proprietary information such as customer lists. Has this information been disclosed only to key employees? Have those employees signed confidentiality agreements and covenants not to compete? If not, and key employees leave and set up a competing business, you may be buying a lot less than you bargained for.

7. Taxes

Again, this applies primarily to a purchase of corporate stock because you want to know what tax liabilities are hanging over the head of the corporation. But whatever kind of purchase you're making, you can gain valuable information about the income and expenses of the business, including the kinds of items that have been tax-deductible in the past. Check on state and local property taxes and sales taxes, federal and state income taxes, and any special taxes levied by federal and state governments.

8. Leases

Look carefully at all space and equipment leases. How long does the lease have to run? Is it renewable? And, most important, if you're purchasing the assets, is it transferable? If the lease isn't clearly assignable, check with the landlord or equipment lessor about taking over the lease. If they respond favorably, get a commitment in writing. (For more on real estate leases, see Chapter 13.)

9. Other Contracts

If the business has contracts with suppliers or customers, become familiar with their terms. In the case of an asset sale, the important question is whether or not the contracts are assignable by the seller. Often, you need the consent of the supplier or customer. For example, if you're buying a gas station, does the oil company have to approve your taking over the contract for that brand of gasoline? Where a contract is freely transferable if all the conditions have been met, make sure the seller isn't in default or otherwise in noncompliance. If he or she is, you may not be able to enforce the contract.

10. Patents and Copyrights

Many small businesses don't own patents or copyrights, but as information becomes a more and more valuable part of many businesses, they are cropping up fairly often. Of course, if you're interested in buying a book, software, or music publishing company, you can be pretty sure that the business's most valuable assets will be its intellectual property.

If patents or copyrights are involved, get hold of the basic registration documents and any contracts that give the business the right to exploit these rights. If you're not fully familiar with these matters, have the documents and contracts reviewed by a lawyer who specializes in this area of law. These lawyers are usually listed in a separate category in the Yellow Pages under "Patent and Trademark."

11. Trademarks and Product Names

Trademarks, service marks, business names, and product names may be important business assets. If so, make sure that you'll have the continuing right to use them. Ask about the extent of any searches for conflicting marks and names, and what has been done to register or otherwise protect the marks and names you'll be taking over. (See Chapter 6 for more on business and product names.)

12. Licenses and Transferability

Check into any special licenses that you'll need to continue the business. For example, if you're buying a restaurant with a liquor license, is the license transferable? Has the existing business obtained an environmental permit for disposal of its wastes? If so, what about transferability? (If not, look into your potential liability.) The same goes for other special permits the existing business has, such as a health department license, or a federal license for trucking or broadcasting. (For more on licenses and permits, see Chapter 7.)

13. Zoning

The existing business may be operating under a temporary zoning variance or a conditional use permit that has important limitations. Learn exactly what the requirements and conditions are and whether you can continue operating under the variance or conditional use permit.

Also, if you buy the business assets rather than corporate stock, you may find that you're no longer covered by prior zoning or building preferences; you may, for example, need more parking, better access, and different signs. (See Chapter 7, Section D, and Chapter 14, Section A, for more on zoning and related requirements.)

14. Toxic Waste

If the business must dispose of toxic waste, or if its activities have any possible adverse impact on the purity of water and air, look into what licenses or permits are needed. Also, especially if your purchase involves real property, check carefully to see how toxic waste has been handled in the past. You could find yourself stuck with liability for past improprieties.

15. Franchisor Approval

If you're looking at a business that's operating under a franchise, the seller undoubtedly will need the approval of the franchisor before assigning the franchise to you. Look at the franchise agreement to see exactly what's involved in obtaining the franchisor's approval and then speak directly to the franchisor to see how the approval process can be expedited. (For more on franchises, see Chapter 11.)

16. Availability of Credit

Find out whether banks and major suppliers will be willing to extend credit to you. Credit may mean the difference between success and failure.

17. Scuttlebutt

Never rely entirely on documents and public records. You can learn a lot simply by talking to people who have had contact with the existing business—bankers, key customers, suppliers, neighboring businesses, and former employees. When talking to key people, take your time and pay attention to subtleties. Many people may be reluctant to talk frankly until they've sized you up, and others will have ties of friendship to the seller or be worried about their own possible legal liability if they divulge unfavorable information about the business.

F. Letter of Intent to Purchase

If all goes well, you and the seller may eventually agree on most major aspects of the purchase. But you still may not be quite ready to put together a formal sales agreement. Perhaps you need time for additional investigation, or maybe your lawyer, business advisor, or key lender is out of town for a week or two.

One device that can be helpful to keep momentum is a nonbinding letter of intent to purchase. The same objective can be accomplished through a more formal "memorandum of intent to purchase"—but a memorandum usually turns out to be more legalistic and, therefore, more threatening to a seller.

Giving the seller a modest, earnest money deposit along with the letter of intent is also helpful, because it shows you're sincerely interested in pursuing the purchase and are not wasting the seller's time. But because details of the purchase have not solidified at this point, be sure to provide that the deposit is to be refunded if the purchase falls through.

A sample nonbinding letter of intent is shown below.

LETTER OF INTENT TO PURCHASE

Robert Tower, President
The Tower Mart Inc.
25 Glen Blvd.
Arlington Heights, IL

Dear Bob:

Thanks for meeting with me again last week. I continue to be interested in purchasing the assets of the Tower Mart Inc. If we reach an agreement regarding my purchase, I plan to transfer these assets to a new corporation that I'm forming. My new company would then run a convenience store similar to what you're currently operating.

I'm interested in purchasing the following assets: the inventory, fixtures, equipment, leasehold improvements, and business name. In addition, I will need all necessary licenses and permits transferred to me. I will expect you to give me a covenant not to compete stating that for three years, you won't open a similar store in our city. The purchase price for all of the assets as well as the goodwill and your covenant not to compete would be $150,000, as we have already discussed.

[*Before referring to a covenant not to compete, see the discussion of such covenants in Section G5, below*]

As an indication of my good faith in pursuing this matter, I am enclosing a check for $1,000 as earnest money. I would pay an additional $49,000 in cash at closing. The balance of $100,000 would be amortized in equal monthly installments over a period of 10 years with interest at the rate of 10% per annum.

Regarding the inventory, we will check this at the time of closing. If the inventory is valued at less than $45,000, the purchase price would be reduced accordingly. Also, as you and I discussed, your corporation would remain responsible for all liabilities of the present business and these would not be assumed by my new corporation.

Before I have my lawyer draft a sales agreement, there are some things I need to investigate:

1. I want to meet with your landlord to make sure that I can take over the existing lease and that I can get an option to extend it for another five years.

2. I need to have my accountant review all of your tax returns and business records for the past five years so that I can satisfy myself regarding the financial condition of your business.

3. I want to make sure that the state liquor board will approve a transfer of the beer and wine retail license to my new corporation.

Assuming that I'm satisfied with these items and all other aspects of the proposed purchase, I will have my lawyer draft a sales agreement and then we can close approximately 45 days from now.

This letter states my intent but it is not a legally binding contract or commitment on either my part or yours. Upon further investigation I may change my mind. If the deal doesn't go through for any reason, I'd be entitled to my earnest money back.

If my letter has captured the essence of what we talked about and you're still interested in pursuing the sale, please let me know. I believe that we are moving toward a transaction that can be advantageous to both of us.

Sincerely,

Mary Beyer

Don't commit yourself. *Make it clear in a letter of intent that it is not intended to be a binding contract. You may or may not need your lawyer's assistance in writing a letter of intent, but I do recommend that you call your lawyer to at least check on the adequacy of the language you use to describe the nonbinding nature of the letter.*

G. The Sales Agreement

The sales agreement is the key legal document in buying business assets or an entire corporation or LLC. You should create a written outline of the terms that you and the seller have agreed on. Next, you may want to have your lawyer review it and help draft the next version of the agreement. Once you and your lawyer are satisfied, present the agreement to the seller.

Why take on the document drafting yourself, rather than letting the seller do it? Because even though it's more time consuming, this approach will almost surely give you more control over the overall shape of the transaction. By seizing the initiative, you may well wind up with 95% or more of what you want.

This section briefly reviews the principal types of clauses in a business sales agreement. Remember, as discussed earlier (Section B2), it's almost always better to buy the assets from the corporation than to buy its stock. Accordingly, these clauses are geared primarily to an asset purchase. If for some reason you decide to buy corporate stock, make corresponding changes in your sales agreement.

Chapter 5 of *Legal Forms for Starting & Running a Small Business* contains various forms for buying a business.

1. Names of Seller, Buyer, and Business

Your sales agreement will start with the name and address of the seller and the buyer. It will also identify the business by its current name.

- *Purchase from or by a sole proprietor.* Name the sole proprietor, adding the business name if it's different from the individual's. *Example:* Mary Perfect doing business as Perfect Word Processing Service.
- *Purchase from or by a partnership.* Use the partnership's legal name and the names of all partners. *Example:* Ortega Associates, a Colorado partnership of William Ortega and Henry Cruz.
- *Purchase from or by a corporation.* Simply use the corporate name and identify it by the state where it's registered. *Example:* XYZ Enterprises Inc., a Massachusetts corporation.
- *Purchase from or by an LLC.* Just use the LLC name and the state where it's registered. *Example:* ABC Associates LLC, an Illinois limited liability company.

If you're going to operate the business you're purchasing as a new corporation or LLC, I recommend either of two procedures: Set up the new corporation or LLC before signing the purchase agreement and name the new entity as the purchaser. Or list the purchaser as yourself as the agent of a corporation or LLC to be formed. Using either of these methods, the assets can go directly into your new corporation or LLC rather than having a two-stage process in which you receive the assets and then transfer them to the new entity.

If you're going to be putting the assets into a corporation or LLC, the seller undoubtedly will want you (and probably your spouse as well) to personally guarantee the payment of any part of the purchase price that's being paid on an installment basis.

2. Background Information

Often, before a sales agreement gets into the terms of the transaction, it outlines some background facts. For example, the sales agreement might state that "Mildred Johnson currently owns a business in Cincinnati that produces ice cream, sorbet, and other dessert products" and that the sales agreement "applies only to the portion of the business operated at seller's west side location at 123 Maple Street."

You can also include some statements about the buyer; for example, "The buyer is a building contractor licensed under the laws of the state of Maine." These statements aren't usually a key section of a purchase agreement, but if they are included, it's important to be accurate.

3. Assets Being Sold

This is where you list what you're purchasing. You can put the details, such as lists of equipment, on a separate page, which is sometimes referred to in the body of the agreement as a schedule or exhibit and specifically made part of the contract. Here's an example of how a sales agreement might list assets being sold:

a. All furniture, trade fixtures, equipment, and mis–cellaneous items of tangible personal property owned by seller and used in the business, listed and described in Exhibit A, which is hereby made a part of this agreement.

b. Customer lists and all other files and records of the business.

c. Assignment of the seller's interest (as tenant) in the lease dated March 1, 2005 for the building located at 123 Main Street owned by Central Property Associates (landlord).

d. Assignment of the seller's interest (as lessee) in the computer equipment lease with CompuLease dated March 1, 2005.

e. All telephone numbers of the business and the right to use the business name, "The Tower Mart." Seller will cease using that name on the day of closing.

If you have so agreed, also include a statement that you're not acquiring any of the liabilities of the business or that you're acquiring only those that are specified.

> Except as otherwise specified in this agreement, buyer is not assuming responsibility for any liabilities of the business. Seller will remain responsible for all liabilities of the business not specified in this agreement, and will indemnify buyer and save buyer harmless from and against such liabilities.

4. Purchase Price and Allocation of Assets

After stating the purchase price, allocate the price among the different categories of assets. Some typical allocations are shown below.

Allocation for a Retail Business

Merchandise on Hand	$ 75,000
Tangible Personal Property	$ 30,000
Assignment of Lease Agreement	$ 4,000
Trade Name and Goodwill	$ 8,000

Allocation for a Small Computer Company

Inventory (Computers and Software)	$100,000
Trade Name and Goodwill	$ 20,000
Patents and Copyrights	$ 5,000
Building Owned by Seller	$100,000
Land	$ 30,000

For tax reasons, as a buyer, you want most of the price assigned to the assets that give you the fastest recovery of your investment. You want the least allocated to items like goodwill, which can't be depreciated and gives you no tax benefits until you sell the business. Here's a summary of the write-off rules:

Type of Asset	Normal Write-Off Period
Inventory	As sold
Furniture, Fixtures, and Equipment	5 to 7 years
Trade Name and Goodwill	15 years
Buildings	39 years
Patents and Copyrights	Remaining Term of Patent or Copyright
Lease Assignment	Remaining Term of Lease
Land	No Write-off

Because you and the seller will have differing tax priorities, you may have to negotiate the allocation of the purchase price. The seller will want the bulk of the purchase price to be assigned to categories that are taxed at long-term capital gains rates rather than ordinary income rates—for example, buildings and goodwill. You'll be more interested in tilting the allocation toward items you can start to write off or depreciate—like equipment. If you wind up allocating the price in a way that saves you a ton of taxes but costs the seller a fair bit of change, you may need to raise the purchase price a little to help even things up. Similarly, if the allocation favors the seller, it's reasonable to work out a modest price reduction. A tax pro can help you crunch the numbers.

In the first example above, inventory and merchandise on hand are given as high a value as can be reasonably supported. In the second example, the seller's building and land could reasonably be valued at anywhere from $130,000 to $160,000 depending on whose appraisal is used. I've assigned the lowest reasonable value to the building and land because, under IRS guidelines, the building must be depreciated over a period of 39 years and the land can't be depreciated at all.

If the seller is going to provide consulting services to you for a year or so, consider assigning a portion of the purchase price to those services so that you can write off that amount quickly as a business expense. Better yet, remove an appropriate amount from the purchase price and put it in a separate agreement for consulting services.

5. Covenant Not to Compete

Especially if the seller is well known and would be a threat to your business if he or she opened a rival outfit, you want a covenant (promise) not to compete. In such a covenant, the seller agrees not to compete directly or indirectly with you in the operation of the type of business that you've purchased. If the seller violates the covenant, judges or arbitrators will usually enforce it unless it unreasonably limits the seller's ability to earn a living.

To increase chances that your agreement will be enforced, it's wise to place a reasonable geographic limitation on the seller's right to run a similar business (for example, within 25 miles of your business) and also a reasonable time limit (for example, three years). If you're purchasing a business from a corporation, have the individual operators of the business sign their own personal promises not to compete.

Obviously, whatever geographic limitations you and the seller agree on should fit the area. In New York City, a 25-mile zone would take in a huge chunk of New Jersey and some 15 to 20 million people—probably an unreasonable restraint on the seller's future ability to earn a living. In drafting a covenant not to compete, get help from a savvy lawyer who knows what the state courts enforce.

An example of a covenant not to compete is shown below.

Covenant Not to Compete

Seller shall not establish, engage in, or become interested in, directly or indirectly, as an employee, owner, partner, agent, shareholder, or otherwise, within a radius of ten miles from

> the city of _____, any business, trade, or occupation similar to the business covered by this sales agreement for a period of three years. At the closing, the seller agrees to sign an agreement on this subject in the form set forth in Exhibit B.

LAW IN THE REAL WORLD
Why You Need a Covenant Not to Compete

Sid is buying a travel agency from Mary Jones, who has been in the travel business for 25 years and is well known in the community. Part of the reason Sid is buying her business is the excellent reputation and following her business has earned.

Two months after Sid takes over the business, Mary—who quickly tired of retirement—opens a new travel agency four blocks away. Inevitably some, perhaps many, of her old customers will abandon Sid and patronize Mary's business. Sid should have included a covenant not to compete in the sales agreement to protect himself against this possibility.

6. Adjustments

You'll probably need to adjust the sales price slightly at closing. For example, you should reimburse the seller for payments the seller has made for such items as rent, utilities, or insurance for periods after you take over. On the other hand, if salaries and wages are paid every two weeks and you take over the business halfway through that period, the purchase price should be reduced at closing to reflect the fact that you'll be paying salaries for a period when the seller still owned the business.

Adjustments may also be made for license fees, maintenance contracts, equipment leases, and property taxes. Your sales agreement should contain a clause spelling out what items will need to be adjusted at closing and the method for making the adjustments.

7. Terms of Payment

Nearly 80% of small business purchases are handled on an installment basis, with the seller extending all or most of the credit. Typically, a buyer puts down about one third of the purchase price and pays the balance over four or five years. For example, in the purchase of a $250,000 business, you may negotiate a contract that requires you to make a $50,000 down payment at closing with the balance paid in five annual installments of $40,000 each plus interest at 10% per year.

At the closing, you'll sign a promissory note for the unpaid portion of the purchase price. The seller generally will want to retain an ownership (security) interest in the equipment and other assets of the business until the purchase price has been paid. Sometimes called a "lien," this is akin to a mortgage on your home. Just as the bank could sell your home to pay off your loan if you fell behind in your payments, the seller of a business who retains a lien on or security interest in your business assets could, if you were delinquent in making payments, take possession of those assets and sell them to cover the balance owing.

Here's a sample terms of payment clause:

> Purchaser will pay seller $_______ at closing and will pay the balance of $_______ according to the terms of a promissory note purchaser will sign at the closing, in the form set forth in Exhibit __. The promissory note will provide for monthly payments of $________ each. The payments will include interest on the unpaid balance at the rate of ____% per annum from and after the date of closing. The first installment will be due on the first day of the month following the closing and the remaining

installments will be due on the first of each month after that until the principal and interest is fully paid. Payments will be applied first on interest and then on principal. The unpaid principal and interest shall be fully paid no later than ____ years from the date of the note. There will be no penalty for prepayment.

Until purchaser has paid the full balance of principal and interest on the debt, seller will retain a security interest in the business assets being purchased. As evidence of such security interest, purchaser, at closing, will sign a security agreement in the form set forth in attached Exhibit __ and will also a sign a Uniform Commercial Code Financing Statement, to be recorded at the appropriate county and state office.

It's a good idea to attach the proposed promissory note as well as the proposed security agreement as exhibits to the sales agreement.

Tax and Usury: Charge Reasonable Interest

The IRS will accept the interest rate agreed to by the seller and buyer if it is reasonable in terms of the current financing market and the risk involved in extending credit. If the interest rate is outside the reasonable range, the buyer may not be able to deduct the excess interest paid. To avoid this, stick close to prevailing interest rates.

Also be aware that state usury laws limit the rate of interest that can be charged. Here, it's the seller rather than the buyer who runs the risk of running afoul of the law. Not only may the seller not be able to collect excessive interest, but he or she may also face criminal penalties.

8. Inventory

Because the inventory of salable merchandise is likely to fluctuate between the time you sign the sales agreement and the closing, consider putting a provision in the sales agreement that allows for adjustment. For example, you might say that you'll pay up to $75,000 for merchandise on hand at the closing based on the seller's invoice cost. You might also provide that if there's more than $75,000 worth of merchandise on hand when you close, you have the right to purchase the excess at the seller's cost, or to choose $75,000 worth and leave the rest in the hands of the seller.

Here's another way to handle this problem. Simply provide that a physical count of all merchandise will be made on the day of sale or another mutually agreeable date. You might define the word merchandise to include only unopened and undamaged merchandise. In a retail business, you can agree to value the merchandise at its current wholesale cost, or at the seller's current retail price less a certain percentage.

If you don't have experience doing an inventory, you might also put in the sales agreement that you and the seller will split the cost of hiring an inventory service company to determine the amount of the purchase price of the merchandise.

In a manufacturing or service business, you may have the analogous problem of placing a value on work in progress.

9. Accounts Receivable

The business you're buying may have sold goods to or performed services for customers who haven't yet paid. These unpaid sums are called "accounts receivable." Usually the accounts receivable of an existing business remain the property of that business and aren't transferred to the buyer. But a seller who prefers to be free of collection problems may want to include them.

Be very careful. When a business changes hands, accounts can be hard to collect. A considerable percentage will probably never be collected, so you should get a substantial discount. How much depends on how collectable these accounts are. By now you should know this through your close examination of the seller's books and, if most of the money is owed by only a few accounts, by checking with them personally.

10. Bulk Sales Compliance

If the business you're buying involves the sale of merchandise from a stock you'll keep on hand, you may have to comply with a "bulk sales" law. Every state used to have such a law, but today only a handful still do. These laws apply to transfers of a major part of the seller's materials, supplies, merchandise, or other inventory. Generally, they don't apply to transfers where the seller's business consists primarily of selling personal services rather than merchandise.

Typically, a seller covered under the bulk sales law must give you a list (sworn to under penalty of perjury) of all business creditors and tell you the amounts due each one. Also, the seller must tell you about any claims made by potential creditors, even if the claims are disputed. Then you send notice to the creditors so that they'll know that the business is changing hands.

If these things are not done, the creditors of the old business will continue to have a claim against the merchandise that you're buying. Sending proper notices protects you from such claims.

Sometimes, to avoid the need to comply with the bulk sales law, a contract will say that the seller will pay all outstanding debts of the business before the closing, or out of the proceeds of the sale at the time of closing, and will furnish an affidavit to that effect at closing.

For more information on your local bulk sales law and the legal forms used to comply with it, the best place to look is a legal newspaper or other major newspaper that publishes legal notices.

11. Seller's Representation and Warranties

In the sales agreement, the seller should guarantee the basic facts of your transaction. Here's an example of the guarantees when the seller is a corporation:

Seller and seller's shareholders represent and warrant that:

1. Andover Corporation is in good standing under the laws of Wisconsin.
2. Andover Corporation's board of directors has authorized (through board resolutions to be delivered to buyer at closing) the signing of this sales contract and all of the transactions called for in the contract.
3. Andover Corporation has good and marketable title to the assets that are being sold and will convey them to buyer free and clear of all encumbrances, except for the assets listed in Exhibit A, which will remain subject to the encumbrances listed there.
4. The balance sheet that Andover Corporation gave buyer correctly reflects the assets, liabilities and net worth of the business as of October 31, 2005, and there will be no material changes between the balance sheet date and the closing.
5. The income statement that Andover Corporation gave buyer accurately reflects the income and expenses of the company during the period covered, and no significant changes in the level of income or expense will occur between the contract date and the closing.

6. The lease under which Andover Corporation occupies space at 789 Oak Avenue is in full effect and is assignable to buyer. Andover Corporation will take all necessary steps to assign the lease to buyer.
7. Between the contract date and the closing, And–over Corporation will operate the business as usual and will take no action out of the ordinary.
8. Andover Corporation has complied with all applicable laws and regulations of the federal, state, and local governments.
9. There are no lawsuits or claims pending or threatened against Andover Corporation other than those listed in Exhibit __, and Andover Corporation does not know of any basis for any other lawsuit or claim against the business.
10. Andover Corporation has disclosed to buyer all material facts that would reasonably affect a prudent investor's decision to purchase the assets covered by this agreement.

In addition, if the seller made specific statements to you about the business and these influenced your decision to buy it, have the seller reiterate these statements in writing in this section of the agreement.

Don't rely on the seller's promises. *Never use the seller's warranties and representations as an excuse for not thoroughly checking all important facts yourself, as discussed in Section C, above. Enforcing a warranty against the seller or suing for a misrepresentation can involve a long and expensive lawsuit.*

If you're buying a business or the assets from a corporation, have the principal owners sign the warranties as individuals in addition to signing them as officers of the corporation. That way, you'll be able to go after their personal assets if they've misrepresented facts or if their warranties are violated.

The contract should also say that the warranties survive the closing. This gives you the right to sue if you discover some unpleasant facts about the business several years after you purchase it. Here's some wording to consider:

> The representations and warranties of the parties to this agreement and those of the seller's shareholders shall survive the closing. The act of closing shall not bar either party from bringing an action based on a representation or warranty of the other party.

12. Buyer's Warranties and Representations

The seller may expect the buyer to sign representations and warranties as well. For example:

> Buyer represents and warrants that:
>
> 1. Buyer is a corporation in good standing under the laws of Wisconsin.
> 2. Buyer has the authority to enter into and perform the buyer's obligations under the sales agreement.
> 3. Buyer has had an opportunity to inspect the assets of the business and agrees to accept the assets as is, except for the items referred to in Exhibit C.

The first representation in this example assumes you've established a corporation. You wouldn't include this statement if you were buying as a sole proprietor or signing on behalf of a partnership.

In the second representation, a corporate buyer would agree to furnish the seller with a board of directors' resolution approving the terms of the sales agreement and authorizing the signing of the purchase documents.

The third representation says that you're accepting the assets "as is." If it turns out that some of the assets are defective, that will be your problem and not the seller's—unless the seller knew about and failed to disclose some hidden defect that you couldn't be expected to discover through an inspection. Before signing a sales agreement, make sure you have actually inspected all the assets. If there are some that you haven't looked at carefully or which you're *not* willing to take as is, list them in an exhibit that specifically excludes them from the "as is" clause.

13. Access to Information

By the time you sign the sales agreement, you should have seen a lot of financial information involving the business, but you may still want to see more to verify that everything is as promised. So it's a good idea to include a paragraph or two in the sales agreement covering your right to get full information. In exchange, the seller will probably want to include language assuring that you'll deal with the information in a responsible manner—that is, that you won't make unnecessary disclosures. (For a discussion of sellers' concerns about confidentiality, see Section C, above.)

Here's some language you might place in the sales agreement:

> Before the closing, seller will provide to buyer and buyer's agents, during normal business hours, access to all of the company's properties, books, contracts, and records, and will furnish to buyer all the information concerning the company's affairs that buyer reasonably requests.
>
> Buyer acknowledges that the company's books, records, and other documents contain confidential information, and that communication of such confidential information to third parties could injure the company's business if this transaction is not completed. Buyer agrees to take reasonable steps to assure that such information about the company remains confidential and is not revealed to outside sources. Buyer further agrees not to solicit any customers of the company disclosed from such confidential information.
>
> The confidential information that may become known to buyer includes customer lists, trade secrets, channels of distribution, pricing policy and records, inventory records, and other information normally understood to be confidential or designated as such by seller.

14. Conduct of Business Pending Closing

Unless the sales agreement is signed at the closing, be sure that the seller doesn't make any detrimental changes in the business between the time you sign the sales agreement and the time you close. We considered some commitments along this line in Section G11 dealing with the seller's warranties and representations.

In addition, if you're purchasing the stock of a corporation, get a commitment that no change will be made in the Articles of Incorporation or in the authorized or issued shares of the corporation. Also, if you're dealing with a corporation, get a commitment that no contract will be entered into by or on behalf of the corporation extending beyond the closing date, except those made in the ordinary course of business.

Finally, have the corporation agree that it won't increase the compensation paid to any officer or employee and won't make any new arrangements for bonuses.

15. Contingencies

A contingency clause is a safety valve that lets you walk away from the transaction if certain things don't pan out. For example, if the location of the business is a crucial part of your decision to buy, you'll want to reserve the right to cancel the deal if you find out that the lease can't be assigned to you. The same thing might be true of a required license; if you're buying a bar, you would make the deal contingent on the state transferring the liquor license to you. If you plan to expand the business or move to a new location, make the deal contingent on your being able to get approval from the local zoning and building officials.

Here's a sample contingency clause:

> This agreement is contingent upon buyer receiving approval, by ____________ , 20____ from the landlord and the city's building and safety department for a remodeling of the premises leased by the business as shown in the plans and specifications attached as Exhibit __.

16. Seller to Be a Consultant

Sometimes it pays to have the seller stay on for a few months as a consultant or employee to help ease your transition into the business and reassure long-time customers and suppliers that the business is in good hands. If you make these kinds of arrangements with the seller, be sure to capture them in the sales agreement, using language such as the following:

> _____________________, as an independent contractor engaged by buyer, will provide consultation, customer relations, general assistance, and information to buyer pertaining to the company for up to 20 hours per week as requested by buyer for a period of eight weeks following closing. For such services, buyer will pay ________________ $______ per week.

The consulting fees are tax deductible as current business expenses.

17. Broker Fees

If a business broker is involved, specify who is responsible for paying the fee, unless you independently hired the broker to help you locate the business. Normally, the seller is responsible.

18. Notices

It's customary to state addresses for both the seller and the purchaser where any notices and demands can be sent—for example, if a payment is late or another contract term is not met. Typically, sales agreements provide that notices can be given by first-class mail, but it is appropriate to require notice by registered mail with a return receipt requested.

19. Closing Date

Include a date for the closing. That's when you'll make your down payment, and both parties will sign any documents that are necessary to transfer the business to you.

H. The Closing

Finally, the big day has arrived—you're about to become the owner of a business. In an ideal world, you'd simply give the seller a check and the seller would give you the keys. Unfortunately, there's lots of additional paperwork involved.

There's also a certain amount of stress and pressure at a closing (after all, it's not every day that you buy a business). Working with your lawyer or other advisor, make a checklist in advance listing all documents to be signed and other actions to be taken at the closing. Review this carefully a couple of days before the closing and be sure you have all your paperwork ready to go. If anything is unclear or doesn't make sense to you, ask your lawyer to redraft the language in plain English so that you and everyone else can understand it.

Checklist for a Typical Closing

- ☐ *Adjust purchase price* for prorated items such as rent payments or utilities, or changes in the value of inventory.
- ☐ *Review documents promised by seller*—for example, a corporate board resolution authorizing the sale or an opinion of the seller's lawyer stating that the corporation is in good legal standing and that the sale has been properly approved by the shareholders and/or directors.
- ☐ *Sign promissory note* if you're not paying all cash for the business. The seller may require your spouse's signature as well so that your joint bank account will be a source of repayment if the business doesn't produce enough income.
- ☐ *Sign security agreement* giving the seller a lien on the business assets if you don't pay the full price in cash at closing. (If you fail to keep up your payments as promised, the seller can take back the assets subject to the security agreement.)
- ☐ *Sign assignment of lease* if you're taking over an existing lease. If the landlord's approval is required, be sure it has been obtained before the closing.
- ☐ *Transfer vehicle titles* if cars or trucks are among the business assets.
- ☐ *Sign bill of sale* transferring ownership of other tangible business assets.
- ☐ *Sign transfer of patents, trademarks, and copyrights* if included in the sale.
- ☐ *Sign franchise transfer documents* if you're buying a business from a franchisee. This should include the signed approval of the franchisor.
- ☐ *Sign closing or settlement statement* listing all financial aspects of the transaction. Ideally, everything in the closing or settlement statement should be based on clear language in the sales agreement so that nothing need be negotiated at the closing table.
- ☐ *Sign covenant not to compete* if seller agreed to one.
- ☐ *Sign consultation or employment agreement* if the seller has agreed to stay on as a consultant or employee.
- ☐ *Complete IRS Form 8594, Asset Acquisition Statement,* indicating how the purchase was allocated among the various assets. You and the seller will attach a copy of the form to your respective income tax returns.

I. Selling a Business

Obviously, when you're just starting out in business, selling it isn't at the forefront of your mind. But there's a good chance that, sooner or later, you'll need to or want to sell. The reasons can vary widely—from not liking working for yourself, to a need to relocate, to one spouse selling to the other as part of a divorce, to retirement.

Let's look at some things you can do get a good price for your business and protect your legal position.

For in-depth guidance on how to sell a business: *See* Sell Your Business: A Step-by-Step Legal Guide*, by Fred Steingold (Nolo). The CD-ROM that accompanies the book contains a full set of forms.*

1. Valuing Your Business

When you contemplate selling all of a business or only part (which might occur if you take in a partner or sell out to your co-owner spouse as part of a divorce), your first task is to determine the value of your business.

> **EXAMPLE:** Pauline has built a thriving retail business with three locations and 24 employees. Now she's getting divorced. She and her husband have agreed that she'll keep the business rather than liquidate it. Pauline must put a value on the business so that she and her husband can arrive at a reasonable property settlement.

You can get help from an appraiser (see Section D, above) or a business broker. If you do use a broker to sell your business, carefully read the listing agreement. Consider these issues:

- Does the broker have the exclusive right to sell your business or can you sell it directly without paying a commission?
- Do you have the right to reject a proposed purchaser because of the purchaser's credit history or for other reasons without having to pay the broker's commission?
- If there's an installment sale, will the broker receive his or her total commission out of the down payment or in installments as you're paid?

If you do business through a corporation, you'll probably be selling only the assets the corporation owns—not the corporation itself—although, from a tax and liability standpoint, it's more advantageous for you to sell the corporate stock.

Timing of a sale can be critical to getting the best price. Suppose your company has had earnings of $400,000 per year for the past three years. And suppose, too, that you have good reason to believe you'll jump to $600,000 next year. You can, of course, tell a prospective buyer why you expect an increase in profits. But there's often a better tactic: hang on to the business for another year so that you have actual numbers to point to—not just a theory.

Would-be buyers will have much more confidence in your figures if you can show them several years' worth of financial statements audited or reviewed by a CPA. (The distinctions between the types of CPA reports are discussed in Section D, above.) Also, keep detailed schedules of expenses so that buyers can compare your business with others in your industry.

Getting a Good Price for Your Business

- *Show steadily increasing profits at or above the industry average.* Plan ahead. To show strong profits, you may need to give up some hidden perks. Don't fret; you'll be handsomely rewarded at sale time.
- *Put your business in good general condition.* Everything should be neat, tidy, and in good working order. Machinery should be in good repair; your inventory should be well balanced and current.
- *Maintain adequate personnel.* A buyer will be put off—and discount the price—if the first chore in running the business is to recruit and train new employees.
- *Get a written appraisal supporting your sales price.* This can help persuade the buyer that the price is right.

These suggestions are from *Valuing Small Businesses and Professional Practices,* by Shannon Pratt (Dow Jones–Irwin).

2. Read Your Lease

Your lease may say that a new business owner can't take over your space without the landlord's consent. If so, such consent will be needed if you signed the lease as a sole proprietor or partner. It will also be needed if the purchaser is buying the assets of your corporation or LLC rather than its stock or membership interests. Find out early whether your landlord will be an obstacle to selling the business and, if so, how you can get his or her support.

3. Protect Your Privacy

A prospective purchaser will want to investigate your business thoroughly before signing a purchase agreement. To protect your privacy, use a confidentiality or nondisclosure agreement in which the potential purchaser promises not to use or disclose confidential information about your business—unless, of course, he or she decides to buy it. (A sample agreement is shown in Section C, above.) A prospective purchaser who violates this agreement can be sued for damages and injunctive relief.

4. Sign a Letter of Intent

In Section F, we looked at the nonbinding letter of intent from the standpoint of a buyer. There's no reason why such a letter can't be drafted by a seller who wants to summarize the terms of the proposed transaction as part of testing whether a potential buyer is serious.

5. Draft a Sales Agreement

To understand the elements of a sales agreement, read the previous sections of this chapter, particularly Section G. Here are some points to consider from the seller's viewpoint:

a. Structure of the Sale

The sales agreement structures the sale. As noted in Section B1, if you're doing business as a sole proprietor or partnership, the structure of the sale is a foregone conclusion: You'll sell the assets of the business to the buyer. But if you're doing business as a corporation or LLC, the matter is more complicated. It's almost always better for you to sell your corporate stock or LLC membership interests than to have your business sell its assets. But for tax and liability reasons, buyers prefer to buy assets rather than stock or membership interests.

b. Excluded Assets

If you're selling the assets of the business or the business itself—whether it be a sole proprietorship, a partnership, a corporation, or an LLC—the purchase agreement lists the assets being transferred. Typically, this includes furniture, fixtures, equipment, inventory and vehicles, and the business name. Equally important, specify any items excluded from the sale, for example: cash, accounts receivable, life insurance policies, or your personal desk or computer.

c. Allocation of Purchase Price

In Section G, we focused on the allocation of the purchase price from the buyer's standpoint. The buyer typically wants to assign a relatively high value to items that can be quickly written off or depreciated for tax purposes. The seller generally prefers to place a high value on assets that will provide long-term capital gain treatment; the tax on such gain is lower than the tax on ordinary income. A tax pro can help size up your particular sale and recommend how to allocate the purchase price. Also, a tax pro can suggest ways to adjust the purchase price up or down to reflect whoever takes the tax hit.

d. Adequate Security for Installment Sales

When a small business is sold on an installment payment basis, the buyer typically makes a down payment of 20% to 40% of the purchase price and pays the balance in monthly installments over three to five years. Plan ahead in case the buyer doesn't keep up the payments as promised. Insist that the buyer's spouse sign all closing documents jointly with the buyer. That way, if you need to sue the buyer because of nonpayment, you have a chance of collecting the judgment out of a house owned jointly by the buyer and spouse, or from bank accounts in their joint names. If the couple's credit is weak, insist that the documents be signed by an outside guarantor.

The purchase agreement should require the buyer to give you a security interest (also called a lien) in the business assets. A financing statement that's filed with county or state officials will give public notice that you have a claim on the business assets.

If you're doing business as a corporation and are selling your stock, consider placing the stock certificates in escrow. That way, the buyer won't receive the certificates until the purchase price has been paid in full.

e. Looking to the Future

The buyer may want to hire you for several months or years as a consultant or employee. If so, spell this out in the sales agreement or in a separate document signed at the same time. Be specific about the types of services you'll be expected to render, the amount of time you're committing, and the amount you'll be paid. Sometimes, compensation for a seller's post-sale services is simply folded into the purchase price so the seller receives no additional payment.

If you've agreed not to compete with the buyer, the terms should be specified in a covenant not to compete. Cover such matters as precisely what business or activities you won't engage in, being careful not to burn all of your bridges. Think carefully about how long you're willing to refrain from working in a competing enterprise and how large a geographical area should be barred during the noncompetition period. (See Section G5.)

f. Warranties

Sales agreements typically contain numerous warranties and representations by the seller and a few by the buyer. (See Sections G11 and G12 for examples.) Read your warranties and representations carefully to make sure they don't go too far.

For example, suppose the proposed warranty language says: "Seller warrants that the business name does not conflict with the name of any other business." What happens if, the day after the sale, a business that you didn't know about surfaces and complains that it had the name first? With the warranty wording given here, you could be liable for damages whether or not you knew about the other company.

If you see a warranty that's too far-reaching, have it rewritten. In our example, you might say something like "Seller warrants that, to the best of seller's knowledge, . . ." Or perhaps you could say: "Seller warrants that it has received no notice that its business name conflicts with that of any other business." ■

CHAPTER

11

Franchises: How Not to Get Burned

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America's landscape is dotted with franchises: Take the first exit off any freeway, and you're likely to spot familiar ones offering fast food, gasoline, groceries, lodgings, and more. So, you might conclude, they must be making money, or they'd pack up and disappear. And why shouldn't you buy into an established chain to get a jump on the learning curve and tap into an existing customer base?

Not so fast. For most people hoping to own a small business, buying a franchise is a poor idea. Most of the franchises you see on the road—or on Main Street or at the mall—are just barely eking out a profit beyond the percentage they must pay to the franchise vendor (the "franchisor"). Worse yet, some of their owners would like to sell, but can't. Because of the legal and economic rules exerted by the franchisor, you may end up feeling more like an indentured servant than an entrepreneur. In my view, you'll be happier and farther ahead financially if you start a business from scratch or buy an existing one.

In this chapter, I'll explain how franchises work, and delve deeper into their pitfalls. Then I'll introduce you to the two most important legal documents that are involved in the purchase of a franchise: the Uniform Franchise Operating Circular (UFOC) and the Franchise Agreement.

For more insight into the perils of franchise ownership: *Read the chapter titled "Don't Buy a Franchise" in* How to Run a Thriving Business*, by Ralph Warner (Nolo). Also see* The Franchise Fraud: How to Protect Yourself Before and After You Invest*, by Robert L. Purvin, Jr. (John Wiley & Sons, Inc.). You'll find additional information on the websites of two organizations dedicated to promoting the rights of franchises: The American Franchisee Association (www.franchisee.org) and The American Association of Franchisees & Dealers (www.aafd.org). Both contain valuable information to help you protect your legal and financial interests. Also, the website of the U.S. Small Business Administration (www.sba.gov) offers a helpful download, "Evaluating Franchise Opportunities."*

Get professional advice before you plunge in. *Don't wait until you find yourself trapped in a costly and frustrating relationship with a franchisor—at which time you may have little legal recourse. It's worth paying for some sound legal and financial advice before you get locked into a contract or pay the franchisor a cent.*

A. What Is a Franchise?

The most convenient analysis and definition of a franchise comes from the Federal Trade Commission (FTC)—the one government agency that has nationwide regulatory power in this field. The FTC recognizes two types of business relationships that qualify for regulation as franchises:

- *The Package Franchise.* The franchisor licenses you to do business under a business format it has established. The business is closely identified with the franchisor's trademark or trade name. Examples include car washes, fast food outlets, motels, transmission centers, tax preparation services, and quick copy shops.
- *The Product Franchise.* You distribute goods produced by the franchisor or under the franchisor's control or direction. The business or goods bear the franchisor's trademark or trade name. Examples include gasoline stations and car dealerships.

This chapter deals primarily with package franchises, which are more common.

The FTC definition is broad. It covers all of the businesses that you and I would ordinarily think of as franchises. Generally, the FTC (and many state agencies that regulate franchises) will classify your business relationship as a franchise if three conditions exist:

- You have the right to distribute goods or services that bear the franchisor's trademark, service mark, trade name, or logo.
- The franchisor significantly assists you in operating your business or significantly controls what you do. For example, your franchisor might assist in site selection, train you and your employees, or furnish you with a detailed instructional manual. A franchisor might exercise control by telling you where your business must be located and how your shop must be designed, or by dictating your hours, accounting and personnel practices, and advertising program.
- You pay a fee to the franchisor of more than $500 for the first six months of operations. (In the real world, you're going to be paying a franchisor much more—probably anywhere from $10,000 or $20,000 to $1 million.)

All of this can add up to a complex and expensive relationship between you and the franchisor.

EXAMPLE: Lila loves the idea of selling doughnuts, and buys a franchise from Munchin Donuts International. She pays Munchin Donuts $50,000 as a franchise fee plus an additional $5,000 for training for herself and an assistant. Lila and her assistant must travel to the Munchin Donuts headquarters in another state for the training. Munchin Donuts helps her find a suitable location for a doughnut shop, then prescribes the store layout and décor. Lila makes the necessary improvements, but can't use her favorite contractor—she must use one on Munchin Donuts' approved list. She buys the doughnut-making equipment and shop furnishings directly from Munchin Donuts, as required by her franchise contract. Munchin Donuts provides Lila with a 500-page operating manual called *Making Donuts the Munchin Way.* Lila is also given the right to use the Munchin Donuts logo in her signage and advertising. Lila must buy all of the doughnut mixes directly from Munchin Donuts, and each month she must pay Munchin 8% of her gross sales, plus a hefty fee for participation in Munchin's co-op advertising program. She must keep the shop open from 7 a.m. to 9 p.m., six days a week, as required by the Munchin Donuts operating manual.

B. The Downsides of Franchise Ownership

During your negotiations to buy a franchise, while everyone is still smiling, the franchisor is likely to assure you that you won't be in business all by yourself, but will be part of a team selling a recognized product or service. Franchisors typically also tout three other supposed benefits:

- *A proven plan for running the business.* The franchisor will furnish an operations manual that can serve as a roadmap to get you started.
- *Help from the franchisor if you run into problems.* The franchisor promises to make people available who are experienced in real estate, personnel policies, accounting, and day-to-day operations.
- *A national or regional marketing program to attract customers.* The franchisor promises to advertise in print and on radio and TV so that the brand will become famous and customers will flock to your door.

Even if the franchisor makes good on all of these commitments—and many won't—the price you'll pay to get these benefits may be backbreakingly high. Do you really need to pay a company month after month, year after year, in order to master the fundamentals of making pizza or cleaning houses? As for business help from the franchisor, can't you simply hire advisors on an as-needed basis to help you with real estate, marketing, or accounting issues? (As a matter of fact, you can probably learn the basic management skills you'll need by taking a course or two at a nearby community college.) And will the franchisor really invest enough money to build the kind of brand recognition that translates into huge profits for you? It's highly unlikely.

It's true that some small business people have signed on for a franchise and found prosperity and happiness, but many more have lost their shirts and feel bitter about their franchise experiences. So before you're seduced by the glitter of the franchisor's glib promises, take a hard look at the downsides of investing in a franchise.

It takes money to make money. *Some franchises may have a high profit potential—but the better ones tend to be well beyond the reach of the small operator. As Ralph Warner convincingly explains in* How to Run a Thriving Business: Strategies for Success & Satisfaction *(Nolo), national hotel and motel groups may offer fine franchise opportunities, since they provide a real service through their 800 phone numbers and reservation booking services. Ditto for auto rental franchises since they, too, offer something of value. And franchises with famous and respected brands such as McDonald's and Pizza Hut may be worth the high cost. But these blue-chip opportunities are expensive to buy into. If you're an ordinary entrepreneur with possibly $50,000 or $75,000 to invest, you'll probably be looking at lesser-known franchises for which the prospects are not nearly so bright.*

Let's look at some reasons why franchises are usually a worse option than starting your own business or buying an existing one.

1. The Franchisor Gets a Huge Chunk of the Pie

The franchisor will almost certainly insist on getting a thick slice of your financial action—often the lion's share. Franchisors have figured out many ways to make money on your business, including:

- *Franchise fees.* You must always pay up front for the right to be a franchisee. These buy-in fees can verge on the astronomical, especially for a successful, nationally established franchise.
- *Royalties.* Commonly, the franchisor gets a percentage of the income your franchise earns. Income usually means gross sales, not profits. If your franchise takes in $200,000 from gross sales and your contract calls for a 10% royalty, the franchisor will be entitled to receive $20,000 whether or not your business earns a profit. Other operating expenses can easily eat up the remaining $180,000 of gross income, leaving nothing—or even less.
- *Markups on equipment, goods, and supplies.* The franchisor may add dollars to the cost of equipment, goods, and supplies that the franchisor furnishes. Many franchise agreements require you to buy certain items from the franchisor rather than from outside suppliers; others let you buy through outside sources if the items meet the franchisor's specifications. If, for example, you're required to purchase cooking equipment from the franchisor, you may pay a bundle more than you'd pay a restaurant supply store.
- *Training fees.* Often you must pay the franchisor to train you and your employees—whether or not you need the training.
- *Co-op ad fees.* These fees cover advertising for the entire group of franchises or a regional group. For example, you may have to contribute to a fund for national advertising or for advertising for all the franchisees in your metropolitan area—whether or not any of your customers are likely to see the ads.

- *Interest on financing.* You may have to pay for deferring payment of a portion of the franchise fee, the cost of improving your business premises, or buying equipment.
- *Leases.* Your franchisor may charge you rent on real estate or equipment. Typically, the franchisor does not lease real estate or equipment to you at the franchisor's cost but adds on a profit factor. But because relatively few franchisors own the premises where their franchisees do business, real estate lease charges are relatively uncommon.

If it appears that I'm painting a grim picture, I am. After you've made all the required payments to the franchisor, there may be very little left for you.

LAW IN THE REAL WORLD
Going It Alone

Phil, a real estate broker, wanted to open his own shop. He first considered going it alone, but then decided he might do better by purchasing a franchise from one of the national organizations. He contacted several and was amazed to find that he couldn't buy a one-office franchise directly from them. Instead he was told that in his region a "master" franchise had already been sold and that he would have to contact this company to purchase a subfranchise.

When he did, he learned that his region had been divided into hundreds of subregions or territories, each of which was for sale through a local real estate office. All training, quality control, and recruiting was done by the master franchise holder, not the national organization.

Eventually, Phil decided not to purchase any of the local franchises he was offered, concluding that the territories had been divided too narrowly. In the meantime, he has opened his own office and is doing fairly well. He might still affiliate with a franchise organization, but only if he can find one that sells good-sized territories at a reasonable price.

2. The Franchisor Can Tell You What to Do

If you're like many entrepreneurs, part of the attraction of owning a business is that you're free to make your own business decisions, test new ideas, and change and improve the products and services you offer. Unfortunately, when you're a franchisee, you give up a great deal of that freedom. The franchisor typically prescribes a formula for running the business and, for the most part, you're locked into using it. Don't be surprised if you soon become frustrated and bored.

But the consequences of signing on as a franchisee can go much farther than just stifled creativity. There's a real chance that your bottom line will be affected. Small businesses normally enjoy a huge advantage over multistate giants: they're nimble enough to respond quickly to local conditions.

By contrast, large organizations can't react nearly as fast, meaning that opportunities for adding profits—or avoiding losses—can be missed. For example, if you own a pizza franchise and notice that everyone in town is going crazy for fresh shiitake mushrooms, you could wait years before your franchisor lets you put any mushroom atop your pizza that isn't straight from a can. You're just a cog in a huge machine.

3. The Franchise Contract Will Favor the Franchisor

When you buy a franchise, you'll need to sign a contract with the franchisor. Contracts aren't bad in and of themselves—they're useful tools for spelling out all the terms and conditions of the relationship. However, the contract that you'll be handed will have been drafted by a team of skilled lawyers hired by the franchisor and will most likely contain dozens of clauses aimed at giving the franchisor every conceivable advantage. And you'll probably be told to "take it or leave it," with no opportunity to negotiate any of the contract terms.

To give you an idea of how one-sided these contracts can be, here are some clauses you're likely to find in the typical franchise contract.

- **Competition.** The franchisor will usually protect its freedom to grant additional franchises without restriction. This means that if your operation is successful, the franchisor may decide to sell a franchise to someone else right down the street, cutting into your market share. By contrast, you'll be required to agree that after the franchise relationship ends, you won't compete with the franchisor—either directly or indirectly. This stops you from working or investing in a similar business. While it's reasonable for the franchisor to want to protect its trademarks and trade secrets, the franchisor already has plenty of legal protection in this area. The franchisor has no solid justification for interfering with your ability to earn a living doing similar work after you've stopped being a franchisee—but it has superior bargaining power. It can usually force even unreasonable restrictions on you as part of the price of buying the franchise.
- **Selling Your Franchise.** When you own your own business, you're free to sell it to whomever you wish. Not so with a franchise. Typically, you can't sell your franchise unless the franchisor approves of the buyer. This means that if you want to retire or move to another state or shift to a different line of work, you're at the mercy of the franchisor. If the franchisor is picky, you may be left with few—if any—prospective buyers, and you may have to settle for a fraction of what the business is worth. Worse yet, the buyer will have to sign a new franchise contract, which may call for even higher royalty charges than you've been paying, making it all the more difficult to sell the business.
- **Disputes.** The contract may require you to resolve any disputes with the franchisor in the courts of the franchisor's home state. If you do business in Oregon and the franchisor's headquarters are in New Jersey, that's a long and expensive trip.
- **Goods and Services.** The contract may force you to buy all your goods and services from the franchisor. If you have to buy your milkshake mix from the franchisor, and your marketing services as well, you'll probably end up paying much more than if you were free to buy from vendors of your choice.

For more on franchise agreements, see Section E.

4. The Government Won't Protect You

Franchisors become very adept at selling franchises—but aren't known for following through on what they promise in the sales presentations. Some franchisors are notorious for misrepresenting key facts about their organization. Many deftly inflate your expectations of the profits you'll bring in. And some are fly-by-night outfits operating entirely by smoke and mirrors.

Don't assume you can go running to the government for help if the franchisor's promises turn out to be puffery. Neither the state nor the federal government is going to thoroughly investigate the accuracy of information in the offering circular or bail you out if things go wrong. True, you may get limited help from a government agency to close down or even prosecute an operator whose actions constitute outright fraud. But even in the case of blatant dishonesty by the franchisor, you'll be pretty much on your own in trying to get back your money.

The time to be cautious is at the beginning, while you listen to the sales banter from the franchisor. Remember that you're almost surely not receiving a balanced, objective point of view. No matter what they say about peace, brotherhood, and all prospering together, most franchisors look at their job as simply to sell as many franchises as possible, as fast as possible, at the highest price possible.

Some Sobering Statistics

Benefits touted by the franchise industry may be overblown. Timothy Bates, an economics professor at Wayne State University, studied the numbers for a four-year period. Here's his comparison of what happened to those who started an independent business from scratch versus those who started a franchised business:

	Started an Independent Business	Started a Franchised Business
Maintained Ownership	62%	54%
Shut Down	32%	38%
Gave up Ownership	6%	8%

Professor Bates also found that after four years, people who bought an independent ongoing business were doing better than those who bought an ongoing franchise business. He cites these figures:

	Bought Into an Independent Business	Bought Into an Ongoing Franchise Business
Maintained Ownership	68%	52%
Shut Down	18%	32%
Gave up Ownership	16%	15%

Professor Bates concluded that whether someone starts a new business or buys one that's already in existence, the risk of having to shut down is greater if the owner takes the franchise route.

Source: *Inc. Magazine*, July 1995

C. Investigating a Franchise

If you've done your research and have identified a few businesses in which you believe you could be successful as a franchisee, investigate the franchisors. A good track record counts. Find out how many franchises each franchisor has in actual operation—information that's readily available in the offering circular. (See Section D20.)

Next, carefully evaluate whether the specific franchise operation you're thinking about makes economic sense. Is there really a demand out there for the product or service that you'll be selling? Can you make a decent profit given how much you can charge and your cost of doing business?

Don't forget to count all those franchise fees. The franchisor may give you actual or hypothetical projections of how much money a typical franchisee can earn. Distrust these. Chances are they're full of hype. Ask for financial details about individual franchise operations that are geographically and demographically similar to the one that you're considering.

Most important, speak to a number of other franchisees. The names and addresses of those in your state will be listed in the offering circular. (Again, see Section D20.)

The more you know about the franchisor, the better. Visit the home office, even if it's in another city or state. Get to know the people you'll be dealing with if you buy. What's the background of the owners, officers, and management staff of the franchisor? Do they have the experience and competence to give you the promised technical support?

Be especially suspicious of franchises that promise big profits for little work and offer a moneyback guarantee. Rarely do you get something for nothing in this world and almost never do you get your money back when business deals go awry.

Learn how much help you can expect from the franchisor in:

- selecting a site
- negotiating a lease
- writing and placing help wanted ads for employees

- interviewing prospective employees
- getting the necessary business licenses, and
- ordering equipment.

Make sure all key promises are in writing. Oral statements don't count: Often they're not legally enforceable, but even where they are, proving in court what someone said years before may be impossible. One good way to get things in writing is to take notes when you talk to the franchisor. Then write up your notes, review them with the franchisor, and ask for the signature of someone in authority.

With a larger franchisor, many of your contacts will be with a district or regional manager. Meet these people and find out what they're like.

Ask about whether any franchise operations have closed. Obviously, this is a sensitive topic for a franchisor. Ideally, the franchisor will be honest in discussing failures with you, but you can't count on this. If the franchisor seems to be stonewalling, try to get the names of franchisees whose operations failed from existing franchisees and talk to them directly.

Investigate the area where your franchise will be located. Talk to people who work or live nearby to learn more about the behavior and tastes of potential customers. What do other business owners have to say about your customer base? How do they think your franchise will fit into the community?

D. The Uniform Franchise Offering Circular

The Federal Trade Commission requires franchisors to give prospective franchisees an offering circular containing details about the franchise. In addition, the franchisor must give you a copy of the proposed franchise agreement and related documents. But FTC rules don't dictate the terms of the deal you and the franchisor agree to. As long as there's full disclosure, the deal can be very one-sided in favor of the franchisor and still be legal.

The FTC does list the items that a franchisor must include in an offering circular and provides a format for the franchisor to follow. Most states that regulate franchise sales prefer a slightly different format called the "Uniform Franchise Offering Circular." Since the FTC says it's okay for a franchisor to use that format, practically every national franchisor does.

Although the FTC requires the disclosure, it doesn't verify or vouch for the information the franchisor discloses. It's up to you to check out anything you don't understand or that sounds too good to be true.

Under FTC rules, if you're a prospective franchisee, the franchisor must give you the offering circular at the earliest of either:

- your first in-person (face-to-face) meeting with the franchisor, or
- ten working days (not counting Saturdays and Sundays) before you sign a contract or pay money to the franchisor.

If a franchisor violates these or other FTC rules, it may face heavy civil penalties. Also, the FTC may sue the franchisor, on your behalf, for damages or other relief, including cancellation of a franchise contract and refunds.

State laws often provide other avenues of relief for violation of disclosure and other requirements. For example, in some states, you may have the right to sue a franchisor who fails to make disclosures properly. In other words, you won't have to rely on the state to make your case for you.

Knowing that these legal avenues are open to you may give you some peace of mind—but don't relax your guard too much. If the franchisor becomes insolvent or goes into bankruptcy, chances are you'll recover only a minuscule part of your loss, or maybe nothing at all.

Here are the 23 items included in the Uniform Franchise Offering Circular and brief comments about how to think about each:

1. The Franchisor, Its Predecessors and Affiliates

Here you'll learn the name of the franchisor and its predecessors and affiliates, as well as the name under which the franchisor does business. You'll also find out if the franchisor is a corporation, a partnership, or some other type of business.

The franchisor then describes its businesses and the franchises being offered, and lists the business experience of the franchisor and its predecessors and affiliates. You can find out how long the franchisor has operated the type of business you'd be franchising. You can also learn whether the franchisor has offered franchises in other lines of business and the number of franchises sold.

Finally, the franchisor must describe any regulations that are specific to the industry in which the franchisee operates.

2. Business Experience

The franchisor must list its principal officers. For each officer, his or her job for the past five years must be disclosed.

3. Litigation

This is where you learn the legal history of the franchisor. If the franchisor or its associated people have a history of legal problems, watch out. If the franchisor follows the FTC rule, you'll discover, for example, whether or not there are administrative, criminal, or civil cases alleging:

- violation of any franchise, antitrust, or securities law
- fraud
- unfair or deceptive trade practices, or
- comparable misconduct.

If any such actions are pending, the offering circular must provide full information.

Furthermore, the franchisor must disclose whether, in the past ten years, the franchisor or its people have been convicted of a felony, pleaded no contest to a felony charge, or have been held liable in a civil action involving any of the offenses listed above.

And there's more: If the franchisor or associated person is subject to an injunction (court order) relating to a franchise or involving any laws on securities, antitrust, trade regulation, or trade practice, the franchisor must disclose this information. This can provide an early warning of potential problems.

Don't rely on the franchisor's explanations of lawsuits involving the company. You can look at the court files, which are open to the public and will name all of the participants on both sides. Call the people on the other side and get their version of events.

4. Bankruptcy

The franchisor must state whether the franchisor or its officers have gone through bankruptcy or been reorganized due to insolvency during the past ten years. The information required is far-reaching. The franchisor must disclose if any officer or general partner was a principal officer of any company or a general partner of any partnership that went bankrupt or was reorganized due to insolvency within one year after the officer or general partner was associated with the company or partnership.

5. Initial Franchise Fee

Read this section carefully to learn how much you'll be charged before you open for business and whether you'll have to pay it in a lump sum or installments. The franchisor must also explain under what conditions your money will be refunded.

If the franchisor doesn't charge identical initial fees to each franchisee, the franchisor must tell how fees are determined, or state the range of fees charged in the past year.

6. Other Fees

Here's where you get detail about any required fees. Using a simple chart, the franchisor must tell you the formula used to compute fees and the conditions for refunds.

When any fees are set by the vote of a cooperative organization of franchisees—for advertising, for example—the franchisor must disclose the voting power of franchisor-owned outlets. If franchisor outlets have controlling voting power, the franchisor must disclose a range for the fees.

7. Initial Investment

These are estimates (or a high-low range) of expenses you'll be responsible for. You'll be told who the payments must be made to, when the payments are due, and the conditions for refunds. If part of your initial investment may be financed, you'll learn the details, including interest rates.

Listed expenses include those for:

- real estate, whether it's bought or leased
- equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements, and decorating costs
- inventory required to begin operation
- security deposits, utility deposits, business licenses, other prepaid expenses, and working capital required to begin operation, and
- any other payments you must make to start operations.

Don't invest everything in a franchise. *These fees can add up to far more than you first expected and dangerously stretch your budget. Never put every last cent into a franchise. Even with an honest franchisor, there's a good chance you won't make any money the first year. Keep enough money in reserve to live on during the startup phase. And always be wary about pledging your house for a loan needed to buy a franchise. It's one thing to risk your savings; it's quite another to risk the roof over your family's head.*

8. Restrictions on Sources of Products and Services

Here, the franchisor states whether you're required to purchase or lease from the franchisor—or from companies designated by the franchisor—any of the following: goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, or real estate.

The franchisor also must say if and how it may earn income from these required purchases or leases. As mentioned in Section B, many franchisors mark up the products they require their franchisees to buy from them.

9. Franchisee's Obligations

In a simple table, the franchisor lists each of your obligations and tells you where each is spelled out in the franchise agreement and offering circular.

10. Financing

Look for the terms and conditions of any financing arrangements offered to help franchisees afford the purchase. Also review the statement of your liability if you can't make the payments.

As you review these, bear in mind that after signing onto a promissory note or financing contract requiring you to make payments to the franchisor, you may find that some other company has acquired the right to collect the debt from you. This can happen if the franchisor sells or assigns (transfers) the promissory note or financing contract to the other company.

In the offering circular, the franchisor needs to state whether or not it plans to handle the financing arrangement this way. It may seem like a minor detail, but it can affect you down the road. Here's why: If you're dealing directly with the franchisor in making your payments, you may be able to withhold payment if the franchisor isn't meeting its obligations to you. By contrast, if the note or financing contract has been transferred to somebody else, you'll probably be obligated to pay regardless of how poorly the franchisor is performing.

Beware of finance charges. *Paying finance charges and interest on notes held by the franchisor is a real financial burden. If you can't afford to pay all of the franchise fees up front, maybe you shouldn't buy the franchise. Think long and hard before you pledge your house as security for these obligations—and before you ask your spouse or a relative to be a cosigner or guarantor of the debt.*

11. Franchisor's Obligations

What are the franchisor's obligations to you before you open your franchise business? For example, will the franchisor select a location for your business? Will the franchisor help you:

- negotiate the purchase or lease of the site?
- make sure the building you'll occupy conforms to local codes?
- obtain required building permits?
- construct, remodel, or decorate the premises?
- purchase or lease equipment, signs, and supplies?
- hire and train employees?

And what kind of assistance will the franchisor give you once your business is operating?

Look for detailed answers to these questions as well as a description of the training program the franchisor will provide, including: the location, length, and content of the training program; when the training program will be conducted; experience that instructors have had with the franchisor; any charges for the training; the extent to which you'll be responsible for travel and living expenses of people enrolled in the training program; and whether any additional training programs or refresher courses are available or required.

12. Territory

Here the franchisor describes whether or not you have any territorial protection. Check to see whether the franchisor has established another franchisee or company-owned outlet in your territory, or has the right to do so in the future. Obviously, your business will be in trouble if the franchisor defines your exclusive territory very narrowly and then floods the market with outlets offering similar products or services.

Even if you have exclusive rights within a territory, you may not be safe from direct competition. Some franchisors require you to achieve a certain sales volume or market penetration to keep those exclusive rights. Make sure you understand under what conditions your area or territory can be altered.

13. Trademarks

Most likely your franchise will require you to use the franchisor's trademarks, service marks, trade names, logos, or other commercial symbols. Fine. In many ways, these represent much of the value of a franchise. In fact, you'll want to research whether the franchisor itself has an ongoing right to use these marks and symbols.

For starters, the franchisor must tell you in the offering circular whether or not the franchisor's trademarks and symbols are registered with the U.S. Patent and Trademark Office. The franchisor must also describe any agreements, administrative proceedings, or court cases that may affect your right to use these trademarks and symbols.

Franchisors should stand behind their trade names and trademarks. Even if a trademark is properly registered, it can still be challenged in court by a company that used it before the franchisor used it or registered it. Make sure that your franchisor is obligated in writing to defend any challenges against its names and trademarks and to indemnify you against any damage awards for using them. The franchisor should also agree to reimburse you for out-of-pocket expenses if you have to replace signs and print new supplies because of an adverse court ruling regarding names or trademarks.

14. Patents, Copyrights, and Proprietary Information

The franchisor must give full details about any patents or copyrights that relate to the franchise and the terms and conditions under which you can use them. Let's say, for example, that a tire store franchisor has published an excellent copyrighted booklet telling consumers how to choose the right tires for their cars. The franchisor needs to disclose whether there have been any administrative or other claims filed that might affect the continued use of the booklet. And the franchisor needs to state whether it can require its franchisees to discontinue use of the booklet in running their franchisees.

Also, the franchisor must state if it claims proprietary rights in confidential information or trade secrets.

15. Obligation to Participate in the Actual Operation of the Franchise Business

Some franchisors permit someone to own a franchise without actively participating in the operation of the business. Other franchisors want the owner to be fully involved. The franchisor must state whether or not it will obligate you to participate personally in operating the franchise business. It must also state whether or not it recommends that you participate.

If the franchisor doesn't require you, as a franchise owner, to personally be present and run the business, it may require that you employ an on-site manager who has successfully completed the franchisor's training program.

16. Restrictions on What the Franchisee May Sell

If you're going to be restricted in the goods or services you can offer or the customers you can sell to, this must be spelled out in the offering circular. Find out if you'll be required to carry the full range of the franchisor's products. For example, with a food franchise, do you have to offer the full menu? Can you add items to the menu?

Also, check whether the franchisor has the right to change the types of goods and services you're authorized to sell.

17. Renewal, Termination, Transfer, and Dispute Resolution

You're entitled to know the conditions under which you may renew, extend, or terminate your franchise and also the conditions under which the franchisor may refuse to deal with you. (See Section E8 for more on termination.)

Look, too, for information on whether disputes must be submitted to mediation or arbitration in place of going to court.

Mediation or arbitration is usually a plus. *Fighting a franchisor in court can be prohibitively expensive for a franchisee. The franchisor usually has very deep pockets and can better afford to finance—or even drag out—the litigation. If a legal* *dispute can't be settled through negotiation, it's almost always better for you to submit the matter to mediation or arbitration rather than go to court. Mediation and arbitration proceedings are much less expensive than lawsuits—and speedier to boot. There's a trade-off, however: In a lawsuit you can compel the franchisor to show you key documents and to answer questions under oath (in what's called a pretrial deposition). Mediation and arbitration offer only very limited opportunities for this type of information gathering. For more on resolving legal disputes, see Chapter 22.*

18. Public Figures

Some franchisors use celebrities to promote franchise operations. The franchisor must disclose any compensation or other benefit given or promised to any public figures for using their names or endorsements. You also need to be told the extent to which celebrities are involved in the actual management or control of the franchisor and how much—if anything—they have invested in the franchise operation.

19. Earnings Claims

The franchisor has a choice. It can disclose the actual or potential sales, profits, or earnings of its franchisees. Or it can say nothing on the subject—which is what most franchisors choose to do. If the franchisor does make any earnings claims, the offering circular must describe the factual basis and material assumptions that underlie these claims.

For earnings claims to make sense, you need to know the franchise locations that the numbers are based on and the number of years that they have been in operation. Actual figures are, of course, more helpful than hypothetical projections. Before you buy a franchise, have your accountant go over the numbers with a fine-tooth comb. Also check with a number of existing franchisees to see how they're doing.

20. List of Outlets

The information in this part of the circular can be a gold mine if you take advantage of it. The franchisor must list the total number of franchise locations and state how many of them were in operation when the offering circular was prepared, as well as how many are covered by franchise agreements but are not yet in operation. The franchisor must also list the names, addresses, and telephone numbers of all its franchises in your state.

A company with a hundred franchises up and running has had a chance to test its business formula and has experience in helping franchisees get started. A company with only eight or ten units in operation is relatively young and still has a lot to learn. But be leery of a franchise that's merely on the drawing board and isn't yet in actual operation. It may never open and, even if it does, may not prosper. Obviously, a franchise that's not yet open can't give you hard information about sales or profitability.

The franchisor must also tell you how many franchises it has canceled or terminated in the last three years; how many it has not renewed; and how many the franchisor has reacquired.

Contact franchisees in your state or in nearby states. Ask questions: "How's it working out? Was it a good deal? Would you do it again? Are you making a profit? How much?" Franchisees sometimes feel locked in and are reluctant to admit that they made a mistake in buying a franchise, but they might level with you if you ask, "Would you feel comfortable recommending that I put my life savings into this deal?"

Ask franchisees whether they get help and support from the home office and how often they see someone from headquarters. Spend a day or two at a few franchises. Picture yourself in that setting. How does the system seem to be working? If there's a franchisee organization, see if you can attend meetings and get old newsletters. Don't rely on what one or two franchisees tell you—they could have unrevealed ties to the franchisor or be unrealistically positive because they're trying to unload their own franchise or will be paid a commission if they help reel you in.

21. Financial Statements

The franchisor must file audited financial statements showing the condition of the company. Unless you have experience in interpreting financial statements, get an accountant with experience with franchises to interpret the figures and help you develop tough questions. You want a franchisor to be financially strong enough to follow through on training commitments, trademark protection, and support services. If a franchisor is financially weak—many are—and folds overnight, your franchise may not be worth much.

To find an accountant with the right experience, seek recommendations from owners of successful local franchises who have been in business for a while.

22. Contracts

The franchisor must attach to the offering circular a copy of all agreements that you'll sign if you purchase the franchise. This includes lease agreements, option agreements, and purchase agreements. Read them carefully and don't sign until you understand everything.

23. Receipt

The last page of the offering circular is a detachable receipt, which you sign as evidence that you received the offering circular.

E. The Franchise Agreement

If you buy a franchise, you and the franchisor will sign a long document called a franchise agreement. There probably will be other documents to sign at the same time, but the franchise agreement is far and away the most important. Whether or not any terms of the agreement are negotiable depends on whether the franchisor is new or long established and on prevailing market conditions. A new franchisor eager to penetrate the market may be more flexible and willing to make concessions than an established franchisor whose franchises are in high demand.

Again, if the franchisor has made any promises to you, make sure that they're in the franchise agreement. Otherwise, chances are you won't be able to enforce them.

LAW IN THE REAL WORLD
Talk to Someone Who's Been There

Joan, a legal secretary, inherited $200,000. To achieve her goal of financial independence, she decided to start a business. Drawing on the experience of her cousin Max, who had done very well running several franchised taco stores, Joan decided to look at franchise opportunities.

Because she couldn't afford a major franchise, she narrowed her search to small outfits. One, a Belgian waffle shop, particularly intrigued her. When she expressed interest and her solvency was documented, she was quickly:

- flown to corporate headquarters
- assigned to two enthusiastic "vice presidents"
- shown an exciting video featuring a waffle shop overflowing with happy customers
- taken on a tour of a "typical" waffle franchise outlet, and
- told there were only a few franchises left and she had to decide quickly.

It almost worked. But at literally the last minute before signing she decided she had better call her cousin Max. He yelled "stop" so loudly that she told the franchise she wanted a few days to investigate, even if it meant losing out on the deal.

The investigation showed that the franchise was almost broke, three lawsuits from disappointed franchisees were pending, and the supposedly successful franchise was owned by the parent company and looked successful because prices were kept artificially low to bring in customers. And, oh yes, the "vice presidents" who dealt with Joan were really sales reps working on commission.

Let's look at a few sensitive areas of a franchise deal that you must be aware of before you plunk down your money and sign an agreement.

1. Franchise Fee

The extent of your personal liability for the franchise fee and other franchise obligations is a crucial consideration for you in making this deal.

Does the franchise agreement allow you to avoid personal liability for franchise-related debts by forming a corporation to serve as the franchisee? Or does the franchisor require you (and perhaps your spouse as well) to be personally responsible for all franchise obligations?

At the risk of being repetitive, I strongly recommend against pledging your house or other assets as security for payment of the franchise fee. (See Section D5 for how the franchise fee is dealt with in the offering circular.)

2. Advertising Fees

If the franchise agreement requires you to pay an advertising fee to the franchisor, make sure that part of that fee is earmarked for local advertising over which you'll have some control. Perhaps the franchisor will agree to match any money you spend on local advertising. This is especially important if your franchise will be in an area where there are only a few other franchise locations. Otherwise the franchisor may spend all the advertising money 1,000 miles away where there are more franchisees—and you'll essentially be paying to support someone else's business.

Be alert for arrangements that allow the franchisor to reap profits from the advertising fees it charges you. In one case, a federal court said it was legal for Meineke Mufflers to set up its own in-house ad agency and hire it to handle franchise system advertising—a scheme that profited Meineke to the tune of millions of dollars in fees. (*Broussard v. Meineke Discount Muffler Shops,* 155 F.3d 331 (4th Cir. 1998).)

3. Royalty Fees

Typically, the royalty fees you pay the franchisor are a percentage of your gross sales. (See Section B.) They may, however, be a flat weekly or monthly charge. Be cautious about a franchisor who charges a small initial franchise fee but then charges you a high percentage of monthly sales.

> **EXAMPLE:** Compare two fast food operations. Franchisor A charges an initial fee of $5,000 and monthly royalties of 8% (in addition to advertising fees). Franchisor B charges a franchise fee of $20,000 and monthly royalties of 5% (not including advertising). Let's say that each franchise has annual sales of $500,000. In the first year, each franchisee will pay $45,000 to the franchisor. But look at succeeding years. Franchisee A will pay $40,000 each year to its franchisor, while Franchisee B pays only $25,000.

Franchise royalties are costly. *Remember that many franchises simply are bad business deals. In a world where it's very hard for any small business to make a 10% profit, giving a huge chunk of money to the franchisor as a royalty rarely makes sense.*

4. Hidden Costs

Read the franchise agreement carefully to uncover any hidden costs—many of which are mentioned earlier in this chapter. (See Section B1.) It's to your advantage if the income received by the franchisor is primarily based on royalties. That way, the franchisor has a direct interest in making your business profitable. The franchisor's incentive to promote your profitability is somewhat reduced if the franchisor begins to see itself as primarily your landlord or supplier rather than as a business partner.

If you must buy equipment, supplies, or inventory from the franchisor, make sure that the prices you'll pay are competitive with those charged by outside sources. You don't want to sign up with a franchisor who plans to gouge you on these items—especially if they're of iffy quality.

Yes, the franchisor has a legitimate interest in seeing that all franchisees run standardized operations, and this can require that certain items such as food supplies be exactly the same. But this need for specialization should be balanced against your need to make a decent profit. Franchisors often allow you to buy equipment and goods through an approved supplier, as long as the franchisor's specifications are met.

5. Quotas

Some franchise agreements require you to meet sales quotas. For example, your agreement might state that if you don't maintain a certain volume of business, you'll no longer have the right to an exclusive territory. In some cases, the franchisor may also reserve the right to terminate your franchise if quotas aren't met.

Watch out for this one. If the quotas aren't realistic or if it takes you longer than you expected to master the business, you face the horrible prospect of losing some or all of your investment.

6. The Franchise Term

Typically, a franchise agreement provides for a term of five to 15 years. Beware of an agreement that states that the franchise can be terminated "at will" by the franchisor upon written notice. See Section E8 for a further discussion of termination provisions.

Also carefully study your renewal rights. Is renewal entirely in the hands of the franchisor? If you do renew, will a renewal fee be charged? Will you have to sign a new franchise agreement containing whatever terms are in effect when you renew? This could change the whole ball game, because ten years from now, when you go to renew, a new franchise agreement could have higher royalties or advertising fees.

Under some franchise agreements, the franchisor can require a franchisee to install expensive improvements in the business premises—even beyond the startup installations. If the franchise agreement doesn't grant you the automatic right to renew your franchise on the same terms, seek language limiting the franchisor's right to force you to put expensive improvements into the business beyond the initial alterations. You want to be sure that if you're forced to put more money into the premises, you have enough time to recover that investment.

7. Assignment

Usually, a franchise agreement says that you must get the written approval of the franchisor before you transfer or assign your franchise agreement to someone else. But what happens if you have a serious health problem that prevents you from running the franchise? Could you transfer the franchise to a family member? Or, if you were to die, would your spouse automatically be able to continue the business for you?

And if you die, is there a deadline (such as 90 days or six months) during which the franchise must be transferred to a new owner to avoid termination of the franchise by the franchisor? Find out how long it takes, if someone wants to buy your franchise, to learn whether the franchisor approves or disapproves of the sale.

One way of dealing with your possible death as an owner of a franchise is a clause allowing your survivors a period of time to elect to keep and operate the business, as long as they meet the franchisor's training requirements.

Assuming you remain hale and hearty, but want to be able to get out of the franchise, some franchisors may be willing to give you the right to sell, subject to the franchisor's right to match any bona fide offer (called a right of first refusal). For example, if someone comes to you with an offer to buy your franchise, you would have to give the franchisor 30 or 60 days to meet the terms of the purchase.

8. Termination

Study carefully what the franchise agreement says about the franchisor's right to terminate the franchise. If the franchisor can terminate your franchise because you have supposedly defaulted upon or breached the agreement, you want to be notified in writing of the franchisor's intent and given at least 30 days in which to clear the defaults or correct the breaches. On the other side of the coin, you may want to have the right to terminate the agreement yourself if the franchisor is in default.

Commonly, the franchisor has the right to terminate the franchise if you either fail to operate the business, understate your gross revenues, don't pay royalties when due, or participate in a competing business.

Termination without good cause. *Watch out for franchise agreements that give the franchisor the right to terminate the franchise whether it has a good reason or not. Such clauses are harsh and unfair—so much so that several states have enacted statutes limiting the right of a franchisor to unilaterally terminate a franchisee. Typically, under such statutes, the franchisor would have to show "good cause" before terminating you.*

9. Competition

It's critical to know where you stand in terms of competition with other franchisees. Typically, the franchisor grants you a protected territory for your franchise operations. Within your territory, your franchisor agrees not to grant another franchise or to operate its own competing business. If you don't have a protected territory, will the franchisor at least give you first crack at buying any proposed new location near yours?

A franchise agreement also usually restricts you from competing in a similar business during the term of the franchise and for several years after its termination. Generally, courts enforce these restrictive covenants if they're reasonable as to time and geographic scope. Franchisors want to make sure their trade secrets aren't misused. You, on the other hand, don't want to give up your right to earn a living in the field that you know best. So take a close look at the noncompetition language and make sure that it doesn't restrict you too severely. Maybe you can live with a provision that says that you won't go into a competing business in the same county as your franchise for two years after a termination; but maybe you can't.

F. Resolving Disputes With Your Franchisor

If you do opt for a franchise, try to keep the lines of communication with your franchisor open. Talk about problems as soon as they begin to emerge. If you wait until a lawsuit is your only option, you'll discover how expensive, time-consuming, and often frustrating or even hopeless litigating with a franchisor can be.

A better option may be for you to band together with other franchisees to try to work out your mutual grievances with the franchisor. You'll gain negotiating power by presenting your concerns as a group.

Some franchisees even form a separate franchisee's organization to negotiate on their behalf. If such negotiation doesn't work, look into whether the FTC—or perhaps the attorney general who enforces the franchise laws in your state—will take up the cudgels for you.

As a final resort, hire a lawyer familiar with franchisee rights to evaluate your prospects of winning a lawsuit. Be aware that franchise law is a relatively specialized area; not all business lawyers are experienced in this field. ■

CHAPTER

12

Insuring Your Business

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A well-designed insurance program can protect your business from many types of perils. Consider the following:

- A fire destroys all the furniture, fixtures, and equipment in your restaurant.
- Burglars steal $75,000 worth of computer equipment you use in your book publishing business.
- A customer visiting your yogurt store slips on the just-washed floor and shatters her elbow.
- On the way to an office supply store to pick up some fax paper, one of your employees runs a stop sign and injures a child.
- A house painter has a severe allergic reaction to a solvent that your company manufactures and distributes.
- One of your employees is hospitalized for four weeks with a severe back injury she received while trying to lift a heavy package.
- The building where you're located is severely damaged by a windstorm. You're forced to close your doors for two months while repairs are made. In addition to having to pay $35,000 for continuing business expenses, you lose the $25,000 of profits you expected for that period—a total loss of $60,000.
- A client installs a lawn sprinkling system based on specifications you recommended as a landscape architect. Because you hadn't checked soil conditions carefully, the system malfunctions, flooding your client's basement and ruining the antique furniture stored there. Your client sues you for professional negligence.

Maybe none of these will happen to your business—but unless you consider yourself permanently exempt from Murphy's Law ("If anything can go wrong it will"), don't bet on it. Fortunately, insurance is available to cover each of these events and for many, if not most of them, is reasonably cost-effective.

Not every small business needs every type of coverage. In fact, a business that tried to buy insurance to cover all insurable risks probably wouldn't have money left over to do anything else. Deciding on insurance coverage usually involves some difficult choices. Here are some general rules to start with:

- Get enough property and liability coverage to protect yourself from common claims. These are the most important kinds of insurance for a small business.
- Buy insurance against serious risks where the insurance is reasonably priced.
- Keep costs down by selecting high deductibles.
- Self-insure if insurance is prohibitively expensive or the particular risk is highly unlikely.
- Adopt aggressive policies to reduce the likelihood of insurance claims, particularly in areas where you're self-insured.

Sections B, C, and D look at the standard types of insurance available to small businesses and how you can put together a reasonable insurance program.

A. Working With an Insurance Agent

Find and work with a knowledgeable insurance agent—one who takes the time to analyze your business operations and to come up with a sensible program for your company.

Generally, it's best to work with a single insurance agent for all your business needs so that coverages can be coordinated. But be sure to find out whether any agent you're speaking to is locked into one insurance company. If so, it may be wise to look elsewhere. The agent you choose should be willing to obtain quotes from several companies so that you don't pay more than is necessary.

To find a competent insurance agent or broker, talk to local business people, particularly those in your line of work. Other people in the same field should be able to give you good leads on insurance agents. Working with an agent who knows your business is advantageous because that person is already a fair way along the learning curve when it comes to helping you select an affordable and appropriate package.

EXAMPLE: Louisa, who owns a plant nursery, wants insurance coverage for risks associated with bugs and toxic substances. She finds an insurance agent who already works with similar businesses. The agent knows what insurance is available for a plant nursery and how to tailor the coverage to Louisa's business so that it will be affordable.

Insurance Terminology

In some parts of the country, the term "insurance agent" refers to a person who represents a specific company, and "insurance broker" refers to a person who is free to sell insurance offered by various companies. Elsewhere, the term "insurance agent" is used more broadly to cover both types of representatives—and that's how it's used in this chapter.

Steer clear of an agent who, without learning the specifics of your business, whips out a package policy and claims it will solve all your problems. Yes, the insurance industry has developed some excellent packages that cover the basic needs of various businesses. For example, there are packages offered for offices, retail sales operations, service businesses, hotels, industrial and processing companies, and contractors. One of these may meet your needs, but neither you nor your insurance agent will know for sure until the agent asks you a lot of questions and thoroughly understands your business. If the agent is unable or unwilling to tailor your coverage to your particular business, find someone else.

Be frank with your agent when discussing your business. Reveal all areas of unusual risk. If you fail to disclose all the facts, you may not get the coverage you need or, in some circumstances, the insurance company may later take the position that you misrepresented the nature of your operation and, for that reason, deny you coverage for exceptional risks.

Make sure you have a clear understanding of what your insurance policy covers and what's excluded. Does the policy exclude damage from a leaking sprinkler system? From a boiler explosion? From an earthquake? If so, and these are risks you face, find out if they can be covered by paying a small extra premium.

Also ask how much the agent will help in processing claims if you do have a loss. Ideally, the insurance company should have a local or regional office that's readily accessible to you. That's normally a better arrangement and more personal than dealing with an insurance company that hires an independent claim service to investigate and deal with claims.

It's a good idea to talk to several agents before making a final selection. Ask for written recommendations on comparable coverage and what the cost will be. There should be no charge for providing this information, because the agents will be eager to get your business.

Is the Company Solvent?

In recent years, many insurance companies have become insolvent. If you wind up with a company that goes broke and you have a loss covered by a policy, you may receive only a paltry portion of the coverage that you paid for or none at all. The best way to minimize this risk is to work with a company that appears in good financial shape.

You can check out insurers in these standard reference works, which rate insurance companies for financial solvency:

- *Best's Insurance Reports* (Property-Casualty Insurance Section)
- *Moody's Bank and Financial Manual* (Volume 2)
- *Duff & Phelps* (Insurance Company Claims-Paying Ability Rating Guide)
- *Standard & Poor's.*

Each publication has strengths and weaknesses. In my opinion, the best overall sources on the list are *Moody's* and *Duff & Phelps*. Some commentators think that *Best's* is too lenient in its ratings. And *Standard & Poor's* is sometimes incomplete because some companies prefer not to pay the huge fee it takes for a listing. Your insurance agent should be able to give you the latest ratings from these publications. You can also check the reference department at a public library.

Also consider the services offered by Weiss Inc., which is reputed to be tougher (more conservative) in its ratings. Weiss offers a variety of low-cost reports on the solvency of an insurance company. You can call Weiss toll-free at 800-289-9222 or go to its website at www.weissratings.com.

B. Property Coverage

In considering property coverage, there are four main issues to think about:

- What business property should you insure?
- What perils will the property be insured against? In other words, under what conditions will you be entitled to receive payment from the insurance company?
- What dollar amount of insurance should you carry? (Obviously, the higher the amount, the higher the premiums. You don't want to waste money on insurance but you do want to carry enough so that a loss wouldn't jeopardize your business.)
- Should you buy coverage for replacement cost or for the present value of the property?

Section B6 outlines property insurance from a renter's point of view. *Renters may want to skip ahead, then return here and read the general information on how property insurance works.*

1. Property Covered

Your insurance policy will contain a section called Building and Personal Property Coverage Form, which lists exactly what property is covered. If you own the building you're occupying, be sure the building is covered, including:

- completed additions
- permanently installed fixtures, machinery, and equipment
- outdoor fixtures (such as pole lights)
- property used to maintain or service the building (such as fire extinguishing equipment).

The policy may also cover additions under construction as well as materials, equipment, supplies, and temporary structures on or within 100 feet of the main building.

Be sure that your business personal property is also covered. A typical policy covers the following items located on the business premises:

- furniture and fixtures

- machinery and equipment
- inventory
- all other personal property used in the business (such as technical books and cassette tapes)
- leased personal property, if you're contractually obligated to insure it
- personal property of others that's in your custody.

Be sure that everything is covered. *Check carefully to be sure the policy covers all the types of personal property that you own or expect to own: furniture, equipment, goods that you sell, products that you manufacture, and raw materials used in the manufacturing process.*

Typically, various items are excluded, such as accounting records, currency, deeds, and vehicles held for sale. If you need coverage on excluded items, you can usually arrange it, for an additional premium.

2. Perils Covered

More than 90% of the time, property insurance for small businesses is written in one of three forms: Basic Form, Broad Form, and Special Form. Special Form coverage is the most common and affords the best protection.

Whichever policy you decide on, read it carefully before you pay for it—not just when you've suffered a loss. You may discover that some coverage is narrower than it first seemed. For example, smoke loss may refer only to loss caused by a faulty heating or cooking unit; it may not cover smoke damage from industrial equipment. Similarly, an explosion may not include a burst steam boiler.

Fortunately, most insurance policies today are written in plain English so you should have little problem in understanding what's covered and what isn't. If you need coverage not provided in the policy, talk to your agent about how to add it on.

Basic Form coverage includes losses caused by fire, lightning, explosion, windstorm or hail, smoke, aircraft or vehicles (but not loss or damage caused by vehicles you own or operate in the course of your business), riot, vandalism, sprinkler leaks, sinkholes, and volcanoes. The policy defines these perils—and also lists some exclusions, such as nuclear hazards, power failures, or mudslides.

Broad Form coverage contains everything that's in the Basic Form and adds protection from a few more perils, including breakage of glass (that is part of a building or structure), falling objects, weight of snow or ice, and water damage. Again, these terms are defined in the policy and, again, exclusions are listed.

Special Form policies are constructed differently than Basic and Broad Form policies and offer wider and slightly more expensive coverage. Instead of listing specific perils such as fire and lightning, Special Form policies simply say that your business property is covered against all risks of physical loss unless the policy specifically excludes or limits the loss. This type of policy offers the most protection. For example, it's a convenient way to insure against loss by theft, which isn't covered by Basic and Broad Form policies. (Section D2 discusses theft insurance.)

If you need additional coverage. *If you're concerned about property loss caused by perils not covered or, in the case of a Special Form policy, excluded from an insurance policy, you can often get the additional coverage through an endorsement (add-on page) to the policy by paying an additional premium. For example, such coverage is usually available for losses due to earthquakes and floods.*

Consider getting insurance coverage for damage caused by terrorists. *The Terrorism Risk Insurance Act of 2002 requires insurance companies to offer such coverage. True, you'll be* *charged an additional premium, but it should be relatively small. The law that requires insurers to offer this coverage will be in effect through 2005, but Congress may extend it beyond that. If your business had an insurance policy in effect on November 26, 2002, and the policy excluded damage caused by terrorists, that exclusion has been temporarily suspended—in other words, the insurance company must pay for such damage. But the insurer can reinstate the exclusion if you don't pay the increased premium for terrorism coverage within 30 days after the insurer bills you for it.*

Earthquake and Flood Insurance

Earthquake insurance can be handled through a separate policy or an endorsement to Basic, Broad, or Special Form coverage. Deductibles in an earthquake endorsement are typically stated as a percentage—such as 10%—rather than as a dollar amount. This means that the higher your policy limit, the bigger the deductible. As a result, some business people choose a $200,000 policy with a $20,000 deductible rather than a $400,000 policy with a $40,000 deductible. They reason that the deductible on the latter policy is so high they're unlikely to ever collect anything.

Flood insurance, by contrast, is usually handled through a separate policy called "Difference in Conditions."

Combining property and liability insurance in one policy. You can purchase property insurance as a stand-alone and buy a separate stand-alone policy for liability coverage (discussed in Section C), or you can buy a policy that combines both coverages. It's often—but not always—cheaper to buy a combination policy. Here's where comparison shopping definitely pays off.

3. Amount of Coverage

Be sure to carry enough insurance on the building to rebuild it. But there's no need to insure the total value of your real property (the legal term that includes land and buildings), because land doesn't burn. Especially if you're in an area where land is very valuable, this is a big consideration.

If you're in doubt as to how much it would cost you to rebuild, have an appraisal made so you know that your idea of value is realistic. Because the value of the building and other property may increase, it's wise to get a new appraisal every few years. Your insurance agent should be able to help you do this.

Usually it's best to insure your property for 100% of its value. If doing this is prohibitively expensive, consider a policy with a higher deductible rather than underinsuring.

Underinsuring to get a reduced premium is a false economy for several reasons. Not only are you not covered if you suffer a total loss, but it may also reduce your ability to recover for a smaller loss. This is because most insurance policies carry a coinsurance clause which states that to recover the full policy amount, you have to carry insurance to cover at least 80% (this percentage may vary) of the property's replacement cost or actual cash value. If you don't, you become a coinsurer if there's a loss, even if it's less than the policy maximum; the policy will only pay off a percentage of its face value.

EXAMPLE 1: Fluoro Corporation owns a $100,000 building. If Fluoro carries $80,000 worth of insurance or more, the insurance company will pay Fluoro for the full amount of any loss up to the policy limit. For example, if the loss is $50,000 Fluoro will get the full $50,000. If the loss is $90,000, Fluoro will receive only $80,000, the policy limit.

EXAMPLE 2: Pluto Associates owns a similar $100,000 building. To get a reduced premium, the partners decide to carry only $40,000 worth of insurance. If there's a fire and Pluto has a loss of $20,000, its insurance company will pay only $10,000. Because Pluto carried only half of the 80% figure mentioned in the policy, it's entitled to only a proportional payment.

4. Replacement Cost vs. Current Value

Historically, in case of a loss, a basic fire insurance contract covered the actual current value of the property, not its full replacement value. Today, policies are routinely available with replacement cost coverage. This is the coverage you want.

EXAMPLE: Sure-Lock Corporation owns a 20-year-old building. The current cash value of the building (the amount someone would pay to buy it) is $150,000. But if the building burned down, Sure-Lock would have to pay $200,000 to replace it. If Sure-Lock buys insurance based on the building's cash value and the policy has an 80% coinsurance clause, the company will need to insure the building for $120,000. If Sure-Lock buys insurance based on replacement cost, it will need to insure for $160,000, which is 80% of $200,000.

The real cost of insurance is reduced when you consider that insurance premiums for a business are a recognized business expense—which means they are tax deductible.

5. Ordinance or Law Coverage

If you're purchasing insurance for an older building—either because you own it or your lease requires it—understand that a normal Basic Form, Broad Form, or Special Form policy designed to replace your existing building should it be destroyed probably won't be adequate. The problem is that legal requirements adopted since the building was constructed will normally require that a stronger, safer, more fire-resistant building be constructed. Doing this can cost far more than simply replacing the old building. To cope with this possibility, you want a policy that will not only replace the building but pay for all legally required upgrades. This coverage is called "Ordinance or Law Coverage."

EXAMPLE: Time Warp Inc. sells antique furniture and building materials removed from old homes. In keeping with its image of days gone by, Time Warp does business in a 100-year-old building in a historic part of town. Time Warp carries insurance for the full replacement cost, $100,000. One day a fire destroys 50% of the building. The insurance pays $50,000 toward reconstruction, but the Time Warp owners learn to their dismay that rebuilding will cost much more and that the additional costs are not covered by their insurance policy. The items excluded by their typical property insurance policy include the following:

- *The cost of meeting current health and safety codes.* The old building was of wood frame construction and lacked an elevator and sprinkler system. That was okay before the fire. The building predated the health and safety ordinances and was "grandfathered"—specifically exempted from the new construction requirements. After the fire, it's a whole new ball game. In rebuilding, Time Warp must spend an additional $100,000 for masonry construction, an elevator, and a sprinkler system required by current health and safety codes.

- *The cost of rebuilding the undamaged portion of the building.* The local ordinance requires that if a building built before current codes is destroyed by fire to the extent of 50% or more, the entire building must be replaced. The cost of replacing the undamaged 50% of the building is another $200,000.

- *The cost of demolition.* The local ordinance requires that, because of the extent of damage, the entire building—both the damaged and undamaged portions—must be torn down before reconstruction begins. That will cost another $25,000.

"Ordinance or Law Coverage" would pay for all of these items.

6. Tenant's Insurance

If you're a tenant, read the insurance portion of your lease. You may have agreed to insure the building and protect the landlord against any liability suits based on your activities, in which case you'll need the type of coverage an owner would carry. This is available through a renter's commercial package policy, which also provides routine product liability coverage for businesses not involved in hazardous activities and allows you to name your landlord as an additional insured.

Even if you haven't agreed to provide insurance coverage in your lease, a renter's commercial policy can make excellent sense. Not only will it cover any of your "leasehold improvements," such as paneling and partitions, but it will also cover damage to the premises caused by your negligence.

For example, if the building you rent suffers fire or water damage as a result of an employee's negligence (a fire in an area where food is prepared spreads and damages the walls and ceiling), you may be liable. This is true even if the building owner is insured and recovers from his or her insurance company, because the owner's insurer has the right to try to recover.

What the insurer will pay you for loss to leasehold improvements is based not on replacement value but on what's called the "use interest" in the improvements. Basically, the insurance company looks at how long you would have had the use of the improvements and reimburses you for the use you lose.

EXAMPLE: Court Reporting Associates (CRA) installs $20,000 worth of paneling in their rented offices. They have a five-year lease with an option to renew for five more years—which, for insurance purposes, is treated as a ten-year lease. Two years into the lease, a fire destroys the paneling. Because CRA used up 20% of the lease before the fire, it will receive payment for only 80% of value of the paneling.

Insurance clauses in leases vary widely. (See Chapter 13, Section D13, for more on such clauses.)

C. Liability Insurance

The second major category of insurance coverage for a small business is liability insurance. Your business can be legally liable to people injured and for property damaged because you or your employees didn't use reasonable care. For example, if a customer falls on a slippery floor and then sues you, you may be liable because you negligently failed to provide safe premises.

As you probably know, when it comes to personal injuries, judges are broadening the scope of what people can sue for—and juries are increasingly generous in awarding damages. Because an injured person can collect not only for lost wages and medical bills but also for such intangibles as pain, suffering, and mental anguish, a single personal injury verdict against your business has the potential to wipe it out. For that reason, unless you have a very unusual business that has no personal contact with customers, suppliers, or anyone else, your insurance program should include liability coverage.

Some intentional acts not involving bodily injuries are also usually covered under the liability portions of an insurance policy. Examples are libel, slander, defamation, false imprisonment, and false arrest.

Toxic Waste Cleanup

Suppose the government orders your company to clean up a toxic waste problem on your property. This can and regularly does occur even if the pollution occurred years before you bought the property. Will your liability insurance policy cover the cleanup costs (called the "response costs")?

Most courts that have considered this question ruled that response costs are covered by a liability insurance policy, but a significant minority have ruled otherwise. If you have a business or own property that by any stretch of the imagination could become involved in a toxic waste or pollution problem, try to find out exactly how far your liability coverage extends in environmental situations. You may need to buy supplementary coverage (if available and affordable) to cover this risk.

Keep yourself informed on this subject. It's likely that, faced with court decisions saying that general liability coverage requires insurance companies to pay for response costs under cleanup orders, insurance companies will tighten up their policy language to exclude these expenses. You may need to buy special coverage if your business faces the possibility of a cleanup order.

1. General Liability Policies

Liability policies are designed to protect you against lawsuit judgments up to the amount of the policy limit plus the cost of defending the lawsuit. They provide coverage for a host of common perils, including customers and guests falling and getting mangled by your front door or otherwise being injured.

Liability policies usually state a dollar limit per occurrence and an aggregate dollar limit for the policy year. For example, your policy may say that it will pay $500,000 per occurrence for personal injury or a total of $1 million in any one policy year.

Excluded claims. *Punitive damages—damages intended to punish your business for willful or malicious behavior rather than compensate the injured person—are not covered by the typical general liability policy. And liability coverage won't protect your business if an employee intentionally assaults a customer. In addition, a general liability policy doesn't cover injuries caused by defective products or motor vehicles, or by an employer's liability for injuries received by workers on the job. Special coverage for these types of liability is discussed in the next three subsections.*

As noted, both building owners and tenants may purchase liability coverage separately or as part of a package policy that also provides a number of other types of insurance, including fire insurance for the building itself.

2. Product Liability Insurance

Product liability insurance covers liability for injuries caused by products you design, manufacture, or sell. You may be liable to a person injured by a defective product or one that came without adequate instructions or warnings.

Product liability insurance can be very expensive, but if your business manufactures, distributes, or sells a product that may injure people, you should seriously consider buying it. For example, if you manufacture medical instruments or chemicals, you'll probably want this coverage. If you're a retailer and sell products in their original packages and provide no product assembly or service or advice, your exposure is drastically reduced; the manufacturer is primarily liable and the product liability coverage provided by standard renter's commercial policies should be adequate.

The amount of product liability insurance that you need depends on the nature of your product and not on your gross sales. Obviously, a company that sells $2 million of paper clips a year will need less coverage than a firm that manufactures gauges critical to the safe operation of heaters and also has $2 million worth of sales annually.

3. Vehicle Insurance

Make sure your business carries liability insurance not only on its own cars and trucks but also on employees' cars and trucks when those vehicles are used for business purposes. This coverage is known as Employer's Non-Owned Automobile Liability and is relatively inexpensive—a premium of $65 to $100 may buy you coverage of $1 million for one year. Vehicle insurance isn't provided under general liability policies.

It wouldn't hurt to check your employees' driving records before you entrust company vehicles to them or send them on business errands using their own cars, but failure to check won't be a problem under most vehicle policies unless the insurance company has listed that employee as an excluded driver. To do this, insurance companies periodically ask businesses for the names of employees who are driving on company business. They then check the names against state driving records. If this results in the discovery of a poor driving record for a particular employee, the insurer will likely exclude that driver from coverage and notify you.

Coverage for injury or property damage while using leased vehicles can be added to either your motor vehicle policy or your general liability policy—which is what a company would do if it owned no vehicles. This is known as Hired Vehicle coverage.

Most vehicle policies also cover physical damage to the car or truck caused by collision, fire, or theft.

4. Workers' Compensation Insurance

As the name implies, workers' compensation insurance covers your liability for injuries received by employees on the job. All businesses with employees are required to provide for some kind of workers' compensation coverage.

Usually, an injured worker can't sue your business for negligence. But as a trade-off, he or she can collect specified benefits from your business for work-related injuries whether or not the business was negligent. All the worker must prove is that the injury came about in the course of employment—a concept that has a very broad definition in many states. For example, an employee injured at a company picnic may have a valid workers' compensation claim.

The amount of money that the employee can recover is limited. The worker can recover for medical treatment and lost wages and, in serious cases, for impaired future earning capacity. But there are no awards for pain and suffering or mental anguish. A growing portion of workers' compensation claims, however, result from mental or emotional stress.

As a sole proprietor, you usually can't be personally covered by workers' compensation insurance for any work-related injuries you sustain; only your employees can be covered. Workers' comp coverage of a partner or of an officer of a small corporation usually isn't required but can be obtained if you choose.

Each state has a law setting out what an employer must do to provide for workers' compensation benefits. Sometimes an employer can self-insure. Usually, that isn't practical for small businesses because they can't afford the type of cash reserve required by state law. Most small businesses buy insurance through a state fund or from a private insurance carrier. Insurance rates are based on the industry and occupation, as well as the size of the

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