Choosing the Right Legal Structure for Your Business

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To make sure that forming a corporation is the best legal and tax approach for your business, this chapter compares the corporation to other small business legal structures, such as the sole proprietorship, the partnership, and the popular limited liability company. A corporation, like a limited liability company, protects your personal assets from business creditors. But the corporation stands apart from all other business forms due to its built-in organizational structure and unique access to investment sources and capital markets. It also uniquely answers a need felt by many business owners who are attracted to the formality of the corporate form, a quality not shared by the other business structures.

The Different Ways of Doing Business

There are a number of legal structures or legal forms under which a business can operate, including the sole proprietorship, partnership, limited liability company, and corporation. These basic structures have important legal and tax variants. For example, the partnership form has spawned the limited partnership and the registered limited liability partnership—two special types of partnership legal structures. And the corporation can be recognized, for tax purposes, as either a standard C corporation, in which the corporation and its owners are treated as separate taxing entities, or as an S corporation, in which business income passes through the corporate entity and is taxed only to its owners on their individual tax returns. Finally, the limited liability company can adopt corporate tax status if it wishes to obtain some of the tax benefits available to the C corporation. We know all of this may sound confusing. Take comfort: These legal and tax differences will become clear as you read through the material below.

Choosing the initial legal structure for your business is one of the most important decisions you’ll make when starting a business. Often, business owners start with the simplest, least expensive legal form (the sole proprietorship), then move on to a more complicated business structure as their businesses grow. Other businesspeople pick the legal structure they like best from the start, and let their businesses grow into it. You are not stuck with the legal entity with which you start out—you can change your legal and tax structure from one form to another during the life of your business. However, there are tax consequences when you change your business entity, so you’ll want to consider that decision as carefully as your initial business entity choice. The analysis we present here, which includes examples of businesses that choose each of these types of business structures, should help you make a good decision about what business entity makes the most sense for you.

Sole Proprietorship

A sole proprietorship is the legal name for a one-owner business. A sole proprietorship has the following general characteristics.

Ease of formation. The sole proprietorship is the easiest business form to establish, in the sense that it requires few formalities to get started. Just hang out your shingle or “Open for Business” sign, and you have established a sole proprietorship. Sure, there are other legal
steps you may wish or be required to take—such as registering a fictitious business name if your business won’t use your personal name or registering for a business license or sales tax permit—but these steps are not necessary to legally establish your business.

Personal liability for business debts, liabilities, and taxes. In this simplest form of small business legal structures, the owner, who usually runs the business, is personally liable for its debts, taxes, and other liabilities. This means that personal assets—for example, cash in a bank account, equity in a home or car, or a personal stock portfolio—can be used to satisfy a court judgment entered against the business. Also, if the owner hires employees, the owner is personally responsible for legal claims—for example, an auto accident—made against these employees acting within the course and scope of their employment.

Simple tax treatment. All business profits and losses are reported on the personal income tax return of the owner each year (Schedule C, Profit or Loss From Business, filed with the owner’s 1040 federal income tax return). And this remains true even if a portion of this money is invested back in the business—that is, even if the owner doesn’t pocket business profits for personal use.

Sole proprietorships in action. Many one-owner or spouse-owned businesses start small, with very little advance planning or procedural red tape. Let’s look at an example. Celia Wong is a graphic artist with a full-time salaried job for a local book publishing company. In her spare time, she takes on extra work using her home computer to produce audiocassette and CD jacket cover art for musicians. These jobs are usually commissioned on a handshake or over the phone. Without thinking much about it, Celia has started her own sole proprietorship business. Celia should include a Schedule C in her yearly federal 1040 individual tax return, showing the net profits (profits minus expenses) or losses of her sole proprietorship. Celia is responsible for paying income taxes on profits,

Legal life same as owner’s. On the death of its owner, a sole proprietorship simply ends. The assets of the business normally pass under the terms of the deceased owner’s will or trust, or by intestate succession (under the state’s inheritance statutes) if there is no formal estate plan.

CAUTION

Don’t let business assets get stuck in probate. Probate—the court process necessary to “prove” a will and distribute property—can take up to one year or more. In the meantime, it may be difficult for the inheritors to operate or sell the business or its assets. Often, the best way to avoid having a probate court involved in business operations is for the owner to transfer the assets of the business into a living trust during his or her lifetime. This permits business assets to be transferred to inheritors promptly on the death of the business owner, free of probate. For detailed information on estate planning, including whether or not it makes sense to create a living trust, see Plan Your Estate, by Denis Clifford (Nolo), or Nolo’s Quicken WillMaker Plus, software that allows you to prepare your own living trust.

TIP

A corporate comparison. Earnings retained in a corporation are not taxed on the owner’s individual income tax return. Instead, this money is taxed at separate corporate income tax rates. Because corporate tax rates are sometimes lower than individual income tax rates, business owners who leave earnings in their businesses often save tax dollars by incorporating. We discuss this feature of corporations—called income splitting—in “The Corporation,” below.
In the past, a husband and wife who worked together in an unincorporated business and shared the profits and losses were considered co-owners of a partnership and had to file a partnership tax return for the business. The only exception was for spouses who lived in a community property state. They could elect to classify their business as a sole proprietorship by filing a single Schedule C listing one spouse as the sole proprietor.

Under current law, spouses in all states can elect to be taxed as a “qualified joint venture.” Having this status means that the couple gets treated as a sole proprietor for tax purposes. To qualify, the couple must be the only owners of the unincorporated business and they must both “materially participate” in the business. The spouses must also file a joint Form 1040, with two separate Schedule Cs showing each spouse’s share of the profits. Each spouse must include a self-employment tax schedule (Schedule SE) and pay self-employment tax on his or her share of the profits. If the couple qualifies for this exception, each spouse gets Social Security credit for his or her share of earnings in the business.

What if a couple jointly owns their business as an LLC? In this case, the spouses will normally be treated as partners and must file a partnership tax return for the LLC. However, if the couple lives in one of the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), they have the option of treating their business as a sole proprietorship. They do this by filing an IRS Form 1040 Schedule C for the business, listing one of the spouses as the owner. There is no requirement that both spouses materially participate in the business so this election is easier than the qualified joint venture status described above.

Alaska: If you have adopted a community property election for your Alaskan spousal business, ask a tax consultant about options for IRS treatment of your business.

Only the listed spouse pays income and self-employment taxes on the reported Schedule C net profits. This means only the listed Schedule C owner-spouse will receive Social Security account earning credits for the Form SE taxes paid with the 1040 return. For this reason, some eligible spouses will decide not to make this Schedule C filing and will continue to file a partnership tax return for their jointly owned spousal LLC. Also, the IRS treats the filing of a Schedule C for a jointly owned spousal LLC as the conversion of a partnership to a sole proprietorship, which can have tax consequences.

Finally, if one spouse manages the business and the other helps out as an employee or volunteer worker (but does not contribute to running the business), the managing spouse can claim ownership and treat the business as a sole proprietorship.

For more information on spousal businesses, see “Forming a Partnership” in IRS Publication 541 and “Husband and Wife Business” and other information on the IRS website at www.irs.gov. In all cases, be sure to check with your tax adviser before deciding on the best way to own, file, and pay taxes for a spousal business.
plus self-employment (Social Security) taxes based on her sole proprietorship income. (IRS Form SE is used to compute self-employment taxes and is attached to a 1040 income tax return.) If Celia has any business debts, she is personally liable for the money owed. For example, she usually owes on a charge account at a local art supply house, or a disgruntled client successfully may sue her in small claims court for money paid for a job she failed to complete. She can’t simply fold up her business and walk away from these debts, claiming that they were the legal responsibility of her business only.

**TIP**

**Put some profits aside to buy business insurance.** Once Celia begins to make enough money, she should consider taking out a commercial business insurance policy to cover legal claims against her business. While off-the-shelf insurance normally won’t protect her from her own business mistakes—for example, failure to perform work properly or on time or to pay bills—it can cover many risks, including slip-and-fall lawsuits and damage to her or a client’s property, as well as fire, theft, and other casualties that might occur in her home-based business.

Running her business as a sole proprietorship serves Celia’s needs for the present. Assuming her small business succeeds, she will want to put it on a more formal footing by establishing a separate business checking account, possibly coming up with a fancier name and filing a fictitious business name statement with the county clerk, and, if she hires employees, obtaining a federal Employer Identification Number (EIN) from the IRS. At some point, Celia may also feel ready to renovate her house to separate her office space from her living quarters. Besides the convenience this might offer, it can also help to convince the IRS that the portion of the mortgage or rent paid for the office is deductible as a business expense on her Schedule C.

Celia can quit her day job, expand her business, and still keep her sole proprietorship legal status. Unless her business grows significantly or she takes on work that puts her at a much higher risk of being sued—and, therefore, being held personally liable for business debts—it makes sense for her to continue to operate her business as a sole proprietor.

**RESOURCE**

**More information about starting and running a sole proprietorship.** A great source of practical information on how to start and operate a small sole proprietorship is *The Small Business Start-Up Kit*, by Peri H. Pakroo (Nolo). Also, see *Tax Savvy for Small Business*, by Frederick W. Daily (Nolo), a small business owner’s guide to taxes that includes a full discussion of setting up a home-based business and deducting its expenses.

**Partnership**

A partnership is simply an enterprise in which two or more co-owners agree to share the profits. No written partnership agreement is necessary, though it’s a good idea to make one. If two people go into business together, they automatically establish a “general partnership” under state law unless they incorporate, form a limited liability company, or file paperwork with the state to establish a special type of partnership, such as a limited partnership. (See “Limited Partnerships,” below, for more on special partnerships.) A general partnership, simply stated, is one where each of the partnership owners is legally entitled to manage the partnership business.

General partnerships are governed by each state’s partnership law. But since all states have
adopted a version of the Uniform Partnership Act, general partnership laws are very similar throughout the United States. Mostly, these laws contain basic rules that provide for a division of profits and losses among partners and set out the partners’ legal relationship with one another. These rules are not mandatory in most cases. You can (and should) spell out your own rules for dividing profits and losses and operating your partnership in a written partnership agreement. If you don’t prepare your own partnership agreement, all provisions of state partnership law apply to your partnership.

A general partnership has the following characteristics.

**Each partner has personal liability.** Like the owner of a sole proprietorship, each partner is personally liable for the debts and taxes of the partnership. In other words, if the partnership assets and insurance are insufficient to satisfy a creditor’s claim or legal judgment, the partners’ personal assets are subject to attachment and liquidation to pay the debt.

**The act or signature of each partner can bind the partnership.** Each partner is an agent for the partnership and can individually hire employees, borrow money, sign contracts, and perform any act necessary to the operation of the business in which the partnership engages. All partners are personally liable for these debts and obligations. This rule makes it essential that the partners trust each other to act in the best interests of the partnership and each of the other partners.

**Partners report and pay individual income taxes on profits.** A partnership files a yearly IRS Form 1065—called *U.S. Partnership Return of Income*—that includes a schedule showing the allocation of profits, losses, and other tax items to all partners (Schedule K-1). The partnership must mail an individual Schedule K-1 to each partner at the end of each year, showing

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### Partnerships Can Choose to Be Taxed Like Corporations

Unlike regular partnerships, where profits pass through the business and are taxed to the individual owners, corporations are taxed as separate entities. (This is explained in detail below in “The Corporation.”) If they choose, partners can elect to change the normal pass-through taxation their partnership receives and have the IRS tax the business like a corporation. Specifically, the “check-the-box” federal tax rules, also followed in most states, let partnerships (and LLCs) elect to be treated as corporate tax entities by filing IRS Form 8832, *Entity Classification Election*. This election means that partnership income will be taxed at the entity level at corporate tax rates, and the partners pay individual income tax only on profits actually paid out to them (in the form of salaries, bonuses, and direct payouts of profits).

Most smaller partnerships will not wish to make this election, preferring instead to have profits divided among the partners and then taxed on their individual tax returns.

But this is not always true. For example, some partnerships—especially one that wants to reinvest profits in expanding the business—may prefer to keep profits in the business and have them taxed to the business at the lower initial corporate tax rates. (For a discussion of corporate tax income splitting, see “The Corporation,” below.) Your tax adviser can tell you if this tax strategy makes sense if you’re considering forming a partnership or an LLC. We believe that any partnership seriously considering making a corporate tax election should also consider converting to a corporation (instead of filing a corporate tax election for the partnership) to get the additional capital benefits that a corporation provides.
Why You Need a Written Partnership Agreement

Although it’s possible to start a partnership with a verbal agreement—or even with no stated agreement at all—there are drawbacks to taking this casual approach. The most obvious problem is that a verbal agreement may be remembered and interpreted differently by different partners. (And, of course, having no stated agreement at all almost always means trouble.) Also, if you don’t write out how you want to operate your partnership, you lose a great deal of flexibility. Instead of being able to make your own rules in a number of key areas—for example, how partnership profits and losses are divided among the partners—the lack of a written agreement means that, by default, state partnership law will come into play. These state-based rules may not be to your liking—for example, state law generally calls for an equal division of profits and losses, regardless of partners’ capital contributions.

Other problems with doing business without a written partnership agreement come up when a partner wants to leave the business. Here are just a few of the difficult questions that can arise:

- If the remaining partners want to buy out the departing partner, how will the partner’s ownership interest be valued?
- Assuming you agree on how much the departing partner’s interest is worth, how will the departing partner be paid for that interest—in a lump sum or in installments? If payment will be made in installments, how big will the down payment be, how many years will it take to pay the balance, and how much interest will be charged?
- What happens if none of the remaining partners wants to buy the departing partner’s interest? Will your partnership dissolve? If so, can some of the partners form a new partnership to continue the partnership business? Who gets to use the dissolved partnership’s name and client or customer list?

Partnership law, which is written in generalities, does not provide context-specific answers to these questions, meaning that in the absence of a written partnership agreement, you may face a long legal battle with a partner who decides to call it quits.

To avoid these and other problems, a basic partnership agreement should, at a minimum, spell out:

- each partner’s interest in the partnership
- how profits and losses will be split up between or among the partners
- how any buyout or transfer of a partner’s interest will be valued and handled, and
- how the former partners can continue the partnership’s business if they want to.

the items of income and loss, credits, and deductions allocated to each partner. When partners file individual income tax returns, the partners report their allocated shares of partnership profits (taken from the partners’ Schedule K-1) and pay individual income taxes on these profits. As with the sole proprietorship, partners are taxed on business profits even if the profits are plowed back into the business, unless the partners elect to have the partnership taxed as a corporation. In that case, the corporate entity is taxed separately. (See “Partnerships Can Choose to Be Taxed Like Corporations,” above.)

Partnership dissolves when a partner leaves. Legally, when a partner ceases to be involved with the business of the partnership (when the
Most smaller partnerships are general partnerships, where all owners agree to manage the partnership together, and each partner is personally liable for partnership debts. However, there are two other fairly common types of partnerships: limited partnerships and registered limited liability partnerships (RLLPs). Each of these is quite different from a general partnership.

**The limited partnership.** Owners use the limited partnership structure when one or more of the partners are passive investors (the “limited partners”) and another partner runs the partnership (the “general partner”). You must file a Certificate of Limited Partnership with the secretary of state (or a similar state filing office) to form a limited partnership, and pay a filing fee. The advantage of a limited partnership is that, unlike a general partnership, where all partners are personally liable for business debts and liabilities, a limited partner is allowed to invest in a partnership without the risk of incurring personal liability. If the business fails, all that the limited partner can lose is a capital investment—that is, the amount of money or the property that partner paid for an interest in the business. However, in exchange for this big advantage, the limited partner normally is not allowed to participate in the management or control of the partnership. A partner who does so can lose limited liability status and can be held personally liable for partnership debts, claims, and other obligations. This disadvantage has caused many a business owner who might form a limited partnership to turn to the limited liability company (LLC). LLCs offer pass-through tax status, limited liability protection, and the ability to participate fully in the management of the business. We discuss LLCs just below.

Typically, a limited partnership has several limited partner investors and at least one general partner who is responsible for partnership management and is personally liable for its debts and other liabilities.

**The registered limited liability partnership.** This is a legal structure allowed in most states and designed specifically for professionals (attorneys, accountants, architects, engineers, and other licensed businesspeople). An RLLP is formed by filing a Registration of Limited Liability Partnership form with the secretary of state (or another state agency that handles business filings). An RLLP relieves professional partners from personal liability for claims against another partner for professional malpractice. However, professionals in an RLLP remain personally liable for their own professional malpractice.

**EXAMPLE:** Martha and Veronica operate a two-person accounting partnership, registered as an RLLP. Each has her own clients. Suppose Martha loses a malpractice lawsuit, and Veronica did not participate in providing services to the client who won the suit. If partnership insurance and assets are not sufficient to pay the judgment, Martha’s personal assets, but not Veronica’s, are subject to seizure to pay the money due. In a general partnership practice that’s not an RLLP, both Martha and Veronica could be personally liable for either CPA’s individual malpractice.

**RESOURCE**

For more LP and RLLP information.

To determine the forms and procedures necessary to set up a limited partnership or an RLLP in your state, go to your state’s business filing office website. (See Appendix A.)
partner withdraws or dies), the partnership is automatically dissolved as a legal entity. However, a properly written partnership agreement provides for these eventualities and allows the partnership to continue by permitting the remaining partners to buy out the interest of the departing or deceased partner (see “Why You Need a Written Partnership Agreement,” above). Of course, if one person in a two-partner business leaves or dies, the partnership must end; you need at least two people to have a partnership.

**RESOURCE**

**A partnership resource.** For a thorough look at the legal and tax characteristics of partnerships, and for a clause-by-clause approach to preparing a partnership agreement, see *Form a Partnership*, by Denis Clifford and Ralph Warner (Nolo).

**Partnerships in action.** George and Tamatha are good friends who have been working together in a rented warehouse space where they share a kiln used to make blown glass pieces. They recently collaborated on the design and production of a batch of hand-blown halogen light fixtures, which immediately became popular with local lighting vendors. Believing that they can streamline the production of these custom pieces, they plan to solicit and fill larger orders with retailers, and look into wholesale distribution. They shake hands on their new venture, which they name Halo Light Sculptures. Although they obtain a business license and file a fictitious name statement with the county clerk showing that they are working together as Halo Light Sculptures, they don’t bother to write up a partnership agreement. Their only agreement is a verbal one to equally share in the work of making the glass pieces, splitting expenses and any profits that result.

This type of informal arrangement can sometimes be justified in the early exploratory days of a co-owned business where the owners, like George and Tamatha, have yet to decide whether to commit to the venture. However, for the reasons mentioned earlier, from the moment the business looks like it has long-term potential, the partners should prepare and sign a written partnership agreement. Furthermore, if either partner is worried about personal liability for business debts or the possibility of lawsuits by purchasers of the fixtures, then forming a limited liability company (LLC) or a corporation probably would be a better business choice.

**The Limited Liability Company (LLC)**

The limited liability company (LLC) is the new kid on the block of business organizations. It has become popular with many small business owners, in part because it was custom-designed by state legislatures to overcome particular limitations of each of the other business forms, including, in some contexts, the corporation. Essentially, the LLC is a business ownership structure that allows owners to pay business taxes on their individual income tax returns like partners (or, for a one-person LLC, like a sole proprietorship). In addition, owners get the legal protection of personal limited liability for business debts and judgments as if they had formed a corporation. Put another way, with an LLC you simultaneously achieve the twin goals of pass-through taxation of business profits and limited personal liability for business debts.

All states allow an LLC to be formed by one or more people. LLC members need not be residents of the state where they form their LLC, or even of the United States, for that matter, and other business entities, such as a corporation or another LLC, can be LLC owners.

Here is a look at the most important LLC characteristics.
Limited Liability
Under each state’s LLC laws, the owners of an LLC are not personally liable for the LLC’s debts and other liabilities. This personal legal liability protection is the same as that offered to shareholders of a corporation.

Pass-Through Taxation
Federal and state tax laws treat an LLC like a partnership—or, for a one-owner LLC, like a sole proprietorship. Again, this means that LLC income, loss, credits, and deductions are reported on the individual income tax returns of the LLC owners. The LLC entity itself does not pay income tax. However, as with partnerships, there are “check-the-box” tax rules that let an LLC elect corporate tax treatment if its owners wish to leave income in the business and have it taxed at separate corporate income tax rates. We explain how corporate tax treatment works in Chapter 3.

RESOURCE
Finding your state’s LLC tax rules. Some states impose an annual fee or tax on LLCs, in addition to individual income tax that owners pay on the LLC profits allocated to them each year. To find out whether your state imposes an LLC tax, go to your state’s tax department website. (See Appendix A.)

Because a co-owned LLC is taxed as a partnership, it files standard partnership tax returns (IRS Form 1065 and Schedules K-1) with the IRS and state, and the LLC owners pay taxes on their share of LLC profits on their individual income tax returns. (Each owner gets a Schedule K-1 from the LLC, which shows the owner’s share of LLC profits and deductions. The owner attaches the K-1 to the owner’s individual income tax return.) A sole-owned LLC is treated as a sole proprietorship for tax purposes. The owner includes profits or losses from LLC operations, as well as deductions and credits allowable to the business, on a Schedule C included with the owners’ individual income tax returns. In essence, for a sole LLC owner, the Schedule C works much like the K-1 schedule filed by the owners of a co-owned LLC.

If a sole-owner or multiowner LLC elects corporate tax treatment, the LLC is treated and taxed as a corporation, not as a sole proprietorship or partnership. The LLC files corporate income tax returns, reporting and paying corporate income tax on any profits retained in the LLC. The LLC members report and pay individual income tax only on salaries paid to them or distributions of LLC profits or losses. However, as is true for partnerships, LLCs that may benefit from electing corporate tax treatment normally decide to go ahead and incorporate. By doing so, they get corporate tax treatment plus the other advantages the corporation provides, such as access to capital, capital sharing with employees, tax deductible employee fringe benefits, and built-in management formalities. To learn more, see “The Corporation,” below.

Management Flexibility
LLCs are normally managed by all the owners (also called members) —this is known as “member-management.” But state law also allows for management by one or more specially appointed managers, who may be members or nonmembers. Not surprisingly (but somewhat awkwardly), this arrangement is known as “manager-management.” In other words, an LLC can appoint one or more of its members, or one of its CEOs or even a person contracted from outside the LLC, to manage its affairs. This manager setup is somewhat atypical and normally only makes sense if one person wishes
to assume full-time control of the LLC, with the other owners acting as passive investors in the enterprise.

**Formation Requirements**

Like a corporation, an LLC requires paperwork to get going. You must file articles of organization with the state business filing office. And if the LLC is to maintain a business presence in another state, such as a branch office, you must also file registration or qualification papers with the other state’s business filing office. LLC formation fees vary, but most are comparable to the fee each state charges for incorporation.

Like a partnership, an LLC should prepare an operating agreement to spell out how the LLC will be owned, how profits and losses will be divided, how departing or deceased members will be bought out, and other essential ownership details. If you don’t prepare an operating agreement, the default provisions of the state’s LLC Act will apply to the operation of your LLC. Since LLC owners will want to control exactly how profits and losses are apportioned among the members as well as other essential LLC operating rules, they need an LLC operating agreement.

**EXAMPLE:** Barry and Sam jointly own and run a flower shop, Aunt Jessica’s Floral Arrangements, which specializes in unique flower arrangements. (The name stems from the fact that Barry used to work for his Aunt Jessica, who taught him the ropes of floral design.) Lately, business has been particularly rosy, and the two men plan to sign a long-term contract with a flower importer to supply them with larger quantities of seasonal flowers. Once they receive the additional flowers, they will be able to create more floral pieces and wholesale them to a wider market. Both men are sensitive to the fact that they will encounter more risks as their business grows. Accordingly, they decide to protect their personal assets from business risks by converting their partnership to an LLC. They could accomplish the same result by incorporating, but they prefer the simplicity of paying taxes on their business income on their individual income tax returns—rather than splitting business income between themselves and their corporation and filing both corporate and individual income tax returns. They also realize that if they begin making more money than each needs to take home, they can convert their LLC to a corporation later to obtain lower corporate income tax rates on earnings kept in the business or, as an alternative, make an IRS election to have their LLC taxed as a corporation without having to change its legal structure at all.

**Creditors’ Attempts to Reach an LLC Interest**

Most of the time, the LLC’s limited liability shield protects LLC owners’ personal assets from claims, lawsuits, and money judgments arising out of LLC business operations. However, this protection doesn’t always work the other way: An LLC owner’s interest in LLC business assets is not necessarily protected from creditors seeking to satisfy personal debts or judgments against the LLC owner.

In most states, if an LLC owner defaults on a personal debt or is hit with a personal money judgment, the owner's interest in the LLC can be reached to satisfy the claim or
The Series LLC—A Rising Star on the Business Entity Horizon

A new type of LLC is taking shape under state LLC laws: the series LLC. States are still in the process of developing their series LLC statutes and it will take time for them to coordinate the laws, fees, and tax treatments. Once this happens, however, and the courts settle some of the legal nuances of series LLCs, the series LLC may become the new big thing in business entity formations. A handful of states have adopted a series LLC formation statute. Go to your state’s online business entity filing office (see Appendix A) to see if your state has jumped on the series LLC bandwagon.

The main characteristic and advantage of the series LLC is that it allows you to set up one or more series of assets within a single LLC. The business and assets of each series can be managed and operated separately—for example, each series can have separate owners and managers, a separate operating agreement that specifies a separate division of profits and losses associated with the series, and other separate formation and operation characteristics. And, under some state statutes, there is also a separation of legal liability between each series within an LLC.

A number of series LLC states allow for this separation of legal liability between each series within an LLC. In these states, assets such as real estate can be put into separate series within an LLC, and, if done properly, each property should be subject only to its own financing obligations. This consolidation of assets in one LLC coupled with a separation of liability between the assets in each series can be an advantage to organizers who want to set up one LLC to develop, encumber, and sell multiple parcels of real estate.

Before you decide to form a series LLC, however, there are certain things you should keep in mind. For one, a state that does not have a series LLC statute may not respect the characteristics of a series LLC formed in another state. And, because these entities are so new, there are other uncertainties. For example, it is not clear that a federal bankruptcy court will respect the separateness of each series within an LLC.

Finally, forming a series LLC may seem like a good way to avoid paying a lot of formation and annual fees for multiple LLC entities. However, some states may not be willing to forgo these filing fees so easily. In California, for example, the Franchise Tax Board assesses an $800 franchise tax payment, plus an annual added gross receipts fee of up to $12,000 per year on each LLC formed or operated within the state. The Board has stated that it will treat each series in many out-of-state LLCs as separate LLCs (see FTB Form 568 and FTB Publication 689 at www.ftb.ca.gov). This means that a Delaware series LLC that operates or owns property in California may have to pay the annual California franchise and any added tax for each series within the LLC. Similarly, when you go to register your series LLC in a state that does not have a series LLC statute, the state may decide that you owe a registration fee for each series in your LLC, not just one for the whole LLC.
debt. Personal creditors (such as credit card companies and mortgage lenders) can obtain a “charging order,” or a lien, against the LLC owner’s personal business interests, including a partnership interest, LLC interest, or stock in a corporation. This charging order allows the creditor to receive profit payments that would otherwise go to the LLC owner.

**Example:** Sam defaults on a personal bank loan unrelated to his LLC business, and the bank obtains a charging order against Sam’s LLC membership interest. This order allows the bank to receive profits that would otherwise go directly to Sam under the terms of the LLC’s operating agreement.

However, a charging order may not do a creditor much good if an LLC does not regularly distribute profits to its owners. In that case, if state law permits, the creditor may be able to convince a court to allow it to foreclose on (become the new legal owner of) the LLC owner’s interest. The foreclosing creditor becomes a “transferee” or “assignee” and is entitled to all economic rights associated with the LLC interest, including a share of any profits paid out on the interest and the value of the interest, if and when the business is sold or liquidated.

Under most state laws, a creditor that forecloses on an LLC interest cannot manage the LLC, become a full voting member, or assume any other membership rights granted to full members.

In exceptional cases, such as when an LLC member has committed a fraud on a creditor, a court may grant the creditor more leeway in recovering any resulting debt, particularly where the court is dealing with a single-member LLC. For example, if a member of a single-member LLC committed fraud during a transaction with a creditor, a judge may allow the assignee creditor to become a full member, with voting rights, including the right to force a sale of the LLC. After all, with a single-member LLC, there is no risk that other members’ rights will be compromised.

This area of law is complex and developing rapidly. If you’re worried about how a charging order may affect your interest in an LLC, please contact an experienced business lawyer to learn about relevant laws in your state.

**The Corporation**

A corporation is a statutory creature, created and regulated by state law. In short, if you want the “privilege”—that’s what the courts call it—of turning your business enterprise into a corporation, you must follow the requirements of your state’s Business Corporation Law or Business Corporation Act (BCA). What sets the corporation apart, in a theoretical sense, from all other types of businesses is that it is a legal and tax entity separate from any of the people who own, control, manage, or operate it. The state corporation and federal and state tax laws view the corporation as a legal “person.” This means the corporation is capable of entering into contracts, incurring debts, and paying taxes separately from its owners.

**Advantages of Incorporating**

Let’s start by looking at the advantages that flow from this separate entity treatment of the corporation. The first and foremost is built-in legal limited liability protection.

**Limited Personal Liability**

Like the owners of an LLC or the limited partners in a limited partnership, the owners (shareholders) of a corporation are not personally liable for business debts, claims, or other liabilities. Put another way, this means
In some unusual situations, corporate directors, officers, and shareholders can be held responsible for paying money owed by their corporation. Here are a few of the most common exceptions to the rule of limited personal liability; these exceptions also apply to other limited liability business structures, such as the LLC.

**Personal guarantees.** Often when a bank or other lender lends money to a small corporation, particularly a newly formed one, it requires the principal corporate owners (shareholders) to agree to repay the loan from their personal assets if the corporation defaults. In some instances, shareholders may even have to pledge equity in a house or other personal assets as security for repayment of the debt.

**Federal and state taxes.** If a corporation fails to pay income, payroll, or other taxes, the IRS and the state tax agency are likely to attempt to recover the unpaid taxes from “responsible persons”—a category that often includes the principal directors, officers, and shareholders of a small corporation. The IRS and state sometimes succeed in these tax collection strategies. Therefore, paying taxes should be a top priority for all businesses.

**Unlawful or unauthorized transactions.** If you use the corporation as a means to defraud people, or if you intentionally make a reckless decision that results in physical harm to others or their property—for example, you fail to maintain premises or a worksite properly when you’ve been warned of the probability of imminent danger to others, or you deliberately manufacture unsafe products—a court may hold you individually liable for the monetary losses of the people you harm. Lawyers call this “piercing the corporate veil,” meaning that the corporate entity is disregarded and the owners are treated just like the owners of an unincorporated business.

Fortunately, most of these problem areas can be avoided by following a few commonsense rules—rules you’ll probably follow anyway:

- Don’t do anything dishonest or illegal.
- Make sure your corporation does the same, by getting necessary permits, licenses, or clearances for its business operations.
- Pay employee wages, and withhold and pay corporate income and payroll taxes on time.
- Try not to become personally obligated for corporate debts unless you decide that the need for corporate funds is worth the personal risk.

**EXAMPLE:**

Rackafraz Dry Cleaners, Inc., a corporation, has several bad years in a row. When it finally files for bankruptcy it owes $50,000 to a number of suppliers and $80,000 as a result of a lawsuit for uninsured losses stemming from a fire. Stock in Rackafraz is owned by Harry Rack, Edith Frax, and John Quincy Taft. Fortunately, the personal assets of these people cannot be taken to pay the money Rackafraz owes.
Corporate Tax Treatment

Unlike other business forms, a corporation is a separate tax entity, distinct from its owners. This means that the company itself is taxed on all profits that it cannot deduct as business expenses. This separate-entity tax treatment brings certain benefits to a corporation—for example, it permits income splitting between the corporation and its owners, and also allows the owners to be classified as “employees” of their own business, making them eligible to receive tax-deductible employee fringe benefits. (Employee benefits are discussed below in “Corporate Employee Benefits and Employee Incentives.”)

Income splitting. Because a corporation is a separate taxpayer, it has its own income tax rates and files its own tax returns, separate from the tax rates and tax returns of its owners. This double layer of taxation allows corporate profits to be kept in the business and taxed at corporate tax rates, which can be lower than those of the corporation’s owners. (See “Federal Corporate Income Tax Treatment” in Chapter 3 for tables setting out corporate and individual tax rates.) Income splitting between the corporation and its owners can result in an overall tax savings for the owners, compared to the pass-through taxation that is standard for sole proprietorships, partnerships, and LLCs.

Example:

Jeff and Sally own and work for their own two-person corporation, Hair Looms, Inc., a mail-order wig supply business that is starting to enjoy popularity with overseas purchasers. To keep pace with sprouting orders, they need to expand by investing a portion of their profits in the business. Since Hair Looms is incorporated, only the portion of the profits paid to Jeff and Sally as salary is reported and taxed to them on their individual tax returns—let’s assume, at the top individual income tax rate of 35%. By contrast, the first $50,000 in profits left in the business for expansion is reported on Hair Looms’s corporate income tax return and is taxed at the lowest corporate tax rate of only 15%, and the next $25,000 at 25%. Above $75,000, corporate income is taxed at 34% and higher.

How Small Corporations Avoid Double Taxation of Corporate Profits

What about the old bugaboo of corporate double taxation? Most people have heard that corporate income is taxed twice: once at the corporate level and again when it is paid out to shareholders in the form of dividends. In theory, the Internal Revenue Code says that most corporations are treated this way (except S corporations, whose profits automatically pass to shareholders each year; see below). In practice, however, double taxation seldom occurs in the context of the small business corporation. The reason is simple: Employee-owners don’t pay themselves dividends. Instead, the shareholders, who usually work for their corporation, pay themselves salaries and bonuses, which are deducted from the profits of the corporate business as ordinary and necessary business expenses. The result is that profits paid out in salary and other forms of employee compensation to the owner-employees of a small corporation are taxed only once, at the individual level. In other words, as long as you work for your corporation, even in a part-time or consulting capacity, you can pay out business profits to yourself as reasonable compensation, and you avoid having your corporation pay taxes on these profits.
LLCs and partnerships can elect corporate tax treatment. Income splitting is no longer a unique aspect of corporate life. As mentioned earlier in this chapter, partnerships and LLCs can elect to be taxed as corporations if they wish to keep money in the business to be taxed at corporate rates. (See “Partnerships Can Choose to Be Taxed Like Corporations,” above.) However, partnerships and LLCs that can benefit from doing this normally decide to incorporate instead of electing corporate tax status for their unincorporated business. By changing to a corporate legal entity, they get corporate income tax splitting plus the other advantages the corporation provides, such as access to capital, capital sharing with employees, tax-deductible employee fringe benefits, and built-in management formalities. See below for more on these advantages.

S corporation tax election. Just as partnerships and LLCs have the ability to elect corporate tax treatment, corporations can choose the type of pass-through taxation of business profits that normally applies to partnerships and LLCs. (But there are some technical differences that lend an advantage to partnerships and LLCs. See “A Comparison of LLC, Partnership, and S Corporation Tax Treatment,” below.) You can do this by making an S corporation tax election with the IRS and your state tax authority.

If your corporation files an S corporation tax election, all profits, losses, credits, and deductions pass through to the shareholders, who report these items on their individual tax returns. Each S corporation shareholder is allocated a portion of profits and losses of the corporation according to that person’s percentage of stock ownership in the corporation. For example, a 50% shareholder reports and pays individual income taxes on 50% of the corporation’s annual profits. These profits are allocated to the shareholders whether the profits are actually paid to them or kept in the corporation.

When Forming an S Corporation Doesn’t Make Sense

S corporation tax status should be something you use only at particular times during the life of your corporation, rather than your corporation’s permanent tax status. In other words, if you really want pass-through tax treatment throughout the life of your business (and you haven’t yet formed your corporation), don’t incorporate. Instead, form an LLC. You’ll get pass-through taxation plus limited liability protection, just like an S corp—in fact, the pass-through benefits of an LLC are even better. (See “A Comparison of LLC, Partnership, and S Corporation Tax Treatment,” below.)

A corporation must meet certain requirements to qualify for S corporation status. It must have 100 or fewer individual shareholders who are U.S. citizens or residents (not entities, except for a few special types), and it must have only one class of stock. The shares may have different voting rights, but otherwise all corporate shares must have the same rights and restrictions. You can revoke an S corporation election to go back to regular C corporation tax treatment, but then you cannot reelect S corporation status for another five years. After you make an S corporation election with the IRS, you can make the election with your state tax agency as well. (Many states automatically recognize your federal S corporation election once it is filed.)

Why would a corporation want to elect S corporation status, given that the separate taxability of the corporation (which the S corporation eliminates) is normally a primary
A Comparison of LLC, Partnership, and S Corporation Tax Treatment

S corporation tax status, though similar to the pass-through tax treatment given to LLC and partnership owners, is not quite as good. Specifically, LLC owners and partners are not required to allocate profits in proportion to ownership interests in the business. They can make what are known as “special allocations” of profits and losses under the federal tax code, but S corporation shareholders can’t do this. Also, the amount of losses that can be passed through to an S corporation shareholder is limited to the total of the shareholder’s “basis” in his stock (that is, the amount paid for stock plus and minus adjustments during the life of the corporation—plus amounts loaned personally by the shareholder to the corporation). Losses allocated to a shareholder that exceed these limits can be carried forward and deducted in future tax years (if the shareholder qualifies) to deduct the losses at that later time.

In contrast, LLC owners and partners may be able to personally deduct more business losses on their tax returns in a given year. LLC members and partners get to count their pro rata share of all money borrowed by the business, not just loans personally made by the member or partner, when computing how much of any loss allocated to the member by the business can be deducted in a given year on an individual income tax return.

Given these differences, you might think that the owners of a regular corporation who wish to receive pass-through taxation of business income should dissolve the corporation and form an LLC or partnership, rather than electing S corporation tax treatment. But this is normally not the case. This type of conversion (from a corporation to an LLC or partnership) is expensive in terms of taxes and legal fees. In other words, it’s normally best for an existing corporation to elect S corporation tax status if it wants pass-through tax treatment, even if the S corporation election does not provide full pass-through tax benefits. This is a complex tax issue; you should check with an expert tax adviser if you are considering S corporation status.

**TIP**

S corporation status can reduce self-employment taxes. There is one area where S corporations do better than LLCs or partnerships: self-employment taxes. Although the current federal tax rules are not specifically written for LLCs, tax experts generally advise their clients that LLC managing owners and managing partners must pay self-employment taxes on their share of business profits. The self-employment tax bite can be hefty: over 15% of taxable income. However, the owners of an S corporation pay self-employment taxes only on compensation (salaries and bonuses) paid to them, not on profits automatically allocated to them as a shareholder. To take advantage of this benefit, some corporate owners elect S corporation tax treatment, then pay themselves a low salary—this means that remaining S corporation profits (which are automatically allocated to the shareholders) are not subject to self-employment tax. This is an aggressive tax strategy, and the IRS may challenge S corporation owners who keep their salaries below a reasonable level simply to avoid self-employment taxes. Again, ask your tax adviser for guidance.
advantage of the corporation? The answer is that there may be times during the life of a corporation where pass-through taxation makes sense, for tax or other reasons. One example occurs when the incorporators expect start-up losses. In a regular corporation, these losses are normally locked into the business; they can be used only to offset future corporate profits. But if an S tax election is made, the losses may qualify to be used to offset other individual income earned by the owners from business activity outside the corporation—for example, salaried income they receive from another business.

As another example, if corporate shareholders who do not work in the business decide it's time for them to receive their share of corporate profits, but the corporation doesn't want to pay out nondeductible dividends, an S corporation election can be made to automatically allocate profits to shareholders—the S corporation itself pays no income tax on the passed-through allocated profits.

**Built-In Organizational Structure**

A unique benefit of forming a corporation is the ability to separate management, executive decision making, and ownership into distinct areas of corporate activity. This separation is achieved automatically because of the unique legal roles that reside in the corporate form: the roles of directors (managers), officers (executives), and shareholders (owners). Unlike partnerships and LLCs, the corporate structure comes ready-made with a built-in separation of these three activity levels, each with its own legal authority, rules, and ability to share in corporate income and profits. To understand how this works, consider a couple of examples.

**Example 1:**

Myra, Danielle, and Rocco form their own three-person corporation, Skate City, Inc., a skate and bike shop. Storefront access to a heavily used Rollerblade, skating, and bike path makes it popular with local Rollerbladers and cyclists. Needing more cash, the three approach relatives for investment capital. Rocco's brother, Tony, and Danielle's sister, Collette, chip in $30,000 each in return for shares in the business. Myra's Aunt Kate lends the corporation $50,000 in return for an interest-only promissory note, with the principal amount to be repaid at the end of five years.

Here's how the management, executive, and financial structure of this corporation breaks down.

**Board of directors.** The board manages the corporation, meeting once each quarter to analyze and project financial performance and to review store operations. The board consists of the three founders, Myra, Danielle, and Rocco, and one of the other three investors. Under the terms of Skate City's bylaws, the investor board position is a one-year rotating seat. This year Tony has the investor board seat, next year it goes to Collette, the third year to Aunt Kate—then the pattern repeats. Directors have one vote apiece, regardless of share ownership; this is a common approach for small corporations and one that is legally established in Skate City's bylaws. This means the founders can always get together to outvote the investor vote on the board, but it also makes sure that each of the investors periodically gets to hear board discussions and have a say on major management decisions.

**Executive team.** The officers of the corporation are charged with overseeing day-to-day business; supervising employees;
keeping track of ordering, inventory, and sales activities; and generally putting into practice the goals set by the board. The officers are Myra (president) and Danielle (vice president). Rocco fills the remaining officer positions of secretary and treasurer of the corporation, but this is a part-time administrative task only. Rocco’s real vocation—or avocation—is blading along the beach and training to be a professional, touring Rollerblader with his own corporate sponsor (maybe Skate City if profits continue to roll in).

**Participation in profits.** Corporate profits, of course, are used to pay salaries, stock inventory, pay rent on the storefront, and pay all the other usual and customary expenses of doing business. The two full-time executives, Myra and Danielle, get a corporate salary, plus a year-end bonus when profits are good. Rocco gets a small stipend (hourly pay) for his part-time work. Otherwise, he and the investor shareholders are simply sitting on their shares. Skate City is not in a position yet to pay dividends—all excess profits of the corporation are used to expand the store’s product lines and add a new service facility at the back of the store. Even if dividends are never paid, the shareholders know that their stock will be worth a good deal if the business is successful. They can cash in their shares when the business sells or when they decide to sell their shares back to the corporation—or, who knows, if Skate City goes public someday. Aunt Kate, the most conservative of the investment group, will look to ongoing interest payments as her share in corporate profits, getting her capital back when the principal amount of her loan is due.

As you can see from this example, the mechanisms used to put this custom-tailored management, executive, and investment structure into place are built into the Skate City corporation. To erect it, all that is needed is to fill in a few blanks on standard incorporation forms, including stock certificates, and prepare a standard promissory note. To duplicate this structure as a partnership or LLC would require a specially drafted partnership or LLC operating agreement with custom language and plenty of review by the founders and investment group—and, no doubt, their lawyers. The corporate form is designed to handle this division of management, day-to-day responsibilities, and investment with little or no extra time, trouble, or expense.

There is a potential downside to this division of corporate positions and participation in profits. Some businesspeople—particularly those who run a business by themselves or who prefer to run a co-owned business informally—feel that the extra activity levels of corporate operation and paperwork are a nuisance. That’s why incorporating may be a bit of an overload for small start-up companies. These may be better and more comfortably served by the less formal business structures of the sole proprietorship or partnership, or, if limited legal liability is an overriding concern, by the LLC legal structure.

**Example 2:**

Leila runs a lunch counter business that provides her both a decent income and an escape from the cubicled office environment in which she was once unhappily ensconced. Business has been slow, but Leila has a new idea to give the business more appeal, as well as make it more fun for her. She changes the decor to reflect a tropical motif, installs a saltwater aquarium facing the lunch counter,
adds coral reef (metal halide) lighting and light-reflective wall paneling, and renames the business The Tide Pool. The standard lunch counter fare is augmented with a special bouillabaisse soup entrée and a selection of organic salads and fruit juice drinks, and a seafood and sushi dinner menu is added to cater to the after-work crowd. Leila has her hands full, doing most of the remodeling work herself and preparing the expanded menu each day.

The new operation enjoys great success, and a major newspaper favorably reviews The Tide Pool in an article on trendy eating spots. Patronage increases, so Leila hires a cook and adds three waiters to help her.

A local entrepreneur, Sally, who represents an investment group, asks Leila if she would be interested in franchising other Tide Pools throughout the country. Sally says the investment group would help develop a franchise plan, plus fund the new operation. Leila would be asked to travel to help set up franchise operations for the first year, and she would receive a managerial role and a stake in the new venture.

Leila likes the idea. True, she’ll have to get back into the workaday world, but on her own terms, and as a consultant and business owner. Besides, she’s not feeling comfortable running the business side of The Tide Pool by herself, and it would be a relief to have the new venture take over. The investment group wants a managerial role in the franchise operation, plus a comprehensive set of financial controls. Leila and the investment group agree to incorporate the new venture as Tide Pool Franchising, Inc. The corporate business structure is a good fit. Leila will assume a managerial role as director of the new company, along with Sally and a member of the venture capital firm. The new firm hires two seasoned small business owners, one as president and one as treasurer, to run the new franchise operation. Business begins with the original Tide Pool as the first franchise, and Leila gets started working for a good salary, plus commission, setting up other franchise locations.

If the new venture makes a go of it, Leila and the investment group can either sell their shares back to the corporation at a healthy profit, or, if growth is substantial and consistent, take the company public in a few years. They will sell their stock in the corporation at a sizable profit, once a market has been established for the corporation’s publicly held shares.

This example highlights the flexibility of the corporate form and its ability to provide an infrastructure to handle changes in corporate management and ownership. When you want to redesign your corporate mission and make management and capital changes, the built-in activity layers of the corporation are ready to meet your needs.

Raising Money—Corporate Access to Private, Venture, and Public Capital

Corporations offer a terrific structure for raising money from friends, family, and business associates. There is something special about stock ownership, even in a small business, that attracts others. The corporate structure is designed to accommodate various capital interests. For example, you can:

- issue common, voting shares to the initial owner-employees
- set up a special nonvoting class of shares to distribute to key employees as an incentive to remain loyal to the business, and
- issue a “preferred” class of stock to venture capitalists willing to help fund future expansion of your corporation. (Preferred stock puts investors at the front of the line
when dividends are declared or when the corporation is sold.) Corporate capital incentives also attract creditors who are more willing to help finance a promising corporate enterprise in return for an option to buy shares.

What’s more, owners of a small corporation can set their sights someday on making a public offering of shares. Even if your corporation never grows large enough to interest a conventional stock underwriting company in selling your shares as part of a large public offering, you may be able to market your shares to your customers or to individual investors by placing your company’s small offering prospectus on the Internet. This strategy has been approved by the federal Securities and Exchange Commission (SEC). And the good news is that no matter how you market your shares, the possibility of handling your own small direct public offering (DPO) is much more available than it was even a few years ago. The reason is that federal and state securities laws have been liberalized to help smaller corporations raise from $1 million to $10 million annually by making a limited public offering of shares.

Of course, raising equity capital by selling stock is not the only way that corporations shine. Incorporated businesses also have an easier time in obtaining loans from banks and other capital investment firms, assuming a corporation’s balance sheet and cash flow statements look good. That’s partially due to the increased structural formality of the corporation (discussed in the previous section). In addition, loans can be made part of a package where the bank or investment company obtains special rights to choose one or more board members or has special voting prerogatives in matters of corporate management or finance. For example, a lender may require veto power over expenditures exceeding a specified amount. The variety of capital arrangements possible, even for a small corporation, is almost limitless, giving the corporation its well-known knack for attracting outside investment.

**EXAMPLE:**

Rara Avis Investment Group lends Eagle Eye Management Corporation $1 million under the terms of a standard commercial promissory note. However, an added kicker to the deal that helps Rara reach its decision to lend the funds is a warrant agreement (much like a stock option grant) that lets it buy future shares of Eagle at its current low share price of $1. Rara expects Eagle to use the funds wisely to increase corporate profitability and raise its share price well above the current $1 level. If so, Rara will exercise its warrant and buy shares at the $1 price, then sell them for a profit.

**TIP**

Employees often prefer to work for corporations. Don’t forget that key employees are more likely to work for a business that offers them a chance to profit through the issuance of stock options and stock bonuses if future growth is strong—and that these financial incentives are built into the corporate form. See the next section for a brief discussion. (For more details, read Chapter 3, which covers the benefits and tax treatment of each of the main types of employee equity plans.)

**Corporate Employee Benefits and Employee Incentives**

Another advantage of the corporate structure is that business owners who actually work in the business become employees. This means that you, in your role as an employee, become eligible for reimbursement for medical expenses and up to $50,000 of group term life insurance paid for by your business. These perks are
not available to employees of unincorporated businesses. (For further information on standard employee fringe benefits, see “Tax Treatment of Employee Compensation and Benefits” in Chapter 3.)

Owners can also establish tax-favored equity-sharing plans, such as stock option, stock bonus, and stock purchase plans, for nonowner employees. As a corporation grows, these employee equity-sharing plans motivate employees by giving them a piece of the corporate ownership pie—at a low cash cost to the business. (See “Employee Equity Sharing Plans” in Chapter 3 for detailed treatment of each of the most common types of corporate employee equity plans.)

EXAMPLE:
Henry incorporates his sole proprietorship, Big Foot Shoes, Inc. He now works as a full-time corporate employee, and is entitled to tax-deductible corporate perks. He also attracts talented employees by setting up a qualified incentive stock option (ISO) plan. Under the plan, employees are granted stock options with a strike (purchase) price of $1 per share (their current fair value as determined by the board). Employees pay nothing for the options, and the corporation itself neither pays for nor deducts any money for the option grants. After the options vest, an employee may exercise the option and buy the shares. Then the employee can sell them for a gain—that is, for more than $1 per share—and get taxed at capital gains rates that are lower than normal individual income tax rates. (To do this, the employee must hold the stock options for one year after buying them, and other conditions must be met.)

Perpetual Existence
A corporation is, in some senses, immortal. Unlike a sole proprietorship, partnership, or LLC, which may terminate on the death or withdrawal of an owner, a corporation has an independent legal existence that continues despite changeovers in management or ownership. Of course, like any business, a corporation can be terminated by the mutual consent of the owners for personal or economic reasons. In some cases it is terminated involuntarily, as in corporate bankruptcy proceedings. Nevertheless, a corporation does not depend for its legal existence on the life or continual ownership interest of a particular individual. This encourages creditors, employees, and others to participate in the operations of the business, particularly as the business grows.

Downsides of Incorporating
Just about everything, including the advantages of incorporating, comes at a price. Let’s look at two of the primary disadvantages.

Fees and Paperwork
The answer to the question “How much does it cost?” is an important factor to weigh when considering whether to incorporate your business. For starters, a corporation, unlike a sole proprietorship or general partnership, requires the filing of formation papers—articles of incorporation—with the state business filing office. Incorporation fees are modest in most states—typically, $50 to $100—and fees are commonly based on the number of shares authorized for issuance in your articles. By the way, incorporation, limited partnership, and LLC fees and paperwork are about the same in terms of cost and complexity in most states.
Does It Make Sense to Incorporate Out of State?

You no doubt have heard about the possibility of incorporating in another state, most likely Delaware, where initial and ongoing fees are lower and regulations may be less restrictive than in other states. Does this make sense? For large, publicly held corporations looking for the most lenient statutes and courts to help them fend off corporate raiders, perhaps yes. But for a small, privately held corporation pursuing an active business, our answer is probably no—it is usually a very poor idea to incorporate out of state.

The main reason is that you will probably have to qualify to do business in your home state anyway. This process takes about as much time and costs as much money as filing incorporation papers in your home state in the first place. You’ll also need to appoint a corporate agent to receive official corporate notices in the state where you incorporate and open the corporate bank account.

It is also important to realize that incorporating in another state with a lower corporate income tax isn’t likely to save you any money. That’s because if your business makes money from operations in your home state, even if it is incorporated in another state, you still must pay home-state income taxes on this income.

**EXAMPLE:**

Best Greeting Card, Inc., plans to open a Massachusetts facility to design and market holiday greeting cards throughout the country. If it incorporates in Delaware, it must qualify to do business in Massachusetts, and pay Massachusetts corporate income tax on its Massachusetts operations. It also must hire a registered agent to act on its behalf in Delaware. It decides to incorporate in Massachusetts.

Unless you plan to open up a business with offices and operations in more than one state and, therefore, have a real reason to compare corporate domiciles, you normally should stay where you are and incorporate in your home state.

The ongoing paperwork that is necessary to keep your corporation legally current is generally not burdensome. But, unlike other business forms, you must pay particular attention to holding and documenting annual meetings of shareholders and directors, and keeping minutes of important corporate meetings. Creating this paper trail is a good way to show the IRS (in case of an audit) or the courts (in case of a lawsuit) that you have respected the corporate form and are entitled to hide behind its insulating layer of limited personal liability.

**Tax Consequences of Corporate Dissolution**

A significant downside to forming a corporation is the tax burden that may result from a dissolution or sale of the business. The general rule is that when a corporation is sold or dissolved, both the corporation and its shareholders are subject to the payment of income taxes on assets held by the corporation. Generally, here’s how it works.

When a corporation dissolves, the corporation pays tax on the difference between the market value of a corporate asset and its tax basis in the asset. The corporation’s basis in the asset is
generally what it paid for the asset, minus any
depreciation it has deducted on the asset during
ownership. Corporations pay taxes on this
spread—the difference between market value
and the corporation’s basis—according to the
corporate tax rate schedule.

**EXAMPLE:**

If your corporation buys a building for
$400,000 and deducts $100,000 in depre-
ciation during five years of ownership, it has
a $300,000 basis in the property. When the
company liquidates and sells the building for
$500,000, it pays corporate income taxes on
the difference between the basis and the sale
price—in this case, $200,000.

Now, here’s the second part: When the corpo-
rion liquidates its assets—that is, converts
them to cash to distribute to shareholders—
technically, it is buying back its shares of stock
from the shareholders. As you probably know,
any sale of property by an individual is subject
to income tax, and this “stock sale” is no excep-
tion. This means that, in the example above, a
portion of the $500,000 sales proceeds is taxed
again to the shareholders when the corporation
distributes cash to them. (Shareholders may
qualify for lower capital gains tax rates, rather
than individual tax rates, if they held their
shares for more than one year. See “Employee
Equity Sharing Plans” in Chapter 3.) The
taxable amount for each shareholder is
determined according to the shareholder’s
individual basis in that person’s shares.

**EXAMPLE:**

Let’s assume that Sharon is the sole share-
holder of the dissolving corporation from
the previous example. Let’s also assume
she paid $100,000 into her corporation at
the beginning to capitalize it. This amount
represents her basis in her shares—that is, is
the amount she paid for her corporate stock.
When Sharon receives $500,000 from the
sale of the building, she must pay individual
income tax on $400,000 (the $500,000
her corporation distributes to her for her
shares, minus her $100,000 basis). Because
Sharon owned her shares for more than
one year (her corporation existed for five
years), she qualifies for capital gains tax rates
when she computes how much she pays on
the $400,000 taxable amount. (In fact, she
probably qualifies for special small business
stock rates, as explained in “Tax Concerns
When Stock is Sold” in Chapter 3.)

If a business owner incorporates by tranfer-
ing to the corporation tangible property—
such as equipment, land, or a building—the
owner gets a basis in stock equal to the
owner’s existing basis in the transferred assets,
instead of cash. (This is governed by Internal
Revenue Code Section 351, which applies to
the incorporation of most small businesses.
See “Tax Treatment When Incorporating an
Existing Business” in Chapter 3.)

**EXAMPLE:**

Continuing with our example, assume
Sharon transfers a building to her
corporation (instead of cash) for her stock.
She paid $100,000 for the building, but it
is worth $400,000 when she transfers it to
her corporation. Her individual basis in her
shares is $100,000—the amount she paid for
the building—even though she transfers it
to her corporation for its current $400,000
market value. When her corporation liqui-
dates and sells the building for $500,000,
Sharon pays tax on the $400,000 difference
between the $500,000 distributed to her
and her $100,000 basis in her shares. What’s
more, the corporation pays corporate income taxes on $400,000, too. When Sharon transferred the building at the time of incorporation, it received her $100,000 basis in the property as its basis. So when the corporation liquidates the building at the time of dissolution, it pays corporate income tax on $500,000 minus its $100,000 basis in the property ($400,000).

You do not have to master these rules—your tax adviser does. But now you know enough to notice the following: Sharon probably should not have transferred the building to the corporation when she incorporated. Why not? Because, when the building is sold, she pays taxes on $400,000 twice: She pays once as a shareholder, and her corporation pays a second time. Each follows slightly different rules to compute taxable amounts, and each pays at different rates, but each pays tax on the same transaction.

Here are two general points to keep in mind if you think your corporation will own significant assets that are likely to appreciate or otherwise be sold for more than their income tax basis:

• If your business plans to own significant assets that will appreciate, you may save yourself a lot of tax when the business is sold by doing business in an unincorporated form—for example, as an LLC, which also provides limited liability protection.

• If the nontax benefits, such as the corporate capital and employee equity-sharing incentives discussed above, make incorporation a top priority, your tax adviser can help you conduct your incorporation so that existing assets that are likely to appreciate are not transferred to the corporation. For example, you may decide to sell business assets prior to incorporation, then use cash to capitalize the corporation. You will pay tax on the sale of property, but you will avoid the double tax consequences that follow from having your corporation own it. Or you may decide to lease the property to the corporation.

SEE AN EXPERT

Ask your tax adviser before you incorporate about the tax consequences of dissolving your corporation. Ask your tax adviser up front whether a major tax cost is likely when you sell or transfer shares in your corporation or sell its assets later. One of the most important preincorporation services your tax adviser can provide is to make sure that the possible dissolution or sale of your corporation will not result in an unexpectedly hefty tax bill for you or the business. If a huge bill looks unavoidable, your adviser will probably steer you away from incorporating and advise the formation of an LLC instead.
Where Does a Business With a Website or a Web-Based Business Need to Incorporate and Qualify?

Like many businesses, yours probably has a website. Or, your business may operate solely through your website, without a brick-and-mortar operation. In either case, you may be wondering whether the website affects your decision on where to incorporate, and whether you need to “qualify to do business” in other states as well. In addition to incorporating in one state, a corporation may need to qualify to do business in other states where it has significant business contacts (for example, engaging in transactions beyond merely shipping goods into the state).

A business incorporates where the majority of its work and operations take place. This can be a little tricky to figure out when you’re running a website-only business. But it’s likely that you operate your business website from a physical location, such as your home or an office. Of course, you may use network servers (computers that process requests and deliver data to other computers via the Internet) that are located somewhere else, but you and your employees have a physical setting where you do business related to the website (such as maintaining the site, taking and fulfilling orders, and answering customer email). This location likely represents your primary physical place of business, and most small business owners would reasonably decide to incorporate in the state where this workplace is located.

Now, given that people across the U.S. can load your Web pages into their Internet browser and possibly order merchandise from your site, should you qualify to do business in other states besides the state of incorporation? In most cases, no. The general rule is you don’t have to qualify to do business in another state unless you have either a physical presence in that state (such as a sales office or warehouse), or you have certain types of repeated and successive business transactions within that state (for instance, your website enters into agreements with companies in that state).

Of course, this is a very general analysis, and the answer will depend on the location, type, and amount of your company’s website-related activity and each state’s qualification laws. If you want to learn more about the issues surrounding operating an Internet business, see Chapter 5 (“Doing Business Out of State”) of LLC or Corporation, by Anthony Mancuso (Nolo).
## Business Entity Comparison Tables—Legal, Financial, and Tax Characteristics

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
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<th>C Corporation</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Who owns business?</strong></td>
<td>sole proprietor</td>
<td>general partners</td>
<td>general and limited partners</td>
<td>shareholders</td>
<td>same as C corporation</td>
<td>members</td>
</tr>
<tr>
<td><strong>Personal liability for business debts</strong></td>
<td>sole proprietor</td>
<td>personally liable</td>
<td>general partners personally liable</td>
<td>no personal liability for shareholders</td>
<td>same as C corporation</td>
<td>no personal liability for members</td>
</tr>
<tr>
<td><strong>Restrictions on kind of business</strong></td>
<td>may engage in any lawful business</td>
<td>may engage in any lawful business</td>
<td>same as general partnership</td>
<td>can’t be formed for banking or trust business and other special business</td>
<td>same as C corporation— but excessive passive income (such as from rents, royalties, interest) can jeopardize S tax status</td>
<td>same as C corporation (in a few states, like California, certain professionals cannot form an LLC)</td>
</tr>
<tr>
<td><strong>Restrictions on number of owners</strong></td>
<td>only one sole proprietor (a spouse may own an interest under marital property laws)</td>
<td>minimum two general partners</td>
<td>minimum one general partner and one limited partner</td>
<td>one-shareholder corporation allowed in all states</td>
<td>same as C corporation, but no more than 100 shareholders permitted, who must be U.S. citizens or residents</td>
<td>all states allow the formation of one-member LLCs</td>
</tr>
<tr>
<td><strong>Who makes management decisions?</strong></td>
<td>sole proprietor</td>
<td>general partners</td>
<td>general partner(s) only, not limited to partners</td>
<td>board of directors</td>
<td>same as C corporation</td>
<td>ordinarily members, or managers if LLC elects manager-management</td>
</tr>
<tr>
<td><strong>Who may legally obligate business?</strong></td>
<td>sole proprietor</td>
<td>any general partner</td>
<td>any general partner, not limited partners</td>
<td>officers</td>
<td>same as C corporation</td>
<td>any member if member-managed or any manager if manager-managed</td>
</tr>
<tr>
<td><strong>Effect on business if an owner dies or departs</strong></td>
<td>dissolves automatically</td>
<td>dissolves automatically unless otherwise stated in partnership agreement</td>
<td>same as general partnership</td>
<td>no effect</td>
<td>same as C corporation</td>
<td>some LLC agreements (and some default provisions of state law) say that LLC dissolves unless remaining members vote to continue business; otherwise LLC automatically continues</td>
</tr>
<tr>
<td><strong>Limits on transfer of ownership interests</strong></td>
<td>free transferability</td>
<td>consent of all general partners usually required under partnership agreement</td>
<td>same as general partnership</td>
<td>transfer of stock may be limited under securities laws</td>
<td>same as C corporations— but transfers to nonqualified shareholders terminate S tax status</td>
<td>most LLC agreements require membership consent to admit new member (absent such consent, transferee gets economic, not voting, rights in the transferor’s membership)</td>
</tr>
<tr>
<td>Business Entity Comparison Tables—Legal, Financial, and Tax Characteristics (cont’d)</td>
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<tr>
<td><strong>Amount of organizational paperwork and ongoing legal formalities</strong></td>
<td>minimal</td>
<td>required, but partnership agreement recommended</td>
<td>start-up filing required; partnership agreement recommended</td>
<td>start-up filing required; bylaws recommended; annual meetings of directors and shareholders recommended</td>
<td>same as C corporation</td>
<td>start-up filing required, operating agreement recommended</td>
</tr>
<tr>
<td><strong>Source of start-up funds</strong></td>
<td>sole proprietor</td>
<td>general partners</td>
<td>general and limited partners</td>
<td>initial shareholders; in some states, shareholders cannot buy shares by promising to perform future services or promising to pay for shares later (promissory notes)</td>
<td>same as C corporation—but cannot issue shares of different classes of stock with different dividend or liquidation rights</td>
<td>members</td>
</tr>
<tr>
<td><strong>How business usually obtains additional capital</strong></td>
<td>sole proprietor’s contributions; working capital loans backed by personal assets of sole proprietor</td>
<td>capital contributions from general partners; business loans from banks backed by partnership and personal assets of partners</td>
<td>investment capital from limited partners; bank loans guaranteed by general partners</td>
<td>flexible; issuance of new shares to investors, bank loans (backed by personal assets of major shareholders if necessary)</td>
<td>generally same as C corporation—but cannot have foreign or entity shareholders and cannot issue special classes of shares to investors (differences in voting rights are allowed)</td>
<td>capital contributions from members; bank loans backed by members’ personal assets if necessary</td>
</tr>
<tr>
<td><strong>Ease of conversion to another type of business</strong></td>
<td>may change form at will to partnership (if a new owner is added), corporation, or LLC</td>
<td>may change form to limited partnership, corporation, or LLC</td>
<td>may change to corporation or LLC</td>
<td>may change to S corporation by filing simple tax election; change to LLC can involve tax cost</td>
<td>generally same as C corporation—may terminate S tax status to become C corporation, but cannot reelect S status for five years</td>
<td>may change to general or limited partnership or to corporation</td>
</tr>
<tr>
<td><strong>Is establishment or sale of ownership interests subject to federal and state securities laws?</strong></td>
<td>generally, no</td>
<td>generally, no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>generally, no, if all members are active in the business</td>
</tr>
</tbody>
</table>
### Business Entity Comparison Tables—Legal, Financial, and Tax Characteristics (cont’d)

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<tr>
<td>Who generally finds this the best way to do business?</td>
<td>sole owner who wants minimum red tape and maximum autonomy</td>
<td>joint owner who are not concerned with personal liability for business debts</td>
<td>joint owner with passive investors who want limited liability protection and pass-through tax status (and prefer not to form an LLC); some real estate syndicates prefer to set up LPs rather than LLCs because they are accustomed to the LP form</td>
<td>owners who want the limited liability, formal structure, and capital incentives of the corporate form and the ability to split business income to reduce overall income taxes</td>
<td>owners who want the formal structure of the corporation form but want pass-through taxation of business profits (note: owners who want limited liability protection plus pass-through taxation should usually set up an LLC instead of an S corporation; some owners form an S corporation simply to minimize the owner’s self-employment taxes</td>
<td>owners who want limited liability legal protection and pass-through taxation of business profits</td>
</tr>
<tr>
<td>How business profits are taxed</td>
<td>individual tax rates of sole proprietor</td>
<td>individual tax rates of general partners (unless partnership elects corporate tax treatment)</td>
<td>individual tax rates of general and limited partners (unless partnership elects corporate tax treatment)</td>
<td>profits are split up and taxed at corporate rates and individual tax rates of employee-shareholders</td>
<td>individual tax rates of shareholders</td>
<td>individual tax rates of members</td>
</tr>
<tr>
<td>Tax-deductible employee benefits available to owners who work in the business?</td>
<td>generally, no, but owner may deduct medical insurance premiums and establish IRA or Keogh retirement plan</td>
<td>same as sole proprietorship (unless partnership elects corporate tax treatment)</td>
<td>same as sole proprietorship (unless partnership elects corporate tax treatment)</td>
<td>tax-deductible fringe benefits, including corporate retirement and profit-sharing plan as well as tax-favored stock option and bonus plan for employee-shareholders; may reimburse employees’ actual medical expenses; group term life insurance also deductible within limits</td>
<td>same as sole proprietorship</td>
<td>same as sole proprietorship (unless LLC elects corporate tax treatment)</td>
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<tr>
<td><strong>Automatic tax status</strong></td>
<td>yes</td>
<td>yes; can elect</td>
<td>yes, on filing</td>
<td>yes; on filing</td>
<td>no; must meet</td>
<td>yes; sole owner</td>
</tr>
<tr>
<td></td>
<td></td>
<td>corporate tax status</td>
<td>certificate of limited partnership</td>
<td>articles of incorporation</td>
<td>requirements and file tax</td>
<td>LLC automatically treated as sole proprietorship, co-owned LLC as partnership; can elect corporate tax status by filing IRS Form 8832</td>
</tr>
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<td></td>
<td></td>
<td>by filing IRS Form 8832</td>
<td>partnership with state filing office; can elect corporate tax status by filing IRS Form 8832</td>
<td>with state filing office</td>
<td>election form (IRS Form 2553)</td>
<td></td>
</tr>
<tr>
<td><strong>Deductibility of business losses</strong></td>
<td>generally, owner may deduct losses from active business income on individual tax return</td>
<td>partners active in the business may deduct losses from active business income on individual tax returns</td>
<td>limited partners not active in the business cannot use losses to offset active business income, but may be able to use them to offset other investment income; limited partners normally get the benefit only of nonrecourse debts—those for which general partners are not at risk; check with your tax adviser</td>
<td>corporation, not individual shareholders, deducts business losses; shareholders who sell their stock for a loss may be able to deduct part of the loss from ordinary income</td>
<td>shareholders receive pro rata amount of corporate loss to deduct on their individual income tax returns, subject to special loss limitation rules</td>
<td>generally, same as general partnership, but subject to special rules—see your tax adviser</td>
</tr>
<tr>
<td><strong>Tax level when business is sold</strong></td>
<td>personal tax level of owner</td>
<td>personal tax levels of individual general and limited partners</td>
<td>two levels: shareholders and corporation are subject to tax on liquidation</td>
<td>normally taxed at personal tax levels of individual shareholders, but corporate-level tax sometimes due if S corporation formerly was a C corporation</td>
<td>personal tax levels of individual members</td>
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Comparing Business Entities

In the table that follows, we highlight and compare general and specific legal and tax traits of each type of business entity. Should any of the additional points of comparison seem relevant to your business, we encourage you to talk them over with a legal or tax professional.

Nolo’s Small Business Resources

Nolo offers plenty of guidance for small business owners who want to set up a new venture and keep it running smoothly. The best place to start is Nolo’s website at www.nolo.com. There, you’ll find dozens of free articles to help you do everything from picking a good location to paying taxes. The following sections offer a partial list of Nolo’s most popular small business publications.

Starting and Running Your Business

The Small Business Start-Up Kit, by Peri H. Pakroo (national and California editions), helps you launch a business quickly, easily, and with confidence. Among other topics, the book shows you how to write an effective business plan, file for necessary permits and licenses, and acquire and keep good accounting and bookkeeping habits.

Legal Guide for Starting & Running a Small Business, by Fred S. Steingold, is a comprehensive business owner’s guide that provides in-depth coverage of topics ranging from raising start-up money and negotiating a lease to adopting the best customer policies, hiring workers, and avoiding legal problems.

Business Buyout Agreements: A Step-by-Step Guide for Co-Owners, by Anthony Mancuso and Bethany K. Laurence, helps you ensure a smooth transition following the departure of a business partner by writing a buy-sell agreement at the start of your business relationship. The book carefully explains each step of the process, providing all the tax and legal information you need to draft your own agreement.

Tax Savvy for Small Business, by Frederick W. Daily, lays out year-round tax saving strategies for business owners that show you how to claim all legitimate deductions, maximize fringe benefits, and keep accurate records to avoid trouble with the IRS.

Deduct It! Lower Your Small Business Taxes, by Stephen Fishman, is a comprehensive guide to tax deductions for small business owners.

The Employer’s Legal Handbook, by Fred S. Steingold, is a complete, plain-English guide to employee benefits, wage laws, workplace safety, and more.

Nondisclosure Agreements: Protect Your Trade Secrets & More, by Richard Stim and Stephen Fishman, is a downloadable eFormKit from the Nolo website (www.nolo.com) that explains what trade secrets are and shows you how to protect them from future competitors.

Partnerships

Form a Partnership, by Denis Clifford and Ralph Warner, thoroughly explains the legal and practical issues involved in forming a partnership and shows you how to write a comprehensive partnership agreement.

LLCs

LLC or Corporation? How to Choose the Right Form for Your Business, by Anthony Mancuso. This book explains the different legal and tax rules that apply to each entity and provides examples showing when it makes the most sense to form an LLC or to incorporate instead. The book isn’t only relevant at the formation stage—it includes comprehensive treatment of the legal
and tax effects of converting from one form of business to another as your business grows.

*Nolo’s Quick LLC: All You Need to Know About Limited Liability Companies*, by Anthony Mancuso, teaches you the basics of limited liability companies and helps you figure out whether forming an LLC is the right thing to do.

*Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso, shows you how to maintain the legal validity of your LLC. The book explains how to prepare minutes of meetings; record important legal, tax, and business decisions; handle formal record keeping; and set up an LLC records book.

**Nonprofit Corporations**

*How to Form a Nonprofit Corporation*, by Anthony Mancuso, shows you step by step how to form and operate a tax-exempt corporation in all 50 states. (California readers should see *How to Form a Nonprofit Corporation in California*, which gives more detailed advice to nonprofiteers in the Golden State.) Both books include step-by-step instructions on how to prepare IRS Form 1023—the tax exemption application that must be filed with the IRS.

*Starting & Building a Nonprofit*, by Peri Pakroo, offers nuts-and-bolts advice on issues like finding people to run your organization, holding board meetings, bookkeeping, marketing, and more.

*Effective Fundraising for Nonprofits: Real-World Strategies That Work*, by Ilona Bray, is a comprehensive guide to fundraising planning and methods, including proposal writing, individual and major donor cultivation, special events, Internet outreach, earned income strategies, planned giving, and more.

*Nonprofit Meetings, Minutes & Records*, by Anthony Mancuso, shows you how to call, notice, hold, and prepare minutes for your nonprofit corporation’s director, committee, and membership meetings.

**Running a Corporation**

*The Corporate Records Handbook*, by Anthony Mancuso, shows you how to establish the essential paper trail of your corporation’s legal life: corporate meeting minutes. The book contains forms to help you call and document meetings, including more than 80 individual resolutions that you can customize and include in your minutes when appropriate.

**Incorporate on Your Computer**

You can form your LLC or corporation directly on your computer using the Internet. Go to Nolo’s website (www.nolo.com) and you’ll find the information you need to form either an LLC or a corporation online. Simply choose whether you want to incorporate or form an LLC and then follow the instructions to create your own customized entity. For both types of entities, you have a choice of packages, although they all include certain basic services, like preparing your articles of incorporation (for a corporation) or operating agreement (for an LLC) and obtaining registered agent services.

**RESOURCE**

For more information about LLCs. See *Nolo’s LLC or Corporation?* by Anthony Mancuso, for a comprehensive comparison of the legal and tax rules that apply to LLCs and corporations and to help you decide which form is best for your business. See *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo), for instructions on how to form an LLC in each state, how to prepare an operating agreement, and how to handle all other LLC formation requirements. You can also learn more about LLC formation procedures and fees for your state by visiting your state’s business filing office website. To find the Web address of your state’s business filing office, see Appendix A.