Choosing a Legal Structure

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You probably already have a rough idea of the type of legal structure your business will take, whether you know it or not. That’s because, in large part, the ownership structure that’s right for your business—a sole proprietorship, partnership, LLC, or corporation—depends on how many people will own the business and what type of services or products it will provide, things you’ve undoubtedly thought about quite a bit.

For instance, if you know that you will be the only owner, then a partnership is obviously not your thing. (A partnership by definition has more than one owner.) And if your business will engage in risky activities (for example, trading stocks or repairing roofs), you’ll want not only to buy insurance, but also to consider forming an entity that provides personal liability protection (a corporation or a limited liability company), which can shield your personal assets from business debts and claims. If you plan to raise capital by selling stock to the public or want to give your employees stock options, then you should form a corporation.

If you’ve considered these issues, then you’ll be ahead of the game in choosing a legal structure that’s right for your business. Still, you’ll need to consider the benefits and drawbacks of each type of business structure before you make your final decision.

In all states, the basic types of business structures are:

- sole proprietorships
- partnerships (general and limited)
- limited liability companies (LLCs), and
- corporations.

To help you pick the best structure for your business, this chapter explains the basic attributes of each type.

This chapter will also help you answer the most common question new entrepreneurs ask about choosing a business form: Should I choose a business structure that offers protection from personal liability—a corporation or an LLC? Here’s a hint as to what the best advice will be: If you focus energy and money into getting your business off the ground as a sole proprietorship or a partnership, you can always incorporate or form an LLC later.

Making the Decision to Go Official

Some of you may be grappling with a more preliminary question than what legal structure you should choose, and wondering whether or not to formalize your business—to go the official route and register your business with the appropriate agencies in your state. For instance, maybe you’ve been doing freelance graphics work on the side for a number of years, but now you’re thinking of quitting your 9-to-5 job to take on graphics work full-time.

Generally speaking, anyone with a good-sized or otherwise visible business should bite the bullet and complete all of the necessary registration tasks to become official. Operating under the table can all too easily be exposed, and the government can come after you for fines and penalties, and might even padlock your business, simply for operating without the necessary paperwork. And if you’re making a profit, ignoring the IRS is definitely a bad idea. Besides fines and back taxes, you could even face criminal charges and jail time.

On the other hand, tiny, home-based, hobby-type businesses can often operate for quite some time without meeting registration requirements. If you’re braiding hair or holding an occasional junk sale out of your garage, for instance, you can probably get by without formal business registration—at least for a while. Keep in mind, however, that just because it may be possible doesn’t mean it’s the best option. Often, formally registering your business can benefit you, the owner, as well, since you can then write off business expenses and reduce your personal taxes. In Chapter 8, we discuss hobby businesses in more depth, including how tax laws deal with businesses that continually lose money.

If you’re not sure whether you want to register your business and open it up to the world of government regulations, the information about registration requirements in this book will put you in a better position to make a decision. Chapter 6 walks you through the many governmental requirements that apply to all new businesses, and explains how to go about finding and satisfying any additional requirements that may apply to your specific business.
Limited Liability

One basic distinction that you’ll probably hear mentioned lots of times is the difference between businesses that provide their owners with “limited liability” and those that don’t. Corporations and LLCs both provide owners with limited personal liability. Sole proprietorships and general partnerships do not.

Limited liability basically means that the creditors of the business cannot normally go after the owners’ personal assets to pay for business debts and claims arising from lawsuits. (Liability for business debts is discussed in detail later in this chapter.)

As you read about specific business types in this chapter, you’ll see how a decision to form a limited liability entity (a corporation or an LLC, mainly) can dramatically affect how you run your business. On the other hand, sole proprietorships and partnerships (which are somewhat simpler to run than corporations and LLCs) may leave an owner personally vulnerable to business lawsuits and debts.

Sole Proprietorships

Sole proprietorships are one-owner businesses. Any business with two or more owners cannot, by definition, be a sole proprietorship. If you know that there will be two or more owners of your business, you can skip ahead to “Partnerships,” below.

A sole proprietorship is simply a business that is owned by one person and that hasn’t filed papers to become a corporation or an LLC. Sole proprietorships are easy to set up and to maintain—so easy that many people own sole proprietorships and don’t even know it. For instance, if you are a freelance photographer or writer, a craftsperson who takes jobs on a contract basis, a salesperson who receives only commissions, or an independent contractor who isn’t on an employer’s regular payroll, you are automatically a sole proprietor. This is true whether or not you’ve registered your business with your city or obtained any licenses or permits. And it makes no difference whether you also have a regular day job. As long as you do for-profit work on your own (or sometimes with your spouse—see “Running a Business With Your Spouse,” below) and have not filed papers to become a corporation or a limited liability company, you are a sole proprietor.

CAUTION
Don’t ignore local registration requirements.

If you’ve started a business without quite realizing it—for example, you do a little freelance computer programming, which classifies you as a sole proprietor by default—don’t think that you’ve satisfied the governmental requirements for starting a business. Most cities and many counties require businesses—even tiny home-based sole proprietorships—to register with them and pay at least a minimum tax. And if you do business under a name different from your own (say, Christina Kennedy does business under the name “Monster Photography”), you usually must register that name—as a fictitious business name—with your county. In practice, lots of businesses are small enough to get away with ignoring these requirements. But if you are caught, you may be subject to back taxes and other penalties. (See Chapter 6 for an explanation of how to make the necessary filings with the appropriate government offices.)

Pass-Through Taxation

In the eyes of the law, a sole proprietorship is not legally separate from the person who owns it. This is one of the fundamental differences between a sole proprietorship and a corporation or LLC, and it has two major effects: one related to taxation (explained in this section), and the other to personal liability (explained in the next).

At income tax time, a sole proprietor simply reports all business income or losses on his or her individual income tax return. The business itself is not taxed. The IRS calls this “pass-through” taxation, because business profits pass through the business to be taxed on the business owner’s tax return. You report income from a business just like wages from a job, except
that, along with Form 1040, you'll need to include Schedule C, on which you'll provide your business's profit and loss information. One helpful aspect of this arrangement is that if your business loses money—and, of course, many start-ups do in the first year or two—you can use the business losses to offset any taxable income you have earned from other sources.

**EXAMPLE:** Rob has a day job at a coffee shop, where he earns a modest salary. His hobby is collecting obscure records at thrift stores and rummage sales. Contemplating the sad fact that he has no extra money to spend at the flea market on Saturday morning, he decides to start selling some of the vinyl gems he's found. Still working his day job, he starts a small business that he calls Rob's Revolving Records.

During his first full year in business, he sees that a key to consistently selling his records is developing connections and trust among record collectors. Unfortunately, while he is concentrating on getting to know potential buyers and others in the business, sales are slow. At year end he closes out his books and sees that he spent nearly $9,000 on records, his website, marketing items such as business cards, and other incidental supplies, while he made only $3,000 in sales. But there is some good news: Rob's loss of $6,000 can be counted against his income from his day job, reducing his taxes and translating into a nice refund check, which he'll put right back into his record business.
CAUTION

Your business can’t lose money forever. See the discussion of tax rules for money-losing businesses in Chapter 8.

RESOURCE

Be ready for the day you’ll owe taxes. Once your business is underway and turning a profit, you’ll have to start paying taxes. (See Chapter 8 for an overview of the taxes that small businesses face.) Taxes can get fairly complicated, however, and you may need more in-depth guidance. For detailed information on taxes for the various types of small businesses, read Tax Savvy for Small Business, by Frederick W. Daily and Jeffrey A. Quinn (Nolo). This book gives exhaustive information on deductions, record keeping, and audits that will help you reduce your tax bill and stay out of trouble with the IRS.

Personal Liability for Business Debts

Another crucial thing to know about operating your business as a sole proprietor is that you, as the owner of the business, can be held personally liable for business-related obligations. This means that if your business doesn’t pay a supplier, defaults on a debt, loses a lawsuit, or otherwise finds itself in financial hot water, you, personally, can be forced to pay up. This can be a sobering possibility, especially if you own (or soon hope to own) a house, a car, or other treasures. Personal liability for business obligations stems from the fundamental legal attribute of being a sole proprietor: You and your business are legally one and the same.

As explained in more detail in the sections that discuss corporations and LLCs, below, the law provides owners of these businesses with “limited personal liability” for business obligations. This means that, unlike sole proprietors and general partners, owners of corporations and LLCs can normally keep their houses, investments, and other personal property even if their business fails. In short, if you are engaged in a risky business, you may want to consider forming a corporation or an LLC (although a thorough insurance policy can protect you from most lawsuits and claims against the business if your company is a sole proprietorship or partnership).

CAUTION

Commercial insurance doesn’t cover business debts. Commercial insurance can protect a business and its owners from some types of liability (for instance, slip-and-fall lawsuits), but insurance never covers business debts. The only way to limit your personal liability for business debts is to use a limited liability business structure such as an LLC or a corporation (or a limited partnership or limited liability partnership).

Creating a Sole Proprietorship

Setting up a sole proprietorship is incredibly easy. Unlike starting an LLC or a corporation, you generally don’t have to file any special forms or pay any special fees to start working as a sole proprietor. You’ll simply declare your business to be a sole proprietorship when completing the general registration requirements that apply to all new businesses, such as getting a business license from your county or city or a seller’s permit from your state.

For example, when filing for a business tax registration certificate with your city, you’ll often be asked to declare what kind of business you’re starting. Some cities require only that you check a “sole proprietorship” box on a form, while other cities have separate tax registration forms for sole proprietorships. Similarly, other forms you’ll file, such as those to register a fictitious business name and to obtain a seller’s permit, will also ask for this information. (These and other start-up requirements are discussed in detail in Chapter 6.)

Partnerships

Bring two or more entrepreneurs together into a business venture, stir gently, and—poof!—you’ve got a partnership. By definition, a partnership is a business that has more than one owner and that
has not filed papers with the state to become a corporation or an LLC (or a limited partnership or limited liability partnership).

**CAUTION**

Partnerships and registration requirements.

Though businesses with two or more owners are partnerships by default, they still must satisfy various governmental requirements for starting a business. Most cities and many counties require all businesses to register with them and pay at least a minimum tax. And if you do business under a name other than the partners’ names, you usually must register that name—known as a fictitious business name—with your county. (See Chapter 6 for an explanation of how to make the necessary filings with the appropriate government offices.)

**General Versus Limited Partnerships**

Usually, when you hear the term “partnership,” it means a general partnership. As discussed in more detail below, general partners are personally liable for all business debts, including court judgments. In addition, each individual partner can be sued for the full amount of any business debt (though that partner can turn around and sue the other partners for their share of the debt).

Another very important aspect of general partnerships is that any individual partner can bind the whole business to a contract or business deal—in other words, each partner has “agency authority” for the partnership. And remember, each of the partners is fully personally liable for a business deal gone sour, no matter which partner signed the contract. So choose your partners carefully.

There are also a couple of special kinds of partnerships, called limited partnerships and limited liability partnerships. They operate under very different rules and are relatively uncommon, so they are only briefly described here.

A limited partnership requires at least one general partner and at least one limited partner. The general partner has the same role as in a general partnership: He or she controls the company’s day-to-day operations and is personally liable for business debts. The limited partner contributes financially to the business (for example, invests $100,000 in a real estate partnership) but has minimal control over business decisions or operations, and normally cannot bind the partnership to business deals. In return for giving up management power, a limited partner gets the benefit of protection from personal liability. This means that a limited partner can’t be forced to pay off business debts or claims with personal assets, but can lose an investment in the business. But beware: A limited partner who tires of being passive and starts tinkering under the hood of the business should understand that his or her liability can quickly become unlimited that way. If a creditor can prove that the limited partner took acts that led the creditor to believe that he or she was a general partner, the limited partner can be held fully and personally liable for the creditor’s claims.

Another kind of partnership, called a limited liability partnership (LLP) or sometimes a registered limited liability partnership (RLLP), provides all of its owners with limited personal liability. In some states, these partnerships are only available to professionals, such as lawyers and accountants, and are particularly well suited to them. Most professionals aren’t keen on general partnerships, because they don’t want to be personally liable for another partner’s problems—particularly those involving malpractice claims. Forming a corporation to protect personal assets may be too much trouble, and some states won’t allow these professionals to form an LLC. The solution is often a limited liability partnership. This business structure protects each partner from debts against the partnership arising from professional malpractice lawsuits against another partner. (A partner who loses a malpractice suit because of personal mistakes, however, doesn’t escape liability.)

**Pass-Through Taxation**

Similar to a sole proprietorship, a partnership (general or limited) is not a separate tax entity from its owners; instead, it’s what the IRS calls a “pass-through entity.”
This means the partnership itself does not pay any income taxes; rather, income passes through the business to each partner, who pays taxes on a share of profit (or deducts a share of losses) on an individual income tax return (Form 1040, with Schedule E attached). However, the partnership must also file what the IRS calls an “informational return”—Form 1065—to let the government know how much the business earned or lost that year. No tax is paid with this return—just think of it as the feds’ way of letting you know they’re watching.

Personal Liability for Business Debts
Since a partnership is legally inseparable from its owners, just like a sole proprietorship, general partners are personally liable for business-related obligations. What’s more, in a general partnership, the business actions of any one partner bind the other partners, who can be held personally liable for those actions. So if your business partner takes out an ill-advised high-interest loan on behalf of the partnership, makes a terrible business deal, or gets in some other business mischief without your knowledge, you could be held personally responsible for any debts that result.

**EXAMPLE:** Jamie and Kent are partners in a profitable landscape gardening company. They’ve been in business for five years and have earned healthy profits, allowing them each to buy a house, decent wheels, and even a few luxuries—including Jamie’s collection of garden sculptures and Kent’s roomful of vintage musical instruments. One day Jamie, without telling Kent, orders a shipment of exotic poppy plants that he is sure will be a big hit with customers. But when the shipment arrives, so do agents of the federal drug enforcement agency, who confiscate the plants, claiming they could be turned into narcotics. Soon thereafter, criminal charges are filed against Jamie and Kent, resulting in several newspaper stories. Though the partners are ultimately cleared, their attorneys’ fees come to $50,000 and they lose several key accounts, with the result that the business runs up hefty debts. As a general partner, Kent is personally liable for these debts even though he had nothing to do with the ill-fated poppy purchase.

Before you get too worried about personal liability, keep in mind that many small businesses don’t face much of a risk of racking up large debts. For instance, if you’re engaged in a low-risk enterprise such as freelance editing, landscaping, or running a small band that plays weddings and other social events, your risk of facing massive debt or a huge lawsuit is pretty small. For these types of small, low-risk businesses, a good business insurance policy that covers most liability risks is almost always enough to protect owners from a catastrophe like a lawsuit or fire. Insurance won’t cover regular business debts, however. If you have significant personal assets like fat bank accounts or real estate and plan to rack up some business debt, you may want to limit your personal liability with a different business structure, such as an LLC or a corporation.

Partnership Agreements
By drafting a partnership agreement, you can structure your relationship with your partners pretty much however you want. You and your partners can establish the shares of profits (or losses) each partner will receive, what the responsibilities of each partner will be, what should happen to the partnership if a partner leaves, and how a number of other issues will be handled. It is not legally necessary for a partnership to have a written agreement; the simple act of two or more people doing business together creates a partnership. But only with a clear written agreement will all partners be sure of the important—and sometimes touchy—details of their business arrangement.

In the absence of a partnership agreement, your state’s version of the Uniform Partnership Act (UPA) or Revised Uniform Partnership Act (RUPA) kicks in as a standard, bottom-line guide to the rights and responsibilities of each partner. Most states have adopted the UPA or RUPA in some form. In California, for example, if you don’t have a
partnership agreement, then California’s RUPA states that each partner has an equal share in the business’s profits, losses, and management power. Similarly, unless you provide otherwise in a written agreement, a California partnership won’t be able to add a new partner without the unanimous consent of all partners. (Cal. Corp. Code § 16401.)

In short, it’s important to understand that you can override many of the legal provisions contained in the UPA or RUPA if you and your partners have your own written agreement.

**RELATED TOPIC**

Businesses with more than one owner should address potential changes in ownership. The partnership agreement provisions discussed in this chapter cover the very basics. Chapter 14 covers what is known as a buy-sell agreement, which establishes rules for what will happen if an owner retires, becomes disabled, dies, gets divorced, or otherwise faces a situation that brings business ownership into question. Buy-sell provisions can exist in a separate document or may be included in partnership agreements or other organizational documents depending on the company structure: operating agreements for LLCs, or bylaws for corporations. Read Chapter 14 to become familiar with the ownership issues that can arise when your business is owned by more than one person—and how best to head off problems with a solid agreement.

There’s nothing terribly complex about drafting partnership agreements. They’re usually only a few pages long and cover basic issues that you’ve probably thought over to some degree already. Partnership agreements typically include at least the following information:

- name of partnership and partnership business
- date of partnership creation
- purpose of partnership
- contributions (cash, property, and work) of each partner to the partnership
- each partner’s share of profits and losses
- provisions for taking profits out of the company (often called partners’ draws)
- each partner’s management power and duties
- how the partnership will handle departure of a partner, including buyout terms
- provisions for adding or expelling a partner, and
- dispute resolution procedures.

These and any other terms you include in a partnership agreement can be dealt with in more or less detail. Some partnership agreements cover each topic with a sentence or two; others spend up to a few pages on each provision. You need an agreement that’s appropriate for the size and formality of your business, but it’s not a good idea to skimp on your partnership agreement.

**RESOURCE**

For more on partnerships. Form a Partnership: The Complete Legal Guide, by Denis Clifford and Ralph Warner (Nolo), is an excellent step-by-step guide to putting together a solid, comprehensive partnership agreement. Also, Business Buyout Agreements: Plan Now for Retirement, Death, Divorce, or Owner Disagreements, by Bethany Laurence and Anthony Mancuso (Nolo), explains how to draft terms that will enable you to deal with business ownership transitions. If you think you may want more than the simple partnership agreements in this book but don’t want to spend a lot of time creating an agreement, there are more detailed partnership agreement forms (as well as many other resources for running your small business) in Quicken Legal Business Pro 2014 software (Nolo). You can learn more about these resources at www.nolo.com.

**FORM**

Take a look at the short sample partnership agreements on the following pages to see how a very basic partnership agreement can be put together. You’ll find a downloadable partnership agreement on the Nolo website; see Appendix B for the link to this form and other forms in the book.

The sample partnership agreements included here and on the Nolo website are about as basic as it gets—the bare minimum—and you’ll almost surely want to use something more detailed for your business.
Partnership Agreement #1

Alison Shanley and Peder Johnson make the following partnership agreement.

Name and Purpose of Partnership
As of September 22, 20xx, Alison and Peder are the sole owners and partners of the Vermont Fly-Fishing Company. The Vermont Fly-Fishing Company shall be headquartered in Rutland, Vermont, and will sell fly-fishing equipment by mail order.

Contributions to the Partnership
Alison and Peder will make the following contributions to the partnership:

<table>
<thead>
<tr>
<th>Name</th>
<th>Contribution Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alison Shanley</td>
<td>cash</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>desk, miscellaneous office furniture</td>
<td>1,000</td>
</tr>
<tr>
<td></td>
<td>Total contribution:</td>
<td>$11,000</td>
</tr>
<tr>
<td>Peder Johnson</td>
<td>cash</td>
<td>$7,000</td>
</tr>
<tr>
<td></td>
<td>computer system</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>Total contribution:</td>
<td>$9,000</td>
</tr>
</tbody>
</table>

Profit and Loss Allocation
Alison and Peder will share business profits and losses in the same proportions as their contributions to the business.

Management of Partnership Business
Alison and Peder will have equal management powers and responsibilities.

Departure of a Partner
If either Alison or Peder leaves the partnership for any reason, including voluntary withdrawal, expulsion, or death, the remaining partner shall become the sole owner of the Vermont Fly-Fishing Company, which shall become a sole proprietorship. The remaining owner shall pay the departing partner, or the deceased departing partner’s estate, the fair market value of the departing partner’s share of the business as of the date of his or her departure. The partnership’s accountant shall determine the fair market value of the departing partner’s share of the business according to the partnership’s book value.

Mediation of Disputes
Alison and Peder agree to mediate any dispute arising under this agreement with a mutually acceptable mediator.

Amendment of Agreement
This agreement may not be amended without the written consent of both partners.

Alison Shanley                                                 Peder Johnson
Signature ___________________________                          Signature ___________________________
Date ___________________________                                Date ___________________________
Address ____________________________________________________   Address ____________________________________________________
Social Security # ___________________________                    Social Security # ___________________________
Partnership Agreement #2

Christine Wenc, Simon Romero, and Brendan Doherty agree to the terms of the following agreement.

1. **Name of Partnership.** Christine, Simon, and Brendan are partners in the Wenc & Romero Partnership. They created the partnership on July 12, 20xx.

2. **Partnership Purpose.** The Wenc & Romero Partnership will provide newspaper clipping services to clients.

3. **Contributions to the Partnership.** Christine, Simon, and Brendan will contribute the following to the partnership:
   - Christine: $1,000 cash; one Macintosh computer (value $1,500); and one monitor (value $500).
   - Simon: $1,000 cash; one fax machine (value $400); one laser printer (value $1,200).
   - Brendan: $500 cash; various office equipment (value $500).

4. **Profits and Losses.** Christine, Simon, and Brendan shall share profits and losses as follows:
   - Christine 40%
   - Simon 40%
   - Brendan 20%

5. **Partnership Decisions.** Christine, Simon, and Brendan will have the following management authority:
   - Christine 2 votes
   - Simon 2 votes
   - Brendan 1 vote

   No partner may accept a new client without the agreement of the others.

6. **Additional Terms to Be Drafted.** Christine, Simon, and Brendan agree that in six months they will sign a formal partnership agreement that covers the items in this agreement in more detail, and the additional following items:
   - each partner’s work contributions
   - provisions for adding a partner
   - provisions for the departure of a partner, and
   - provisions for selling the business.

7. **Amendments.** This agreement may not be amended without the written consent of all partners.

Christine Wenc
Signature __________________________ Date __________________
Social Security # __________________________

Simon Romero
Signature __________________________ Date __________________
Social Security # __________________________

Brendan Doherty
Signature __________________________ Date __________________
Social Security # __________________________
What a Partnership Agreement Can’t Do

Although a general partnership agreement is an incredibly flexible tool for defining the ownership interests, work responsibilities, and other rights of partners, there are some things it can’t do. These include:

- freeing the partners from personal liability for business debts
- restricting any partner’s right to inspect the business books and records
- affecting the rights of third parties in relation to the partnership—for example, a partnership agreement that says a partner has no right to sign contracts won’t affect the rights of an outsider who signs a contract with that partner, and
- eliminating or weakening the duty of trust (the fiduciary duty) each partner owes to the other partners.

Limited Liability Companies (LLCs)

Like many business owners just starting out, you might find yourself in this common quandary: On one hand, having to cope with the risk of personal liability for business misfortunes scares you; on the other, you would rather not deal with the red tape of starting and operating a corporation. Fortunately for you and many other entrepreneurs, you can avoid these problems by taking advantage of a relatively new form of business called the limited liability company, commonly known as an LLC. LLCs combine the pass-through taxation of a sole proprietorship or partnership (taxes on business income are paid on each owner’s individual income tax returns) with the same protection against personal liability that corporations offer.

Limited Personal Liability

Generally speaking, owners of an LLC (called “members”) are not personally liable for the LLC’s debts. (There are some exceptions to this rule, discussed below.) This protects the members from legal and financial liability in case their business fails, or loses a lawsuit, and can’t pay its debts. In those situations, creditors can take all of the LLC’s assets, but they generally can’t get at the personal assets of the LLC’s members. Losing your business is no picnic, but it’s a lot better to lose only what you put into the business than to say goodbye to everything you own.

EXAMPLE: Callie forms her own one-person mail-order business, using most of her $25,000 in savings to establish a professional website and buy mailing lists. Callie realizes that she’ll have to buy a significant portion of her sales inventory up front to be able to ship goods to her customers on time, so she plans to buy those items on credit. While she is willing to risk her $25,000 investment to pursue her dream, she is worried that if her mail-order business fails, she will be buried under a pile of debt. Callie decides to form an LLC so that if her business should fail, she’ll only lose the $25,000; no one will be able to sue her personally for the business debt that she owes. She feels more secure going into business knowing that even if her business fails, she can walk away without the risk of losing her house or her car.

While some LLCs opt for a structure in which the company is run by specially designated managers, most LLCs are simply managed by the members. This
more common setup is called a “member-managed” LLC; one that is run by managers (who are elected by the members) is called a “manager-managed” LLC. A manager-managed LLC might be appropriate if some of the LLC’s owners are passive investors (similar to limited partners), while a smaller group intends to actively run the company. If all the LLC owners intend to actively manage the company, you’ll generally use the more common member-managed structure.

With this in mind, remember that, like a general partner in a partnership, any member of a member-managed LLC can legally bind the entire LLC to a contract or business transaction. In other words, each member can act as an agent of the LLC. In manager-managed LLCs, any manager can bind the LLC to a business contract or deal.

While LLC owners enjoy limited personal liability for many of their business debts, this protection is not absolute. There are several situations in which an LLC owner may become personally liable for business debts or claims. However, this drawback is not unique to LLCs—the limited liability protection given to LLC members is just as strong as (if not stronger than) that enjoyed by the corporate shareholders of small corporations. Here are the main situations where LLC owners can still be held personally liable for debts:

- **Personal guarantees.** If you give a personal guarantee on a loan to the LLC, then you are personally liable for repaying that loan. Because personal guarantees are often required by banks and other lenders, this is a good reason to be a conservative borrower. Of course, if no personal guarantee is made, then only the LLC—not the members—is liable for the debt.

- **Taxes.** The IRS or the state tax agency may go after the personal assets of LLC owners for overdue federal and state business tax debts, particularly overdue payroll taxes. This is most likely to happen to members of small LLCs who have an active hand in managing the business, rather than to passive members.

- **Negligent or intentional acts.** An LLC owner who intentionally or even carelessly hurts someone will usually face personal liability. For example, if an LLC owner takes a client to lunch, has a few martinis, and injures the client in a car accident on the way home, the LLC owner can be held personally liable for the client’s injuries.

- **Breach of fiduciary duty.** LLC owners have a legal duty to act in the best interest of their company and its members. This legal obligation is known as a “fiduciary duty,” or is sometimes simply called a “duty of care.” An LLC owner who violates this duty can be held personally liable for any damages that result from the owner’s actions (or inactions). Fortunately for LLC owners, they normally will not be held personally responsible for any honest mistakes or acts of poor judgment they commit in doing their jobs. Most often, breach of duty is found only for serious indiscretions such as fraud or other illegal behavior.

- **Blurring the boundaries between the LLC and its owners.** When owners fail to respect the separate legal existence of their LLC, but instead treat it as an extension of their personal affairs, a court may ignore the existence of the LLC and rule that the owners are personally liable for business debts and liabilities. Generally, this is more likely to occur in one-member LLCs; in reality, it only happens in extreme cases. You can easily avoid it by opening a separate LLC checking account, getting a federal employer identification number, keeping separate accounting books for your LLC, and funding your LLC adequately enough to be able to meet foreseeable expenses.

TIP

There’s a new flavor of LLC on the scene: the low-profit limited liability company, or L3C. For details, see the “Benefit Corporations, L3Cs, and Emerging Business Structures for Socially Conscious, Mission-Driven Businesses” section, below.
LLC Taxation

Like a sole proprietorship or a partnership, an LLC is not a separate tax entity from its owners; instead, it’s what the IRS calls a “pass-through entity.” This means the LLC itself does not pay any income taxes; instead, income passes through the business to each LLC owner, who pays taxes on the share of profit (or deducts the share of losses) on the owner’s individual income tax return (for the feds, Form 1040 with Schedule E attached). But a multiowned LLC, like a partnership, does have to file Form 1065—an “informational return”—to let the government know how much the business earned or lost that year. No tax is paid with this return.

LLCs give members the flexibility to choose to have the company taxed like a corporation rather than as a pass-through entity. In fact, partnerships now have this option as well. (See Chapter 8 for more about taxes.)

You may wonder why LLC owners would choose to be taxed as a corporation. After all, pass-through taxation is one of the most popular features of an LLC. The answer is that, because of the income-splitting strategy of corporations (discussed in “Corporate Taxation,” below), LLC members can sometimes come out ahead by having their business taxed as a separate entity at corporate tax rates.

For example, if the owners of an LLC become successful enough to keep some profits in the business at the end of the year (or regularly need to keep significant profits in the business for upcoming expenses), paying tax at corporate tax rates can save them money. That’s because federal income tax rates for corporations start at a lower rate than the rates for individuals. For this reason, many LLCs start out being taxed as partnerships, and when they make enough profit to justify keeping some in the business (rather than doling it out as salaries and bonuses), they opt for corporate-style taxation.

LLCs Versus S Corporations

Before LLCs came along, the only way all owners of a business could get limited personal liability was to form a corporation. Problem was, many entrepreneurs didn’t want the hassle and expense of incorporating, not to mention the headache of dealing with corporate taxation. One easier option was to form a special type of corporation known as an S corporation, which is like a normal corporation in most respects, except that business profits pass through to the owner (as in a sole proprietorship or partnership), rather than being taxed to the corporation at corporate tax rates. In other words, S corporations offered the limited liability of a corporation with the pass-through taxation of a sole proprietorship or partnership. For a long time, this was an okay compromise for small-to-medium-sized businesses, though they still had to deal with requirements of running an S corporation (discussed in more detail below).

Now, however, LLCs offer a better option. LLCs are indeed similar to S corporations in that they combine limited personal liability with pass-through tax status. But a significant difference between these two types of businesses is that LLCs are not bound by the many regulations that govern S corporations.

Here’s a quick rundown of the major areas of difference between S corporations and LLCs. (Keep in mind that corporations, including S corporations, are explained in more detail in the next section.)

- **Ownership restrictions.** An S corporation may not have more than 75 shareholders, all of whom must be U.S. citizens or residents. This means that some of the C corporation’s main benefits—namely, the ability to set up stock option and bonus plans and to bring in public capital—are pretty much out of the question for S corporations. And even if an S corporation initially meets the U.S. citizen or resident requirement, its shareholders can’t sell shares to another company (like a corporation or an LLC) or a foreign citizen, on pain of losing S corporation tax status. In an LLC, any type of person or entity can become a member—a U.S. citizen, a citizen of a foreign country, another LLC, a corporation, or a limited partnership.

- **Allocation of profits and losses.** Shareholders of an S corporation must allocate profits according to the percentage of stock each owner has. For
example, a 25% owner has to receive 25% of the profits (or losses), even if the owners want a different division. Owners of an LLC, on the other hand, may distribute profits (and the tax burden that goes with them) however they see fit, without regard to each member’s ownership share in the company. For instance, a member of an LLC who owns 25% of the business can receive 50% of the profits if the other members agree (subject to a few IRS rules).

- **Corporate meeting and record-keeping rules.** For S corporation shareholders to keep their limited liability protection, they have to follow the corporate rules: issuing stock, electing officers, holding regular board of directors’ and shareholders’ meetings, keeping corporate minutes of all meetings, and following the mandatory rules found in their state’s corporation code. By contrast, LLC owners don’t need to jump through most of these legal hoops—they just have to make sure their management team is in agreement on major decisions and go about their business.

- **Tax treatment of losses.** S corporation shareholders are at a disadvantage if their company goes into substantial debt—for instance, if it borrows money to open the business or buy real estate. That’s because an S corporation’s business debt cannot be passed along to its shareholders unless they have personally cosigned and guaranteed the debt. LLC owners, on the other hand, normally can reap the tax benefits of any business debt, cosigned or not. This can translate into a nice tax break for owners of LLCs that carry debt.

### Forming an LLC

To form an LLC, you must file Articles of Organization with your Secretary of State or other LLC filing office. You should also execute an operating agreement, which governs the internal workings of your LLC. Also, be aware that an LLC might not be as cheap to start as a partnership or sole proprietorship. A few states charge significant filing fees, plus annual dues (alternately called minimum taxes, annual fees, or renewal fees). These fees can push the costs of starting an LLC into the several-hundred-dollar range. Illinois, for instance, charges a $500 filing fee, and California requires that you pay a minimum annual LLC tax of $800 when you start your LLC—on top of its $70 filing fee.

Many brand-new business owners aren’t in a position to pay this kind of money right out of the starting gate, so they start out as partnerships until they bring in enough income to cover these costs. And if you’re thinking of forming a corporation instead, keep in mind that most states charge at least as much in fees for corporations. This plus the added expenses of running a corporation (legal and accounting fees, for example) will almost always make a corporation more expensive to run than an LLC.

#### CAUTION

**Some LLCs must comply with securities laws.** LLCs that have owners who do not actively participate in the business may have to register their membership interests as securities or, more likely, qualify for an exemption to the registration requirements. For information about exemptions to the federal securities laws, visit the Securities and Exchange Commission’s website at www.sec.gov and click “Information for Small Businesses.”

#### RESOURCE

**For more on LLCs.** Your Secretary of State or other LLC filing office will have lots of information on LLC rules and procedures in your state. To find yours, see the list of LLC Offices included in Appendix A and on the Nolo website. *Form Your Own Limited Liability Company*, by Anthony Mancuso (Nolo), gives detailed information on LLCs, including step-by-step instructions and forms for creating one. For a briefer treatment, consult *Nolo’s Quick LLC: All You Need to Know About Limited Liability Companies*, also by Anthony Mancuso. It offers an overview of LLCs as well as comparisons to other business structures, but does not include any start-up forms. Nolo also offers a comprehensive LLC package to form your LLC online (see www.nolo.com for details).
Corporations

For many, the term “corporation” conjures up the image of a massive industrial empire more akin to a nation-state than a small business. In fact, a corporation doesn’t have to be huge, and most aren’t. Stripped to its essentials, a corporation is simply a specific legal structure that imposes certain legal and tax rules on its owners (also called shareholders). A corporation can be as large as IBM or, in many cases, as small as one person.

One fundamental legal characteristic of a corporation is that it’s a separate legal entity from its owners. If you’ve already read this chapter’s sections on sole proprietorships and partnerships, you’ll recognize that this is a major difference between those unincorporated business types and corporations. Another important corporate feature is that shareholders are normally protected from personal liability for business debts. Finally, the corporation itself—not just the shareholders—is subject to income tax.

SEE AN EXPERT

Publicly traded corporations are a different ball game. This section discusses privately held corporations owned by a small group of people who are actively involved in running the business. These corporations are much easier to manage than public corporations, whose shares are sold to the public at large. Any corporation that sells its stock to the general public is heavily regulated by state and federal securities laws, while corporations that sell shares, without advertising, to a select group of people who meet specific state requirements are often exempt from many of these laws. If you plan to sell shares of a corporation to the general public, you should consult a lawyer.

Limited Personal Liability

Generally speaking, owners of a corporation are not personally liable for the corporation’s debts. (There are some exceptions to this rule, discussed below.) Limited personal liability is a major reason why businesses: to protect themselves from legal and financial liability in case their business flounders or loses an expensive lawsuit and can’t pay its debts. In those situations, creditors can take all of the corporation’s assets (including the shareholders’ investments), but they generally can’t get at the personal assets of the shareholders.

EXAMPLE: Tim and Chris publish Tropics Tripping, a monthly travel magazine with a focus on Latin America. Because they both have significant personal assets, and because they will have to borrow a lot of capital to start up their magazine, they form their business as a corporation to protect their personal assets in case their magazine fails. They do great for a few years, but suddenly their subscription and advertising revenue starts to suffer when a recession plus political unrest in several Latin American countries reduces interest in travel to that area. Hoping the situation will turn itself around, Tim and Chris forge ahead—and go deeper into debt as it proves impossible to pay printing and other bills on time. Finally, when their printer won’t do any more print runs on credit, Tim and Chris are forced to call it quits. Tropics Tripping’s debts total $250,000, while business assets are valued at only $90,000—leaving a $160,000 debt to creditors. Thankfully for Tim and Chris, they won’t have to use their personal assets to pay the $160,000, because, as owners of a corporation, they’re shielded from personal liability.

TIP

Corporations aren’t the only option. With the advent of limited liability companies, corporations aren’t the only business entities that provide limited liability status for all owners. (See the section on LLCs, above.)

Forming a corporation to shield yourself from personal liability for business obligations provides good, but not complete, protection for your personal assets. Here are the principal areas in which corporation owners still face personal liability:
• **Personal guarantees.** If you give a personal guarantee on a loan to the corporation, then you are personally liable for the repayment of that loan. Because lenders often require a personal guarantee, this is a good reason to be a conservative borrower. Of course, if no personal guarantee is made, then only the corporation—not the shareholders—is liable for the debt.

• **Taxes.** The IRS or the state's tax agency may go after the personal assets of corporate owners for overdue corporate federal and state tax debts, particularly overdue payroll taxes. This is most likely to happen to owners of small corporations who have an active hand in managing the business, rather than to passive shareholders.

• **Negligent or intentional acts.** A corporate owner who is negligent (that is, careless) or perhaps even intentional, and ends up hurting someone, can't hide behind the corporate barrier to escape personal liability. Shareholders are subject to personal liability for wrongs they commit—such as attacking a customer or leaving a floor wet in a store—that result in injury.

• **Breach of fiduciary duty.** Corporate owners have a legal duty to act in the best interest of the company and its shareholders. This legal obligation is known as a “fiduciary duty,” sometimes simply called a “duty of care.” If an owner violates this duty, the owner can be held personally liable for any damages that result from his or her actions (or inactions). Fortunately for corporate owners, run-of-the-mill mistakes or lapses in judgment aren’t usually considered breaches of the duty of care. Most often, breach of duty is found only for serious indiscretions such as fraud or other illegal behavior. For example, if a corporate officer ignored repeated warnings and written reports that one of its manufacturers was using toxic ingredients in the pet products sold by the corporation, that officer could be held personally liable for any damages that result from that breach of duty to the company.

• **Blurring the boundaries between the corporation and its owners.** When corporate owners ignore corporate formalities and treat the corporation like an unincorporated business, a court may ignore the existence of the corporation (in legal slang, “pierce the corporate veil”) and rule that the owners are personally liable for business debts and liabilities. To avoid this, it’s important that corporate owners not allow the legal boundary between the corporation and its owners to grow fuzzy. Owners need to scrupulously respect corporate formalities by holding shareholders’ and directors’ meetings, keeping attentive minutes, issuing stock certificates, and maintaining corporate accounts strictly separate from personal funds.

Also, bear in mind that while limited personal liability can prevent you from losing your home, car, bank account, and other assets, it won’t protect you from losing your investment in your business. A business can quickly get wiped out if a customer, employee, or supplier wins a big lawsuit against it and the business has to be liquidated to cover the debt. In short, even if you incorporate to protect your personal assets, you should purchase appropriate insurance to protect your business assets. (Insurance is discussed in Chapter 7.) But remember, insurance won’t help if you simply can’t pay your normal business debts.

**Corporate Taxation**

The words “corporate taxes” raise a lot of fear and loathing in the business world. Fortunately, the reality of corporate taxation is usually less depressing than its reputation. Here are the basics—think of it as Corporate Tax Lite. If you decide to incorporate, you’ll likely want to consult an accountant or small business lawyer who can fill you in on the fine print. (See Chapter 16 for information on finding and hiring a lawyer.)

The first thing you need to know is that you’ll be treated differently for tax purposes depending on whether you operate as a regular corporation (also
called a C corporation) or you elect S corporation status for tax purposes. An S corporation is the same as a C corporation in most respects, but when it comes to taxes, C and S corporations are very different animals. A regular, or C, corporation must pay taxes, while an S corporation is treated like a partnership for tax purposes and doesn’t pay any income taxes itself. Like partnership profits, S corporation profits (and losses) pass through to the shareholders, who report them on their individual returns. (In this respect, S corporations are very similar to LLCs, which also offer limited liability, along with partnership-style tax treatment.) These two types of corporations are explained in more detail just below.

C Corporations

As a separate tax entity, a regular corporation must file and pay income taxes on its own tax return, much like an individual does. After deductions for such things as employee compensation, fringe benefits, and all other reasonable and necessary business expenses have been subtracted from its earnings, a corporation pays tax on whatever profit remains.

In small corporations in which all of the owners of the business are also employees, all of the corporation’s profits are often paid out in tax-deductible salaries and fringe benefits—leaving no corporate profit and, thus, no corporate taxes due. (The owner/employees must, of course, pay income tax on their salaries on their individual returns.)

Initial rates of corporate taxation are comparatively low (see “Marginal Tax Rates for Corporations,” below). Corporations that keep some profits in the business from one year to the next—rather than paying out all profits as salaries and bonuses—can take advantage of 15% to 25% tax brackets. This practice, sometimes called income-splitting, basically involves strategically setting salaries at a level so that money left in the business is taxable only at the 15% or 25% corporate tax rate (which applies to profits up to $50,000 or $75,000). Since any amount of “reasonable” compensation to employees is deductible, corporate owners have lots of leeway in setting salaries to accomplish this.

### Marginal Tax Rates for Corporations

The following chart shows tax rates for corporations. For example, if a corporation’s taxable income was $75,100, it would pay 15% of its first $50,000 of income, 25% of the next $25,000, and 34% on its remaining $100 in income. The corporation’s marginal tax rate—the tax rate a corporation would pay on the last dollar of its income—would be 34%.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to $50,000</td>
<td>15%</td>
</tr>
<tr>
<td>$50,001 to $75,000</td>
<td>25%</td>
</tr>
<tr>
<td>$75,001 to $100,000</td>
<td>34%</td>
</tr>
<tr>
<td>$100,001 to $335,000</td>
<td>39%</td>
</tr>
<tr>
<td>$335,001 to $10,000,000</td>
<td>34%</td>
</tr>
<tr>
<td>$10,000,001 to $15,000,000</td>
<td>35%</td>
</tr>
<tr>
<td>$15,000,001 to $18,333,333</td>
<td>38%</td>
</tr>
<tr>
<td>Over $18,333,333</td>
<td>35%</td>
</tr>
</tbody>
</table>

**Note:** These corporate rates don’t apply to professional corporations, which are subject to a flat tax of 35% on all corporate income.

**Example:** Alexis and Matt run Window to the Past, Inc., a glass manufacturing business that specializes in custom work for architectural renovations. Toward the end of the year, they calculate that year’s profit to be approximately $145,000. They decide to give themselves each a $50,000 bonus out of the profit (on top of their $40,000 salaries). Because both salaries and bonuses are tax-deductible business expenses, this reduces Window to the Past’s taxable income to $45,000. The resulting corporate profit of $45,000 will be taxed at only 15%, the lowest rate. (If Alexis and Matt had left all the profits in the business, the profits over $75,000 would have been taxed at 34%, and profits over $100,000 would have been taxed at a whopping 39%.) Of course, the bonuses Alexis and Matt give
themelves increase their personal income, which will be taxed on their individual returns. Still, their personal tax rates are lower than the high corporate rates of 34% and 39%.

This income-splitting strategy is available only to shareholders who also work for the corporation. If they’re not at least part-time employees, then shareholders won’t be in a position to earn salaries or bonuses and will be able to take money from the corporation only as dividends.

### Fringes and Perks

Like employee salaries, corporations can deduct many fringe benefits as business expenses. If a corporation pays for benefits such as health and disability insurance for its employees and owner/employees, the cost can usually be deducted from the corporate income, reducing a possible tax bill. (There’s one main exception: Benefits given to an owner/employee of an S corporation who owns 2% or more of the stock can’t be deducted as business expenses.)

As a general rule, owners of sole proprietorships, partnerships, and LLCs can deduct the cost of providing these benefits for employees, but not for themselves. (These owners can, however, deduct a portion of their medical insurance premiums, though it’s technically a deduction for the individuals, not a business expense.)

The fact that fringe benefits for owners are deductible for corporations may make incorporating a wise choice. But it’s less likely to be a winning strategy for a capital-poor start-up that can’t afford to underwrite a benefits package.

### Double Taxation

This brings us to the vexing problem of double taxation, routinely faced by larger corporations with shareholders who aren’t active employees. Unlike salaries and bonuses, dividends paid to shareholders cannot be deducted as business expenses from corporate earnings. Because they’re not deducted, any amounts paid as dividends are included in the total corporate profit and taxed. And when the shareholder receives the dividend, it is taxed at the shareholder’s individual tax rate as part of personal income. As you can see, any money paid out as a dividend gets taxed twice: once at the corporate level, and once at the individual level.

You can avoid double taxation simply by not paying dividends. This is usually easy if all shareholders are employees, but probably more difficult if some shareholders are passive investors anxious for a reasonable return on their investments.

### S Corporations

Unlike a regular corporation, an S corporation does not pay taxes itself. Any profits pass through to the owners, who pay taxes on income as if the business were a sole proprietorship, a partnership, or an LLC. Yet the business is still a corporation. This means, of course, that its owners are protected from personal liability for business debts, just as shareholders of C corporations and members (owners) of LLCs are.

Until the relatively recent arrival of the LLC (discussed above), the S corporation was the business form of choice for those who wanted limited liability protection without the two-tiered tax structure of a C corporation. Today, relatively few businesses are organized as S corporations, because S corporations are subject to many regulations that do not apply to LLCs. (See “LLCs Versus S Corporations,” above, for more information)

### Forming and Running a Corporation

In addition to tax complexity, major drawbacks to forming a corporation—either a C or an S type—are time and expense. Unlike with sole proprietorships and partnerships, you can’t clap your hands twice and conjure up a corporation. To incorporate, you must file Articles of Incorporation with your Secretary of State or other corporate filing office, along with often hefty filing fees and minimum annual taxes. And if you decide to sell shares of the corporation...
to the public—as opposed to keeping them in the hands of a relatively small number of owners—you’ll have to comply with lots of complex federal and state securities laws.

Finally, to protect your limited personal liability, you need to act like a corporation, which means adopting bylaws, issuing stock to shareholders, maintaining records of various meetings of directors and shareholders, and keeping records and transactions of the business separate from those of the owners.

**CAUTION**

Corporations must comply with securities laws. Corporations must either register their shares with the Securities and Exchange Commission or qualify for an exemption to securities registration requirements. For information about small business exemptions to the federal securities laws, visit the Securities and Exchange Commission’s website, at www.sec.gov.

To sum up, the protection afforded by incorporating comes at a price. Figure in the likelihood that you’ll have to hire lawyers, accountants, and other professionals to keep your corporation in compliance, and it’s easy to see how expensive running a corporation can be.

**RESOURCE**

Recommended reading on corporations. For more information on the many complexities of running a corporation, read The Corporate Records Handbook: Meetings, Minutes & Resolutions, by Anthony Mancuso (Nolo).

**Benefit Corporations, L3Cs, and Emerging Business Structures for Socially Conscious, Mission-Driven Businesses**

Entrepreneurs who start businesses that want to emphasize sustainability or other goals in the public interest sometimes wonder if they should start a regular for-profit business versus structuring as a nonprofit. The nonprofit structure, however, is fundamentally different from a for-profit business, and business owners may find it too constraining on important issues such as being able to make a profit and needing to manage the business with a board of directors.

**RESOURCE**

The basics of starting a nonprofit. Starting & Building a Nonprofit, by Peri Pakroo (Nolo) provides step-by-step advice on getting a nonprofit up and running, from obtaining federal tax-exempt status to recruiting and managing board members. Also, check out the “Nonprofits” section of Nolo.com for dozens of articles on the subject.

In recent years, businesses in many states have some new options that are somewhat like for-profit/nonprofit hybrids. Three new structures are benefit corporations, Certified B Corps, and L3Cs.

**Benefit Corporations**

A benefit corporation is legally required to prioritize a positive social impact in addition to making profits for shareholders. Structuring as a benefit corporation may be appealing for businesses that want to incorporate a social mission into the core of their business.

Specifically, benefit corporations feature the following elements:

- The corporation has a purpose to create a material positive impact on society and the environment.
- The corporation is accountable through a fiduciary duty not only to corporate shareholders, but also to workers, community and the environment.
- The corporation is run transparently, and must publish public annual reports on overall social and environmental performance against an independent and transparent third-party standard.

As of late 2013, legislation has been passed allowing benefit corporations in the following states: Arizona,
Arkansas, California, Colorado, Delaware, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, Nevada, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, and Washington. Legislation has been introduced in several other states.

Certified B Corps
Benefit corporations are virtually identical to another structure called a Certified B Corp, which is a business that has been assessed and certified to meet sustainability-related criteria by B Lab, a nonprofit. The difference between benefit corporations and Certified B Corps is just that benefit corporations are an actual corporate structure recognized by the state, while the Certified B Corp is a certification conferred by a nonprofit.

If you live in a state that does not recognize benefit corporations, you can still seek to be certified as a Certified B Corp. For more information, check out B Lab’s website at www.bcorporation.net.

Low-Profit Limited Liability Companies (L3Cs)
Another hybrid-type business structure available in several states is the low-profit limited liability company, or L3C. An L3C is similar to a nonprofit in that its primary purpose must be to benefit the public. But an L3C is run like a regular profit-making business and is allowed to make a profit as a secondary goal. This type of business structure was born so that charitably oriented LLCs could receive seed money (specifically, “program-related investments,” or PRIs) from large nonprofit foundations, taking advantage of IRS rules that allow foundations to invest in businesses principally formed to advance a charitable purpose.

A small but growing number of states allow L3Cs, including Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming. It has also been adopted by the tribal governments of the Oglala Sioux Tribe and the Crow Indian Nation of Montana. However, because it’s such a new business structure and definitive rulings on various aspects of L3Cs have not yet been issued by the IRS, plenty of questions remain. Keep an ear to the ground as the L3C develops.

Choosing the Best Structure for Your Business
Although there are many differences among the various types of business organizations, most business owners choose an operating structure based on one legal issue: the personal liability of owners for business debts. It’s true that the issue of personal liability can have a huge impact on successful small businesses a few years down the road. But business owners who are just starting out on a shoestring often care most about spending as little money as possible on the legal structure of their business. This is certainly an understandable approach: Far more new businesses die painful deaths because they don’t control costs than because they lose costly lawsuits. In short, for many new small businesses, incorporating or organizing as an LLC is as unnecessary an expense as a swank downtown office or a gleaming chrome espresso machine in the lunchroom.

That said, owners of any business that will engage in a high-risk activity, rack up large business debts, or have a significant number of investors should always
insist on limited personal liability, either with an LLC or a corporation. This is even more true if the business can’t find or afford appropriate insurance.

If you decide that limiting your personal liability is worth the extra cost, you still need to decide whether to form a corporation or an LLC. With the LLC’s arrival, many business owners who want limited liability protection realize that incorporation normally only makes sense if a business needs to take advantage of the corporate stock structure to attract key employees and investment capital. No question, corporations may have an easier time attracting capital investment by issuing stock privately or publicly. And some businesses may find it easier to attract and retain key employees by issuing employee stock options. But for businesses that never go public, choosing to operate as LLCs rather than corporations normally makes the most sense if limited liability is the main concern. If the corporate stock structure isn’t something you want or need for your business, the simplicity and flexibility of LLCs offer a clear advantage over corporations.

### Analyzing Your Risks

Starting a business is always risky. In some businesses, however, the risks are particularly extreme. If you’re planning to launch an investment firm or start a commercial building construction company, there is little doubt that you’ll need all the protection you can get, including limited personal liability as well as adequate insurance. Other businesses are not so obviously risk-laden, but still could land you in trouble if fate strikes you a blow. When analyzing your business, note that red flags for riskiness include:

- using hazardous materials, such as dry cleaning solvents or photographic chemicals, or hazardous processes, such as welding or operating heavy machinery
- manufacturing or selling edible goods
- driving as part of the job
- building or repairing structures or vehicles
- caring for children or animals
- providing or allowing access to alcohol
- allowing activities that may result in injury, such as weightlifting or skateboarding, and
- repairing or working on items of value, such as cars or antiques.

If you’ve identified one or more serious risks your business is likely to face, figure out whether business insurance might give you enough protection. Some risky activities, such as job-related driving, are good candidates for insurance and don’t necessarily warrant incorporating. But if insurance can’t cover all of the risks involved in your business, it may be time to form an LLC or a corporation.

Keep in mind that insurance will never insulate you from regular business debts. If you foresee your business going into serious debt, an LLC or corporation may be the best business structure for you.
Chapter 1 Checklist:
Choosing a Legal Structure

☐ Identify the number of owners of your business.

☐ Analyze your business’s risks and decide how much protection from personal liability you’ll need.

☐ Determine how you’d like the business to be taxed (as a pass-through entity or as a corporation).

☐ Decide if your business would benefit from the stock structure of a corporation (by being able to distribute stock options and sell stock).

☐ Choose a business structure.

☐ If you will structure your business as a partnership, draft and sign a partnership agreement.

☐ If you will structure your business as an LLC or corporation, file articles with your state and draft bylaws (for corporations) or an operating agreement (for LLCs).
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