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Legal Guide for STARTING & RUNNING A Small Business

Attorney Fred S. Steingold,
author of *The Employer's Legal Handbook*

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Legal Guide for Starting & Running a Small Business

Attorney Fred S. Steingold

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Please note

We believe accurate, plain-English legal information should help you solve many of your own legal problems. But this text is not a substitute for personalized advice from a knowledgeable lawyer. If you want the help of a trained professional—and we'll always point out situations in which we think that's a good idea—consult an attorney licensed to practice in your state.

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About the Author

Fred S. Steingold practices law in Ann Arbor, Michigan. His main practice areas are business law and real estate law. Fred is the author of several Nolo books, including *Legal Guide for Starting & Running a Small Business*, *Legal Forms for Starting & Running a Small Business*, *The Employer's Legal Handbook*, *Negotiate the Best Lease for Your Business*, *The Complete Guide to Buying a Business*, and *The Complete Guide to Selling a Business*.

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Your Legal Companion for Starting and Running a Small Business

Starting and running a small business can be both profitable and emotionally satisfying. Being an entrepreneur offers rewards of many sorts: the opportunity to spread your wings and use your natural talents, the freedom of being your own boss, the possibility of huge financial success, and more. And in an era when job security can seem like a relic of a bygone era, owning a business means you will never be fired or outsourced at someone else's whim.

Of course, nothing this exciting ever comes without risk. Demographic changes, recessions, changing tastes and styles, new technologies—any of these or a hundred other factors can challenge even the most astute and experienced businessperson. That's why it's so important to increase your chances of success not only by working hard and planning carefully but also by knowing how the law affects your business. It can help you avoid many costly risks.

Every businessperson runs into legal questions. Maybe you're just looking to start (or buy) a small retail, service, or manufacturing business, alone or with others, online or off, and are wondering how to structure your ownership. Maybe you're considering setting up a corporation or LLC if doing so would be legally advantageous. You might have questions about taxes or employees.

In plain English, this book covers all those issues and lots of others—all the major legal issues that a small business is likely to face, in fact. You'll learn about preliminary issues such as raising money, forming the business, and choosing and protecting a business name. There's also lots of good information about how to get the business up and running, including hiring employees, getting permits and insurance, and negotiating a lease. The book also covers the maintenance of your business—paying taxes, dealing with customers and problem employees, and resolving legal disputes.

Other Useful Nolo Books, Forms, and Resources for Small Businesses

Throughout this book, we recommend other Nolo books (all available as hard copy and e-book) to help you handle a specific business issue or task, from forming an LLC to hiring employees. One especially useful title is *Legal Forms for Starting & Running a Small Business*, also by Fred Steingold. The *Legal Forms* book includes over 75 of the most important forms you'll need to run your small business—from borrowing money to writing contracts of various sorts to preparing corporate bylaws.

For more information, and lots of free articles on business issues, see Nolo's Small Business section at www.nolo.com/legal-encyclopedia/small-business. Also, be sure to check out the Business Formation: LLCs & Corporations section at www.nolo.com/legal-encyclopedia/llc-corporations-partnerships; here you'll find many 50-state articles of interest to small business owners, including each state's requirements for forming an LLC or establishing a sole proprietorship, and links to the best 50-state and federal resources for small businesses.

Finally, when you're on the Nolo website, be sure to check out the online business legal forms published by Nolo. And if you're in the market for a business lawyer, see Nolo's Lawyer Directory at www.nolo.com/lawyers.

Legal Guide for Starting & Running a Small Business will help you take key preventive measures that will dramatically cut the number of expensive visits you'd otherwise make to a lawyer's office. You'll know exactly where you may be vulnerable to lawsuits so you can wisely take steps to reduce the risks. And you'll know when it makes sense to call in a lawyer or a tax pro for special assistance before small problems turn into big ones. You'll be able to spend your time on what really counts: running a sound and successful business.

Congratulations on taking the first steps toward owning and running your own enterprise. You have a lot of hard work ahead of you, and Nolo is here to help you along the way. So roll up your sleeves and dig in—the world awaits your success. Good luck!

Get Updates and More at This Book's Companion Page on Nolo.com

When there are important changes to the information in this book, we'll post updates online, on a page dedicated to this book (what we call the book's companion page):

www.nolo.com/back-of-book/RUNS.html

You'll likely find many updates in the coming months. When this book went to press in early 2017, Donald J. Trump had just been elected president. The new administration may well initiate substantial changes to tax and other laws that affect small businesses. Those changes could include the following:

- lower federal income tax rates and fewer tax brackets
- adjustments in tax deductions for businesses and individuals
- phasing out of all or most of Obamacare, including requirements that businesses with employees provide certain types of health insurance, and
- elimination of the 3.8% net investment income tax and 0.9% Medicare tax on higher income individuals, the alternative minimum tax (AMT), and federal estate taxes.

Some of these changes may take effect in 2017, but it's likely that many won't start until 2018 or even later. We'll keep you up to date on these and other changes on the update page for this book at www.nolo.com/back-of-book/RUNS.html.

In addition to updates, you'll also find on this book's companion page a handy checklist of the key tasks involved with starting a business, from developing your business idea to hiring workers. See the appendix for a copy of this checklist.

CHAPTER

1

Which Legal Form Is Best for Your Business?

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

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

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

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

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

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

RELATED TOPIC

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

SEE AN EXPERT

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

Ways to Organize Your Business		
Type of Entity	**Main Advantages**	**Main Drawbacks**
Sole Proprietor	Simple and inexpensive to create and operate Owner reports profit or loss on his or her personal tax return	Owner personally liable for business debts
General Partnership	Simple and inexpensive to create and operate Owners (partners) report their share of profit or loss on their personal tax returns	Owners (partners) personally liable for business debts
Limited Partnership	Limited partners have limited personal liability for business debts as long as they don't participate in management General partners can raise cash without involving outside investors in management of business	General partners personally liable for business debts More expensive to create than general partnership Suitable mainly for companies that invest in real estate
C Corporation	Owners have limited personal liability for business debts Fringe benefits can be deducted as business expense Corporate profit can be split among owners and corporation, resulting in lower overall tax rate	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners Separate taxable entity
S Corporation	Owners have limited personal liability for business debts Owners report their share of corporate profit or loss on their personal tax returns Owners can use corporate loss to offset income from other sources	More expensive to create than partnership or sole proprietorship More paperwork than for a limited liability company, which offers similar advantages Income must be allocated to owners according to their ownership interests Fringe benefits limited for owners who own more than 2% of shares
Professional Corporation	Owners have no personal liability for malpractice of other owners	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners All owners must belong to the same profession
Nonprofit Corporation	Corporation may not have to pay income taxes Contributions to certain charitable corporations are tax-deductible Fringe benefits can be deducted as business expense	Full tax advantages available only to groups organized for the following purposes: charitable, scientific, educational, literary, religious, testing for public safety, fostering national or international sports competition, and preventing cruelty to children or animals Property transferred to corporation stays there; if corporation ends, property must go to another nonprofit

Ways to Organize Your Business (continued)		
Type of Entity	**Main Advantages**	**Main Drawbacks**
Limited Liability Company	Owners have limited personal liability for business debts even if they participate in management Profit and loss can be allocated differently than ownership interests IRS rules allow LLCs to choose between being taxed as partnership or corporation	More expensive to create than partnership or sole proprietorship A member's entire share of LLC profits may be subject to self-employment tax
Professional Limited Liability Company	Same advantages as a regular limited liability company Owners have no personal liability for malpractice of other owners Gives state-licensed professionals a way to enjoy those advantages	Same as for a regular limited liability company Members generally must all belong to the same profession or related professions.
Limited Liability Partnership	Mostly of interest to partners in old-line professions such as law, medicine, and accounting Owners (partners) aren't personally liable for the malpractice of other partners Owners report their share of profit or loss on their personal tax returns	Unlike a limited liability company or a professional limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders, and landlords Not available in all states Often limited to a short list of professions

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

Sole Proprietorships

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

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

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

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

Personal Liability

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

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

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

One of the major reasons to form a corporation or an LLC is that, in theory at least, you'll avoid most personal liability. (But see Chapter 12 for a discussion of how a good liability insurance policy may be enough to protect a sole proprietor from personal liability if someone is accidentally injured.)

Income Taxes

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

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

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

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

Fringe Benefits

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

When it comes to medical expenses for you and your family, however, there can be a tax advantage to setting up a corporation or an LLC. As a sole proprietor, you can take a tax deduction for the entire amount of your health insurance premiums, but you can deduct only part of your medical expenses not covered by insurance. The situation is different if you form a corporation or LLC and choose to have the corporation or LLC taxed as a separate entity. Your corporation or LLC could hire you as an employee and—if you're the only employee—the business could set up a medical reimbursement plan that pays for your health insurance premiums and 100% of other health costs incurred by you, your spouse, and your dependents. However, if you prefer to be a sole proprietor and you're married, you can reach a similar result by hiring your spouse as an employee. See "Hiring Your Spouse Can Have Tax Benefits," below, for details.

Hiring Your Spouse Can Have Tax Benefits

If you choose to do business as a sole proprietor, there's a way you can deduct more of your family's medical expenses. First, hire your spouse at a reasonable wage. Then, set up a written health benefit plan covering your employees and their families. Your business can then deduct 100% of the medical expenses it pays for you, your spouse, and your dependents. (**Caution:** Don't do this if you plan to hire additional employees. It only works if your spouse is your sole employee.)

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

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

RESOURCE

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

Also, check out Nolo's Social Security Center at www.nolo.com/legal-encyclopedia/social-security for useful articles on the subject.

Routine Business Expenses

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

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

It's simple to keep track of business income and expenses if you keep them separate from the start—and challenging if you don't.

Partnerships

If two or more people are going to own and operate your business, you must choose between establishing a partnership, a corporation, or an LLC. This section looks at the general partnership, which is the type of partnership that most small businesses will be considering. The limited partnership is described toward the end of this chapter.

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

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

Law From the Real World

First Things First

Ellen, Mary, and Barbara—all superb cooks—planned to open a catering business. They would hold on to their day jobs until they could determine whether the new business could support all three of them.

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

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

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

Personal Liability

As a partner in a general partnership, you face personal liability similar to that of the owner of a sole proprietorship. Your personal assets are at risk in addition to all assets of the partnership. In other words,