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WealthWorks Guides

for Coordinators and Coaches

Wake Forest University School of Law

Community Law and Business Clinic

FORMALIZING YOUR BUSINESS

About the Authors

The Wake Forest School of Law Community Law & Business Clinic (CLBC) is a clinical education program launched in 2009 at Wake Forest University School of Law that provides law and graduate business students with an opportunity to develop skills needed to practice in the increasingly complex legal and regulatory environment they will encounter as professionals. CLBC has been providing guidance in legal matters to WealthWorks coordinators and coaches since 2010. For more information, please visit http://community-clinic.law.wfu.edu/.

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We hope that this guide and its companion volume, **WealthWorks Value Chain Business Law Guide**, will help WealthWorks coordinators and coaches better understand the range of options available for formalizing a business and other legal issues that commonly arise in market-driven value chains. Another guide, **Keeping Wealth Local**, provides additional guidance regarding structures for ownership and control. For these publications and more information about WealthWorks, please visit www.wealthworks.org.

WealthWorks Value Chains and the Purpose of this Guide

This guide is one of two pieces written to assist you as a WealthWorks value chain coordinator or coach in working with businesses and demand partners that are part of WealthWorks value chains. The other guide is called **WealthWorks Value Chain Business Law Guide** and provides basic information on issues frequently encountered in building WealthWorks value chains such as how to think about contracting and intellectual capital, and ways to mitigate business risks. Taken together, these guides provide basic information on some of the common legal issues related to the business of value chain construction and operations. Neither guide should be viewed as a substitute for legal advice.

WealthWorks is a twenty-first century approach to economic development that links community assets with market demand for sustainable livelihoods. A WealthWorks value chain is a coordinated network of business partners that work together for mutual benefit to provide products and services in response to market demand. WealthWorks value chains are: 1) organized to deliver a range of values such as transparency, environmental benefits, and social benefits that matter to buyers; 2) intentionally inclusive of people and places that have been economically marginalized; and 3) committed to creating multiple forms of wealth that stick for those that have been excluded from the mainstream economy. The types of wealth built by WealthWorks value chains include natural, social, intellectual, individual, built, cultural, political, and financial capital.

WealthWorks emphasizes the importance of creating structures within WealthWorks value chains that increase the ownership and control of multiple forms of wealth by and for the benefit of people and places that have been economically marginalized. There are many different ways to do that, including, but not limited to, formalizing a business. It has been the experience of participants in WealthWorks value chains that certain legal issues tend to arise with some regularity at certain points during the value chain life cycle. It can be extremely disruptive to the regular operations of a value chain for an unanticipated legal issue to arise. Participants who can anticipate these legal issues BEFORE they arise can save time and money, and can prevent the deterioration of goodwill between value chain partners and customers. This guide is designed to walk you through one of the most important legal issues that affect small businesses: entity selection.

To select an entity is to decide how you want to define your business legally. The entity you choose can determine how your business is treated with respect to its tax liabilities, management, owner liability, efficiency, longevity, and transferability. It is important to have a solid understanding of why formalizing your business is important before you can determine which business entity is right for you.

Why Formalize Your Business?

In general, starting a business is risky. You can never be completely sure that customers will like your product or service, that you'll be able to get the proper financing necessary to operate, or that all of your employees will be professional and capable. These risks are inherent in any business, no matter what measures you take to ensure your success. There are, however, other risks that can be controlled. By legally separating yourself from your business, you can greatly reduce any personal liability for the debts and obligations of your business.

When you start a small business with no formal structure, you and your business are considered the same legal entity. That means that whatever happens to your business, happens to you. For example, let's say you own a landscaping service. One day, when one of your employees was taking down a tree in a client's yard, the tree unexpectedly falls over and destroys their neighbor's roof. Now, assume the neighbors wish to sue your landscaping service for destroying their property. If a court finds that your landscaping service was at fault for destroying the roof, you can be held personally liable for the damage. Now, if your landscaping business had been a Limited Liability Company, for example, you could not be held personally responsible for the damage that the lawn service caused to the neighbor's roof. The reason for this is that even though you own the service, it is considered a separate legal entity from you.

There may be some situations where your business is so small, and you have so few assets, that the cost of formalizing your business into a separate entity may not make sense. However, nearly every small business could benefit greatly from the protection that entity formation provides their owners.

Different Entity Options

Types of Business Forms

There are many different business forms or structures, but the most common are the following:

- Sole Proprietorship
- Partnerships
  - General Partnership
  - Limited Liability Partnership
  - Limited Partnership
- Corporations
  - Subchapter S Corporations
  - Subchapter C Corporations
    - *Either of which may be a "closely held corporation."
- Alternative Entity Options
  - B Corporation
  - Cooperative

Limited Liability Company (LLC)

Considerations in Choosing a Business Entity:

Just as there are many reasons for everything you do with your business, there are many considerations for choosing a particular business structure. At a minimum you should consider the following five things when deciding on a business structure:

Efficiency – Will the structure you use make it easier for you to run your business? If not, are you able to manage the additional work?

Management – Will it be easier to manage your business? If you are creating more work and management problems, are there other benefits that will make it worthwhile?

Limitation of Liability – If you are concerned about liability, will you be able to limit your liability through forming a business entity? Are there other, easier, ways to protect you from liability?

Transferability of Interest – Will the business structure allow you to transfer a part of the business to a new owner or your family easily and without having to pay additional taxes?

Tax Planning – Can you reduce the taxes you pay with a different business structure? With some structures you may have lower taxes, but also have to observe more legal formalities. Is the reduced amount of taxes worth the added time commitment? **If your decision about which business form to adopt is tax-driven, you should consult an accountant or an attorney specializing in tax law to be sure that your choice will reduce your taxes.**

Business Entities

Below is a chart showing the most common entities used in the WealthWorks value chains, and a detailing of characteristics that differentiate them. This chart is merely intended as a short hand reference; following the chart are more detailed descriptions of each entity type. Remember that these are general descriptions, and that the structure for each entity may vary greatly depending on the state in which you are doing business.

	Ownership	Taxation	Management	Liability
Sole Proprietorship	Single Owner	Taxed at personal income rate of owner	Completely controlled by owner	Unlimited liability
General Partnership	Two or more partners	Taxed at personal income rate of partner	Managed by the partners, unless otherwise agreed to	Unlimited liability and each partner is liable for the debts of the other
Limited Partnership	Two or more partners	Taxed at personal income rate of partner	Managed by a designated general partner, limited partners cannot manage	Unlimited for general partner, limited to individual investment for limited partners
Limited Liability Partnership	Two or more partners	Taxed at personal income rate of partner	Managed by the partners	Limited to individual investment in the partnership
Limited Liability Company	One or more "members"	Taxed at personal income rate of members	Can be manager managed or member managed	Limited to individual investment in the LLC
S Corporation	One or more "shareholders"	Taxed at personal income rate of shareholder	Managed by Board of Directors	Limited to value of shares owned by the individual
C Corporation	One or more "shareholders"	Taxed at corporate level and shareholder level	Managed by Board of Directors	Limited to value of shares owned by the individual
B Corporation	One or more "shareholders"	Taxed at corporate level and shareholder level	Managed by Board of Directors	Limited to value of shares owned by the individual
Cooperative	Owned by "user-owners"	Taxed at individual user-owner level	Managed by user-owners	Can be limited if cooperative is incorporated

Sole Proprietorship

A sole proprietorship is a business conducted in one owner's individual capacity and without the organization of a separate legal structure. The business and the business owner are one in the same.

Apart from the general requirements set out in the preceding section, no formal documents are required to form a sole proprietorship. The business owner obtains any necessary permits or licenses and opens up for business.

The sole proprietorship is the easiest way to start a business. It is very easy to manage a sole proprietorship. No shares of stock are needed to represent ownership. All of the business' assets are owned directly by the business owner. All control of the business is in the hands of the owner.

The disadvantage with a sole proprietorship is the potential risk to the owner's non-business assets, such as a home or savings. Since the business owner and the business are one and the same, the owner is subject to all debts and liabilities of the business. If the business owes money, due to a contract or court judgment for example, the owner will be responsible for the debt or judgment as well.

Many risks of liability can be managed with adequate insurance. For most businesses insurance coverage can be found for a few hundred dollars a year. (Even if you organize a corporation for your business, you should get insurance.) But there is no insurance to pay business bills if the business goes under. A sole proprietor will have to pay these bills.

In a sole proprietorship income to the business is income to the owner. Income is taxed only once, at the owner level. This income should be reported on Form 1040 and Schedule C. Quarterly estimated payments may be required.

Sole proprietors will also have to pay self-employment tax. This tax collects money for Social Security and Medicare. If you are an employee, 7.65% of your income is withheld by your employer to cover these taxes. Your employer matches your contribution. But if you are self-employed, then you must pay the entire tax—15.3%—out of your own pocket.

It can be difficult to transfer a sole proprietorship, either to the next generation or to someone interested in buying your business because it is such a personal enterprise. Inventory, other property and goodwill can be sold, but it's hard to sell personal relationships. It will be difficult to sell while staying involved. By definition there can only be one owner. For these reasons, a sole proprietorship has limited transferability.

Pros

- Low startup costs.
- Easy to form.
- Flexible.
- Direct control.
- Income taxed to owner solely.

Cons

- Unlimited liability.
- Lack of continuity, difficult to transfer.
- Self-employment tax.

Partnerships

A partnership is an association of two or more individuals who organize as co-owners to carry on a business for a profit. There are three basic types of partnerships:

- General Partnership
- Limited Liability Partnership
- Limited Partnership

General Partnership

In the vast majority of cases, general partnerships are formed by executing and delivering a "partnership agreement" among the partners. There are no formal requirements for the form or content of the partnership agreement. In fact, the partnership agreement does not have to be in writing. However, we strongly urge you to put the partnership agreement in writing. A partnership agreement is a contract, and all parties are best served when contracts are put in writing.

General partnerships are managed in accordance with the terms of their partnership agreements, which can be extremely flexible. The partnership agreement can specify:

- Who will actually oversee the day-to-day operations of the business.
- How profits and losses will be allocated.
- Limitations on sale of a partner's interest and admission of new partners.
- How fundamental decisions, such as ending the partnership, will be made.
- With very few limitations, anything else the partners agree to. (The partnership agreement may **not** eliminate personal liability unless the partners comply with the requirements for setting up a limited liability partnership.)

Unless the partnership agreement provides to the contrary, each partner in a general partnership has the authority to bind the partnership to a contract. The partnership as a whole, including the other partners, may also be obligated for the debts of the other partners acting on behalf of the general partnership.

All partners are "jointly and severally liable" for the debts of the partnership. This means that each partner is liable for **all** of the partnership's debts, not just his or her proportionate share of the debts. A creditor may collect from only one of the partners if that partner is the only one with assets or the only one the creditor can find. If the partnership goes out of business without paying off all its debts, creditors can collect from individual partners.

With this much on the line, you will want to be very careful about who you choose as a partner. You also want to be sure that you do not put yourself in a position where a court could decide that a partnership exists even if you didn't intend to create one. Be sure to spell out relationships with employees or independent contractors to make it clear that you are paying them for their work as opposed to giving them a share of the business.

Partnership interests may be transferred or sold, subject to any limitation contained in the partnership agreement. Sale or assignment of a partnership interest does not force the termination of the partnership.

Unless the partnership agreement provides otherwise, the transferee or buyer does not become a partner unless the other partners agree. A transferee who does not become a partner cannot participate in the management of the partnership. He or she is only entitled to receive the transferor's share of any distributions approved by the partners.

This makes it difficult to sell an interest in a partnership without the consent of the other partners. Few people want to invest in a business in which other people have the sole authority to decide whether they will receive any return on their investment.

General partnerships do not pay taxes themselves, but they have to file an "information return" that indicates how the partnership's gains and losses have been allocated among the partners (Federal Form 1065). Partners should receive a Form K-1 from the partnership that sets out their allocated share of gains and losses. Partners then report these gains and losses on their individual returns, using federal Schedule E.

Please note that partners pay tax on their allocated share of the partnership's gains and losses **regardless of whether any money is actually distributed to them**. If the partnership decides to retain its profits to fund operations or expansion, then a partner may be taxed on money that he or she has not actually received. Many partnership agreements include a provision requiring the partnership to distribute at least enough money to cover each partner's taxes arising from the partnership.

Like sole proprietors, partners must pay self-employment tax.

Limited Liability Partnership

Limited liability partnerships are subject to most of the same statutes that apply to general partnerships. Like general partnerships, they are governed by partnership agreements. Limited liability partnerships are taxed in the same way as general partnerships.

The difference is that partners in a limited liability partnership are not personally liable for the debts of the partnership. This is a major advantage over a general partnership. Formation of a limited liability partnership requires filing an application for registration with the Secretary of State. It must include a provision that the partnership elects to become a limited liability partnership as well as other general information such as the name and street address of the partnership. Once the application for registration is filed, the partners are no longer personally liable.

Limited personal liability is a major advantage that appears to be worth the trouble of executing an application for registration and filing it with the Secretary of State.

Limited Partnership

As with a general partnership, a limited partnership is formed through a partnership agreement. Unlike a general partnership, only "general partners" face the uncertainty of liability for partnership debts. Limited partners risk losing their investment in the partnership, but not other assets.

The limited partnership must file a "Certificate of Limited Partnership" with the Secretary of State. This contains the basic information about the partnership, including the membership and nature of the partnership's business.

The limited partnership is managed by a "general partner." The general partner may bind the limited partnership to contracts and other financial agreements. Actions of the general partner may also result in liabilities for the limited partnership.

General partners are jointly and severally liable for partnership indebtedness. Limited partners, however, are liable only for partnership indebtedness to the extent of their capital contribution (investment). Limited partners may not participate in management without losing limited liability.

Transferability is usually limited. A limited partner will ordinarily be able to demand that the partnership redeem his or her interest under terms set out in the limited partnership agreement.

Limited partners are taxed in the same manner as partners in a general partnership.

Pros

- Ease of formation.
- Flexibility of partnership agreement.
- Low startup costs.
- Provides additional sources of capital (particularly limited partnerships).
- Limited outside regulation. Partnership agreement governs in most cases.

Cons

- Unlimited personal liability for general partnerships (but not for limited liability partnerships and limited partnerships).
- Lack of continuity with business on transfer.
- Divided management authority (but can be controlled through partnership agreement).
- Limitations on transfer may make it hard to sell interest in partnership without unanimous consent.

- Self-employment tax.

Corporations

There are two legal forms available for corporations: C Corporations ("C Corp") and S Corporations ("S Corp"). C Corps and S Corps are taxed differently.

In addition to these two legal forms, there are practical differences between a corporation whose stock is bought and sold on an open market ("publicly traded corporation") and a corporation whose stock is held by a few people, usually relatives or friends ("closely held corporation"). A closely held corporation may be either a C or an S Corp. Publicly traded corporations are C Corps.

The following discussion first describes the legal formalities that are common to all corporations. It will then discuss some of the differences between C Corps and S Corps. Finally, it will set out some of the potential advantages and disadvantages created by a closely held corporation. Most small businesses that choose the corporate form operate as closely held S Corps.

Corporations—Formation

Most small business owners will think of a "corporation" as the preferred way to structure their business. A corporation is a creature of statute and to form a corporation you must follow very specific requirements of the state in which you are incorporating.

When a corporation is organized you are creating a person that can sue and be sued, own property, and pay taxes—all in its own name. The corporation is separate from its shareholders, who are the owners of the business.

To form a corporation "Articles of Incorporation" must be filed with your state's Secretary of State's office. For details regarding fees and other requirements, please consult your state's Secretary of State's office.

Corporations—Ongoing Operation

The statutes also impose a number of legal requirements for the ongoing operation of a corporation. A corporation must:

Hold regular board meetings and shareholder meetings (at least annually).

Give notice of all meetings as required by its bylaws.

Record minutes of actions taken at these meetings and keep them as permanent records.

Take action through formal resolutions, included in the minutes.

In addition, a corporation may be required to comply with federal and/or state securities laws.

Corporations—Management

Shareholders in a publicly traded corporation do not manage the business. They elect a board of directors that has overall responsibility for management. The board of a large corporation will delegate authority over day-to-day operations to a Chief Executive Officer or President. This has some benefits because it allows for specialized management as the business expands to new activities or locations. Separating ownership from management will allow the business to run in an effective and efficient manner.

Corporations—Liability

Shareholders, board members, and officers are not personally liable for the corporation's debts. The shareholders' investment, the amount they paid for the corporation's stock, is always at risk. But corporate creditors cannot take their personal assets.

Please recall that there are practical and legal limitations on the protection from personal liability provided by small corporations. Most lenders will require personal guarantees from new or small business owners. A personal guarantee makes the signer personally liable for the debt regardless of whether the business is a corporation. Please be aware that there are practical limitations to limitations of liability.

If the owners of a corporation—particularly a closely held corporation—do not observe the required legal formalities, they may also find themselves personally liable for the corporation's debts. This is particularly true if it appears that the owners of a closely held corporation are using it for personal business such as paying their house payment directly from a corporate account or buying personal items with a corporate credit card. In such cases corporate creditors will try to "pierce the corporate veil" and make the owners personally liable. Creditors in these cases argue that the corporation is a sham.

Corporations—Transferability

Shares of publicly held corporations are freely transferable through selling, pledges, assignments, or gifts. However, shares of closely held corporations will ordinarily be subject to restrictions on transfer. In any case, transfers also may be limited by state and/or federal securities and tax laws.

Distinctions between C Corps and S Corps: Limitations on S Corp ownership

Generally speaking, an S corporation may have a maximum of 100 shareholders. Shareholders must be individuals, estates, or certain kinds of trusts. All shareholders must agree to become an S Corp. Lastly, an S Corp may only have one class of stock.

None of these limitations should pose any problem for a small business.

Distinctions between C Corps and S Corps: Taxation

C Corps and S Corps are taxed very differently.

A C Corp is subject to "double taxation." The C Corp pays its own taxes on any profits using federal Form 1120. Individual shareholders are then taxed on any distributions, such as dividends, they receive from the corporation. The individual shareholder reports the distributions on federal Schedule B and Form 1040.

The result is that any corporate income distributed to shareholders is taxed twice. That reduces the net amount that finally finds its way into a shareholder's pockets after taxation.

An S Corp, on the other hand, is taxed like a partnership. That means that the S Corp itself does not pay taxes. Like a partnership, the S Corp files an information return that describes how its gains and losses have been allocated among its shareholders. Shareholders are then taxed as individuals on their allocated share. As with a partnership, a shareholder in an S Corp may be taxed on income that he or she has not actually received.

Corporate shareholders do not pay self-employment tax regardless of whether the corporation is a C or S Corp.

An S Corp is created when a corporation files a form with the IRS electing to be treated as a Subchapter S corporation for tax purposes (federal Form 2353). All shareholders must agree to the S Corp election.

If you are considering whether to become an S Corp, you should consult your accountant or a lawyer specializing in taxation to be sure that this will result in reduced taxes.

Closely Held Corporations

A closely held corporation is a corporation like any other. The same steps are necessary to create and maintain it. The difference is a practical one. A closely held corporation is owned by a few people. Shares of stock are issued, but there is no public market for them. The corporate bylaws will usually place restrictions on stock transfers. The owners are often family or friends, but this is not necessarily so. Also, a closely held corporation can be owned by one person.

One advantage is that a closely held corporation is much more flexible than a publicly traded corporation. It is easier to observe corporate formalities if there are only a few shareholders. For example, annual meetings and notices should not be a problem if only four or five people are involved. Resolutions still have to be adopted and minutes kept, but the proceedings will usually be simple. Ownership and management will merge because the shareholders will usually also be the directors and officers. In a one-person corporation the same person can be shareholder, director, and officer(s).

There may also be tax advantages. Shareholders may also be employees of the corporation. A shareholder-employee must actually perform services for the corporation, and his or her compensation must be reasonable in light of the services performed. If those conditions are met, then shareholder-employees may receive salaries and benefits from the corporation. They will pay taxes individually.

Salaries and benefits are deductible expenses for a corporation. It is possible that a closely held corporation will have little or no taxable gain after these deductions. So the corporation may not have to pay taxes. There will be no need for distributions to the shareholders because they are receiving a return on their investment in the form of salaries and benefits. As a result, “double taxation” may not be a problem for a closely held corporation.

A closely held corporation may also create problems. Minority shareholders may find themselves frozen out of management. If this happens, they will be unable to assure that they are employed by the corporation or that the corporation makes distributions to shareholders. They will not be able to sell shares on an open market. Minority shareholders may find themselves locked into a corporation without receiving any return on their investment. This can be true even if the corporation is doing very well.

Deadlock is another potential danger. If the shareholders are evenly divided on a question and unable to compromise, it will be impossible for the corporation to make a decision.

There are ways to resolve these problems after the fact, but they usually involve litigation. If you are planning to do business as a closely held corporation you should adopt bylaws that will address these issues before they arise. Hopefully, you will never need to use these provisions of the bylaws, but business and family relations sometimes break down.

Pros for corporations in general:

- Limited liability.
- Specialized and efficient management (not true for closely held corporations).
- Ownership is transferable (not true for closely-held corporations).
- Continuous existence.
- Independent legal entity.

Cons for corporations in general:

- Controlled by statute. More rigid form.
- Most expensive to organize.
- Extensive record keeping and formalities.
- Double taxation (not true for S Corps).

Pros specific to closely held corporations:

- Easier to comply with corporate formalities. More flexible.
- Possible tax advantages: corporate salaries as opposed to dividends.

Cons specific to closely-held corporations:

- Oppression of minority shareholders.
- Potential for deadlock.

B Corporation

A B-Corporation or benefit corporation is a corporate form available in some states designed for for-profit entities that wish to consider social concerns in addition to the profit motive. The purpose of a benefit corporation includes creating general public benefit, which is defined as a material positive impact on society.

Benefit corporation laws address concerns held by entrepreneurs who wish to raise growth capital but fear losing control of the social or environmental mission of their business. Chartering as a benefit corporation also allows companies to distinguish themselves as businesses with a social conscience, and as one that aspires to a standard they consider higher than profit-maximization for shareholders. General provisions of a B-corporation include:

- Creating a general public benefit.
- Has a right to name a specific public benefit purpose.
- Shall publish annual Benefit Report in accordance with recognized third party standards for defining, reporting, and assessing social and environmental performance.
- Benefit corporations are treated like all other corporations for tax purposes.

Requirements on B Corporations vary from state to state. Make sure you understand your state's rules on B Corporations in order to fully understand the pros and cons of choosing this entity for your business.

Cooperative

A cooperative ("coop") or co-operative ("co-op") is generally an association of persons who voluntarily cooperate for their mutual social, economic, and cultural benefit. Cooperatives include non-profit community organizations and businesses that are owned and managed by the people who use its services (a consumer cooperative) or by the people who work there (a worker cooperative) or by the people who live there (a housing cooperative), hybrids such as worker cooperatives that are also consumer cooperatives or credit unions, multi-stakeholder cooperatives such as those that bring together civil society and local actors to deliver community needs, and second and third tier cooperatives whose members are other cooperatives.

Cooperatives are typically based on the cooperative values of "self-help, self-responsibility, democracy and equality, equity and solidarity" and the seven cooperative principles:

1. Voluntary and open membership
2. Democratic member control
3. Economic participation by members
4. Autonomy and independence
5. Education, training and information
6. Cooperation among cooperatives
7. Concern for community

Cooperatives have gained in popularity in recent years and have shifted from primarily being a method for agricultural businesses to organize, into an entity form used by numerous other varieties of business. There is even a movement toward the "new generation cooperative" structure that blends the traditional cooperative structure with some of the limited liability benefits of an LLC or corporation. Because cooperatives are evolving structurally and gaining in popularity, many states are beginning to develop laws that specifically deal with the new approaches to structuring cooperatives.

Before making the determination as to whether or not a cooperative is the right entity for your business, find out what the laws of your state require to form a cooperative. Because this is particular type of entity is not as universally applicable as a corporation or LLC, the laws from state to state that deal with cooperatives vary greatly. Check with your state's Secretary of State's office to find cooperative requirements, and to find out if there are "new generation cooperative" structures available to you.

Limited Liability Companies

A limited liability company (LLC) is a hybrid combining the advantages of both partnerships and corporations.

LLC—Formation

The LLC is formed by filing "Articles of Organization" with the Secretary of State (check Secretary of State's website for filing fees). Much less detail is required in the Articles of Organization than in the Articles of Incorporation. The owners of an LLC are called "members." Some LLCs have only one member. There is no upper limit on the number of members.

LLC—Management

Like a partnership, an LLC is highly flexible. Typically, state law allows LLC members to enter into agreements called "operating agreements." An operating agreement may set out and control virtually all aspects of the business. The LLC statutes only come into play if there is no operating agreement or if the operating agreement is silent on an issue. If you choose to form an LLC, **you will want a well written, comprehensive operating agreement**. If you don't have one, then your LLC will be controlled by state statutes rather than by mutual agreement of the members.

An LLC may be either "member-managed" or "manager-managed." In a member-managed LLC the operating agreement can provide that all members can act as managers or it can limit management powers to a particular member or members. Here, again, the LLC gives members the flexibility to shape management as they see fit.

An operating agreement may also provide that the LLC is to be managed by managers who are not members. This allows an LLC to employ experienced managers without making them co-owners of the business. If an LLC chooses this option, members will not be engaged in the day-to-day operation of the business.

If there is no operating agreement or if the agreement doesn't address management, then the LLC will be managed by its members. Each member will have management power in proportion to such person's contribution to the capital of the limited liability company. The member or members contributing more than 50% of the LLC's capital will control it.

Regardless of whether the LLC is managed by its members or by outside managers, the members as a whole will want to reserve the power to make fundamental decisions such as whether to admit new members or sell the business. A well-crafted operating agreement can accomplish this.

LLC—Formalities for Operation

There are almost no legal formalities required to operate an LLC. Annual meetings, minutes, resolutions, and the other formalities associated with corporations are not required for LLCs. The LLC will want to retain written records, but the form of the records is left to the members. The members may also choose to have annual meetings, etc., but they are not required to.

It will still be important to maintain separate financial accounts and records for the LLC. Failing to do this may make the members personally liable for the LLC's debts.

LLC—Liability

Like a corporation, an LLC protects its owners from personal liability. LLC members are not personally liable for the debts or obligations of the LLC. Members can lose the money they've invested in the LLC—their "capital contribution." But creditors of the LLC cannot take the members' separate property.

LLC—Transferability

Operating agreements usually contain restrictions on a member's power to sell or transfer his or her interest in the LLC. LLCs are similar to partnerships in this regard. A common restriction requires a member who has received an offer to give the other members the right of "first refusal," the right to buy the member's interest at the price set by the offer.

Operating agreements may also provide that even if a member sells his or her share, the buyer will not become a member without the consent of the other members. If they buyer doesn't become a member, then the buyer has not right to engage in management at any level. The buyer will have made an investment in which other people have complete control over return on his or her investment. Few people want to make such an investment.

As a practical matter, sale of a member's interest will require the approval of the remaining members. An operating agreement can require majority approval, unanimous approval, or anything in between. This is not necessarily bad. It promotes stability in the LLC. But it also means that LLC members will find it difficult to transfer their interest without the other members' approval.

As with a closely held corporation, such restrictions also create the potential for oppression of members with a minority interest.

However, operating agreements are not required to have such limitations. The members can agree to make it easier to sell memberships or to require remaining members to pay fair market value for a departing member's interest.

LLC—Taxation

An LLC will ordinarily be taxed in the same way as a partnership with the same consequences. However, an LLC may elect to be taxed as a C Corp if this is advantageous. The LLC just has to file an election with the IRS saying that it wants to be taxed as a C Corp.

LLC members, like partners, are subject to self-employment tax.

Pros

- Limited liability.
- Ease of organization.
- Flexible operation. Operating agreement provides many options.
- Specialized management is possible with manager-managed LLC.
- Taxed at owner level.

Cons

- Restricted power to transfer interest.
- May be difficult to raise capital.
- Potential for oppression of minority interests.
- Lack of court experience with LLC form.
- Self-employment tax.

Conclusion

Remember that no single form works for all businesses and all business owners. Each has advantages and disadvantages. Choosing the best business structure for you and your value chain is a matter of weighing the considerations discussed in this chapter and deciding which are most important to you. Is the flexibility of a sole proprietorship or general partnership more important than the protection from personal liability offered by a corporation or LLC? Will one of these forms significantly reduce your taxes? Is it more important for you to be able to sell or transfer your interest easily, or to maintain control over who can buy into the business?

Some forms, such as partnerships and LLCs, give the owners great discretion in how to structure the business. Partners and LLC members can agree to make it difficult or easy to sell their interests. They can decide whether the company will operate by mutual consent of all partners or members or whether day-to-day responsibilities will be entrusted to a particular person. If you choose one of these forms, take care to create a partnership or operating agreement that takes advantage of this flexibility.

Do not be afraid to ask for help. Look for another business owner who has already started and is currently running a successful business. Find a mentor that is willing to help you succeed. Lastly, look for a competent lawyer or accountant who can work through the legal and tax issues that will confront your business.

Finally, do not make a decision without reviewing your state's laws regarding entities. Each State may differ greatly with respect to taxes, reporting requirements, fees, and many other statutory provisions that govern entities. The previous descriptions of the various business entities were intended to give you a general idea of how these separate business entities work, but they may operate very differently in your state. In most cases, visiting the website for your state's Secretary of State's office can be a critical step in the information gathering process for deciding which entity form to choose. To find your state's Secretary of State's website simply type the name of your state, followed by "Secretary of State," into a search engine and the first result will likely be a direct link to their website. Good Luck!

Additional Resources

For more information about forming a business entity, please take advantage of the below resources:

For information regarding B-Corporations:

- BCorporation.net - www.bcorporation.net
- Benefit Corp Information Center - www.benefitcorp.net

For information regarding Co-operatives:

- Community Wealth.org - www.community-wealth.org
- National Council of Farmer Cooperatives - www.ncfc.org

For information regarding Employee Owned Companies:

- Ohio Employee Ownership Center - www.oeockent.org
- National Center for Employee Ownership - www.nceo.org

For information regarding more traditional methods of entity formation (LLC, C-Corp, etc.):

- The Internal Revenue Service - http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Business-Structures
- Entrepreneur - www.entrepreneur.com
- U.S. Small Business Administration - www.sba.gov
- Your state's Secretary of State's website