

BUSINESS METAMORPHOSIS:

WHEN AND WHY TO CHANGE YOUR
BUSINESS STRUCTURE



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When and Why to Change Business Your Structure**

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Introduction – Choosing the Right Business Structure

Starting your own business or becoming self-employed is an exciting time in anyone's life. You're getting a chance to live your dream of working for yourself in a field that you love and not having a boss telling you what to do and when.

Working for yourself also means not having a company that automatically takes Social Security taxes out of your paycheck or protects you from lawsuits. The business structure that you set up when forming your business is important because it can shield you from some personal liability and change the way you pay taxes.

There are four main types of business structures allowed in the United States:

- Sole proprietorships
- Partnerships
- Limited liability companies
- Corporations

Each business model has pros and cons, and there are reasons why you might want to choose one over the others when you start your business, or change from one to another as your business grows.

This ebook will guide you through the process of choosing the legal structure that is right for your business. In particular, it will discuss when businesses might want to change from a sole proprietorship – the most basic legal structure – to a corporation or limited liability company and how to go about doing that.

Case studies for the different kinds of business models will be provided to give you an idea of how different people chose the legal structure of their business. Through these examples you will discover the perfect legal structure for your business and how to go about getting your business set up.

Chapter One – Sole Proprietorships

The sole proprietorship is the most popular business structure. According to the Internal Revenue Service, more than 20 million people filed non-farm sole proprietorship income tax returns in 2014, which represented a 4.5 percent jump from the previous year.

Many individuals go with the sole proprietorship model because of its ease. It is the preferred legal structure for businesses in which one person is the owner and the chief employee (through a sole proprietorship may have other employees as well).

Some people are sole proprietors and don't even know it. If you're moonlighting for your own business or doing freelance work on the side, you're automatically a sole proprietor.

Just Start Working

There is no paperwork involved in becoming a sole proprietor if you are doing business in your own name, unless there are state or local permits you need to file to set up your business. You should, however, open a business account that is separate from any other income you might have to keep your business funds together. Likewise you should have a separate bookkeeping system for the business instead of doing your personal and business accounting together.

One advantage of a sole proprietorship is the lack of paperwork.

Doing Business As

If you do want to name your business something other than your name, you probably will have to file a fictitious name report or a "doing business as" statement with your city or county clerk's office. This notice lets people know that you are the person behind the business.

Most sole proprietorships are still run in the business owner's name, meaning customers write checks to you instead of to your fictitious business name, and your business checking account is in your name. That's because your business doesn't really exist apart from you, as you'll see in the section on taxes.

Business Naming Tips

Of course you want your business name to be unique, so do a little searching around, at least in your local area, to make sure no other business has the name you're planning to use.

If another business is using the same name, you might be infringing on their copyright if you choose the same name, so you want to make a good effort to ensure there isn't another business that has trademarked the name. The easiest way to find out if another business has the name you want is to do a search on your favorite search engine.

Your name should be easy to remember and spell. If you want to start a Website with the same name, you'll need a name for which the web address is available. The name of your business should also be sufficiently descriptive so that people will know basically what you do just from reading the name of the business. This is helpful for business cards and listings in the phone book, where you won't be able to offer a lot of extra detail.

Here are some questions that you might want to think about when looking for a good name: • Should your name describe your products or services? • Would you like your name to convey your experience in your field? • How can your name grab attention? • Is your name easy to remember?

Also think about whether you want your personal name to be part of the business name, and where it will fall in alphabetical order (as in phone listings).

Steps for Naming a Business

No matter what legal structure your business is going to have, it is important to check the availability of the name you would like to use before you do anything else. You don't want to learn that your name is taken after you order business cards, for instance.

Once you know your name is good, file the necessary paperwork to get your business going (for sole proprietorships and partnerships, that just means any tax forms or permits). Then register for a domain name using your business name if you want, and, finally, order your business cards, letterhead and other business documents after you know that your name has been accepted.

Getting Permission

Check with your state, county and local officials to make sure you don't need any permits or licenses to start your business. Depending on what sort of business you are in, you may need to be certified or licensed before you will be allowed to open your doors. Some cities and states also require tax forms or other documents before your business is legal.

Your state's Department of Finance and Administration Web site should be able to give you all the information you need about starting a business in your state, or check for Small Business Administration Web sites run by local offices. You could also call the nearest Small Business Administration office for more information.

You should not have to notify any agency of the federal government that you are starting a business unless it is in a field that is regulated by the government such as transportation, investment advice or businesses having to do with alcohol, tobacco or firearms.

Always check with your state business licensing office (usually part of the Secretary of State's office) if you are professionally licensed in your state. Some business structures are not allowed for certain types of businesses.

Sole Proprietors and Employees

If you are planning to have employees in your sole proprietorship, you will need to apply for an Employer Identification Number. This is a code similar to a Social Security number that identifies your business for tax purposes.

If you have employees, you have to have this number no matter what legal structure your business has. If you are in a partnership or a corporation or are making the switch from a sole proprietorship to another business structure, you have to have this number even if you don't have employees.

You can find the form to apply for an EIN at the Internal Revenue Service Web site.

Taxes and the Sole Proprietor

In the eyes of the law and the government, a sole proprietor and his or her business are the same thing. That means you report all your income and business losses on your personal income tax return, with the addition of a form called the Schedule C, Profit or Loss from a Business.

Another term for this process is pass-through taxation, because the profits in essence pass through the company to you as an individual and you pay all the taxes, rather than having the business itself pay some taxes, as happens with a corporation.

The main difference when you are working for yourself is that there isn't an employer to withhold Social Security and Medicare payments for you. You're still required to pay these taxes through estimated tax filings throughout the year.

How to Pay Estimated Taxes

Estimated taxes are based on a percentage of the amount of money you expect to make in the current calendar year. The current self-employment tax rate is 15.3 percent. In 2016, only the first \$94,200 made by an individual was subject to

the full tax; for income beyond that level, only the 2.9 percent Medicare tax had to be paid.

Estimated taxes are paid quarterly and are due on:

- April 15
- June 15
- September 15
- January 15 of the next year

People must pay estimated taxes if they expect to owe more than \$1,000 in taxes by the end of the year and you expect the amount withheld to be less than the smaller of 90 percent of the amount withheld in the previous year or 100 percent of the tax shown on your previous year's tax return.

Self-employment taxes can be complex, but the IRS provides a lot of good information to help business owners figure out when and how much to pay. In particular, check out <http://www.irs.gov/publications/p505/ch02.html#d0e4547> on tax withholding and estimated tax calculation.

When you start making a lot of money from your business, you may also have to pay estimated personal income taxes to your state. Check with your individual state's revenue department for more information on the income tax rates and at what level you will start to be penalized if you do not pay estimated taxes (in most states it is when you owe \$1,000 or more, just like with the federal government).

Spouses as Employees

If you want to file a joint tax return with your spouse, you still can even though your business is classified as a sole proprietorship. You do not have to legally become a partnership to make this acceptable. Whomever's name is on the Schedule C filed with your personal income tax will be considered the owner of the business.

Your spouse can also volunteer to work for your business without pay so that you do not have to pay payroll taxes or go through the paperwork involved in having employees. But if you're ever audited and the IRS thinks you're getting too much work for free or your spouse's contribution is too substantial, you might have to pay back employment taxes.

Sole Proprietor Liability

Probably the biggest negative aspect of the sole proprietorship is the fact that there is no limited liability for the business owner. That means that if the business is sued, the individual who owns the business can be held personally liable and have personal property taken away or used to pay the debts of the business.

Case Study: Sole Proprietor Liability Kate owns a small business making jewelry as a sole proprietorship. Business is booming, and she buys a large supply of gemstones and other supplies to make merchandise for a big show.

Unfortunately, she doesn't sell as much as she expected and her supplier comes after the business for not paying its bill. Because Kate is a sole proprietor, the company can seize not only business assets to get the debt paid, but also Kate's personal assets, such as her car and even her home.

Case Study: Sole Proprietorship Harold began working as a freelance writer while still working at his day job. Even before he quit his job to freelance full time, he was technically a sole proprietorship in the eyes of the IRS.

When Harold had enough business to give up his day job, he became a full-time freelancer and decided to stick with the sole proprietorship form of business structure for several reasons.

First, he liked the ease of being a sole proprietor. There was no need for filling out forms or filing his taxes in a different way. He didn't expect to ever hire any employees since he only took on as much work as he could do himself.

Liability was a concern for Harold, but he did not think it was likely that the clients he was working for would ever have occasion to sue him, and he worked hard to keep from accumulating debt to vendors. Since he worked with most of his clients as an independent contractor, there wasn't a lot of risk.

Writing is not a high-risk business, so it did not seem worth the added expense and paperwork that would have been involved to form a corporation or limited liability company.

Harold decided that he should re-evaluate his choice of business structure in a few years to make sure a sole proprietorship is still meeting his needs.

Chapter Two – Partnerships

A partnership is the most informal business structure that has more than one owner. If you and a partner or partners are starting a business and you haven't filed papers to incorporate or form a limited liability company, you are by definition operating in a partnership.

The partnership form of business structure is similar to the sole proprietorship, except there are two or more business owners instead of just one.

There are two different types of partnerships: general partnerships and limited partnerships.

General Partnerships

A partnership is considered "general" if each partner takes part in running the business. Each partner also takes personal financial responsibility if the business fails, is sued, or can't pay its debts.

Much like in the sole proprietorship scenario, each partner's personal assets can be used to pay the debts of or settlements against the business.

All members of the partnership have the authority to speak for the business and to make business decisions that all the

other partners are bound to. Usually, only one partner needs to sign a contract to make it binding over all members of the partnership, for example.

Trust is Key

It is vital that you trust all the people with whom you are forming a partnership because one person can make deals or sign contracts that bind all members of the partnership. If business debts must be paid off, each partner is equally liable, so you have to trust that each person will be willing and able to pay off any business debt that may come about, or you could end up having to sue your partners for payment.

A partnership agreement is a vital part of running a successful partnership.

Get it in Writing

There is no requirement that a contract be written up before a partnership is formed; a word-of-mouth agreement is all that is legally required to form a partnership. But it's a very good idea to have some kind of partnership agreement drawn up to lay out the formalities of the partnership and what happens if one partner decides to leave (or dies) or if the other partners want to remove a partner.

It is important to define how much each person's vote is worth when the partnership must vote on matters, as well as how profits are split.

An attorney can help you write a partnership agreement. Prices vary widely depending on the complexity of the agreement, ranging from a few hundred dollars to a few thousand dollars.

Partner Meetings

It is vital to keep the lines of communication open when working as a partnership. Even if you see your partner or partners every day, take time once a week or once a month to have a more formal meeting during which you discuss issues of importance to the partnership, make any decisions that need to be made and air grievances or give criticism.

Partnerships and Taxes

Like a sole proprietorship, a partnership is not separate from its partners in terms of taxes. That means your profits and losses are reflected on your personal income tax return along with a Schedule K-1, which shows the profits and losses for each partner in the partnership.

In addition, your partnership must file Form 1065 each year. This is just an informational statement that outlines the partnership's profits and losses for the year as well as each partner's share. This helps ensure that each partner reports his or her income from the business properly.

Just like with a sole proprietorship, people in partnerships pay their own self-employment taxes and must pay estimated taxes quarterly if they anticipate owing more than \$1,000 in taxes. And like a proprietorship, the partners are responsible for paying taxes on all profits, even if that money hasn't actually been withdrawn from the business' account.

What's in a Name?

As with other business structures, if you want to name your business something other than the names of the partners – which is usually the case – you'll need to file a Doing Business As or fictitious name registration with your city or county clerk.

Case Study: Partnerships Melinda designs brochures, Web sites and other promotional materials for small businesses. She's been working as a sole proprietor for some time when she meets Andrea, a former ad agency representative who wants to go into business for herself planning ad campaigns and doing publicity.

The women decide that their skill sets would go together quite well and they decide to form a partnership to formalize their relationship. They have a partnership agreement drawn up and being to file taxes as a partnership.

In the future, Melinda and Andrea might want to consider converting their partnership to a more formal LLC or corporation, but they decide a traditional partnership is fine for the time being.

Limited Partnerships

In a limited partnership there is one partner or partners, known as the general partner(s), who has the authority to run the business and the liability if things go wrong. The other partners are little more than investors, who can not be held liable for more than their initial investment and who do not have a say in the day-to-day operations of the business.

Limited partnerships are actually decreasing in popularity these days in favor of the limited liability company, which is similar in structure but protects all members of the partnership, including the general partners, from personal liability if the business fails.

The big drawback of this kind of arrangement is that the general partner or partners are still personally liable for debts and claims against the company, and if a limited partner becomes active in the business, he or she can lose limited liability status.

A way to get around this problem is if the general partner or partners form a corporation to manage the limited partnership, but now that a limited liability company can be formed to give everyone limited liability no matter their role in the business, that makes a lot more sense because it is easier.

Case Study: Limited Partnership Julia and her husband want to open a restaurant, but they can't afford to do it on their own. They can get a bank loan for a portion of start-up costs, but they also need investors, so they decide to form a limited partnership to solicit money from family and friends.

Those "silent partners" are not involved in the day-to-day running of the business and can't tell Julia what to do with their investments. Likewise, if the business fails, they aren't responsible for paying any debts of the business. They do, however, get a share of the profits when the business starts making money.

Limited Liability Partnerships

A third type of partnership, which will not be chosen by any individual small business owner, is the limited liability partnership, also known as a registered limited liability partnership.

This business structure is designed to protect the individual partners from personal responsibility for the actions of other partners or for the debts of the business. A limited liability partnership is sort of a step between more traditional partnerships and more structured corporations.

This legal structure is popular among groups of lawyers, insurance agents or other professionals who work together under the same roof. They are a partnership in the sense that they advertise together and share expenses, but each individual partner is only personally liable for his or her own malpractice and they have limited liability when it comes to the actions of others in the firm. Matters of taxation are the same as with other partnerships.

Because of this, these forms of partnerships usually require a large amount of insurance and are rather expensive to set up.

Chapter Three – Limited Liability Companies

Limited liability companies, or LLCs, take away the major negative aspect of forming a sole proprietorship. When your business is structured as an LLC, you will not be held personally responsible for the debts of the business.

In all states, one person is all that is needed to form an LLC, but they can have as many owners or members as you like.

The History of LLC

The limited liability company is actually a relatively new choice for business organization. The first state to allow this structure was Wyoming, which passed its LLC law in 1977.

But it wasn't until 1988 that the IRS officially declared that LLCs would have pass-through status like sole proprietorships and partnerships do. Changes in tax law since that time have made it a lot easier for people who want to form LLCs, and they are a great "happy medium" choice that provides you with limited liability without the complexity of forming a corporation.

The Liability Shield

In a limited liability company, the owners of the business can lose only the money they invest in the company. If the company is sued and forced to pay damages, or if the company goes into debt, no one who owns the company will be held financially responsible.

Individual members of the LLC aren't immune from all legal repercussions, however. If one person directly harms another – as in an automobile accident – or commits fraud, fails to deposit taxes, or does something else illegal, or if the person guarantees a loan that the business defaults on, then the individual can be held personally responsible and have his or her personal property taken to pay damages or debts. Another way a person can be held personally liable is if he or she does something financially irresponsible or that is not in the best interests of the business that leads to a claim being filed against the company.

Damages caused by injuries or malpractice claims may be covered by insurance, but it is difficult and costly for a small business to get enough insurance to cover every potential lawsuit or problem the business may have. That's why the liability shield is so important and makes the LLC such a good choice for many businesses.

Treating it Like a Business

Another way that an individual can get in trouble when part of a limited liability company is if he or she and the other members of the LLC treat the business as an extension of their personal lives rather than as a separate business entity.

It is important that everyone who is part of the LLC takes it seriously and treats it as a legitimate business. That means keeping separate business accounts, acting within the bounds of the law and having a legal agreement that formally sets up your LLC as an official entity.

If you aren't able to show that the LLC is a true separate entity, the IRS could decide that your LLC is really a group of sole proprietors and that each member should be liable for the business' debts.

Organization Matters

One of the best ways to prove that you are truly running your LLC as a separate entity and not as an extension of your personal life is to keep good records. Have a notebook or file folder that includes all the formal paperwork required to form your LLC, articles of incorporation, annual reports or filings that go to the state each year, records from any formal meetings your group might have (such meetings are not required, but serve as more proof that you're taking your business seriously), contracts with vendors and other important paperwork.

Another way to show that you take seriously the existence of your LLC is to always include the name of the LLC on paperwork when you sign contracts, letters or other correspondence. Have your LLC name listed first; then sign your name. For instance, you might have a contract end like this:

R&S Lawn Care LLC By _____ Your Name

Sign your name on the line, and you're covered. Your business cards, company letterhead and banking account should all include the name of the LLC as well.

Taxes and the LLC

Limited liability companies are not considered separate from their owners in the eyes of the law, so people involved in LLCs can report their business earnings and losses on their individual tax returns, just like sole proprietors and people in partnerships.

Also like partnerships, LLCs have to file a Form 1065, which shows the profits and losses for the company and what share goes to each member of the company. This is to ensure that all members of the LLC are properly reporting their earnings.

One thing that many businesses like about the LLC format is that profits can be divided in any way the owners see fit. Most businesses divide profits based on the percentage each person contributed to the business' start-up costs, but that is not always the best option.

If one member of the LLC doesn't have a lot of cash but contributes in other ways, such as doing more of the legal legwork to get the business started or taking on other projects, then it might not seem fair to give that person a much lower percentage of the profits.

How you allocate profits is something that should be discussed and included in your operating agreement (see below).

Members of the LLC who do not work for the company don't have to pay self-employment taxes on any profits they receive, because they aren't thought to have earned the money through their own effort. Those who do work for the LLC and are paid salaries or bonuses do have to pay self employment taxes and may be subject to making quarterly estimated tax payments.

Taxation Choices

As mentioned above, LLCs are generally taxed in the same pass-through way that all the other business models we have talked about thus far are taxed. But now LLCs can also choose to be taxed like corporations without having to officially incorporate.

Why would a business choose to do this? With the passthrough system, all profits the business makes are taxed as income, even if you leave money in the business to pay upcoming expenses.

With a corporation, money kept in the business at the end of the year is taxed at a different, corporate tax rate. The corporate tax is on a sliding scale. A 15 percent tax is charged on the first \$50,000 kept in the business, 25 percent for the next \$25,000, and so on up the scale.

If you're planning to keep \$75,000 or less in your business, using the corporate taxing structure can save you money, as the self-employment and income taxes you would pay on that money with pass-through taxing would be more than you will pay with the corporate taxing structure.

Changing to the corporate tax structure requires filing a form with the IRS, known as Form 8832. All members of the LLC must sign the form, or one person who is authorized by the group may sign it for everyone (if this power is given to one member, make sure there's a written and signed agreement to that end in your LLC paperwork file).

Corporate-style taxation will then be in effect until you file another form asking to be switched back to pass-through taxation. This usually can't be done for at least five years, so think

seriously about your business plan and make sure you expect to have profits you want to keep in the business for at least the next five years before you make the change.

Operating an LLC

A limited liability company may be run by an individual or by a group of partners. If more than one person is involved, they can share management duties equally, or one person or a group may manage the day-to-day activities of the business while other investors are not involved in management but still collect profits.

An LLC in which all partners collectively manage the business is the most popular form and is known as member management. When some members or an outside person manages the business, it is known as a manager management arrangement.

Operating Agreements

In either case it is not legally required that you have a partnership operating agreement, but it is a good idea to have one, for many reasons. First, it shows that you are serious about your business and running it as an LLC, which should help convince the IRS and the courts to limit your individual liability should something go wrong.

This is why it is important to have such a document even if you are the only member of your LLC. It shows the world that you intended your business to be a limited liability company instead of a sole proprietorship. This will help establish your limited liability should you ever be part of a lawsuit or have business debts that need to be settled.

It is always a good idea when entering into a partnership to have a document that spells out the structure of the business, who will share in profits and how they will be divided, how decisions will be made among the group, what happens if someone wants to leave or dies, or if someone new wants to join, and other issues. Having such a document ensures that everyone knows how the business will be structured and may eliminate some arguments later.

It is particularly important if your LLC is made up of a group of people to have a section in the operating agreement known as a buyout agreement. This section states specifically what happens if one of the partners wants to leave, or if someone dies, gets divorced, or goes bankrupt. This section should explain whether other members can buy out a person and force him or her to leave, who can buy out the departing person, how much each person's share of the company can be bought for and other issues concerning getting rid of a partner or adding a new one.

Things change over time in every business, and it is vital to set this information out in the beginning to avoid arguments in the future, even if the only major change your business ever has to face is someone retiring.

Every state has default laws regulating LLCs, and having your own operating agreement supersedes those rules. This is useful if you have a different structure from those of most small businesses or want to allocate profits in an unusual way.

You can find sample operating agreements online, and there are several different software packages and online services that will help you draft an operating agreement. If your business structure is quite complex or involves a lot of people, hiring a local lawyer with experience working with small businesses is probably your best option.

Securities

Small LLCs that are member-managed usually do not have to worry about the issue of securities. In the case of manager managed LLCs, where some investors are not actively participating in the development of the business, the interests in the business are considered securities by the federal Securities and Exchange Commission.

Once ownership in your company is considered a security, you either have to open up your investment opportunity to the public or get an exemption from the securities laws that allows you to do a private offering. The exemption can be granted by your state Secretary of State's office and must be done before you can accept investments.

The good news is that such exemptions are very common. Check for more details on your state's Web site or call the Secretary of State's business or commercial services department for more information.

Registering an LLC

All states require formal registration of a limited liability company. The form you will need to fill out goes by different names in different states, but is usually called the articles of organization. It might also be called a certificate of organization or a certificate of formation. You should be able to find this document, which mostly involves filling in blanks, at the Web site of your state's Secretary of State.

The information required on the articles of organization varies from state to state, but all will require at least the name and address of the LLC, the nature of the business (usually stated very broadly), the name and address of the LLC's registered agent, who will receive paperwork

for the company, and the names of any managers or members of the LLC known at the time of filing.

You'll also have to pay a filing fee, and in some states you'll need to publish a notice of your intent to form an LLC in the newspaper before you can officially form your company. Requirements are different in each state, so make sure you check with your state's Secretary of State's office for more details.

The filing fee is usually around \$100 but can run as high as \$800, as in California. Once you've gone through all these steps, you'll also have to get any other state or local permits, sales tax forms, licenses or waivers to make sure your business is completely legal before you start helping customers.

If you are going to have employees, you will also need to register for an Employer Identification Number so that you can withhold taxes from your employees' paychecks.

Naming Matters

When filing your paperwork to register your LLC, you'll need to provide a business name. You cannot have the same name as another LLC, and the Secretary of State's office where you register can help you find out if another business has the name you wanted.

One difference between LLCs and sole proprietorships or partnerships is that you do not have to file a fictitious name report or a Doing Business As declaration in most cases. That's because you're already formally registering your business name with the state when you file your articles of incorporation. The exception is if you want to change your name or want your business itself to go by a name other than the name of the LLC. In that case you would have to file a Doing Business As statement.

Another difference is that your name must include LLC, Limited Liability Company, Limited Company, or some other recognized abbreviation that lets people know your business is an LLC.

Working with Your Spouse

When a spouse is involved in the other spouse's limited liability company, the law can look at that person's relationship to the company in a number of different ways. He or she may be viewed simply as an independent contractor, who could be held personally liable for any wrongdoing. Your spouse could be considered an employee, who has very little risk of having his or her personal property involved in a business-related lawsuit.

He or she could be seen as an agent of the LLC, which usually means your property could not be affected by the agent's actions, and the agent would not be liable as long as his or her actions fell under the scope of acting as an agent of the business. Or your spouse could be seen as a general partner of the business, which would make him or her personally liable for wrongdoing.

If your spouse is going to take an active role in the business, is going to work with you and is going to be paid, it's probably a good idea to make your spouse a member of the LLC so you know your personal property and assets are out of danger. Consult with your attorney for more information on how to structure your LLC for the least potential for personal harm.

Case Study: Limited Liability Company Andrew wanted to start his own computer programming and consulting company. He thought about starting a sole proprietorship because he didn't ever plan to have any employees and it is the easiest legal structure.

The more he thought about it, he realized the potential for lawsuits could be high if he didn't complete a project on time or if his client believed that he did not follow their contract to the letter. He was also worried about potential personal financial losses in the event of another downturn in the dotcom cycle.

Still, a corporation didn't seem like the right choice for such a small business, so he formed a limited liability company instead. With the help of a lawyer he drew up his articles of incorporation and an operating agreement that firmly established his business as an LLC in the eyes of the law.

Now Andrew is protected from personal liability should his business fail or have a lawsuit filed against it, but without all the extra hassle of forming a corporation.

Chapter Four — Corporations

Corporations are the most complicated form of business structure. A person can't just decide to form a corporation and do all the work by him or herself. It is the most expensive and time-consuming legal structure to form, but there are benefits such as the ability to sell stock, provide fringe benefits and possibly save a little on your taxes.

While each state (as well as the District of Columbia and Puerto Rico) has different corporation statutes, many of them are quite similar because of efforts by the American Bar Association to streamline the laws and make them more alike from state to state.

In some states, one person can form a corporation and be all the corporate officers and the sole shareholder of the company. In other states, different people need to play those different roles. Check with your state's business incorporation office (usually part of the Secretary of State's office) for more on what's necessary to incorporate in your home state or the state in which you want to incorporate (more on that later).

Even in a corporation of one, there is technically a three tiered structure:

- Board of directors: This group of people oversees the company on behalf of the shareholders and is responsible for making decisions for the company.
- Corporate officers: Usually a president, vice president and secretary, they manage the operation of the corporation on a daily basis.
- Shareholders: These people buy stock in the company; they technically own it and enlist the board of directors to run the company in their best interests.

Liability and Corporations

All members of a corporation, including corporate officers and shareholders, have limited liability in claims against the company or any debts the company has. Liability is the same regardless of how active a person is in the business.

Again, there are circumstances under which limited liability can be nullified, as when you commit a criminal act, personally injure someone, cosign on a loan that is defaulted or do something against the interests of the corporation, for instance.

Changing to a corporation can lower your tax bill.

Corporations and Taxes

The main difference between limited liability companies and corporations is clear at tax time. Your business is considered a separate entity in the eyes of the law, and you are paid a salary instead of just taking on the profits or losses the business incurred during the past year.

That means that you report any income paid to you by the company on your personal income tax return, but you also have to file a tax return, known as a Form 1120, Corporate Income Tax Return, for the business. Profits that are left in the business after paying out salaries and other expenses are then taxed at a special corporate tax rate.

This can be a big advantage for people who are willing and able to leave money in the business at the end of the year, because the tax rate for corporations starts out lower than the taxes paid by individuals. That money can then be used for salaries, equipment, rent or other expenses in the future.

There are tax consequences if you ever decide to sell or dissolve your business; you will have to pay taxes on the increased value of your business assets as well as income tax on the value of the business. This is known as double taxation. It's not a reason not to incorporate, but it is something to think about and discuss with your accountant as you consider whether to incorporate.

Profit Allocation

In a corporation, profits and losses can only be allocated in proportion to the investment that each owner put into the business. This is a potentially negative difference when compared to a limited liability company, in which you can decide to allocate profits in any proportion you like.

Where to Incorporate

It seems pretty simple that you would want to incorporate your business in the state in which you live. That is probably where you intend to do the most business, and of course it is simpler for tax purposes to have your business based where you live.

If you don't plan to do a lot of business outside of your home state, this is all you ever need to do. But if you want to expand your business into another state, you will probably need to register as a business in that state before doing business there.

Check with the Secretary of State's office in that state for a certificate of authority for a foreign corporation or similar document. In this case foreign just means from another state. You'll likely have to pay a filing fee and then you'll be ready to do business.

What About Delaware?

If you've done any research online about incorporating your business, you might have run into some Websites talking about incorporating in Delaware and that they would be happy to help you do it for a fee.

Delaware is a popular spot for large corporations to incorporate because it has what are considered more business-friendly tax laws than other states. Incorporation in Delaware is inexpensive, doesn't require you to disclose a lot of information and has lenient corporate codes.

Businesses love Delaware because of the low incorporation fees, the ability for a single person to hold all corporate offices, and the fact that there is no state corporation income tax for corporations based in the state but started by people who don't live there.

No physical business location in the state is required to incorporate in Delaware; businesses only need to have a registered agent in the state. Also, the state has a court of chancery that hears only business cases, so the judges there are very experienced in business law and the backlog of cases tends to be smaller than in states without such a system.

But for small businesses, the lower cost of incorporating and lower paperwork hassles will probably be outweighed by the fact that you'll still have to register as a business in your home state and pay taxes there on the money you are paid as income as well. It adds an extra layer of work that just isn't worth the savings for most small businesses.

Nevada Business Law

Another popular incorporation location is Nevada, for good reason – the state has no corporate tax on profits, no annual franchise tax and no personal income tax.

Stockholders' names can be kept secret, and one person can hold all corporate offices. No one who is part of the business needs to live in Nevada, hold meetings in Nevada, or even be a U.S. citizen. It is important that your business have some kind of address in Nevada to ensure that you get the maximum tax benefits.

The state has minimal disclosure and reporting requirements and low fees. The directors of the corporation are not required to hold stock in the company. Corporations don't even have to file state tax returns!

Nevada makes a big deal of attracting corporations to the state and there are many incorporation service companies (which we'll talk about below) located in the state.

If you have plans to take your company nationwide, or you happen to live in the southwest and might expand to Nevada at some point anyway, it makes a lot of sense to incorporate in Nevada. You'll pay fewer taxes and have fewer legal hurdles than you might face in other states.

How to Incorporate

Going through the process of incorporation takes a good deal of time, though it starts out much the same as starting an LLC. First you need to pick a name that no other corporation in your state has. Your business name must end with Company, Limited, Incorporated or an abbreviation of one of those words that designates it a corporation.

Once that's done, you need to choose the officers for your corporation (a president, vice president and secretary are all that are usually required, though some states also include a treasurer) and file your articles of incorporation with the state Secretary of State or other office that deals with starting businesses.

In some states, the same person can hold all three offices – if you are a corporation of one – while in other states different people can hold multiple positions. For example, you might be the president and secretary of your company while your spouse or business partner is the vice president and treasurer.

Articles of Incorporation

Like an LLC has the articles of organization, corporations have the articles of incorporation, which is a similar document outlining the basic facts of the corporation, including its name; address; the name and address of the agent of the incorporation (who will receive legal paperwork) and the person filing the incorporation paperwork; the purpose of the corporation; and the number of authorized shares of stock and their base value, among other things.

You can add information about the structure of your business to the articles of incorporation, but it is important to remember that the articles will be filed with a state agency (usually, but not always, the Secretary of State's office) and become part of the public record.

So, don't include anything in your articles that you wouldn't want your competitors to see. If a topic is sensitive, such as compensation, add that information to your bylaws instead of your articles of incorporation.

You can always amend your articles at any time. You may need to do this if you want to increase the number of shares of stock your company has, add or delete details about rights or voting, change your registered agent or alter any other terms of the articles.

Most states have specific forms that should be used to file amendments to the articles. Doing this requires a formal approval from the directors and shareholders (or just the directors if your company does not have shareholders at the time of filing the amendment).

The process involved in amending the articles is another good reason to keep them as simple as possible and include information you might want to change in your corporate bylaws instead.

Bylaws

Another paperwork step that is required when starting a corporation is drawing up the bylaws of your corporation. This document sets out the rules that govern the corporation, such as when and where the board of directors and shareholders meet, voting requirements, compensation issues, what constitutes a quorum for meetings, and other basics.

You'll want to include information on the number, qualifications and terms for your board of directors, as well as laying out their powers. Include information about how to remove and choose new board members and corporate officers.

This document does not have to be complex. There are many models out there that can help you, either online or in books on starting a business. You can also get a lawyer who works with small businesses to help you draft your bylaws and complete the incorporation process.

There's a lot of standard legal language that often goes into bylaws, and it's important that this information be included. If you don't understand any of the provisions laid out in the bylaws, ask your attorney to explain them. You are bound to follow your corporate bylaws, even if you don't understand them.

Bylaws are not a public document, and usually only the officers, directors and shareholders are allowed access to it. This is the place to define more sensitive areas of corporation governance, as opposed to the articles of incorporation.

Board of Directors

Every corporation has to have a board of directors. In many states, the owner or owners of the business can be the whole board. When choosing your board of directors, however, make sure you have an odd number of people so you won't have to worry about tie votes.

Once the bylaws have been written, the first board of directors meeting must take place. At this meeting, the bylaws will be adopted and the corporate officers will be appointed. You can also define your fiscal year and authorize the issuing of stock.

Stock Matters

Having stock in your business is a legal requirement of running a corporation in most cases (nonprofits, for example, are often corporations that don't issue stock). You need to decide how you want your stock certificates to look and what kind of seal you will use on them to ensure authenticity. This is usually decided at the first board of directors meeting.

Issuing stock formally divides ownership of your corporation, and you should really issue stock before you begin doing business if at all possible. The reason for this, again, is because doing things in their proper order and having records in place makes it look like you are seriously running a business.

You'll also need to decide early on how many shares of stock you're going to sell. This information may be required on the articles of incorporation, or it should be included in the bylaws of the corporation.

In some states the incorporating fee varies based on how many shares of stock are available in your company. If you are incorporating in one of these states, make sure you limit the number of shares to a number that is workable for your corporation but isn't going to cost you a lot of extra money.

When it comes to issuing stock, you will need to follow securities law, which is a complex system for most laypeople to understand. Fortunately, many small businesses can get exemptions from the securities laws by having a private stock offering to a small number of family and friends, or by offering stock only in their home state.

Both states and the federal government have their own securities exemptions, so you'll need to know about the rules of both entities before you proceed.

Since you certainly don't want to run afoul of the Securities and Exchange Commission, talk to a good lawyer who specializes in small businesses and has worked with corporations on such matters before. The fees you will pay will be worth every penny.

SIC Codes

The articles of incorporation in many states also ask for what's known as a SIC code. This stands for the Standard Industrial Classification and is a number devised by the Securities and Exchange Commission to classify different kinds of businesses.

The codes are used in the government's business information databases and to organize responsibility for different corporations within the division of corporate finance. You can find the codes at the Securities and Exchange Commission Web site:
<http://www.sec.gov/info/edgar/siccodes.htm>.

Types of Stock

Corporations are able to have two different kinds of stock if they choose, known as common stock and preferred stock. Many small businesses just have common stock, which means that each shareholder's stock has the same weight when it comes to voting issues.

Usually each share of stock a person owns gets them one vote. The rights of the shareholder are set out in your state's corporation statutes, and they include having voting rights, receiving meeting notices and having the right to inspect company records.

Sometimes companies have different classes of common stock, normally known by such names as Class A stock and Class B stock. Different kinds of stock might give shareholders different rights, as laid out in the articles of incorporation and the bylaws of the corporation.

The other type of stock, known as preferred stock, gives shareholders special, or preferred, rights. The most common right given with preferred stock is getting a yearly dividend payment, which is not guaranteed for owners of common stock.

Preferred stock holders only get their dividends if there is enough money in the company to pay them. There can also be different classes of preferred stock with different rights pertaining to the different classes of stock.

Deciding if or how to divide shares depends somewhat on your goals for the company and whether you want to use stock options as an incentive to get people to work for you. It's a good idea to talk to an accountant or financial planner with experience working with small businesses to help you decide how best to structure your company's stock.

Using an Incorporation Company

You can incorporate your company yourself relatively easily with the help of a lawyer or accountant, or you can use an incorporation service company.

These companies can help you write and file your articles of incorporation, make sure you qualify to do business in your state or any other state in which you plan to do business, reserve your corporate name, work as your registered agent, file paperwork for your corporation (such as for your federal Employer Identification Number or to become an S corporation) and give you a corporate kit.

This kit will contain customized stock certificates, a stock ledger, corporate seal and personalized sample forms. Corporation service company fees vary widely. You can find such companies by looking in your local phone book, or search online.

The Life of a Corporation

Corporations have to do certain things that businesses with other legal structures do not, such as holding annual meetings, writing annual reports and distributing them to shareholders, keeping minutes of meetings, formally recording all corporate actions, and keeping records on the legal and financial history of the company.

If your corporation is very small, this extra work will not be that time-consuming. But don't brush it off. Diligently following through with the rules that govern corporations proves that you are serious about your business, which is important if you ever get into tax or legal trouble.

Case Study: Corporations A group of friends from college wants to start an online file sharing service. They think it will be the next big thing in social bookmarking and video sharing, but they know they're going to need lots of outside investors to get to that level.

They also don't expect to have a big budget to attract top talent to their start-up, so they want to be able to offer fringe benefits, particularly stock options, to attract people who are as passionate about their idea as they are and who see the profit that could be made from getting in on the ground floor with their stock.

The only choice for this type of business is incorporation. First, the owners need the limited liability that a corporation offers to shield their personal property in case the business fails, goes into debt or has legal claims made against it.

More importantly, however, the corporation model is the only one that allows fringe benefits and stock options to be part of your employee package. You can have different classes of stock and give a lower-class stock to employees, while the owners get the higher-end stock.

Forming a corporation will also make it easier for the group to get outside investors. If they can generate enough buzz, they might even consider having an initial public offering (IPO) for their stock, which is impossible to do with any other kind of legal structure.

S Corporations

S corporations have a slightly different kind of corporation structure. They're called S corporations because they are taxed under Subchapter S of the Internal Revenue Code. Legally, an S corporation is treated exactly the same way as a traditional corporation.

The only difference has to do with taxes. Becoming an S corporation gives the company pass-through taxation, just like a sole proprietorship, a partnership or an LLC.

In the past, becoming an S corporation was the only way for a business to get limited liability and the easier tax structure of a sole proprietorship or partnership, but now more people are opting for the limited liability company format because those businesses have the same legal and tax structure benefits without the hassle of forming a corporation.

“S” corporations can only have one kind of stock, common stock, which makes them less flexible than the more traditional form of corporation. They also have a maximum number of shareholders, usually around 75. They must be formed in the United States, and generally all shareholders must be individuals (though some exceptions may be made for trusts or estates that want to own shares), and all shareholders must be U.S. citizens.

Further, all these requirements have to be met when the corporation is formed and for the entire life of the business. If these conditions are ever unmet, the corporation automatically forfeits its S corporation status, which can cause quite a mess for your accountant.

Another potentially negative difference is that an S corporation’s debts can’t be passed on to any shareholders who did not cosign on loans, meaning that shareholders don’t get the same tax advantages from the company taking on debt that managers of an LLC get, even when they haven’t cosigned on a loan.

Using debt to your tax advantage is a tricky area of tax law, so always consult with your accountant before making any big investments to learn how those changes will affect your tax bill.

One advantage of S corporations right now is that they don’t have to pay self-employment taxes on profits that are given to shareholders as disbursements beyond their regular salary. LLC owners are taxed for all of the money in the business, whether paid out as salary or a bonus, or retained in the company. It is expected that the law will change soon to put LLCs and S corporations on more even footing, but it hasn’t happened yet. Again, your accountant is the best source of information on changes to the tax law.

Forming an S Corporation

To form an S corporation, all shareholders need to agree to the change in writing. You’ll need to fill out IRS Form 2553, which must be filed within a year of when you want the change to take place or before the 15th day of the third month of the tax year you want the change to take place (for most companies, that would be March 15).

S Corporations and Debt

In some cases, the IRS can decide to consider your corporate debt as a second class of stock, which will nullify your S corporation and take you back to the rules of a traditional corporation in the eyes of the IRS.

This can happen if you don't document loan transactions in the corporate minutes, don't pay down your loans, receive loans from shareholders equal to what they own in stock, receive loans from family members or have loans in which repayment is tied to the company's profits.

This is a very unusual situation and most companies don't have to worry about it, but if you have an S corporation and a significant amount of debt, it is important to document that debt and efforts to repay the money so that your debt won't be reclassified as a second kind of stock.

Close Corporation

Another model you might hear about is known as the close corporation. This isn't really a different business model, just a different way of running a corporation.

A close corporation is not available in all states. This structure limits the number of shareholders to 50 or fewer. The company must be regulated by the close corporation statutes, which keep shareholders from transferring stock to outsiders without consent and allow them to remove members of the board of directors or limit the actions of the board, giving the shareholders more power.

This option may not be available to you or be something that you are interested in, but if you ever see information pertaining to a close corporation, this is what it means.

Case Study: S Corporation Michael is planning to start an Internet design company. He knows that he'll have to start small, but he has big goals for his business. He hopes to have employees in the next year or so that he would like to be able to offer stock options and other incentives, so he knows that he'll need to form a corporation.

Right now, however, the company isn't making enough money for the traditional corporate taxation system to make sense; he'd rather be taxed as a pass-through entity because he's still doing his own taxes right now.

Because Michael is the whole corporate board for his business, it's easy for him to decide to become an S corporation. In the future, when he has more profits and can afford an accountant, he simply will elect to be taxed as a corporation and everything will be in place for his corporation to take off.

Chapter Five: Pros and Cons of Different Business Forms

Now that you know the basics of the different legal forms your business can take, you might be wondering how to determine which one is best for your business. Here's a quick run-down of the pros and cons of sole proprietorships, partnerships, LLCs and corporations to help you decide which business structure will work best for you.

Sole Proprietorships

Pros:

- Very easy to set up and run.
- No paperwork involved in setting up the business structure.
- Management system is flexible.
- Business funds and personal funds can be combined.
- No special bookkeeping is required.
- All business profits and losses are treated as personal income, so each person only needs to file one tax return.

Cons:

- No limited liability means you are liable for business debts and lawsuits.
- It's not a good choice if you plan to have employees.
- You can't sell stock, so it may be difficult to raise money for your business.
- There are no tax deductions available for employee benefits, if you do have employees.
- It is difficult to pass on your business, since it doesn't technically exist apart from you.

Partnerships

Pros:

- Very easy to set up and run.
- No paperwork involved in setting up the business structure, though drafting a partnership agreement is a wise idea.
- Management system is flexible.
- Business funds and personal funds can be combined.
- No special bookkeeping is required.
- All business profits and losses are treated as personal income, so each person only needs to file one tax return.

Cons:

- No limited liability means you are liable for business debts and lawsuits.
- You can't sell stock, so it may be difficult to raise money for your business.
- There are no tax deductions available for employee benefits.
- It is difficult to pass on your business, since it doesn't technically exist apart from you.

Limited Liability Companies

Pros:

- Personal liability is limited, meaning in most cases you won't be held liable for claims against your business.
- The management system is flexible.
- There is comparatively less paperwork and formalities than with corporations.
- All business profits and losses are treated as personal income, so each person only needs to file one tax return.
- The business can be taxed like a corporation if you choose, so you can save by paying the corporate tax while keeping the informal structure of an LLC.
- No special bookkeeping is required.
- It's better for people with employees because expenses for employee benefits are tax-deductible.
- Customers may trust your business more with the LLC after your name.
- There is flexible profit allocation.

Cons:

- More complicated to set up than a sole proprietorship or general partnership.
- Requires paying a filing fee and perhaps annual fees.
- Tax paperwork is slightly more complicated since you need to file a Form 1065 along with your tax return.
- You can't sell stock, so it may be difficult to raise money for your business.
- Corporate records are more complicated than with a sole proprietorship or general partnership.

Corporation

Pros:

- Personal liability is limited, meaning in most cases you won't be held liable for claims against your business.
- Forming a corporation shows you're serious about your business.
- Customers may trust your business more because of the "Inc." or "Ltd." after your name.
- You can sell stock, so it is easier to attract investors, including foreign investors.
- Expenses for employee benefits are tax-deductible.
- Corporate income tax on money kept in the business may save you money.

- It is relatively easy to pass on or sell a corporation since it is a separate entity.

Cons:

- Can be expensive and complicated to form.
- The structure of your business is mandated by law, including having regular meetings, board members, etc.
- Bookkeeping and other formalities are more complicated.
- Two tax returns must be filed: one for the corporation and one for the individual.
- If you sell stock widely, you may be subject to securities laws.
- Less flexible in terms of dividing profits.
- Double taxation can be a problem when selling assets of the business.

Chapter Six: Top Five Reasons You Might Want to Change Business Structures

1. Limited liability: The biggest reason to change from a sole proprietorship or a partnership to a limited liability company or corporation is to shield your personal property from liability should the business be sued or if the business goes into debt. Gaining limited liability is the most popular reason to change legal structure. You might decide you need liability protection when you start working at your business full-time, when you hire employees, when you open a storefront, or because you work in a high-risk business or plan to take on a lot of debt.

2. Stock: If you want the ability to sell stock to raise money for your business, you have to incorporate. Many business owners decide they want to incorporate for the purposes of selling stock when they've been around for a few years and need a boost of capital to take them to the next level.

3. Increase credibility with customers: Customers tend to trust companies that look like they are in it for the long haul. Even if you're running a business out of your house, having LLC or Inc. after your name lets customers know you're a little more serious and can be trusted more than if you were a sole proprietorship without such additions to your name. It may seem like a silly reason to make a change, but it really does make a difference in the minds of your potential customers.

4. Tax savings: In the case of a corporation, you could see significant tax savings by being able to leave money in the business and having it taxed at the corporate tax rate instead of at your personal income tax rate. Check with your accountant for more information.

5. Get more clients: If you work in the service industry and are seeking clients as a sole proprietorship, some companies might be wary of working with you unless you are incorporated or have formed an LLC. That's because the IRS might decide at some point in the future to classify you as an employee of their company instead of an independent contractor, in which case the company would owe back taxes. This is not a concern for many companies, which include an independent contractor clause in their contracts, but if you find yourself in a situation where people don't want to hire you because of your business structure, it can certainly be worth your while to change it.

Chapter Seven: Changing to an LLC

In some states, registering as a limited liability company after being a sole proprietorship or a partnership is as simple as filling out the articles of organization as if you had never had a different business structure.

In other states there is a different form, called a certificate of conversion, that is used when a partnership is being converted to an LLC. For sole proprietors and those in states without such a form, the same process is used to start an LLC as described above.

Another step that may be involved in converting a partnership to an LLC is a formal dissolution of the old partnership. This can be done through a notice in the newspaper or filing a certificate of termination, depending on the type of partnership and the rules in your state. Check with your state's Secretary of State's office for more information.

Taxes

If you're planning to change your business from a sole proprietorship or partnership to a limited liability company, the government does not view that as a sale of assets, merely as a change in business structure, so there is no tax penalty for making a change.

Also, the tax forms you will use as an LLC are exactly the same: the 1040 with Schedule C for a one-person LLC and Schedule K1 for partnerships.

Making the Change

When you convert your business from a sole proprietorship or partnership to an LLC, remember to get your business name changed on all corporate accounts, licenses, permits and policies. You'll need to change your name on your federal Employer Identification Number, on your state and local tax certificates, and on any other state and city permits.

Remember also to change your name on your business cards, letterhead, signs and other promotional material you might use. It's important to use your LLC's name because that's a sign that you take your business seriously and the courts or the IRS are less likely to assume that you're really a sole proprietorship or partnership that should not have limited liability.

Though an LLC is not taxed any differently from the way a sole proprietorship or general partnership is, you might still want to wait to make the change until the end of a tax year so there is no confusion on any legal or tax documents you might receive.

Dealing with Debt

If you have any creditors who are owed money when you change your business to an LLC, make sure you notify them and ask them to start sending bills to your new business entity.

Under no circumstances should changing your business structure be used as a way to try to avoid old debts, but if you find that you are in a dispute with a creditor about debts, consult with a lawyer who specializes in small business issues before making any changes to your legal structure.

Bulk Sales Rules

If your business is in retail, wholesale or manufacturing, or you own a restaurant, you could be subject to what are known as bulk sales rules. These rules call for publication of announcements in the local newspaper about your intention to change business forms and a waiting period during which creditors can submit claims of unpaid debts.

These rules are designed to keep business from changing forms, which will give them less personal liability, as a way to avoid paying debts.

Checklist for Forming an LLC

1. Decide where to form your LLC. In most cases, it makes the most sense to file in your home state, but other states such as Nevada or Delaware may be more attractive.
2. Determine the paperwork and fees necessary for your chosen state.
3. Pick a name. Make sure you have a couple of alternatives in mind in case your first name is already being used by someone in your area or is a big name on the Internet. You might also consider a name for which the domain name is still available so your company and your Web site can have the same name. Remember that Limited Liability Company, LLC, L.L.C. or Ltd. Liability Co. must be part of your official name.
4. Decide if you want to be member-managed or manager-managed. If you go for a manager, you'll need to pick someone (or multiple people) to fill this role.
5. Pick a registered agent. No matter the size of your LLC, a registered agent with a valid physical address is required. The agent can be a member of the LLC or part of an incorporation

services company if you're filing in a state other than your home state. Your lawyer can also serve as your registered agent.

6. Fill out paperwork and pay filing fee.

7. Decide how you want to allocate profits, how voting will work among members, when you will hold meetings if you decide to and other issues, and work up a formal agreement among all members of the LLC. Even if you are a single person forming an LLC, make some kind of document like this to show that you are serious about forming an LLC. 8. Register for your domain name and build your Website. Wait until you are sure that your business name has been approved before doing this.

9. Order business cards, stationery and other business goods with your new name on them.

10. Notify all clients, vendors, and others on your mailing list of your new business name. Ask for bills to be sent in the new business name. Also make sure you get your business name changed on any licenses, permits or legal forms, the lease to your office space, your Employer Identification Number and any other documents that identify your business.

Once you're in business, don't forget that you need to file a Form 1065 in addition to your personal tax return so that the IRS knows what each member of your LLC's profits or losses were that year. If you are a one-person LLC, you can skip this step.

Case Study: Changing to an LLC Monica had worked as a sole proprietor while working full time and doing freelance wedding photography on the side. Now that she's making enough money to quit her day job, she's started thinking about restructuring her business.

She's always been a little bit worried about liability issues, since she has to drive to different locations to do her work, and you never know what could set off a bride and make her threaten, if not file, a lawsuit if her pictures don't come out perfect.

Forming a limited liability company is a no-brainer for Monica. She likes the idea of being able to limit her liability without making her bookkeeping any more complicated, and this business form will be easier for her should she ever decide to hire an assistant so she can expand the business.

Many business owners like Monica decide to change from a sole proprietorship or partnership to an LLC as soon as they stop moonlighting and start doing their new business work full-time. It costs a little more money to have an LLC, but it is worth it to most people to be able to limit their liability without having to move up in complexity as they would if they formed a standard corporation.

For a lot of people, an LLC is the best of both worlds: the easy tax processes of a sole proprietorship with the legal protection of a corporation.

Chapter Eight: Changing to a Corporation

Converting your business to a corporation after having been a sole proprietorship or partnership (or even an LLC, though that is rare) is a little more complicated than going to an LLC from the other business forms.

That's because your business is finally becoming an entity separate from you when it becomes a corporation, and that changes your entire tax structure as well as the way you are required to run your business.

So the first thing to do when you're considering changing to a corporation is to really spend some time thinking about it. What are the benefits to your business if you incorporate?

Are you making too much money and you want the option of some of it being taxed at a corporate rate? (Remember that limited liability companies can be treated like corporations for tax purposes without making such a radical change in your business structure.)

Do you want to sell stock or provide deductible fringe benefits to your employees? In that case, you have no choice but to incorporate.

Getting Help

As mentioned earlier, it is possible to incorporate your business yourself, but it can be difficult for people without legal backgrounds to do on their own. You will want to seek advice from a lawyer and probably an accountant both in deciding whether to incorporate and for help while you are going through the process.

Seek out professionals who work with small businesses regularly and have experience with the issues you are likely to encounter as you incorporate. There are a lot of legal hoops to jump through in order to get your corporation set up, and missing any of them could void your corporation. You certainly don't want to go through all the work of setting up a corporation and not take the time to do it right.

Professional help is a business expense, but it is certainly worth it to make sure that you do everything the right way.

Making the Switch

As with changing to an LLC, there should not be tax consequences to changing your form of business from a sole proprietorship or partnership into a corporation. You're not selling any business assets, just converting the legal form of your business. But it's always a good idea to check with your accountant or tax advisor before making a switch to make sure there won't be any unintended tax consequences at the time of conversion or after.

Because there is no legal paperwork involved in forming either of these business structures, you can just go about forming a corporation in the same way that anyone starting a new business from scratch would.

As with forming an LLC from an existing company, it makes good sense to try to make the switch at the end of a tax year (usually the end of a calendar year) so that all your bookkeeping for one year will be in one system and you can start the new year with your new corporate bookkeeping system.

Of course it's not as simple as it sounds. There are many steps you must take to convert your business to a corporation, and it can be quite time-consuming.

Checklist for Forming a Corporation

1. Decide where you would like to incorporate. Most businesses start in their home state, but if you're planning to go nationwide and don't mind a somewhat unusual business setup, incorporating in Delaware or Nevada could save you a lot of money.
2. Decide on a business name. Since you're converting an existing business, it's probably a good idea to try to name your new business something similar to that of your old business. Remember that you have to include Company, Incorporated, Limited, or an abbreviation of one of these words, in your business title.
3. Check to make sure your chosen business name is not already in use by another business and does not violate copyright or trademarks. Always have a couple of fallback names in mind in case your first choice is taken.
4. Register your name as soon as you know it is available.
5. Choose a board of directors for your corporation.
6. Write, sign and file the articles of incorporation, along with the filing fee.
7. Write your corporation's bylaws, and a buyout agreement, if necessary. This is a document that lays out what happens if a shareholder wants to be bought out of the company and how a buyout occurs.

8. Open a corporate bank account. If you already have a separate account for your old business, wait until the paperwork goes through and then change your business name on your existing account.
9. Start a minute book to keep track of the minutes of your board meetings, and have your first board of directors meeting, at which the board approves the sale of stock.
10. Issue stock certificates.
11. Ensure that you have all the necessary business licenses and that your permits, tax records, bills and other documents now have your corporation name on them.
12. Register a new domain name, if necessary. You can also register a new domain name and simply have it redirect browsers to your old site, if you don't want to deal with redesigning your Web site at this time (just make sure the name of the business is changed throughout).
13. Order new business cards, stationery and other business papers after your incorporation has gone through and you know your new name is final.
14. Make sure you follow up on all the rules of corporate life, including holding regular board and shareholder meetings, keeping shareholders apprised of goings on in the business, and filing the appropriate reports and tax information with the federal government. An accountant and/or a lawyer can be a big help in keeping track of all the necessary legal hurdles.

Case Study: Changing to a Corporation

Sandy and John started their publishing business as a partnership. Back then they were self-publishing cookbooks and other small books of regional interest. They weren't worried about debt because they had books printed on demand and didn't hold much inventory.

Now the business is expanding into publishing other people's books, which is a whole different world in terms of possible legal trouble. They could get sued if one of their authors is accused of plagiarism, and there is always more potential for trouble when you're dealing with a bunch of individual contracts.

Sandy and John think it's time to form a corporation. They need limited liability, but they also need a new Web site, better printers, and maybe even a warehouse so they can start doing their own order fulfillment. They need to raise capital and think that selling stock would be the best way to do it.

Like Sandy and John, if you're about to take on new business responsibilities and new debt, a legal form that gives you limited liability is the best option for your business. If you want to sell stock or are planning employee benefits, a corporation is the only way to go.

Chapter Nine: Using a Business Plan to Decide on a Legal Structure

Most business experts recommend writing a business plan before starting your own business. However, many people do not do it. A business plan is a must if you are trying to get funding for your business, because it lays out your plans for the business and forces you to think about what you are going to have to do to succeed.

That's why writing a business plan can be such a powerful thing even for businesses that are not looking for outside investors or trying to get loans. Having a solid business plan focuses you on where you are and where you want to go.

What does this have to do with your business' legal structure? If you know from the beginning that your business has the potential to become much bigger than it is currently, that might help you decide to incorporate or form an LLC instead of remaining a sole proprietorship.

If you know as part of your business plan that you'd like to offer your employees or investors stock, then you know you have to incorporate.

Writing a business plan gives you a great road map to follow and actually allows you to do some planning you might not otherwise have done.

If you're not seeking funding for your business, your business plan does not have to be as formal as that of someone looking for investors, but that doesn't mean you should blow it off. Having a good business plan is a great tool for you and your partners that allows you to talk about your goals for the business and to have something to go back to months and years later to see if you are on track.

A business plan is largely about money: how much you're starting with, how much you need to spend to get the business going, how much you expect to bring in each month, and how much you'll need to pay out in salaries, rent and other expenses.

You need to have a good grasp on exactly what products or services your business will be providing, who your customers and competitors are, how you will market your products, and how you intend to make a profit.

It's really important for you to have income and expense projections so you can estimate when you will break even and start making a profit. For example, you might have thought you could

make the business work on your own before doing this analysis, but now you know that you need investors and should think about incorporating instead of being a sole proprietor.

This information will also give you a good idea of how much debt you'll need to take on and how long you anticipate working without making a profit. If the numbers are scary, you might want to change that partnership you were planning into a limited liability company so you and your partners don't face as much personal risk if your business fails.

Your business plan should also include a discussion of your goals for the company. If you are thinking you'll expand into other areas that might be riskier than your current niche, starting out as an LLC or corporation might make sense. Sure, you may have to grow into the business model you have chosen, but you'll be glad that you're not trying to change business forms in the middle of dealing with the day-to-day operations of your by-now very successful business.

If you've already started a business as a sole proprietorship or a general partnership and you haven't written a business plan for your business (or haven't looked at it in a long time), now's the perfect time to re-evaluate your goals for the business and whether you should change legal forms.

It's better to take some time to think about making the change when you're not busy and worried about potential lawsuits ruining both your business and your personal assets, or fretting about the amount of taxes you are going to have to pay because you're making too much money for the current legal structure of your business.

Reading this book is a great first step, but you should also take some time to think about your goals for your business and where you think the business is going. Ask yourself some questions, such as:

- Where do you see your business in five years? What kinds of products and services will you be offering? What will your profits be like?
- How about in ten years?
- Do you ever envision your company "going public" or selling stock in your enterprise?
- How many employees do you think you might have in the future?
- Can you envision someone ever suing you for something that happened in your business or related to your business? (Don't think realism here. People sue businesses for crazy things.)
- Are you worried about your personal liability should something happen to your business?
- Do you want to be able to pass on your business to your children or sell it when you retire?

The answers to each of these questions will help you decide if you want to stay in a sole proprietorship or partnership or change to an LLC or corporation.

Case Study: Writing a Business Plan Richard has always loved tinkering with cars, and it is his dream to open an auto repair shop. He knows as soon as he starts looking at different legal models for his business that the sole proprietorship and partnership are out because he needs limited legal liability.

To help him decide if an LLC or a corporation is right for him, Richard decides to write a business plan. He thinks he can get a small business loan for the start-up costs of his business and expects to be able to turn a profit within the first year.

The shop will be small, so he thinks he will only hire part-time help so he won't have to worry about paying for benefits.

After writing his business plan and thinking about his goals for the business, Richard decides to form his business as an LLC. He likes the informality of the structure and the fact that he is personally protected from lawsuits or business debt beyond what he has put into the business. And when his profits get larger and he has money to keep in the business, he can opt to be taxed like a corporation if he wants without the paperwork hassles of incorporating.

A Final Word

Having a sole proprietorship or partnership is not necessarily bad. There is no one legal structure for a business that is right for all people, all businesses and all situations. That is why the government allows different options.

Your business might be such that you'll never have to worry about personal liability or having so much money in your business that you are paying way too much in taxes. In that case a sole proprietorship is a fine option and you may never have to change.

But if you're worried about personal liability, tax issues, selling stock, offering incentives or benefits to employees, or just looking more credible to your customers, changing to a limited liability company or a corporation is a great choice.

Thank You,
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