Starting Your Business:

COSTS, STRUCTURES, AND PITFALLS

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Every new business owner faces two crucial questions: What municipal, state, and federal costs are involved in starting a business? And how should the business be structured?

The answer to the second question contains the answer to the first, because business structure determines start-up costs. As the owner of a business that recently celebrated its tenth birthday, I've made my share of mistakes, and some of my most fundamental errors have resulted from not choosing the best structure for my business. While I can't tell you which structure is best for your business—you'll need to make that decision with the advice of trusted financial and legal advisors—I hope the fundamental considerations related in this article will help aspiring business owners avoid my mistakes and develop some idea of the costs and paperwork involved in starting a business.

Please note that I write from the perspective of a small business owner in California. My experiences can help you know what to expect when starting a business, but your local requirements may vary, so be certain to consult qualified legal and/or financial advisors before starting your business.

Business Structures

There are four types of legal structures for businesses: sole proprietorship, partnership, limited liability company, and corporation. Each structure requires you to pay fees to the Internal Revenue Service (IRS) and to your city, county, and/or state.

Sole Proprietorship

A sole proprietor is a person who operates his or her own business, usually from a home office. I originally chose this structure because it requires the least paperwork.

Sole proprietors pay taxes on their business income through IRS Forms C and SE, which are included with the Form 1040 packet. If you run your business out of your home, you can deduct the costs of your home office from your income taxes. The county where your business is located may require you to pay annual personal property taxes based on the value of the equipment you use to run your business.

You must also set up your own business bank checking account. Sole proprietors are personally liable for any debts incurred by the business, so if your business fails, you will pay debts from your personal account. The good news with sole proprietor bank accounts is that you can transfer monies from your business to your personal account without writing a check.

You'll need to check with the business department of your local government to find out the requirements for owning a business. For example, I had to purchase a business license to do business in Roseville, Placer County, California. And because my business name (Butow Communications Group) suggests that several people run the organization, Placer County required me to run a fictitious name statement in a general-circulation county newspaper. If your county requires you to file a fictitious name statement, you'll need to download the form from the county's Web site, complete it, and send it back to the county with the appropriate fee. You must also publish the statement within a certain period of time after you file your statement with the county. Your county Web site should provide a list of general-circulation newspapers in which you can publish your statement; if not, contact your county clerk office. Prices for publishing statements vary from paper to paper, so it's a good idea to shop around.

Your city or county may have other specific requirements for sole proprietors. For example, a home business license in your area may forbid you to put a business sign on your front lawn or have customers come to your home. If you rent your apartment or home, your landlord may have to sign a city and/or county form giving you permission to run a business.

Partnership

If you're going into business with one or more people, you may want to form a partnership. When forming a partnership, consult a lawyer to draw up a partnership agreement that spells out what each partner will do. A carefully drawn partnership agreement will be invaluable in setting forth each partner's responsibilities and protecting you in the event of disagreements.

Although you can purchase many legal forms in book form through publishers such as Nolo Press, you should also consider low-cost alternatives such as prepaid legal plans. Whether you decide to use a form or a plan, it may be worthwhile to run your agreement past a lawyer.

If you're forming a partnership, you'll need to decide whether you want a general or a limited partnership. For tax purposes, general partnerships are treated much like sole proprietorships: The profits and losses are passed to the partners, who report the income on their individual tax returns. All partners are liable for any company debts.

Limited partnerships comprise both general partners and limited partners. The general partners assume responsibility for running the business, while the limited partners are investors who share some risk with the general partners. In California, limited partnerships require at least one general partner and one limited partner. As with general partnerships and sole proprietorships, the profits and losses of limited partnerships are passed to the partners, who report the income on their individual tax returns.

Your state may also recognize limited liability partnerships (LLPs), which provide limited liability protection for all general partners. LLPs are most commonly used in professional organizations. Some states limit LLP designations to specific business types; for example, in California, LLP status applies only to partnerships that practice law, architecture, or public accountancy.

Partnerships must file with the state's Secretary of State, and forms and fees vary. Contact your state's Secretary of State Web site to learn more.

Limited Liability Company

The limited liability company (LLC) provides some liability protection to its members—that is, the owners of the company—but all company profits and losses pass to its individual members, who report those profits and losses on their personal tax forms.

LLCs can have an unlimited number of members, but your state may require at least two members to form an LLC. In 2000, California began accepting single-member LLCs. As with partnerships and corporations, California requires companies to complete forms and submit fees to establish the LLC. California also requires LLCs to pay an $800 minimum tax. You must fill out the appropriate state LLC tax form and submit it annually.

Corporations

The corporation provides the most protection from liability, but also requires the most paperwork and fees. Corporations must file paperwork and fee payments with the IRS as well as with the state.

Corporations are entities separate from their owners, who have stock in the corporation but are not legally liable for the acts of the corporation. If the corporation goes out of business, the owners are not personally liable for any debts incurred by the corporation. Corporations are required to have written bylaws and articles of incorporation. You must keep written minutes of corporation meetings, including the required annual meeting—even if you're the only person at the meeting!

There are two types of corporations: the C corporation and the S corporation. ("C" stands for corporation; "S" stands for the Subchapter S section of the IRS tax code that allows corporations to be taxed like partnerships.) Both types require one or more owners to own stock in the corporation; the amount of and payment for the shares can vary. Talk with your financial advisor about how to set up shares in your corporation.

The IRS requires S corporations to have seventy-five or fewer shareholders, and is often the best structure for small companies. S corporations pay no taxes on any profits since they're all passed to the shareholders, who report all profits and losses on their personal tax returns. However, S corporations may have to pay state income taxes. In California, S corporations pay a state tax of 1.5 percent on the company's taxable income.

C corporations, however, are prone to "double taxation." Unlike S corporations, C corporations do not pass profits to the shareholders. C corporations pay taxes on those profits, albeit at a lower rate than the personal tax rate—a 15 percent federal tax on the first $50,000 in profits, with graduated rates as high as 38 percent. Shareholders also pay taxes on their dividends. That 15 percent tax on the first $50,000 in profits is one good reason why business owners choose C corporation status over S corporation. C corporations can also deduct more benefits from their tax returns than S corporations.

California requires C and S corporations to provide a written statement of information form to the Secretary of State (with a small fee) every year. During the first year of the corporation's operation, the corporation pays only a percentage of its gross fees in taxes. Starting with the second year, the corporation must pay a minimum tax of $800 per year.

Your corporation must also pay its employees a salary; if you are the only employee, you must set a competitive salary for yourself, document the salary in your corporate bylaws, and then pay yourself that salary regularly. You can also take money from your corporation in the form of distributions without having to pay payroll taxes. Taxes on distributions are paid through your own personal income taxes; however, the IRS pays very close attention to the ratio of salary to distributions, and if you pay less in salary than you do in distributions, you run the risk of an audit. If you must pay distributions, pay them sparingly and keep the amounts small.

Choosing Your Status

Sole proprietorships and partnerships are taxed in much the same way—profits and losses are passed to the owner(s), and the income is reported on each owner's tax return. So how do you select the right business status?

Obviously, if your business has more than one owner, it isn't eligible for sole proprietorship, and must form a partnership, LLC, or corporation. You must look at your liabilities and your prospects for future growth, especially if you want to hire employees. If you want your company's liabilities kept separate from your personal accounts, corporation status provides the most protection. Before you choose your business status, talk with a financial advisor whom you trust. Good advisors will advise you on the basis of the needs and outlook for your business.

Some Advice

My business has had the status of sole proprietorship, LLC, and S corporation at different times. The following advice is based on my decisions and (sometimes painful) experiences.

Check with your city and county first. Many of the city and county requirements for a sole proprietor also apply to partnerships, LLCs, and corporations. However, the size and type of your business could determine which requirements apply to your business and how much money you must pay. Contact your city and county Web sites first to see what they require.

Find a qualified financial advisor who will give you sound advice on the proper structure for your business. Seek recommendations about hiring a financial advisor from your family, friends, and trusted colleagues. I made the mistake of working with someone I didn't know, an Enrolled Agent (a former IRS agent), who told me to become a corporation to save money. This was not the right choice for Butow Communications Group. Moving to a corporate structure caused me financial and personal stress; my business was not growing the way I had expected it to, and since I was the sole owner with few liabilities I decided to dissolve my corporation and go back to being a sole proprietor. I dropped the Enrolled Agent and hired my parents' certified public accountant. I've been much happier since.

If you're thinking of starting an LLC or corporation, read Nolo Press books. A well-known publisher of legal books, Nolo Press sells books describing the procedures for creating LLCs and corporations in various states. If you're considering converting your business to an LLC or corporation, purchase one of these books and read it carefully. They are not replacements for information from a financial representative or lawyer, but they do prepare you to talk knowledgeably with a professional.

Buy accounting software. If you have a sole proprietorship, accounting software such as *Quicken Home and Business* will suffice. But partnerships, LLCs, and corporations are required to have an actual accounting system. Many CPAs use *QuickBooks* and can help you set up your accounts so you can manage your business monies yourself. Note also that *QuickBooks* and other accounting software packages are supported with new data (such as payroll tax calculations) for a set number of years; afterward, you have to buy a new version of the software.

Have your financial advisor do your taxes. My CPA caught an error in my 2001 taxes, which I did myself. That error cost me dearly—but not as dearly as it would have if the IRS had caught it. Since then, I have had my CPA do my taxes. The savings in time and stress more than justify the preparation costs.

Determine if you need an Employment Identification Number (EIN). If you are a sole proprietor, you don't need to have an EIN from the IRS—you can use your social security number. However, if your company is established as an LLC, corporation, or partnership, you should apply for an EIN via the IRS Web site.

Pay attention to deadlines. The state and IRS have filing deadlines, such as those for payroll and income taxes, that you must meet to avoid penalties. Find out the penalties for missing a deadline, or if you can still apply for a change in status even if you've missed the deadline. For example, you can apply to the IRS for S corporation status after the March 15 deadline, but you must submit a written explanation of why the application is late. The IRS will weigh your explanation when making its decision.

Don't believe the out-of-state corporation hype. Here in California I've heard radio commercials and seen Internet ads touting incorporation in Nevada as a way to avoid California corporate taxes. Unfortunately, if your business is based in California, you pay corporate taxes no matter where you have incorporated. If you want lower corporate taxes by incorporating in Nevada, you have to move to Nevada.

Determine if you must pay workers' compensation fees and employment taxes. Workers' compensation has been a big issue in California. The good news is that if you are a sole proprietor—even the sole owner of a corporation—you do not have to pay workers' compensation in California. However, some clients may require your business to have workers' compensation in place even if you're a one-person company. There is also confusion about how to treat independent contractors and whether the IRS considers them employees. Consult the IRS Web site and your financial advisor for more information.

Don't start your LLC or corporation until after the first of the year. If you don't wait, you will have to pay the $800 LLC fee or corporate taxes for the previous year, even if your LLC or corporation was in business only for a few days at the end of December. I found this out the hard way. When I changed my business status from an LLC to a corporation, I received a bill for more than $1,000 from the state for year 2000 LLC fees—even though I had started my LLC on December 27, 2000.

End your LLC or corporation before the first of the new year. By the same token, if you don't do this, you will have to pay the LLC fee or corporation taxes for that new year.

Preparing Yourself

Visit the Web sites for your city, county, and state for more specific information about business fee and form requirements. Also visit the IRS site for more information about tax requirements and helpful information for starting a business. The more prepared you are, the more you can focus on growing your business.

References

California Secretary of State Web site, ***www.ss.ca.gov***

IRS Web site, ***www.irs.gov***

Nolo Press, ***www.nolo.com***

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