

# The Small Business START-UP GUIDE

**Practical Advice on  
Starting and Operating a  
Small Business**

**Robert Sullivan**

Bruce bought a fast food franchise because the opportunity looked too good to pass up. It might have been, but Bruce knew nothing about the food or restaurant business, and as far as I knew, didn't even like fast food! Care to guess how successful he was? Or how long it lasted? Care to guess what happened even though "all the details are taken care of for you?"

## CHECKLIST #2: CHOOSING A BUSINESS

- ☐ Is this the kind of work I really enjoy?  
Look to your current interests. Many successful small businesses grow out of hobbies because a hobby is chosen for all the right reasons ... you enjoy the task, the challenge, the time spent.
- ☐ Do I have the required technical expertise?  
Don't get involved in a business if you know little or nothing about it. The story related above is a true one ... and one of many like it. When you have the necessary technical expertise, you can ask the right questions, make good business decisions and assess other "expert" opinions.
- ☐ Can I make enough money in this business?  
First, your financial goals should be realistic. Then look around at similar businesses to see how they are doing. Talk to the owners. Most will give you enough information for you to decide if it's right for you financially. This will

help you to pick a business that can satisfy your financial goals.

- ☐ Can I get the help I will need?

If your business is not going to be a one-person operation, you need to find out if the right kind of help is available in your immediate area. Are there similar businesses in the area? Also check with local employment agencies.

- ☐ Do I understand the market?

Will you be able to find customers? Do you have the knowledge required to set prices appropriately? Will you be able to direct a marketing program? (You might not do this yourself, but you may have to manage the effort).

## CHOOSING THE BUSINESS LEGAL STRUCTURE

Okay, you've chosen your business. What next? No doubt, one of the most asked questions by the prospective business owner is "Should I incorporate?" To answer this question, we need to examine what the options are and their respective advantages and disadvantages.

Actually, you have three basic structures from which to choose:

1. Sole proprietorship
2. Partnership (limited or general)
3. Corporation

### TRUISM 7

There is no "best choice" for a business structure.

The legal structure you choose depends on a number of things, including your type of business, individual situation, goals for the business, and a number of other personal and financial factors. Before deciding what's best for you, discuss your plans with your accountant and attorney. Make sure you are prepared to describe your business plans in some detail. It will be money and time well spent. Making the right choice can help you avoid a mistake that can cost you big in terms of possible future liability (See Chapter 6, Get Professional Advice).

Before you have any discussions with your professional advisors, it is useful to understand the basics of the various legal structures available to you ... sole proprietorship, partnership, and various forms of corporations.

### SOLE PROPRIETORSHIP

This is the most popular form of small business and, as the name implies, ownership is totally vested with one person. It is the easiest to establish since no legal formalities are necessary. The only business requirement may be a license from your local jurisdiction to allow you to conduct the type of business you are planning. For example, you may need a license to sell food to the public.

#### Sole Proprietorship Advantages:

1. Easy and quick and usually the least expensive to establish.
2. You have total ownership and control of the business.
3. All the profits of the business belong to you, the owner.

4. No additional Federal taxation on business profits (No double taxation).
5. No periodic business reporting to the IRS or other government agency is required.
6. Income tax filing is simply part of your annual personal tax return (Schedule C).

#### Sole Proprietorship Disadvantages:

1. The owner is personally liable for all business debts and the liability is not limited to the value of the business. You are personally liable for any and all business debt you incur.
2. It is generally more difficult to borrow money or obtain outside investment than with other types of legal structures.
3. If the owner is incapacitated for any reason, the business is likely to fail.
4. All management responsibility is with the owner which can be a heavy burden.
5. You must pay self-employment tax on the business net income.

### IMPORTANT NOTE

A "home business" is frequently a sole proprietorship and offers a number of unique advantages. However, just because you are conducting business from your home does not exempt you from possible legal or other liabilities. See Appendix III for a listing of the advantages of a home-based business.

## PARTNERSHIP

This type of business is just what the name implies: Business ownership is divided between two (or more) partners. The general partnership is the most common and is formed to conduct a business with two or more partners being fully involved in the operation of the business. All the partners share both profits and liabilities. A limited partnership, as the name implies, provides for limited liability of the partners. (This liability can be no greater than the partner's investment in the partnership). In a limited partnership there must be a least one general partner who remains liable for all the debts of the partnership.

Forming a partnership is complex and legal advice is very important. The kind of partnership and the type of partner you will be determines your potential personal liability.

### Partnership Advantages:

1. Synergy as a result of pooling partners' different areas of expertise.
2. The partnership does not pay Federal income taxes. An informational tax return (IRS Form 1065) must be filed which shows the pass-through of income/loss to each partner.
3. Liability may be spread among the partners.
4. Investment can come from the partners in the form of a loan which creates interest income for the partners and a business deduction for the partnership.

### Partnership Disadvantages:

1. Formation and subsequent changes in structure are complex.
2. Problems with partner(s) as the result of misunderstandings, different goals, etc., can weaken or destroy the partnership.
3. Limited partners are liable for debt if they are active managers in the business. General partners have unlimited liability. You may also be liable for the commitments of your partners.

## CORPORATION

There are three major types of corporations, the C-corporation ("regular corporation"), the S-corporation (or "S-Corp"), and the Limited Liability Corporation (or "LLC"). All of these forms of the corporation are complex legal entities. Their detailed structure may vary from state to state (incorporating a business in a given state allows you to conduct business only in that state). It is essential for you to obtain legal advice if you are thinking about forming a corporation. (See Chapters 6 and 10). Since each state has its own set of corporation laws, you should contact the appropriate state office in your state (usually the office of the Secretary of State) for additional material and procedures. A listing of these offices for all 50 states is included at the end of this chapter. Most offices can provide a guide for new businesses to follow for incorporation and doing business in their state. Call or write for a copy.



Most people immediately think of incorporating in order to minimize their personal liability. Indeed, the liability of stockholders (owners) in a corporation is limited under certain and complex conditions. Today, with the Tax Reform Act of 1986 and other legislation, there are really few good tax reasons to incorporate (with the exception of dividing corporate profits as noted below). The best reason for incorporating is, in fact, the limited liability. However, there is no such thing as total insulation from liability resulting from doing business as a corporation.

Record keeping and tax matters with a corporation are difficult and time-consuming tasks usually requiring the services of an accountant. You need to keep this in mind when considering operating costs for your business.

Avoid the "do it yourself" incorporation guides. Incorporating is a complex process and you should not take on the task yourself. You cannot afford any mistakes at this point in your new business, so if you decide incorporation is for you, do it right and spend the money required to have it done professionally. Legal fees for setting up a corporation can run between \$350 and \$1,500 (assuming it is relatively straightforward). See Chapter 6.

## REGULAR CORPORATION

The corporation is a taxable entity and, as such, pays taxes. This results in the "double taxation" you may have heard about. The corporation pays corporate taxes on its profits, and then, you the owner (shareholder), pay personal taxes on the dividends your corporation pays you. (The

dividends are not deductible by the corporation). This is one of the biggest disadvantages of a corporation.

On the other hand, incorporating your business usually makes it easier to establish credit with suppliers and borrow from banks. If you expect to use outside investors for business capital, a corporation is a must.

### Regular Corporation Advantages:

1. Shareholders (the owners) enjoy personal limited liability.
2. It is generally easier to obtain business capital than with other legal structures.
3. Profits may be divided among owners and the corporation in order to reduce taxes by taking advantage of lower tax rates.
4. The corporation does not dissolve upon the death of a stockholder (owner) or if ownership changes.
5. Favorable tax treatment for employee fringe benefits including medical, disability, and life insurance plans.
6. 70% of any dividends received by the corporation from stock investments are deductible (unless you purchased the stock with borrowed money).

### Regular Corporation Disadvantages:

1. More expensive and complex to set up than other legal structures.

2. Completing tax returns usually requires the help of an accountant.
3. Double taxation on profits paid to owners (corporation pays corporate taxes on profits and owner pays personal taxes on dividends from the corporation).
4. Recurring annual corporate fees.
5. Tax rates are higher than individual rates for profits greater than approximately \$75,000.
6. 28% accumulated earnings tax on profits in excess of \$250,000.
7. Business losses are not deductible by the corporation.

### **S-CORPORATION**

The S-corporation offers the limited liability advantages of a corporation but does NOT pay Federal taxes. All the earnings and losses of an S-corporation are passed through to the shareholders. It is a popular form of incorporation in the startup years of a business but there are some subtle disadvantages that need to be taken into account as you grow. Again, because of the complexities involved, talk with your attorney and accountant. Also, subtle changes to the tax laws in 1996 made the S-corporation even more desirable.

#### **S-corporation Advantages:**

1. Owners enjoy personal limited liability as in a regular corporation.
2. No Federal income tax liability, and in most cases, no state income tax.

3. Profit/losses are passed to owners ... no double taxation.
4. The S-corporation does not dissolve if one of the owners dies or otherwise leaves (like a regular corporation).
5. Wholly owned subsidiaries are permitted.

#### **S-corporation Disadvantages:**

1. Legal assistance is required to set up.
2. Maximum of 75 shareholders.
3. Only one class of common stock is permitted (no preferred stock).

### **LIMITED LIABILITY CORPORATION (LLC)**

This type of corporation blends the tax advantages of a partnership and the limited liability advantages of a corporation. Owners of an LLC are referred to as "members." As you might expect, it also has some limitations but is definitely worth considering. Ask about the LLC when you contact your appropriate state office for incorporation information as suggested earlier in the chapter.

#### **LLC Advantages:**

1. Limited personal liability for the owners (like a corporation).
2. No Federal taxes (like a partnership).
3. No limit on the number of stockholders (unlike an S-corporation).
4. More than one class of stock is permitted (unlike an S-corporation).

### LLC Disadvantages:

1. Legal assistance is required to set up.
2. No "continuity of life" as in a regular corporation. The LLC dissolves if one of the owners dies or otherwise leaves. However, other formal agreements between the owners can overcome this.

### MAKING YOUR CHOICE

As already noted, it is difficult to give specific advice as to the choice of legal business structure since every situation will be unique. The advantages and disadvantages noted above should be assessed based on your particular situation. In any case, it is important to discuss your plans with advisors including both an attorney and an accountant prior to making your final decision. The various tax consequences for corporations and partnerships are complex and must be carefully considered for each specific situation.

When discussing your plans with your advisors, keep in mind the following points:

- The LLC is well worth looking into.
- Saving taxes is one of most important reasons to consider when selecting your structure. Keep in mind that there are generally few tax advantages with a corporation if your total taxable business income is more than \$75,000.
- Don't select the corporation structure based on possible tax advantages of profit-sharing plans since the Keogh, SEP, and IRA plans

available to a sole proprietorship are equally beneficial.

- If you consider a partnership, be certain to have a complete partnership agreement drawn up by your attorney. (See Chapter 4).
- Consider a S-corporation if you expect business losses for the first year or two of your business. These losses can be passed through to the owners as tax relief whereas they provide no current benefit in a regular corporation.

### OTHER REQUIREMENTS

There are a number of other items that must be addressed when starting your business regardless of its structure and type. Before conducting any business activity, review the following listing lest you get yourself into legal trouble or, at the very least, become liable for various fines. Once again, it is a good idea to review these items with your attorney and get help where required.

- Business licenses and permits.

Depending on your type of business, Federal, state, county, and local business licenses and/or permits may be required. It is impossible to list all the specific requirements by business or jurisdiction. You should first check on your state's requirements by contacting the appropriate state office or agency. (See the listing at end of this chapter). They may also be able to assist you with the local, and possibly the Federal requirements. Then check with your local city or county government offices (usually in the courthouse) for information



about local requirements. Don't overlook this, since heavy fines are usually associated with conducting a business without proper licenses and permits.

- Business name.

Give some careful thought to the name of your business. You should select more than one possibility since you may not be able to use your first choice. You cannot and should not use a name already in use. Most states will allow you to "reserve" your desired name for a short period of time in order to allow you to complete other required paperwork. The state office can tell you if your selected name is in use and suggest you pick another one, if necessary. You should also check with your local county clerk to see if the name you picked is being used locally. In any case, you do not want your business name confused with another for a variety of obvious reasons. Some states require you register for a "fictitious name" if the name of your business is something other than your own full legal name (e.g., "Robert Sullivan Consulting Services"). The cost to register varies but is generally between \$10 and \$100. Check with your local government for specific requirements.

- Tax payments.

You will be required to make periodic estimated Federal and sometimes state tax payments regardless of your business legal structure. The requirements vary and you should discuss the matter with your accountant. Don't be late in filing since penalties accrue.

- Various IRS reporting requirements.

There are a large number of IRS reporting requirements that you need to be aware of since penalties can be severe. These include such requirements as the filing of different types of Form 1099 for payments to individuals and reporting different kinds of income. It is very important for you to discuss what requirements must be met with your accountant.

The checklist on the following page taken from IRS publication #334 (Rev. Nov 91), will give you an idea of the Federal tax requirements for various business legal structures.

- Collection of sales tax.

If your business will be selling goods to end-user customers (the public), it is likely you will have to collect sales tax for the state and/or local government. Check with your local government offices on this one ... every state is different. You will probably have to apply for a sales tax identification number that will identify you to the local and state government as a seller of goods. The process is easy and usually no cost is involved. There can also be monthly reporting requirements.



You may be liable for	If you are:	Use Form	Due on or before
Income tax	Sole proprietor Individual (partner) or S corp shareholder Corporation	Schedule C (1040) 1040 1120 or 1120-A	Same day as 1040 15th day of 4th month after end of tax year Same but 3rd month
Self-employment tax	S corporation Sole proprietor, or individual who is a partner	1120S Schedule SE (1040)	Same but 3rd month Same day as 1040
Estimated tax	Sole proprietor, or individual who is a partner or S corp shareholder	1040-ES 1120-W	15th day of 4th, 6th, 9th mos of tax yr, and 15th day of 1st mo after end of tax yr 15th day of 4th, 6th, 9th, 12th mo of tax yr
Annual return of income	Corporation Partnership	1065	15th day of 4th mo after end of tax yr
Social security & Medicare taxes (FICA)	Sole proprietor, corporation, S corp, or partnership	941	4/30, 7/31, 10/31, and 1/31
Withholding of income tax	Sole proprietor, corporation, S corp, or partnership	8109 (for deposits) W-2 (to employee)	1/31
Providing info on social security and Medicare taxes (FICA) & the withholding of income tax	Sole proprietor, corporation, S corp, or partnership	W-2, W-3 (to SSA)	Last day of Feb
Federal unemployment (FUTA) tax	Sole proprietor, corporation, S corp, or partnership	940-EZ or 940 8109 (for deposits)	1/31
Info returns for payments to non employees & transactions with other persons	Sole proprietor, corporation, S corp, or partnership	Forms 1099: See IRS Pub #334, Chapter 37	4/30, 7/31, 10/31, 1/31 if liability >\$100 1/31 to recipient and IRS by 2/28
Excise taxes	Sole proprietor, corporation, S corp, or partnership	See IRS Pub #334, Chapter 36	See instructions on the forms

The following checklist of business legal requirements is excerpted from "Starting & Operating a Business in [state]" and reprinted here with permission from The Oasis Press® and M. D. Jenkins. It provides an excellent summary of those items that need to be considered when starting a business in a specific state. (The chapter numbers shown in parenthesis refer to chapters in this guidebook where additional information on that item may be found.) Some of the material below duplicates the requirements listed in the IRS publication checklist shown above.

### CHECKLIST #3:

#### NEW BUSINESS LEGAL REQUIREMENTS

- ☐ Obtain local business licenses.
- ☐ Check on local zoning ordinances, regulations, and other land use restrictions.
- ☐ Determine if your particular business requires a state license to operate (3).
- ☐ Determine if any Federal permit or license is required (3).
- ☐ Be prepared to make estimated income tax payments almost immediately after starting business or incorporating.
- ☐ Apply for a sales and use tax seller's permit if you will sell tangible personal property.
- ☐ File sales and use tax returns, if sales or use tax must be collected on your sales.
- ☐ File with the county clerk and "publish" a fictitious business name statement, if the business operates under a fictitious name, and

an affidavit of publication with the county clerk (in most states).

- ☐ Locate a good insurance agent or retain and meet with an insurance consultant regarding fire, accident, liability, theft, and other types of commercial insurance you need. Then obtain the necessary insurance coverage (11).
- ☐ If you purchase real estate, you must withhold up to 10% of the purchase price and remit it to the IRS if the seller is a foreign individual or foreign owned company, under the Foreign Investment in Real Property Tax Act. Otherwise, you should insist upon receiving an affidavit that the seller is not a non-resident alien, with his or her taxpayer identification number, unless you are certain that he or she is a U.S. citizen or resident.
- ☐ For a sole proprietorship, report any self-employment income on Schedule SE of Federal Form 1040, and report income or loss on Schedule C of Form 1040.
- ☐ A partnership files Form 1065, to report partnership income. Each partner reports their portion of the partnership's income on Schedule SE of Form 1040 and income and loss from the partnership on Schedule E of Form 1040.
- ☐ For a limited partnership, file a Certificate of Limited Partnership with the Secretary of State and copies in counties where the partnership will have places of business or real estate (in most states).
- ☐ For a corporation, file articles of incorporation, adopt bylaws, and observe the necessary corporate formalities. File Federal income tax

return Form 1120 (or 1120-S for an S-corp). If property is transferred to the corporation tax-free under IRS Section 351, report required information relating to the transfer on the corporation's income tax return for that year.

- ☐ For a corporation or a partnership, apply for a Federal Employer Identification Number on Form SS-4, even if the business has no employees.
- ☐ File annual tax information returns, Forms 1096 and 1099 series, for payments of \$600 or more for items such as rent, interest, and compensation for services, and send 1099's to the payees. File Form 1098 for mortgage interest of \$600 or more your business receives in a year from an individual. Also, report any cash payments or cash equivalents of more than \$10,000 that you receive to the IRS within 15 days. Such filing may have to be done on computer-readable magnetic media.
- ☐ If your business is a corporation, be sure to obtain an adequate supply of Federal tax deposit coupons in time to make your estimated tax payments.

After reading over the previous list, you'll have a better understanding of why it's important to talk with both your attorney and accountant. Remember, also, that there may be additions to this list for certain states. You should check with your own state (see listing below) for specific compliance requirements necessary for your type of business. Also refer to Chapter 11 for additional requirements if you are going to hire employees.