

Forms Of Business Organization

A business can be organized in one of several ways, and the form its owners choose will affect the company's and owners' legal liability and income tax treatment. Here are the most common options and their major defining characteristics.

Sole Proprietorship

The default option is to be a sole proprietor. With this option there are fewer forms to file than with other business organizations. The business is structured in such a manner that legal documents are not required to determine how profit-sharing from business operations will be allocated.

This structure is acceptable if you are the business's sole owner and you do not need to distinguish the business from yourself. Being a sole proprietor does not preclude you from using a business name that is different from your own name, however. In a sole proprietorship all profits, losses, assets and liabilities are the direct and sole responsibility of the owner. Also, the sole proprietor will pay self-employment tax on his or her income.

Sole proprietorships are not ideal for high-risk businesses because they put your personal assets at risk. If you are taking on significant amounts of debt to start your business, if you've gotten into trouble with personal debt in the past or if your business involves an activity for which you might potentially be sued, then you should choose a legal structure that will better protect your personal assets. Nolo, a company whose educational books make legal information accessible to the average person, gives several examples of risky businesses, including businesses that involve child care, animal care, manufacturing or selling edible goods, repairing items of value, and providing alcohol. These are just a few examples. There are many other activities that can make your business high risk.

If the risks in your line of work are not very high, a good business insurance policy can provide protection and peace of mind while allowing you to remain a sole proprietor. One of the biggest advantages of a sole proprietorship is the ease with which business decisions can be made.

LLC

An LLC is a limited liability company. This business structure protects the owner's personal assets from financial liability and provides some protection against personal liability. There are situations where an LLC owner can still be held personally responsible, such as if he intentionally does something fraudulent, reckless or illegal, or if she fails to adequately separate the activities of the LLC from her personal affairs.

This structure is established under state law, so the rules governing LLCs vary depending on where your business is located. According to the IRS, most states do not allow banks, insurance companies or nonprofit organizations to be LLCs.

Because an LLC is a state structure, there are no special federal tax forms for LLCs. An LLC must elect to be taxed as an individual, partnership or corporation. You will need to

file paperwork with the state if you want to adopt this business structure, and you will need to pay fees that usually range from \$100 to \$800. In some states, there is an additional annual fee for being an LLC.

You will also need to name your LLC and file some simple documents, called articles of organization, with your state. Depending on your state's laws and your business's needs, you may also need to create an LLC operating agreement that spells out each owner's percentage interest in the business, responsibilities and voting power, as well as how profits and losses will be shared and what happens if an owner wants to sell her interest in the business. You may also have to publish a notice in your local newspaper stating that you are forming an LLC.

Corporation

Like the LLC, the corporate structure distinguishes the business entity from its owner and can reduce liability. However, it is considered more complicated to run a corporation because of tax, accounting, record keeping and paperwork requirements. Unless you want to have shareholders or your potential clients will only do business with a corporation, it may not be logical to establish your business as a corporation from the start - an LLC may be a better choice.

The steps for establishing a corporation are very similar to the steps for establishing an LLC. You will need to choose a business name, appoint directors, file articles of incorporation, pay filing fees and follow any other specific state/national requirements.)

There are two types of corporations: C corporations (C corps) and S corporations (S corps). C corporations are considered separate tax-paying entities. C corps file their own income tax returns, and income earned remains in the corporation until it is paid as a salary or wages to the corporation's officers and employees. Corporate income is often taxed at lower rates than personal income, so you can save money on taxes by leaving money in the corporation.

If you're only making enough to get by, however, this won't help you because you'll need to pay almost all of the corporation's earnings to yourself. If the corporation has shareholders, corporate earnings become subject to double taxation in the sense that income earned by the corporation is taxed and dividends distributed to shareholders are also taxed. However, if you are a one-person corporation, you don't have to worry about double taxation.

S corporations are pass-through entities, meaning that their income, losses, deductions and credits pass through the company and become the direct responsibility of the company's shareholders. The shareholders report these items on their personal income tax returns, thus S corps avoid the income double taxation that is associated with C corps.

All shareholders must sign IRS form 2553 to make the business an S corp for tax purposes. The IRS also requires S corps to meet the following requirements:

- Be a domestic corporation
- Have only allowable shareholders, including individuals, certain trusts and estates
- Not include partnerships, corporations or non-resident alien shareholders
- Have no more than 100 shareholders
- Have one class of stock
- Not be an ineligible corporation (i.e., certain financial institutions, insurance companies and domestic international sales corporations)

General Partnerships, Limited Partnerships (LP) and Limited Liability Partnerships (LLP)

A partnership is a structure appropriate to use if you are not going to be the sole owner of your new business.

In a general partnership, all partners are personally liable for business debts, any partner can be held totally responsible for the business and any partner can make decisions that affect the whole business.

In a limited partnership, one partner is responsible for decision-making and can be held personally liable for business debts. The other partner merely invests in the business. Although the general structure of limited partnerships can vary, each individual is liable only to the extent of their invested capital.

LLPs are most commonly used by professionals such as doctors and lawyers. The LLP structure protects each partner's personal assets and each partner from debts or liability incurred by the other partners. Different states have varying regulations regarding these establishments of which business owners must take note.

Partnerships must file information returns with the IRS, but they do not file separate tax returns. For tax purposes, the partnership's profits or losses pass through to its owners, so a partnership's income is taxed at the individual level. LPs and LLPs are also state entities and must file paperwork and pay fees similar to those involved in establishing an LLC.

Regardless of the way a business is structured, its owners will have the same overarching goals when it comes to the company's financial management.

Should You Incorporate Your Business?

Home-based computing and the ability for people to easily communicate globally has led many to consider home-based businesses or work as independent contractors. A majority of these ventures are legitimate establishments that are best managed as corporate entities.

Becoming a corporate businesses allows home-based businesses to take advantage of benefits originally designed for larger companies. Even small businesses, such as those that produce incomes around \$50,000 (or, in Canada, anything over \$30,000), can benefit from incorporation. Incorporation can build legitimacy for a business and its services. Compared to being a sole proprietor, incorporation also provides benefits by reducing personal liability or income taxes.

The reduction of personal liability or taxes is achieved by incorporating as a limited liability company (LLC) or as an S-corporation (S-corp). In this article, we'll take a look at these two corporations and show you how to determine which is most appropriate for your company.

Limited Liability Company (LLC)

LLCs mitigate the financial liability of their owners by limiting the financial liability to only the corporate assets. Conducting business can be highly litigious. The advantage to the owners and employees is that only the corporate entity is held liable for its business actions. But just because independent contractors and sole proprietors may work for a larger concern, doesn't mean that the company will indemnify them from legal issues arising from their actions if they aren't employees. Unless specifically contracted in writing, many independents can be held responsible for legal issues arising from their labors.

For example, multi-level marketing companies (MLMs) may put a significant number of individuals at risk. MLMs tend to forgo a sales department by allowing contractors to act as distribution channels. By advocating the consumption of products and services to consumers, these independent contractors may be subject to lawsuits if the service providers are found negligent and injure their customers.

If an independent contractor or sole proprietor becomes an LLC, the individual's liability is limited, which often puts the owner's personal assets out of harm's way. Small business owners are least able to overcome the loss of any personal assets and therefore have the most to gain from structuring their businesses as an LLC. Individuals who may be taking on personal liability because of their affiliation to another related business should consider restructuring their business as an LLC to shield themselves from financial losses

to their personal savings. Business owners who, as a normal course of business, create a potential risk of injury to themselves or others should purchase business or personal liability insurance in addition to sheltering their assets with the LLC.

In most situations, the LLC's business profits flow through to the individual members, allowing it to avoid the double taxation of paying corporate tax and individual tax. This can be a tax advantage over traditional corporate structures, but compare the corporate tax rate for a business of your size with your personal tax rate, to see which tax rate would be better for you.

LLCs also have much greater flexibility in how they are organized and managed; they can issue a variety of classes of stock (S-corps can have only one class), have more than 100 shareholders, and shareholders can include nonresident aliens, a category not permitted to an S-corporation.

S-Corporation

By incorporating your business as an S-corporation, you also protect yourself against being personally liable for corporate debts. As with an LLC, your personal assets cannot be seized to repay liabilities of your S-corporation. Similarly, the S-corporation cannot be held liable for judgments against you personally. Being an S-corporation can reduce the impact of self-employment tax depending on the difference between the amount that the business makes by providing a service and the amount that would normally be paid to an employee for providing the same. This self-employment tax (SE Tax) covers anyone who engages in a business or trade to earn his or her livelihood or a profit and has not created a corporation to do so.

Sole proprietors who provide full- or part-time services such as independent contractors, farmers and some government officials, will incur this tax. Had they been an employee, their employer would have deducted the requisite Social Security tax from an employee's paycheck, matched that amount and then sent the total tax payment to the IRS. The self-employed report their earned income and pay the equivalent taxes (the employee share plus the employer share) directly to IRS. These taxes are a significant portion of all the tax incurred by sole proprietors or independent contractors.

According to the IRS, self-employment tax for 2016 is 15.3%. The rate consists of two parts: 12.4% for Social Security and 2.9% for Medicare. Only the first \$118,500 (this value is periodically adjusted) of combined wages, tips and net earnings is subject to any combination of the 12.4% Social Security part of self-employed tax.

Example - Incorporation and Tax Benefits

Let's take a look at a sole proprietor who makes \$125,000 for providing a particular service. She would pay 12.4% on the first \$118,500 and then

2.9% on the entire \$125,000 for a total of \$18,319. As an S-corporation, she could reduce the impact of self-employment taxes, because she could pay herself a salary equal to the salary paid by an employer. Deriving the appropriate salary is a gray area and can be subject to IRS scrutiny, but the advantage can be significant.

The same individual, who makes \$125,000 from her business, determines that a person doing the same job for an employer makes \$40,000 per year. As the owner of an S-corp, this individual could pay herself a salary of \$30,000 and only pay self-employment taxes on this figure – which would equate to roughly \$6,120, thus reducing the overall tax liability by \$12,199. While the entire \$125,000 is subject to normal income taxes, the \$85,000 is sheltered from self-employment taxes.

Note: Shareholders receiving any income from the corporation are also subject to normal income taxes on corporate distributions and dividends.

There are additional strategies that S-corporations can use to reduce income tax expenses. Distributions from an S-corporation are not subject to FICA taxes. Cash distributions and dividends are subject to ordinary income taxes, but still save the 15.3% that would normally have been assessed if paid as wages. Owners should ask tax professionals about the variety of alternate methods for withdrawing income from an S-corp that would result in the reduction of self employment taxes.

Corporate Benefits

There are many intangible benefits that are achieved through incorporation.

- Corporate entities that create a market identity for themselves and their products through name recognition and brand identity are often better regarded by consumers and market participants than independent contractors.
- Corporations also last beyond the original owner. When the main contributor to a small business is unable to perform his or her duties, these businesses ultimately fail. Sole proprietorships tend to underscore this risk and impede a business's reputation as an ongoing entity.
- Corporate entities can apply to and receive funding more easily than sole proprietors. Sole proprietorships can find it hard to raise capital because institutions look to the net worth and creditworthiness of the individual when deciding to provide financing. Investors and customers prefer to deal with entities

that are perceived to have long-term potential. Small business lenders using strict underwriting criteria find it easier to make more competitive loans when they feel that the business has entity-level value that can be sold or that ownership can be transferred. Investors want to be assured that ownership will continue to be valuable even when the principal contributor to the business no longer manages the business.

Drawbacks of Incorporation

The drawbacks for LLCs and S-corps are similar to those of partnerships.

- In some circumstances, LLCs may have difficulty in raising equity capital and using debt capital as a main source of financing. Although the economic interest in an LLC is transferable, the right to vote and participate in the management of the business can be difficult to execute. Providers of equity or debt capital may shy away from infusing capital where they cannot gain managerial control in the event of default or low performance.
- Some states put conditions on corporate structure, in some cases requiring the LLC to dissolve once all members have withdrawn. These problems can be circumvented by incorporating in another state.
- S-corporations are more difficult to form and maintain because they require the same governance structure as a regular corporation. Articles of incorporation must be filed with the state, bylaws need to be developed and stock has to be issued.
- Corporations must have their own financial accounts and file the names of all officers with the state. Like corporations, a board of directors is established and it is this board that makes managerial decisions.
- An S-corp can only have one type of stock limited to no more than 100 shareholders, and states limit the types of businesses that can become an S-corp. As mentioned above, shareholders can not be nonresident aliens.

The Bottom Line

Whether one chooses an LLC or an S-corporation, some corporate structure is better than being a sole proprietor or independent contractor. Home businesses that continue to be managed as sole proprietorships may miss out on benefits that can easily be achieved by following relatively simple procedures and corporate governance. The opportunity to enhance a business's standing in the eyes of the marketplace provides a boost to its longevity that is hard to create as an independent contractor or one-man shop. In some cases, consumers might not perceive a small corporation any differently than ones with millions in revenue.

Therefore, incorporating one's business can provide a potential boost to business growth that is much more difficult to achieve without it. To receive these benefits, certain paperwork must be filed regularly and more rules must be followed than required for mom-and-pop companies, so make sure you are ready to jump in with both feet when you

choose to incorporate. Then consult carefully with your financial advisors to decide which structure would be the most beneficial for your business.

S Corp. Vs. LLC: Which Should I Choose?

A business structure, in terms of the legal entity you choose for your business, significantly impacts a number of important issues in your business life, including exposure to liability, and at what rate and in what manner you and your business are taxed. Your choice of corporate structure can also substantially affect issues such as financing and growing the business, the number of shareholders the business has and the general manner in which the business is operated.

In addition to the basic legal requirements for various types of business entities that are generally codified at the federal level, there are variations between state laws regarding incorporation. Therefore, it is generally considered a good idea to consult with a corporate lawyer or accountant to make an informed decision regarding what type of business entity is best suited for your specific business.

The choices of limited liability companies (LLC) and S corporations are increasingly popular due to their basic benefits of liability protection and pass-through taxation. LLCs protect the owners' personal assets from losses, company debts or court rulings against the company. LLCs also avoid the double taxation to which C corporations are subject by passing all company income through to the tax returns of the individual owners. An S corporation structure also protects business owners' personal assets from any corporate liability and passes through income, usually in the form of dividends, to avoid double corporate and personal taxation. However, while both options offer these basic benefits in one form or another, there are significant distinctions between them that require careful consideration when establishing a business entity.

Both LLCs and S corporations surged to the forefront around the time of the Small Business Protection Act of 1996 that contained a number of changes to basic corporate tax law, such as enabling S corporations to hold any percentage of stock in C corporations. C corporations, however, are not allowed to own stock in S corporations.

Factors in Choosing Between an LLC and an S Corporation

The choice of business entity is going to be guided largely by the nature of the business and how the owner envisions the business unfolding and growing in the future. The general guidelines for making a choice are listed below.

A business owner who wants to have the maximum amount of personal asset protection, plans on seeking substantial investment from outsiders or envisions eventually becoming a publicly traded company and selling common stock will likely be best served by forming a C corporation, and then making the S corporation tax election. It is important to understand that the S corporation designation is merely a tax choice made to have your business taxed according to Subchapter S, hence the designation, of Chapter 1 of the Internal Revenue Service Code. All S corporations begin as some other business entity, either a sole proprietorship, a C corporation or an LLC. The business then elects to become an S corporation for tax purposes.

An LLC is more appropriate for business owners whose primary concern is business management flexibility. This owner wants to avoid all but a minimum of corporate paperwork, does not project a need for extensive outside investment and does not plan on taking her company public and selling stock. In general, the smaller, simpler and more personally operationally managed the business is, the more appropriate the LLC structure is. If your business is larger and more complex, such as a multinational financial services firm, an S corporation structure is more appropriate.

Differences Between LLCs and S Corporations

The IRS is more restrictive regarding ownership for S corporations. An LLC is allowed to have an unlimited number of owners, commonly referred to as "members." However, S corporations are not allowed to have more than 100 principal shareholders or owners. S corporations cannot be owned by individuals who are not U.S. citizens or permanent residents; however, non-U.S. citizens and non-U.S. residents are allowed to be members/owners in an LLC. S corporations cannot be owned by any other corporate entity. This includes other S corporations, C corporations, LLCs, business partnerships or sole proprietorships. LLCs may be owned by any other type of corporate entity. LLCs also face substantially less regulation regarding the formation of subsidiaries.

There are also significant legal differences in terms of formal operational requirements, with S corporations being much more rigidly structured. While LLCs are urged to follow the same guidelines, they are not legally required to do so. The numerous internal formalities required for S corporations include strict regulations on adopting corporate bylaws, conducting initial and annual shareholders meetings, keeping and retaining company meeting minutes, and extensive regulations related to issuing stock shares. For LLCs, business operations are much simpler and the requirements are minimal. For example, in lieu of the detailed requirements for corporate bylaws for S corporations, LLCs merely adopt an LLC operating agreement, the terms of which can be extremely flexible, allowing the owners to basically set up the business to operate in whatever fashion they most prefer. LLCs are not required to keep and maintain records of company meetings and decisions in the way that S corporations are required to do.

Differences also exist in basic management structure. The owners/members of an LLC are free to choose whether owners or designated managers run the business. If the LLC elects to have the owners occupy the company management positions, then the business

operates more closely resembling a partnership. In contrast, S corporations are required to have a board of directors and corporate officers. The board of directors oversees management and is in charge of major corporate decisions, while the corporate officers, such as the chief executive officer (CEO) and chief financial officer (CFO), manage the company's business operations on a day-to-day basis.

Other differences include the fact that an S corporation's existence, once established, is usually perpetual, while this is not typically the case with an LLC, where events such as the departure of a member/owner may result in the dissolution of the LLC. One area where LLCs typically face more stringent regulation than S corporations is that of transfer of ownership. Transfer of LLC ownership interests is usually only allowed with the approval of the other owners. In contrast, stock in S corporations is freely transferable.

Differences in accounting requirements also exist. One primary difference is that LLCs are typically required to use accrual accounting and are not allowed to opt for cash basis accounting, although there are some exceptions allowed. S corporations can choose either accounting option.

Making the Right Choice

LLCs are easier and less expensive to set up, and simpler to maintain and remain compliant with the applicable business laws since there are less stringent operational regulations and reporting requirements. Nonetheless, the S corporation format is preferable if the business is seeking substantial outside financing or if it will eventually issue common stock. It is, of course, possible to change the structure of a business if the nature of the business changes so as to require it, but doing so often involves incurring a tax penalty of one kind or another. Therefore, it is best if the business owner can determine the most appropriate business entity choice when first establishing the business.

The Basics of Forming A Limited Liability Company (LLC)

The thought of "being your own boss" is sure exciting and if you plan to do it by setting up your business and are ready with a business plan, the next crucial step is deciding the right business structure. This decision has far reaching repercussions for the business and thus requires careful selection. The factors like personal liability, regulations, tax treatment, etc are governed by the form of your business entity which could be a Sole Proprietorship, Corporation, Partnership, or a Limited Liability Company (LLC).

One of the easy, efficient and fast ways to start a company is to set up a Limited Liability Company (LLC). Let's explore what exactly is an LLC, its suitability, advantages and

disadvantages along with other fundamental factors which can help you decide if an LLC is right for you and your business.

What is a LLC?

The LLC is a relatively newer form of business entity in the U.S. It was Wyoming which enacted the first formal LLC statute in 1977. The act amalgamated the beneficial features of a partnership and corporations and was based on the 1982 German Code and the Panamanian LLC. Over the years, all states have passed legislation and even modified the acts to afford LLC its present form.

An LLC is a hybrid form of business entity which has selected features of a corporation and a partnership. It has been structured in a way to benefit from the pass-through taxation feature of a partnership along with allowing flexibility in operation and management and yet have limited liability like in the case of a corporation. In the U.S., the LLCs laws are governed by individual states but are recognized in all. The laws further vary across countries. The “owners” of the company in case of LLC are referred to as “members”. Usually a single person can start an LLC and there is no upper ceiling on the number of members. There are many established and well-known companies which are structured as LLCs. Few names are Chrysler Group LLC, Westinghouse Electric Company LLC, Dougherty & Company LLC, Blockbuster LLC. Some businesses like banks, insurance, medical services are ineligible to file as LLCs because if the “liability” protection given to LLCs.

Advantages

- **Limited Liability**

This is one of the features of a LLC in which it resembles the corporations. LLC provides its owners a protective shield against business debt and liability. Let’s take an example, there is a shoe store “boot & boot” owned by Jimmy which loses its customers to one of the more fancy store around the corner. The business is not doing well and the company hasn’t paid rent for last 8 months and bills for three shipments of shoes. Thus “boot & boot” owes approximately \$75,000 to its creditors who have filled a lawsuit against the company. The creditors have full right to claim the money owed from the company but have no right to Jimmy’s personal assets (bank deposits or gold or real estate). In an LLC, only the company’s assets can be liquidated to repay the debt and not the owners. This is a big advantage which is not provided by a sole proprietorship or partnership where owners and the business are legally considered the same adding vulnerability of personal assets.

- **Taxation**

The company is not taxed directly by IRS as a LLC is not considered a separate tax entity. Instead, the tax liability is on the members who pay through their personal income tax. Let’s look at an example. Say “boot & boot” has two members and has made net

profits to the tune of \$60,000 in a year. The net profits will be divided into two (number of members) and this amount will be taxed as their personal income depending upon their overall tax liability. Because of non recognition of LLC as a business entity for taxation purposes, the tax return has to be filed as a corporation, partnership or sole proprietorship. Remember that certain LLCs are automatically classified by IRS as a corporation for tax purposes, so be sure to know if your business falls in this category. Those LLCs which not automatically classified as a corporation can pick the business entity of choice by filing the Form 8832. The same form is used in case the LLC wants to change the classification status.

- **Less Hassles**

Among all forms of companies, start-up of a LLC is easier with lesser complexities, paperwork and costs. This form of company comes with a lot of operational ease with less record keeping and compliance issues. LLCs also provide a lot of freedom in management as there no requirement of having a board of directors, annual meetings or maintaining strict record books. These features reduce unnecessary hassles and help save a lot of time and effort. The formation of an LLC broadly requires filing the “articles of organization” which is a document including basic information like business name, address, members. The filing is done with the Secretary of State for most states and has an associated filling fee. Next comes creating an Operating Agreement which though is not mandatory in most states but is recommended especially for multi-member LLCs. On registration of the business, other licenses and permits have to be obtained. Additionally, some states like Arizona and New York require publishing about the LLC formation in the local newspaper.

- **Flexibility in Allocation**

LLC provides a lot of flexibility when it comes to investing as well as profit sharing. In an LLC, members can opt to invest in a different proportion than their ownership percentage i.e. a person who owns 25% of the LLC, need not contribute money in the same proportion for initial investment. This can be done by creating an operating agreement which states percentages of company profits (and losses) for each member regardless of the amounts of their initial investments. So, it’s possible to have an outside investor put money in the business without ownership. The same applies to distribution of profits where LLC members have the flexibility to decide the allocation of profits. The distribution of profits can be in a different proportion than ownership. A certain member may take a bigger chunk of profits by consensus for the extra hours or effort he/she has put in carrying out the business.

Disadvantages

While a limited liability company (LLC) offers an edge over some of the other forms of business entity, there are also some drawbacks which need to be looked at before selecting an LLC as the business structure.

- **Limited Life**

The life of an LLC is limited by the tenure of its members. While there can be variations across states, in most of them the business is dissolved or ceases to exist when a member departs an LLC further requiring the other members to complete the remaining business or legal obligations needed to close the business. The rest of the members can choose to set-up a new LLC or part ways. This weakness of an LLC can be overcome by including appropriate provisions in the operating agreement.

- **Self Employment Taxes**

The members of an LLC have to pay the self-employed tax contributions towards Medicare and Social Security as they are considered as self-employed. Due to this the net income of the business is subject to this tax. To avoid this, depending upon the business turnover and tax burden, the entity can choose to be taxed like a corporation if it works out more beneficial. Consult an accountant before making this choice.

- **Fees**

The fee which is typically paid by an LLC as initial costs or ongoing charges is more than that for business entities like sole proprietorship or general partnership but less than what a C-corporation has to pay. The various types of fees include - applicable state filing fees, ongoing fees, annual report fees, etc.

- **Precedent is Less**

LLC is a relatively newer business structure and thus there have not been many law cases related to them. For this reason there is not much legal precedent or case law for LLCs as there is for the older forms. Having a certain legal precedence helps to act accordingly in the same given case scenario. There is more vulnerability as there are few established laws.

Bottom Line

LLC is a good combination of protection with flexibility and tax benefits. It provides an array of taxation alternatives while shielding individual members from personal liability. LLCs are seen as apt for small businesses as there is less hassle and complexity in its functioning. However, consulting an accountant or lawyer for expert opinion is advisable before taking the final call.

The LLC Operating Agreement Template, And Why You Need It

A Limited Liability Company, popularly known as an LLC, is a type of U.S. business entity that is easy to form and simple to manage. Since an LLC is a hybrid of a partnership and corporation, it provides the twin benefit of pass-through taxation with limited liability. To take full advantage of having an LLC, you should go one step further and write an Operating Agreement during the startup process. Many tend to overlook this crucial document since it is not a mandatory requirement in many states. Only a few states specify the need of putting an operating agreement in place (California, Delaware, Maine, Missouri, New York). But be sure this is what you want before proceeding.

The Operating Agreement is a document which spells out the terms of a Limited Liability Company (LLC) according to the members. It sets forth the path for the business to follow and brings in more clarity in operations and management.

Case For Inclusion

- **Default Rules**

In the U.S., the LLC formed in a certain state is *recognized* by all U.S. states, but it operates according to the rules and regulations of that state. These rules are meant for all LLCs in general, and may or not cater to the specific requirements of a particular business. To overcome this problem, the members can opt to have an Operating Agreement in place. For example, an LLC by the default rules in many states ceases to exist when one member (owner) departs. The rest of the members are left with a choice to part ways or start all over again. This can be bad for a well-established business and its members. This situation can be avoided if suitable provisions are included in the Operating Agreement of the LLC.

- **Customized Structure**

Members with the help of an Operating Agreement can customize the financial, managerial and operational structure of the business. For example, in a two-member LLC, "Jim" has contributed 30% and does 70% of the work, while "Tim" does just 30% of the work and has contributed 70%. The two can agree to split profits in a proportion they like (say 50% each) by including it in the Operating Agreement. Or say, if Tim and Jim plan to add another member in the future, the rules and procedures can be set and included in the agreement.

- **Avoid Misunderstandings**

Business shouldn't be run on verbal agreements. In the present circumstances, members may decide and agree to do things in a certain way but there can be conflicts about the

same issue at a later date with change in circumstances or say the view of a member changes. By adding the terms decided in written form, there is no room for ambiguity as the document can be referred to in times of such conflicts in the future.

- **Liability Protection**

The use of an Operating Agreement helps to distinguish the status of a single-member LLC from that of a sole proprietorship or partnership. In its absence, there could be a case of mistaken identity. The court honors and recognizes the agreement and thus helps to shield the personal liability of LLC members.

The Skeleton

While every Operating Agreement is different, it serves the basic purpose of laying out the parameters according to which a business will function. Different states have their own set of regulations with regards to this document. It should be drafted according to the needs of the respective states and there should be no contravention of rules. For example in New York, it is a compulsory document and it has to be adopted before, at the time of, or within 90 days after the Articles of Organization are filed.

While you can prepare an LLC Operating Agreement yourself using online and other resources, it is advisable to consult an attorney for reviewing it. This is to make sure that no important point is left out, to have the suitable inclusions especially if any state default rule doesn't concur with your business and also to make sure that it complies with the state laws in general. Below is an Operating Agreement in skeleton form, it shows the basic aspects to be included.

Operating Agreement Of (Company), LLC

A (State) Limited Liability Company

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Bottom Line

Just as “One size doesn’t fit all,” the state default LLC rules don’t suit all. The best way to counter this problem is by writing an Operating Agreement, which gives freedom, protection and control to your business. Though it's best to include an Operating Agreement in the initial stages, if you have missed on that, it’s never too late to put it in place provided all members agree to it. The document can also be modified at a later stage with the guidance and help of an attorney.