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Setting Up Shop – An Introduction to Starting Your Own Business

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Picture this: you and Hank have been best friends since your glory days at college. Even though you both now have careers, spouses and children, you still manage to find time to escape to the mountains every now and then to partake in your favorite activity, fly fishing. One day, while you and Hank are out on the river casting lines and catching some pretty impressive rainbows, Hank leans over to you and says, "This is the life! Don't you wish we could do this for a living?" To which you respond, "Hank, you are a genius. Let's go into business together and teach others how to fly fish!" And with that, you and Hank have taken your first steps into the exciting world of business ownership.

Now what? Starting your own business can be a daunting endeavor, but that's where we can step in and help guide you along the way. This article will provide an overview of two common types of business entities recognized in Colorado: the Corporation and the Limited Liability Company. While this article is certainly not an exhaustive analysis of these two options, it should serve as a useful starting point for new business owners.

The first step is to select the type of legal business entity that is appropriate for your business needs and goals. Prior to choosing the right type of entity, you should spend some time taking stock of what is important to you and your business partners. Think about the type of business you are forming, the size, the level of control you want to have over the day-to-day operations, the tax implications and how much personal liability exposure you are willing to assume.

1. Corporation: The defining characteristic of a corporation is that a corporation exists as a legal entity entirely separate from the people who own it (called "shareholders"). This type of legal separation creates stability to a corporation's existence, meaning that if a shareholder dies or desires to sell his or her interest in the company, the corporation continues to exist and conduct business, unless or until the corporation is formally dissolved (which will not be addressed in this article). One potential disadvantage to this type of legal separation means that corporate profits may be subject to double taxation. Not only must a corporation pay tax on its income because it is a separate legal entity, but if a shareholder receives profit distributions, then he or she must also report those profits on his or her individual tax returns, thus resulting in the potential for a "double tax".

   A corporation's existence is dependent upon the entity adhering to strict corporate formalities, which are designed to protect against individuals who unlawfully attempt to shield themselves from liability. For example, you must keep complete separation of personal and business funds, you must maintain corporate records and minutes, you must keep current filings with the Secretary of State, and you must adopt Bylaws, just to name a few. Observing corporate formalities ensures that your personal assets are safe from the claims and debts of the business.

2. Limited Liability Company ("LLC"): An LLC is a relatively newly recognized type of business entity. An LLC is often an appealing choice for business owners because it essentially combines the tax concepts of a partnership, and the limited liability features of a corporation. First and foremost, an LLC shields its owners (called "members") from personal liability, similar to the way shareholders are protected in a corporation. This means that an individual member's personal assets are protected from being used to satisfy any outstanding debts of the business (of course, this also means that the members must observe similar types of corporate formalities as a corporation, though the requirements are less stringent). Also, in most situations, LLC members are shielded from litigation if the LLC is sued (a common exception is if a member breaches a fiduciary duty, for example).

   Another attractive characteristic of an LLC is that it avoids double taxation because an LLC's income is included on the personal income tax returns of its members. An LLC will be treated as a partnership for tax purposes if there are two or more members, unless the LLC expressly elects to be taxed as a corporation. If the LLC only has one individual member, then the LLC will be treated as a sole proprietorship for tax purposes. Either way, the members of an LLC get to enjoy the benefit of what is known as "pass-through taxation" because the LLC itself does not pay taxes directly, so owners of an LLC avoid the type of double taxation that corporate owners experience.

Once you have selected the type of entity for your new business, it is time to file the formation document with the Secretary of State. Filing the document for both a corporation and an LLC is a relatively easy and straightforward process and can be done through the Secretary of State's online filing system; however, in each case, there are certain business decisions that you must carefully consider:

1. Corporation: A corporation is formed when the Articles of Incorporation are filed with the Secretary of State and the Bylaws are adopted. The Articles of Incorporation require certain information, including the principal office address, the registered agent and the number of shares the corporation is authorized to issue. In addition to the Articles of Incorporation, the initial board of directors must adopt the corporation's governing document, known as the Bylaws. The Bylaws establish the methods by which a corporation conducts its affairs and handles day-to-day operations. They specify how the company will call meetings, how to maintain corporate records, and how to manage the sale and transfer of stock, for example.

A corporation is owned by its shareholders and run by a board of directors who are elected by the shareholders. Depending on the size of the corporation, the board of directors may also elect officers to manage the day-to-day operational side of the business. A corporation's directors and officers can be the same people. Both the directors and the shareholders of a corporation owe certain fiduciary duties to the corporation, including the duty of loyalty, good faith and fair dealing.

2. <u>LLC</u>: In the case of an LLC, the Secretary of State requires the filing of Articles of Organization. This document will ask for information including your principal office address, the name of your registered agent and whether the LLC is member-managed or manager-managed. The differences between a member and a manager-managed LLC are significant, though you can to file an amendment to your Articles of Organization if you decide to change how the LLC is managed at a later point in time. If all the members are going to actively participate in the management and the day-to-day operations of the business, then you will most likely want to choose a member-managed LLC. This is the most common form for single-member LLCs and LLCs with two members. However, if some of the members will only be providing financial support, or if you anticipate that you will add members in the future who will only be passive investors, then a manager-managed LLC is probably the best choice. A manager does not have to be a member of the LLC, and there may be more than one manager.

   While not required by law, it is advisable for an LLC to create an Operating Agreement because this document not only helps to legitimize the LLC, but it also helps to protect an LLC's limited liability status. The Operating Agreement outlines the day-to-day operation of the business, including identifying the rights and duties of the LLC's members, the capital contributions, the transfer of interests (especially in the case of death or disability), and the dissolution of the LLC, just to name a few.

Now that you have the formation document filed with the Secretary of State and you have adopted the operational document, you're off and running, right? Technically, yes – but don't jump the gun. Even though your company is legally formed once the Secretary of State accepts the formation document, you must bring your company to life by considering all of the other items that you must check off of your to-do list so that your company can function, flourish and grow.

Is your industry subject to license requirements? Many types of businesses, both corporations and LLCs, need to obtain permits or licenses from various federal, state or municipal agencies prior to being allowed to legally operate. Maintaining compliance with permit and license requirements sets your company up for continued success and avoids headaches down the road, especially if you decide to sell your business one day.

Will you hire employees or hire independent contractors? Do you know the differences between the treatment of each for legal and tax purposes? You may want to implement employment agreements or independent contractor agreements to document the rights and obligations of each party. There are also various tax consequences for each, so be sure to check with your accountant or tax attorney prior to making any decisions.

How about planning for the future? What if you get seriously injured? What one of your business partners decides to leave and move to Fiji? Planning for the "what ifs" may not be the most comfortable conversation, but it is essential to develop a plan in order to ensure that your business will continue to thrive should you encounter the inevitable unexpected bump in the road.

Now back to you and Hank. After the initial excitement of deciding to start your own fly-fishing company, it's time to get down to business (pun intended). You and Hank decide to create an outline of your business goals, the structure of your preferred business arrangement, and a list of questions you want to discuss with your attorney. We here at Foster Graham Milstein & Calisher are here to help during the formation and throughout the lifecycle of your business. We recognize that one size does not fit all, which is why we are equipped to advise on all aspects of your business and customize a legal strategy to cater specifically to your needs by providing insightful advice and thoughtful legal guidance.