

Smart & Final®

# Business Advantage

News and savings for business and community groups

## PROTECTING WHAT'S YOURS!

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Two brothers spent three years building up a small specialty market in Northern California. As partners, they shared in the profits and paid expenses through a dba account. Things began to unravel when a customer slipped in the store and sued them both personally seeking compensation for injuries. They realized too late that their partnership did not protect their personal assets from lawsuits involving their business.

While the idea of going solo or partnering with a friend or relative in a business venture can sound appealing, small business owners sometimes unknowingly expose themselves to personal liability by setting up their business as a sole proprietorship or partnership.

"I try to steer people away from using a partnership. If the business gets sued, the partners are jointly and separately liable," says Gary Barr, an attorney with Alpert & Barr, APLC in Encino, California. "Plaintiffs can pick and choose who they try to collect from. If partners have a house, bank accounts or other assets outside the business they are subject to the debt. In

the personal assets of the owners are better protected against this business' legal issue."

There are other benefits to a corporation. Corporations can issue shares to those interested in investing capital into the business. Small businesses with multiple partners may find incorporating advantageous since its partners can convert their ownership interest into shares of stock. This way, a tangible value can be placed on their portion of ownership.

Corporations, however have their downside. A corporation is required to document its activities, have bylaws outlining the corporation structure including names of directors and officers, hold regular shareholder meetings and take meeting minutes. The corporation formalities can be time consuming and costly, but necessary to show the corporation is legitimate.

"Just because one has formed a corporation does not guarantee that the incorporator can protect personal assets from attack, the primary purpose of incorporating. The business must keep its corporate veil intact," says Mark Mauriello,

entity's debts. That's one of the reasons why the formalities have to be followed. A red flag is comingling personal and corporate assets. You obviously should not pay your personal bills from the corporate account."

There is also the issue of double taxation. "Corporations are taxed at the business entity level. The corporation pays tax on its earnings before profit or loss is distributed to the owners," explains Ken Boyd. "Normally, owners of a corporation are shareholders. They receive business profits in the form of a dividend. That dividend is taxable on the shareholder's personal return." Thus, the possibility of double taxation.

### Limited Liability Company (LLC)

A cross between a partnership and corporation is a Limited Liability Company (LLC). "Partnerships have been losing popularity since the late 1990s with the introduction of LLCs," says Benjamin. "LLCs came about to replace partnerships." A single member LLC is considered a disregarded entity by the IRS and distributions are passed through on a

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California, a community property state, the pay of a partner's spouse may also be levied. A partnership opens up almost everything to potential liability."

### The Corporation Alternative

An alternative to a partnership and one in which owners are protected from business legal liability and debts is a corporation. From a legal standpoint, a corporation is considered a separate entity from its owners.

"A corporation can offer the strongest protection against legal liability to the owners," says Ken Boyd, author of *Cost Accounting for Dummies*. "That's because the corporation is legally separate and distinct from the owners. Assume a restaurant is incorporated. A customer is injured in the restaurant and sues. Because the corporation is a separate legal entity,

a small business owner and New York City area attorney. "You have to observe the formalities of the corporation. If you fail to do so, someone who sues the company can get at your personal pocketbook."

"The owners, or shareholders of a corporation must maintain a formal legal separation between their business and personal finances to avoid a finding by a court that the corporation is the alter ego of the owners or just a sham," explains Elliott Benjamin an attorney with Parker Shumaker Mills LLP in Los Angeles. "The personal liability of the owners for the entity's debts is limited. People who sue a corporation can try to 'pierce the corporate veil' by proving that the owners were operating the business as if the entity did not exist. If they are successful, the owners could be held personally liable for the

personal tax return. For two or more members, LLCs issue KIs to LLC members who report the distribution on their individual tax return. An LLC acts like any other company entity when it comes to paying employees. Employees are given W2s for tax reporting purposes.

Just as important, an LLC offers the same owner liability protection as a corporation. "This protection can be maintained with much less formality than a corporation but nonetheless, the separation must still be preserved," says Benjamin. "The company can simply have an operating agreement outlining how it will run. The agreement is optional (although most banks will require one to open a bank account), but it's good practice to have one. If you don't have an operating agreement, your business will be



*Making the best decision to save your assets may depend on the legal entity you form for your business.*

*By Diane Rumbaugh*

governed only by the state statute.”

How popular are LLCs for small businesses? “Over the last five years, our firm has formed more than 100 LLCs but only a handful of corporations,” says Benjamin. “Corporations are becoming old school, especially for small businesses.”

#### **Corporation or LLC?**

The decision on whether to form a corporation or LLC should not be made solely by the business owners, say experts. “I’m a

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firm believer that when a client needs to make a decision between a corporation and LLC, it should always be done in conjunction with the client’s attorney and accountant,” says Barr.

Online sites such as LegalZoom.com and MyCorporation.com offer to help businesses set up an LLC or corporation. “I think it is a huge mistake to use an online do-it-yourself program,” says Barr. “There are too many decisions to be made, too many intricacies. A layperson is likely to do it in a fashion that could create problems at a later point in time.

State websites provide forms, fee schedules and basic information. “Formation is ultimately a very simple process—identify and fill out the necessary form, read the state’s basic requirements for forming a corporation and disclose and

submit the Articles of Incorporation along with the statutory filing fee,” says Mauriello. “However, LegalZoom or doing it yourself may leave you, in the absence of deeper investigation and comprehension of future issues and concerns, not knowing what you do not know, and not knowing the filing requirements you face in the future—a potentially precarious condition.”

#### **Comparing Costs**

The fees to form a corporation or LLC are similar. “Going forward, a LLC will generally have fewer expenses than a corporation,” says Barr. “Corporations have to file a tax return every year. LLCs usually do not. LLCs have less accounting requirements from a tax-reporting standpoint. Corporate formalities such as annual meetings, shareholder and board of

directors meetings, and the compilation of corporate minutes have to be done every year. These all cost money. Small businesses that are still operating as partnerships are living dangerously. “I always tell my clients not to engage in unprotected commerce, but if you are in a partnership you are doing exactly that,” says Mauriello. “We are the most litigious country on the planet. Why not protect yourself?”

#### **State Agencies**

- *Arizona Corporate Commission*  
<http://www.azcc.gov/>
- *California Secretary of State*  
<http://www.sos.ca.gov/>
- *Nevada Secretary of State*  
<http://nvsos.gov/>