

NEBRASKA MICROENTERPRISE HANDBOOK



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CHAPTER ONE: OVERVIEW

This handbook is written with microenterprises in mind. However, we hope that it is useful to all small business owners.

A microenterprise is typically defined as a business with five or fewer employees. Often there are no employees, just the owner, perhaps with unpaid help from his or her family. Microenterprises require less money to start; \$35,000 is often cited as the upper limit. Microenterprise offers a way up for many people, allowing them to take greater control over their future and to better support themselves and their families.

Microenterprises also benefit their communities by creating jobs and adding to the community's general economic and social health. This is particularly true of rural areas where larger employers may be few and far between. Rural microenterprises enable their owners to remain in the area they call home as opposed to migrating to a city.

Microenterprise is also an attractive alternative for women and for people who may find it difficult to obtain high-paying jobs because of lack of education or because they do not speak English.

With that in mind, the purposes of this handbook are:

- To explain terms like “limited liability,” “pass-through taxation,” and “formalities.”
- To present issues that often come up in businesses owned by an individual or by a few people regardless of whether the business is organized as a partnership, limited liability company, or corporation.
- To suggest possible solutions for these issues.
- To present the pros and cons of conducting business as a sole proprietor, partnership, limited liability company, C corporation, or S corporation.
- To provide information about topics of interest to businesses:
 - Contracts
 - Insurance
 - Independent contractors and employees
 - Intellectual property: trade names, trademarks, and copyright

CHAPTER 2: DEFINITIONS

Allocated share or allocations: In partnerships, limited liability companies (“LLCs”), and S corporations all a company’s gains and losses “pass through” to their owners for income tax purposes each year. Each owner is credited or debited with a share of gains or losses that is usually in proportion to his or her share of the company. This is the owner’s allocated share.

Allocated shares are different from distributions. Owners are allotted an allocated share of gains even if no money is distributed to them. Allocated shares have important tax effects for owners of partnerships, LLCs, and S corporations. See the following definitions of distributions and pass-through taxes.

Basis: The value of an asset for income tax purposes. Basis starts with the purchase price of the asset, but may be adjusted over time. When an asset is sold, its basis is subtracted from the sales price to determine whether there is a capital gain or loss. The higher the basis, the less the gain or the greater the loss. In some business forms basis increases if the business does well. This reduces an owner’s capital gain when the business is sold.

Closely held business: A business that is owned by a single person or a small group of people, often friends or relatives. Shares or units in a closely held business are not sold on public stock exchanges. A sole proprietorship is always a closely held business. Partnerships, LLCs, and corporations also can be closely held. Closely held businesses are contrasted with “publicly traded companies” in which shares can be purchased on public stock exchanges. The lack of a public market makes it difficult to sell an interest in a closely held business. See pages 6-10 for more information.

Distributions: Payments by the company to owners based on their percentage ownership of the business as opposed to compensation for services to the company. Distributions will usually be made out of company profits. Owners may leave profits in the business to support future growth or take the profits out of the business in the form of distributions. Owners will decide whether to make distributions and how much to distribute. In “pass-through” entities—partnerships, LLCs, and S corporations—distributions are usually tax free.

Formalities: Legally required steps or actions to create or maintain a business form. Some forms, such as corporations, must observe lots of formalities. Others, such as sole proprietorships, have none. Formalities are different from filings, licenses, and permits that are required for some businesses regardless of what business form they use. For example, a restaurant must get health permits regardless of whether it is a sole proprietorship or a corporation. But only the corporate restaurant would also have to observe corporate formalities. See pages 4-5 for information about filings and other actions required for most businesses regardless of form.

Liability: A legally enforceable obligation to pay a debt. A borrower is liable to the lender for the amount of the loan. If the borrower does not pay back the loan as agreed, then the lender can sue the borrower and collect the debt from the borrower's assets. A liability can be created by a contract (like a loan) or through negligence, such as personal injuries caused by a driver who runs a red light.

Limited liability or limited personal liability: A feature of some business forms that protects an owner's personal assets from the business' debts (and vice versa). In these business forms an owner is not personally liable for the business' debts, and creditors cannot collect a business' debt from the owner's personal assets. This protection is not fool proof and can be lost under some circumstances. See pages 11-13 for information about which business forms provide limited liability and how limited liability can be lost.

Pass-through taxation: Partnerships, LLCs, and S corporations do not pay income tax themselves. Their annual gains and losses are treated as if they had "passed through" directly to their owners for income tax purposes. The owners report their allocated share of gains and losses on their personal tax returns each year. Allocated gains will increase the owners' personal income tax, while allocated losses will reduce their income tax if they are actively engaged in running the business.

C corporations, on the other hand, pay their own income tax on their gains and losses each year. When they pay dividends, the owners pay taxes at the individual level. See the discussion of "double taxation" at pages 33-34.

Personal liability: A liability that can be collected from an individual's income and assets. In some business forms, the owners are not personally liable for the business' debts.

CHAPTER 3: FILING REQUIREMENTS, MOST BUSINESSES

Most businesses are required to file certain documents with federal or state government or obtain permits or licenses regardless of whether they operate as a sole proprietorship or choose some other business form. These filings or actions include the following:

1. **Federal Employer Identification Number (EIN)** (IRS form SS-4, no charge)

You will probably need an EIN unless you are a sole proprietor with no employees. Even in that situation an EIN may be required if the sole proprietor pays certain taxes. You can obtain an EIN on-line. You do not need a lawyer to do this. It's simple and only takes a few minutes. Information about who needs an EIN and how to apply is available at <http://www.irs.gov/businesses/index.html>.

If you are starting a new business, you should wait to get an EIN until you've chosen a business form. In some situations a business that starts out as a sole proprietorship but then becomes a corporation will have to get a new EIN for the corporation. The link in the previous paragraph also has information about when a business that changes its form has to get a new EIN.

Banks usually require an EIN to open a business account.

2. **Registration of Trade Name, Neb. Sec. of State** (\$100 + publication costs)

The name of your business is a trade name, and you should take steps to protect it. If your business is a sole proprietorship or general partnership, you do this by filing an Application for Registration of Trade Name form with the Nebraska Secretary of State. Filing will protect your right to use the name and will prevent others from using it. The Application for Registration of Trade Name is available on the Secretary's website: <http://www.sos.ne.gov/dyindex.html>.

Limited liability companies (LLCs) and corporations are required to file documents with the Secretary of State that, among other things, protect their trade names. So they will usually not have to file the Application for Registration of Trade Name.

All owners should check with the Secretary of State **in advance** to be sure the name you want is available. If you fax a name to the Secretary's office, they will tell you if it is available. Fax: (402) 471-3666. You can also do this by email. If you do business under a trade name that is already in use, then you may have to change the

name later. You will lose the good will and reputation that you have built around the trade name.

For more information about trade names, see pages 52-53.

3. Nebraska Tax Application

(Nebraska Department of Revenue Form 20)

Retailers selling goods or services subject to sales taxes must file this form. Businesses with employees must also file in order to withhold and submit Nebraska income taxes. Form 20 is available on the Department of Revenue's web site: www.revenue.ne.gov/index.html

4. Federal filings, employees

If you have employees, you will have to withhold and submit the employees' federal income tax and FICA. You will have to match the employees' FICA. There are a variety of other taxes that you may be subject to such as federal unemployment tax. See "Small Business Forms and Information" on the IRS website, www.irs.gov/businesses/small/index.html.

5. Zoning, permits, licenses

You should also check with local and county governments to be sure your business complies with zoning regulations and to obtain any necessary permits or licenses. For example, most food processing and restaurant business will require health inspections and permits. Day care centers require a state license.

CHAPTER 4: CLOSELY HELD BUSINESS

1. Common issues

Regardless of which business form a microenterprise adopts, it will be a “**closely held**” business. That is, the business will be owned by an individual or by a small group of people. Shares in the business will not be registered with the federal or state government or sold on a stock exchange. In most cases owners will be actively involved in the business.

Closely held businesses are different than “publicly traded” businesses that may have millions of owners. Shares of publicly traded businesses are bought and sold on national stock exchanges. These shares must be registered with federal and state securities agencies. Stock holders in publicly traded companies are investors. Usually, they are not involved directly in the business.

Closely held businesses with more than one owner face potential problems that should be resolved in advance. They arise from the owners’ personal involvement in the business and the fact that it will be difficult to sell an owner’s share of the company to outsiders. As a practical matter any sale will probably require the permission of all the other owners.

One potential issue is **stability**. Even if a closely held business is organized as an LLC or a corporation, it will function much like a partnership. Ordinarily, the owners will all be active in management and production. Each owner will contribute something that the others consider valuable, and they will be able to work together. None of the owners will want to be a position in which a new “partner” can be forced on them.

Also, the owners will want to avoid any situation in which any departing owner can force the company to buy him or her out immediately at a substantial cost. Even a business that is doing well may not have the necessary cash. An obligation to pay right away may kill the business.

Liquidity is the other side of the stability issue. Each owner will want to be able to cash out of the business under some circumstances. In the case of debilitating illness, there may be no choice. In other situations, such as a fundamental disagreement between the owners, the best solution may be for one of them to move on. It will be difficult for the departing owner to sell his or her interest to someone outside the business without the consent of the remaining owners.

Owners of closely held businesses need to plan how they will balance the needs for stability and liquidity in a variety of situations. They should do so at the creation of the business, when no one knows who will be an owner that wants to cash out or an owner that wants to stay in the business. Then they can agree on solutions that are acceptable to all of them.

Organic Beauty, LLC.

Consider a fictional business called Organic Beauty, LLC that is owned by three unrelated people:

- Mary has invested 40 percent of the capital and owns 40 percent of the business.
- Bob has invested and owns 30 percent.
- Pete has invested and owns 30 percent.

All three are actively involved in the business, and the LLC is their primary source of income.

Organic Beauty, LLC has been in business for four years. Like most new businesses, it lost money to begin with. But the company is now making money, and the future looks bright.

Mary, Bob, and Pete have not agreed about what will happen if one of them needs or wants to sell his or her share. Therefore, Nebraska's LLC Act will determine what happens in these situations. (They could have avoided the following problems if they had taken the time to work out a written agreement about how they were going to operate the company. The agreement would trump the LLC Act. See discussion below at pages 36-37.) Consider the following possibilities:

2. An owner wants out

Mary and Bob want to launch a new product line that will eat up all of Organic Beauty's profits and require substantial new investments by the owners. Pete is strongly opposed. He believes the new product line will ruin the company.

Pete will be able to block the change if he can convince Mary and Bob or a court that the decision to launch a new product line is "outside the ordinary course of the activities of the company." Under the LLC Act such decisions require unanimous approval. Note that this would give even a one percent owner veto power over the decision.

If a court decides that a new product line is "a matter in the ordinary course of the activities of the company," then the decision only requires majority approval.

Note that there is already a troublesome issue—whether a new product line is in or outside the ordinary course of company activities—that may lead to litigation. Litigation will be costly and delay the decision. It may destroy the business.

Assume that a decision to launch a new product line is in the ordinary course of Organic Beauty, LLC's business. Mary and Bob, with a combined 70 percent interest in the business, decide to go ahead over Pete's objection. Pete wants out. What does he do?

Pete does not have any right under the LLC Act to compel Mary and Bob to buy him out.

What about selling Pete's LLC interest to someone else? The LLC Act provides that Pete has a "transferable interest" that he can sell. But there is a problem. Pete cannot sell his right to participate in managing Organic Beauty, LLC. All he can sell is his right to receive future distributions from the LLC, if any.

Who decides whether to make any future distributions? The majority in interest, in this case Mary and Bob. They can decide to pay themselves salaries and not make any distributions at all. Pete will not find many buyers willing to rely on Mary and Bob's good will.

What's more, Pete will remain a member of the LLC even after he sells his transferable interest (unless Bob and Mary expel him). That means that Pete could be required to make additional contributions to the LLC.

As a practical matter, Pete will only be able to get his money out of the LLC with the consent of both Mary and Bob. He will have to negotiate a price with them, and they will have most of the leverage. Not a good outcome for Pete.

3. An owner dies

Consider another possible scenario. Mary is hit by a drunk driver and dies, leaving behind three small children. Under the LLC Act, neither Mary's children nor their guardian will have any right to participate in the management of Organic Beauty, LLC.

Mary's children are in the same situation as Pete was in the first scenario. All they will get is whatever distributions the LLC would have made to Mary if she were still alive. As in the first scenario, Bob and Pete could take all of Organic Beauty's profits out in salaries for themselves. That would leave nothing to be distributed to Mary's children. It would be mean, but it would be legal. The children's guardian might be able to sue to have the company dissolved, but dissolution might yield very little for the children.

This is not what Mary would have wanted. Presumably, it is not what Bob and Pete would have wanted for their families if they had been hit by the drunk driver instead of Mary.

4. Keeping the business going

On the other hand, allowing Pete in the first example or Mary's children in the second to receive immediate full payment for their share of Organic Beauty could destroy the business. Most small businesses do not have large amounts of cash. To

raise the money, Organic Beauty might have to take on crippling debt or simply shut down and sell all its assets. In that case, everybody loses because a successful company's assets are usually worth less than its value as a going concern.

5. Protecting minority interests

Another common issue is control of the company. Owners usually agree to make decisions on a *per rata* basis. The vote or votes of owners owning more than 50 percent of the company control. (If the owners do not agree on this point, then issues are decided on a *per capita* basis. Each owner has one vote.) This can be disastrous for owners who own less than 50 percent of the business.

In the Organic Beauty, LLC example, none of the three owners owns a majority of the company. That means that any two of them could gang up against the third. Mary has the largest share of the company at 40 percent. But if Bob and Pete combine against her, they would have 60 percent.

If two owners combine against the third, they could fire the third owner and pay themselves high-end salaries. They could reduce or even eliminate distributions. In that case, the third owner is trapped in the business with no way to get his or her money out.

6. Written agreement: resolving issues in advance

These situations and others can be resolved through a well-structured written agreement between the owners. Such agreements are private documents. They are not filed with any public office. These agreements have different labels depending on the business form:

- For partnerships, the agreement is a partnership agreement.
- For corporations, the agreement may be contained in bylaws or in a separate buy/sell agreement.
- For LLCs, the agreement is an operating agreement.

In an LLC or a partnership such agreements trump Nebraska statutes on almost all issues. If the parties make a deal, the law will enforce it even if the deal is different than the statutes. The LLC or Partnership Act only applies if the owners' agreement does not address an issue. There is slightly less room for maneuver with a corporation, but the owners still have great freedom in putting together an agreement.

Such agreements usually include provisions that determine how the value of a withdrawing owner's interest will be calculated and a procedure that gives the remaining owners a "right of first refusal." Right of first refusal gives the remaining owners the option to buy the withdrawing owner's interest for the same price an outsider has offered or at a price set by the agreement.

These provisions do not have to be the same for all situations. For example, in the case of a death most owners will want the family to get a fair price. The agreement can require a fair price but spread payment out over a number of years (with interest) to allow the business to continue operating.

In the case of a disgruntled owner who just wants out, an agreement could be harsher. It could forbid withdrawal altogether. Or it could provide that the most the withdrawing owner could get would be the amount he or she invested in the business.

Another common provision requires the unanimous consent of all the remaining members before a purchaser can become a member. That gives each of the remaining owners a veto over any proposed sale.

Owner agreements should also protect minority shareholders or interests. An agreement can list specific decisions —such as adding a new product line—that are outside the ordinary course of business. The agreement can provide that these decisions require a supermajority, such as 70 or 75 percent approval, or unanimous approval. A supermajority can be defined so that it requires approval by most owners without giving veto power to owners with a small share of the business.

An agreement for Organic Beauty, LLC could also provide that Mary, Bob, and Pete will be employed by the LLC and that none of them can be fired except for misconduct or incompetence. This would prevent any two of the owners from combining to fire the third arbitrarily.

If one owner owns over 50 percent of the company, then owners with smaller shares will want to negotiate as much protection as possible. Again, they may want to require supermajority or unanimous consent for fundamental changes in the enterprise. Owners with a minority interest may want provisions to protect their jobs or to require distributions under some circumstances. Whether they can get such provisions will depend on what the majority owner is willing to agree to.

CHAPTER 5: LIMITED LIABILITY

1. General rule

The issue here is whether creditors of the business can take an owner's personal assets—a house, personal bank accounts, the family car, etc.—to pay for debts of the business. This is a major concern for many small-business owners.

Corporations and LLCs protect their owners' personal assets from liability for business debts. In legal jargon, these forms provide "limited liability" or "limited personal liability." Limited liability partnerships and limited partnerships also provide limited liability protection to at least some of the partners.

Limited liability is a major advantage. Starting a business is risky. Limited liability protection allows an entrepreneur to put limits on the risk. With limited liability, an entrepreneur can take a chance without risking everything.

Sole proprietorships and general partnerships do not provide limited liability. Their owners' personal property can be taken away by creditors of the business.

Consider Organic Beauty, LLC as an example again. This time assume that the enterprise goes broke. After selling all of the LLC's assets and using the money to pay its debts, the company still owes its creditors \$50,000. Because the company was formed as an LLC, Mary, Bob, and Pete will not have to pay the creditors anything out of their personal assets. They will lose whatever money they invested in the business, but no more.

If, however, Organic Beauty had been formed as a general partnership, the business' creditors could take Mary's, Bob's, and Pete's individual assets to pay off the business' remaining \$50,000 debt. In fact, creditors could take the whole \$50,000 from any one of the three owners. See discussion at pages 20-21.

2. Exceptions

Limited liability protection is **not absolute**. There are still situations in which an owner of an LLC or a corporation can become personally liable for some or all of the businesses' debts. The most common exceptions are:

- **Personal guarantee:** If an owner personally guarantees a business loan or a bill such as phone or internet, then the owner is no longer protected. The owner becomes a co-signer for the loan or bill. The lender or creditor can take the owner's personal property to pay off the guaranteed debt. Owners of small start-ups may find it difficult to get loans or open accounts without a personal guarantee. This is not necessarily fatal; you should just know

that you will be personally liable for the guaranteed debt. A time will come when your company has proven itself and can get credit in its own name.

- **Personal negligence:** Owners of LLCs and corporations remain liable for their own negligence. If an owner runs a red light and injures someone while driving a company vehicle, both the driver-owner and the company will be liable. The injured person could take the driver-owner's personal assets. But other owners, who were not driving the vehicle, will not be personally liable.

- **Failure to maintain separate business identity:** Corporations and LLCs are legal "persons." They can own their own assets and have their own debts. They can sue and be sued in their own name. This separate existence is what creates limited liability for the owners. The LLC's or corporation's debts are not the owners'.

But if owners fail to maintain the legal separation between the business and themselves, they can lose limited liability protection altogether. This usually happens because the owners treat the LLC's or corporation's property as if it belonged to them. People set up separate business accounts, but then pay personal expenses directly out of the company account. If owners use business accounts as if they were a personal ATM, then a court may allow business creditors to collect business debts from owners' personal assets.

- **Inadequate capitalization:** If the LLC or corporation never has any assets of its own, then a court might treat it as a sham and allow business creditors to collect from the business owners' personal assets. There is no minimum investment required to create an LLC or corporation. But the owners should invest enough money or other property in the LLC or corporation to give it substance.

You should take every opportunity to emphasize the fact that your LLC or corporation is a separate legal person from you. Use the business' name, including "LLC" or "Inc." on letterhead, contracts, and business cards. When you sign documents, make it clear that you are signing on behalf of the company rather than as an individual. For example, Mary in our Organic Beauty, LLC example should sign business documents like this:

Organic Beauty, LLC

By: _____
Mary X, Member

If you choose to form as a corporation, then there are a number of additional steps that you will have to take to maintain the corporation's separate existence such as creation of a board of directors and regular board and shareholder meetings. See the discussion below, pages 28-30.

Even with these limitations, limited liability is still valuable. It will protect owners from personal liability for the negligence of employees or from any debts that they do not personally guarantee. As the business grows and establishes a track record, it may become possible for owners to demand credit in the business' name alone. Limited liability will also make it easier to attract investors, who will not want to put all of their assets on the line.

Finally, you will want business liability insurance even if you form as an LLC or a corporation. Business creditors may still sue you personally. You should win, but you may have substantial legal fees. Also, insurance is available to protect the business itself as well as the owners from personal injury and other kinds of claims.

CHAPTER SIX: SELF-EMPLOYMENT TAX

Self-employment tax is an important concern for all self-employed people regardless of whether they operate as a sole proprietor, partnership, LLC, or S corporation. Self-employment tax is how self-employed people pay Social Security and Medicare taxes. It is the equivalent of FICA (Federal Insurance Contributions Act) for employees. The difference is that employers pay one-half of their employees' FICA taxes. Self-employed people pay it all themselves.

Self-employment taxes are paid only on compensation: salaries and hourly wages. Income that is not compensation—dividends, interest, and capital gains—is not subject to self-employment tax. (As of 2013 some high income households will have to pay employment taxes on some of their investment income. A “high-income” household is a household with \$250,000 or more in adjusted gross income for those who file as married, filing jointly and \$200,000 for those filing individual returns.)

This creates a major tax advantage for income that is not compensation. Entrepreneurs receiving dividends, interest, or capital gains will not have to pay self-employment taxes on this income.

The rate for self-employment tax is a combined 15.3 percent. This includes 12.4 percent for Social Security and 2.9 percent for Medicare. Social Security is paid on compensation up to \$113,700 in 2013. Earnings over \$113,700 are not subject to the 12.4 percent Social Security tax. (The cap is raised each year.) There is no cap for Medicare tax. The 2.9 percent for Medicare is paid on all of a person's compensation.

Owners can be employed by their partnerships, corporations, and LLCs. In that case, the company withholds 7.65 percent of an owner-employee's compensation for Social Security and Medicare. The company matches this 7.65 percent just as it does for any other employee and submits the combined 15.3 percent to the federal government.

The difference for an owner-employee is that the company's money is the owner's money. Both the withholding and the match come out of the owner's pockets. In effect, the owner-employee winds up paying the whole 15.3 percent that a self-employed person pays.

Self-employed people pay self-employment taxes on about 92 percent of their compensation. Unlike income tax, there are no deductions, credits, or exemptions. As a result, many people pay more in self-employment tax than they do in federal income tax.

For example, consider a person who is the sole owner of a business that he or she manages. Assume that the business had a net profit of \$90,000 in 2009. The owner is married, has two children, and files a joint return. The family has no other

income. The owner would be able to subtract at least the standard deduction, four exemptions, and other items from his or her gross income to determine taxable income. Using 2009 federal tax rates, the owner's federal income tax would be about \$8,269.

The owner would pay much more in self-employment taxes because he or she would not be able to subtract deductions or exemptions in determining the amount subject to tax. The owner will first multiply his or her compensation by 92.35 percent. The owner will then pay 15.3 percent of this figure in self-employment tax. The amount due would be \$12,717:

$$\$90,000 \text{ compensation} \times .9235 = \$83,115.$$

$$\$83,115 \times .153 = \$12,716.60$$

Clearly, anything that a self-employed person can do to protect some income from self-employment tax will be beneficial. (However, there is a trade-off. The less a person pays in self-employment taxes, the less he or she will receive in Social Security benefits on retirement.)

Sole proprietors pay self-employment tax on all of their profit from self-employment.

Owners of C corps will only pay self-employment tax on compensation from the company. They will not pay it on dividends.

When it comes to partnerships, LLCs, and S corps, the situation is not as clear. Nevertheless, there are some tools for reducing income subject to self-employment tax. In an S corp, active owners must pay themselves reasonable compensation, and they will pay self-employment taxes on this compensation. But their share of the S corp's profits is not subject to self-employment tax. See pages 31-32.

Partners and LLC owners may take advantage of this option by notifying the IRS that the LLC wants to be taxed as if it were an S corporation. See page 39.

Another possibility is that "passive" LLC members or partners will not have to pay self-employment tax on their allocated share of the company's profits. To qualify as a passive owner, an owner must work no more than 500 hours a year for the company and also must not have management or contractual authority. See page 39.

CHAPTER 7: CHOOSING A BUSINESS FORM

This chapter is written primarily from the perspective of someone starting a new business, but it should also be useful for readers already in business.

If you are already in business, you have selected a business form whether you meant to or not. If you are in business by yourself and have not created a limited liability company (LLC) or a corporation, then you are a sole proprietorship. If you are in business with other people and have not adopted some other business form, then you are in a general partnership. You will find information about both in this chapter.

Whether you are starting a new business or considering whether to reorganize an existing one, you should take a practical approach. No business form is right or best for every business. Each has advantages and disadvantages. As an entrepreneur, you are working long days already. There is no point to creating or changing a business form unless there are concrete advantages for you.

1. Legally recognized businesses

There are four general Nebraska business forms. Partnerships and corporations have several subcategories:

- Sole proprietor
- Partnerships, including:
 - General partnership
 - Limited partnership
 - Limited liability partnership
- Corporations, including:
 - C corporation (“C corp”)
 - S corporations (“S corp”)
- Limited liability companies (LLCs)

In choosing a form you should consider:

- The ease or difficulty of creating and maintaining the business form. What formalities, if any, are required?
- How flexible and effective is the business form in resolving the issues faced by closely held companies?
- What are the tax consequences of each form, including self-employment tax and tax basis? I
- Does the form offer limited liability protection or are the owners personally liable for the business’ debts?
- How difficult is it to transfer the business to someone else?
- Does the business form facilitate estate planning?

2. Sole Proprietorship

A sole proprietorship is a business owned by one person who has not formed a corporation or an LLC. The business and the business owner are one and the same. Apart from the general requirements discussed above, pages 4-5, no legal formalities are required. The business owner obtains any necessary permits or licenses and opens up for business.

It is especially important for a sole proprietor to register his trade name with the Secretary of State. Other business forms, such as corporations, require a filing with the Secretary of State that will include the businesses' trade name. For a sole proprietor, the registration of trade name is the only form that will be filed with the Secretary of State.

From a legal perspective, it is easy to start and manage a sole proprietorship. No shares of stock are needed to represent ownership. The owner controls the business. No property has to be transferred to the business because all of the owner's property is also property of the business. The owner is responsible for all the business' debts.

The disadvantage is that all of the owner's property (except certain kinds and amounts that are "exempt") can be taken by business creditors if the business fails. This includes property that is not connected with the business such as a house or personal vehicle. This risk is unavoidable for a sole proprietorship. Since the business owner and business are one and the same, all of the business' debts are automatically the owner's debts too. If the business owes money, the owner owes it too.

Many risks of liability can be managed with adequate insurance. But there is no insurance to pay business bills if the business goes under.

In a sole proprietorship, all net profit is income for the owner. Income is taxed only once, at the owner level. This income should be reported on Schedule C and Form 1040. Quarterly estimated payments may be required.

Sole proprietors will also have to pay self-employment tax on about 92 percent of all profits. As pointed out above, pages 14-15, this means a tax of 15.3% in addition to income taxes.

It can be difficult to transfer a sole proprietorship, either to the next generation or to a third party because it is such a personal enterprise. Inventory, other property, and good-will can be sold, but it's hard to sell personal relationships. It will be difficult to sell while staying involved. By definition there can only be one owner. For these reasons, a sole proprietorship has limited transferability.

A. Sole proprietorship pros & cons

Pros

- Easy to form
- Flexible
- Direct control
- Profit taxed only once, at the owner's level

Cons

- Unlimited personal liability
- Lack of continuity, difficult to transfer
- Self-employment tax on all profit

3. Partnership types

A partnership is a business formed by two or more “persons” as co-owners to carry on a business for profit. Individuals, another partnership, a corporation, or an LLC are “persons” and can own part or all of a partnership. Partnership is the “default” form for businesses with two or more owners. If a business has two or more owners and the business is not an LLC or a corporation, then it is a partnership.

There are three types of partnerships in Nebraska:

- General partnership
- Limited liability partnership
- Limited partnership

4. General partnership

A. Formalities to create and operate

A general partnership can be created without filing documents with the Secretary of State. The law does not require that partnerships hold regular meetings or record their decisions in writing either. The only requirement is that two or more persons become co-owners of a business for profit.

The law presumes that all general partnerships have a **partnership agreement**. Partnership agreements may be written, oral, or implied from the partners' actions. Your agreement should be in writing. This will minimize future disagreements. A comprehensive written partnership agreement will also allow you to decide in advance on the major issues confronting closely held businesses.

Flexibility is the greatest advantage of a partnership. Partnership law is basically contract law. Nebraska has adopted the Uniform Partnership Act, a set of statutes

regarding general partnerships. But the Act applies **only** to issues that are not addressed in the partnership agreement. Partners are free to structure their deal in virtually any way they please, and the law will enforce the deal.

For example, the Uniform Partnership Act provides that all partners have equal management rights. But a partnership agreement can limit management to one or a few partners. The partnership agreement will control in any dispute between the partners about management decisions.

One good way to appreciate the advantages of a partnership agreement is to ask what will happen if there is no agreement or if the agreement is incomplete. In that case, the Uniform Partnership Act controls. The Act's key provisions include the following:

- Each partner has an equal right to manage and conduct the business.
- Disagreements arising in "the ordinary course of business" will be decided by the majority vote of the partners.
- Each partner is entitled to an equal share of the partnership profits.
- New partners may be admitted only with the unanimous consent of all existing partners.
- Each partner may transfer partnership property by signing the transfer document in the partnership's name.

These statutory provisions may create significant problems and defeat a partner's expectations. For example, consider a partnership with three partners. Partner A invests \$15,000, Partner B \$8,000, and Partner C \$2,000. Under the Uniform Partnership Act:

- 1) All three partners will have an equal say in managing the business. C has just as much power to make contracts for the partnership as A and B.
- 2) If there's a disagreement about how to run the business, it will be decided by **a majority vote based on the number of partners, not their respective shares of the business**. That means A can be outvoted by B and C even though A has a 60% interest.
- 3) If the business has a \$90,000 profit, it will be divided equally among the three partners. A, B and C will each get \$30,000 even though A has invested almost twice as much as B and more than seven times as much as C.
- 4) If A decides to sell his interest in the partnership, he will need C's permission because admission of new members requires unanimous approval.

This is probably not what A wanted when he invested his \$15,000. He could find himself in a partnership that's controlled by B and C despite the fact that he is the majority owner.

If A, B, and C had a thorough partnership agreement, it would trump the Uniform Partnership Act provisions. The partners could make any deal they could agree on. The agreement will reflect the relative contributions and leverage of each partner.

A big advantage of a partnership agreement is that **allocations and distributions can be disproportionate to a partner's investment**. Consider the partnership of A, B, and C again. Assume that C is the only partner with experience in the business. She has very valuable contacts with suppliers and customers and is vital to the success of the business.

In that case, the partners could decide that C will manage the company and that she will receive a guaranteed salary. The parties could also decide that C will get 10% of net profits even though she has only put up 8% of the capital.

(A provision for division of gains and losses that is out of proportion to the partners' investments in the business is called a "special allocation." Under IRS regulations special allocations must have "substantial economic effect." The rules for determining substantial economic effect are extremely complex. If you want to include special allocations in your partnership agreement, be sure to consult a tax expert in this field.)

Suppose that A is leery of keeping his money in the company for more than five years. The partnership agreement could give A the option of withdrawing after five years, and provide a mechanism for determining how much A's interest is worth at that point. It could also craft an arrangement for paying A over a period of years with interest so that the partnership does not have to come up with the money all at once.

Or suppose that A wants C to handle the day to day operations but wants to make fundamental decisions such as merging with another company or incurring major new debt. A partnership agreement could require 60% approval of such decisions, thus assuring that A would control the outcome.

These are only a few examples of the flexibility of general partnership agreements. If you decide to do business as a partnership, you should take full advantage of this flexibility. It is worth consulting a business lawyer. He or she can advise you about potential situations that you probably will not have thought of.

Partnership agreements are internal, private documents. They do not have to be filed with the Secretary of State or any other government office.

The agreement should be **in writing** and signed by all the partners. Courts will enforce verbal contracts. The problem is that the partners will disagree about what the agreement is. People do not necessarily lie, although that happens. It is just human nature to remember things in the light most favorable to oneself. Then a judge has to decide who to believe.

It is even worse if a court has to figure out an "implied" partnership agreement by examining the partners' actions. With either an oral or implied agreement, the partners basically leave it up to judge to decide what their deal is.

B. Limited personal liability

Unlimited personal liability is the major disadvantage of a general partnership. **Each** partner is responsible for **all** of the partnership's debts. If the business fails and cannot pay its debts, then the partners are personally responsible for paying them. Again, each partner is personally responsible for all of the debt.

A partnership creditor may collect its entire debt from any one of the partners. This will happen if there is only one partner with substantial assets or if the creditor can only find one partner. The partner who is left holding the bag can demand that the other partners pay their share. But that is meaningless if the other partners are broke or if they have left town.

Remember that the general rule is that each partner has equal power to manage the business, including the power to make contracts and borrow money. An unscrupulous partner could create partnership debts without telling the other partners. Each of the other partners would still be personally liable for that debt.

With this much on the line, you will want to be very careful about choosing a partner.

There is a brighter side to unlimited personal liability. A partner forced to pay a partnership debt out of his or her own pocket can demand that the other partners pay their share. The same is true for a partner sued in connection with the partnership. He or she can require the other partners or the partnership to compensate him. As long as other partners have significant personal assets, the power to compel contributions can be an important safeguard.

C. Income tax, including tax basis

Partnerships, S corps, and LLCs are all "pass-through" organizations for income tax purposes. Please see the definition of pass-through taxation at page 3. General partners include their allocated share of partnership gains and losses in their personal tax returns. If there is a net gain, then each partner will pay income tax at the partner's individual rate as determined by their total income. If there is a net loss, then partners may be able to offset income from other sources. This offset will reduce total income and the partner's income tax.

Partners pay tax on their allocated share of the partnership's gains **regardless of whether any money is actually distributed to them**. If the partnership decides to retain its profits to fund future operations or expansion, then a partner may be taxed on money that he or she has not actually received. (A partnership agreement can require the partnership to distribute at least enough money to cover each partner's taxes arising from the partnership.)

Why would anyone want to use a business form that may result in taxes on money he or she has not received? Because partners do not pay income tax on distributions. Partners only pay income tax on partnership profits once, in the year the partnership has the profit. Subsequent distributions are tax-free as long as the partner has a positive capital account.

Partners should receive a Form K-1 from the partnership that sets out their allocated share of gains and losses. Partners then report these gains and losses on their individual returns, using federal Schedule E.

Pass-through taxation means that partnership profits are only taxed once, at the individual partners' tax rates. C corp profits may be taxed twice, once at the corporate level and again at the shareholder level. See "Corporations," below, pages 33-34.

Pass-through entities also have a significant tax advantage when it comes to basis. Please see the definition of basis at page 2. In pass-through tax entities an owner's basis is adjusted each year. The general formula is as follows:

Contributions (money or value of property invested in business)
+ Allocated share of gains
- Allocated share of losses
- Distributions
= Adjusted basis

If the business does well and if the owners leave a substantial portion of profits in the business as opposed to distributing the profits to themselves, then the owners' basis will steadily increase. If the owners choose to sell the business, the higher basis will mean a smaller capital gain and less income tax.

In a C corp, basis is the amount of money paid for shares. It is not adjusted in light of the business' performance. When owners of a successful C corp sell their business, their basis will be substantially lower than it would be if the business was a partnership, LLC, or S corp. Their capital gain will be substantially more, and so will their taxes.

D. Self-employment tax

Like sole proprietors, general partners must pay self-employment tax on all of the business' profits. This is true even if the money is not actually distributed to them. The partnership's net profit will be allocated among the partners each year, and active partners will pay self-employment tax as well as income tax on their allocated share of profit.

However, a partnership may be able to elect to be taxed as if it were an S corporation. This would allow the partners to protect some profits from self-employment tax. See pages 31-32 and 40.

E. Transfer

As a practical matter, it may be impossible to sell your interest in a partnership without the agreement of all your partners. Unless the partnership agreement provides otherwise, the buyer does not become a partner without unanimous approval of the partners.

A buyer who does not become a partner has no management rights. He or she is only entitled to receive the seller's share of any distributions approved by the partners. This is called an "economic interest." It may be worthless. The partners are not required to make any distributions. They could take money in the form of salaries and leave the buyer with nothing.

Few people want to invest in a business in which other people have the sole authority to decide if and when they will receive any return on their investment.

Partnerships are also very personal relationships, and this can make it difficult to sell an interest. Third parties may not be interested in becoming partners with people they do not know well. By the same token, existing partners will not want to be in a position in which a stranger can be forced upon them as a new partner. Many partnership agreements include provisions that restrict partners' rights to sell their share.

It is different if all the partners decide to sell the business. The partners could sell the business to another partnership, an LLC, a corporation, or an individual (in which case it would become a sole proprietorship). Former partners would remain personally liable for any debts created while they owned the partnership. The new owners would be free to restructure the business however they pleased. This makes it easier to sell a general partnership than a sole proprietorship.

As pointed out on page 22, partnerships—as well as LLCs and S corporations—have a significant tax advantage when the business or an interest in it is sold.

F. Estate planning

When a general partner dies, the other partners face a choice under the Partnership Act. One option is to pay the deceased partner's estate for his share of the business. The estate will receive the higher of the decedent's share of the company's assets or his share of the business' value as a going concern.

The other option is to terminate the partnership. Termination triggers a process that results in sale of all the partnership's assets, payment of its debts, and distribution of any remaining money to the partners, including the deceased partner's estate.

With either option the decedent's heirs do not become partners. The partners can provide for a different outcome in their partnership agreement. For example, parents may want one or more of their children to become partners on their death. A partnership agreement can accomplish this.

Partners can also permit transfer of part or all of a partner's interest during the partner's lifetime. Such transfers can bring interested children into the business while minimizing estate taxes by taking advantage of federal gift rules. This can be a valuable estate planning tool. See the discussion of gift tax discounts for closely held businesses in the LLC section, page 40. **But there are special rules for family gifts of interests in partnerships. Also, gift and estate tax rules are complex and often change from year to year. Be sure to consult an estate expert before implementing an estate plan that includes partnerships.**

But remember that anyone who becomes a general partner is liable for all of the partnership's debts, even if his share of the partnership is very small. Accepting a gift of a general partnership interest can be risky.

G. General partnership pros & cons

Pros

- Great flexibility. Courts will honor partners' contract or deal.
- No legal formalities to create. (But written partnership agreement essential.)
- No double income taxation. Income tax paid by individual partners.
- Distributions tax free.
- Owners may include other partnerships, LLCs, and corporations as well as individuals.
- Power to compel contributions by other partners if partner is sued or forced to pay a partnership debt.

Cons (Note that many cons can be fixed through partnership agreement.)

- Each partner liable for all partnership debts. No protection of partner's individual property. (Can not be altered by partnership agreement.)
- Difficult to sell interest.
- Default rules are equal control, equal division, and per capita majority rule.
- All profit subject to self-employment tax.

5. Limited Liability Partnership

Limited liability partnerships are just like general partnerships except that the partners get the same limited liability protection provided by LLCs and corporations. That is, the partners are not personally liable for the partnership's debts simply because they are partners.

Partners must file a simple form called a “statement of qualification” with the Secretary of State. It must be approved by the same vote required to amend the partnership agreement. A statement of qualification must include:

- The name of the limited liability partnership, which must include the term “limited liability partnership” or an abbreviation of it.
- The street address of its “chief executive office” in Nebraska.
- A statement that the partnership elects to be a limited liability partnership.

The filing fee for a statement of qualification is \$200.00 plus \$5.00 a page as of January 2013.

For \$205.00 partners can change a general partnership into a limited liability partnership and eliminate the main drawback of a general partnership: unlimited personal liability. They would retain partnership benefits such as its flexibility and tax structure.

Why would any partnership not do this? The answer is that becoming a limited liability partnership is not necessarily good for all the partners.

Whether a limited liability partnership is right for you depends on what your role is in the partnership. The more active your role, the less likely it is that you would benefit from a limited liability partnership. If your role is largely passive, a limited liability partnership will be beneficial to you.

If you are dealing directly with customers, making deals, hiring and firing, and/or overseeing the production of goods or provision of services, then it is more likely that you will be sued personally if something goes wrong. A customer could claim that you committed fraud or that you were responsible for a defective product. If you have to pay out of your own funds, you cannot compel the other partners to compensate you. Thus active partners in a limited liability partnership are taking a much bigger risk than their passive partners.

Whether to become a limited liability partnership is something else for partners to negotiate. Perhaps an active partner would be willing to assume more risk if he or she is paid substantially more or if the company purchases liability insurance in his or her name. The law leaves it up to the partners to decide this issue.

Limited liability partnerships must file annual reports with the Secretary of State, but the forms are simple and do not require an attorney. Partners can elect to become a general partnership again by revoking the statement of qualification.

A. Limited liability partnerships pros & cons

Pros:

- Great flexibility. Courts will honor partners' contract or deal.
- No double income taxation. Income tax paid by individual partners.
- Distributions tax free.
- Partners may include other partnerships, LLCs, and corporations as well as individuals.
- Limited personal liability protection.

Cons:

- Some legal formalities to create: statement of qualification and written partnership agreement.
- No power to compel contributions by other partners if partner is sued or forced to pay partnership debt.
- Difficult to sell interest.
- Default rules are equal control, equal division, and majority rule.
- All net profit for active partners subject to self-employment tax.

6. Limited Partnership

A. Formalities to create and operate

Limited partnerships have two classes of partners: general and limited. General partners manage the business, while limited partners are investors with no management rights. Limited partnerships are often used to form a pool of money for real estate or stock investments. However, any business can be formed as a limited partnership.

A limited partnership is created when the general partners file a "certificate of limited partnership" with the Secretary of State. The certificate contains the name of the partnership, which must include the words limited partnership or limited or the abbreviations L.P. or Ltd. The certificate must also include:

- 1) The partnership's office address.
- 2) The name and street address of the agent for service of process.
- 3) The name and business, residential, or mailing address of each general partner.

The filing fee for a certificate of limited partnership is \$200.00 plus an additional \$5.00 a page.

A written partnership agreement is required and may be quite complex. In addition to the rights and duties of general and limited partners, it will often include detailed information about the past performance of the limited partnership and the qualifications of the general partners.

B. Limited personal liability

General partners are responsible for managing the business and are personally liable for partnership debts. Limited partners are not personally liable for partnership debts. They are investors. They hope to make money through the successful efforts of the general partners. If things go badly, limited partners can lose their investment, but that is the extent of their risk.

C. Income tax, including tax basis

A limited partnership is a pass-through entity for income tax purposes, just like general and limited liability partnerships. The partnership reports its gains and losses to the IRS, but it does not pay income tax itself. The gains and losses will be allocated to the partners and reported on the partner's income tax returns. Each partner should receive a Schedule K-1 from the partnership with his share of gains and losses.

As in a general partnership, partners in a limited partnership will pay income tax on their allocated share of gains and losses even if no money is actually distributed. Subsequent distributions will not be subject to income tax.

Basis is adjusted each year just as it would be in a general partnership. See page 22.

D. Self-employment tax

It is absolutely clear that limited partners will not have to pay self-employment tax on their allocated gains. Limited partners are not in business for themselves. They are investors, just like shareholders in a publicly traded corporation.

General partners will pay self-employment tax on their allocated share of gains.

E. Transfers

The partnership agreement will usually prohibit the sale of limited interests to third parties. However, it will also require the partnership to buy back or redeem a limited partner's interest on request, subject to certain terms and conditions. The conditions will probably limit redemptions to specific time periods each year. Nevertheless, it is easier for a limited partner to cash out than it is for a partner in a general partnership.

F. Estate planning

Limited partnerships can be a valuable tool in estate planning. Parents can transfer limited interests in the family business to children, giving the children a share of the business while maintaining control in the parents as general partners. Or a parent could make a child who is actively involved in the business a general partner. These gifts can be coordinated with gift and estate tax provisions to minimize estate taxes on the parent's death.

However, the IRS has created a complex set of rules dealing with the gift or transfer of interests in partnerships to a relative. If you violate these "family partnership" rules, you may find yourself owing unexpected taxes and penalties. **Please consult an accountant or attorney who is experienced with partnerships as estate planning tools before transferring or giving an interest in a partnership to a relative.**

G. Limited partnership pros & cons

Pros:

- Good means of attracting investors without giving up control.
- Flexibility. Partnership agreement governs in most cases.
- Valuable for estate planning if you do not violate family partnership rules.
- Limited liability for limited partners.
- Limited partners do not pay self-employment tax.

Cons:

- Some formalities to create: Certificate of limited partnership.
- Additional formalities: disclosures to limited partners.
- General partners personally responsible for partnership debts.
- General partners subject to self-employment tax.

7. Corporations

There are two types of corporations for our purposes: C Corporations ("C corps") and S corporations ("S corps"). They are created the same way under state law. However they are treated differently for income tax purposes. In fact, the two types are named after the subchapters of the Internal Revenue Code that deal with them: Subchapters C and S respectively.

The following discussion first describes the legal formalities and other characteristics that are common to all corporations. It will then discuss some of the differences between C Corps and S Corps. Most microenterprises that choose the corporate form choose the S corp.

8. Common Characteristics of C and S Corps

A. Formalities to create and operate

Corporations are less flexible than partnerships or LLCs. Nebraska's Business Corporations Act imposes very specific requirements both for creating and maintaining corporations. These requirements are referred to as "corporate formalities" or just "formalities."

When a corporation is organized you are creating a person that can sue and be sued, own property, and pay taxes—all in its own name. The corporation is a separate legal person from its owners, who are called "shareholders."

Here are the formalities to create and maintain a corporation:

i. Articles of Incorporation. Articles of incorporation must be filed with the Nebraska Secretary of State. The filing fee varies according to the value of "authorized" shares of stock. Authorized stock is the upper limit on shares a corporation can issue. "Issued" stock is stock that someone has purchased. A corporation could authorize 10,000 shares but only issue 10 shares at first. Filing fees start at \$60.00 for up to \$10,000 worth of authorized shares.

Articles of Incorporation must include the following information:

- The corporate name, which has to include either corporation, incorporated, company, or limited or an abbreviation for one of them.
- Number of authorized shares and their "par value" (the minimum amount that shares will be sold for, often \$1.00).
- Street address of the registered office and name of the registered agent.
- Name and street address of each incorporator (the person or persons who organize the corporation).

Articles may, and often do, contain other information such as a statement that the corporation will engage in any business permitted by law. Articles may also name an initial board of directors.

S Corp articles should include restrictions on the number and types of owners as well as the type of stock that may be issued. These restrictions are discussed below, pages 32-33. The articles often include a statement that the corporation will elect to be taxed as an S corp.

ii. Publication. Once the Secretary of State has accepted the articles of incorporation, notice must be published once a week for three succeeding weeks in a "legal newspaper of general circulation in the county" where the corporation is located. The notice must include:

- Corporate name.
- Number of authorized shares.
- Street address of registered office and name of registered agent.
- Name and street address of each incorporator.

The notice does not have to specify whether the corporation will be a C or S corp.

The cost of publication varies from \$30 to \$60 depending on the newspaper.

iii. Bylaws. The corporation must also adopt bylaws that will govern its internal operations. Bylaws are not filed with the Secretary of State and are not public documents. The Business Corporations Act imposes requirements such as annual meetings of shareholders and boards of directors, notice provisions, and officers. All of these requirements will be set out in the bylaws.

Bylaws may also include restrictions on the transfer or sale of stock. Such restrictions may also be included in a separate agreement called a buy-sell agreement. While bylaws are binding on all the shareholders and the corporation, buy-sell agreements are only binding on the shareholders who sign them. Such agreements are often signed by all shareholders, but this is not required.

iv Organizational meeting. Once the articles of incorporation have been accepted by the Secretary of State, an organizational meeting has to be held. If the articles name an initial board of directors, the board calls the meeting. If not, the incorporator(s) call it. At the meeting, a board of directors will be chosen (or confirmed if there already is one), officers will be selected, and bylaws will be adopted. The board will conduct any other necessary business such as issuing shares and approving a form stock certificate.

There are no size requirements for a corporate board. The board may consist of one person. Also, one person may hold all of the officer positions.

Once you have filed articles of incorporation, published notice, held an organizational meeting and adopted bylaws, corporate formation is complete. You need not do things in exactly this order, except that filing articles is always the first step.

v. Ongoing operations. The statutes also impose a number of formalities for the ongoing operation of a corporation. These include:

- Regular board meetings and shareholder meetings (at least annually).
- Notice of all meetings as required by the bylaws.
- Permanent written records or minutes of actions taken at these meetings.
- Action through formal resolutions, included in the minutes.

vi. Corporate formalities in a closely held corporation. The requirements to create and maintain a corporation may seem difficult, even intimidating. And they will be difficult and costly for a large publicly traded corporation with millions of shareholders who must be notified in writing of each meeting.

But corporate formalities are much easier to deal with in a closely held corporation that has only a few owners or even a single owner. Annual meetings and notices should not be a problem. Resolutions still have to be adopted and minutes kept, but the proceedings will be simple. Ownership and management will merge because the shareholders will also be the directors and officers.

The law permits one-person boards of directors and allows one person to hold multiple offices. So in a corporation with only one shareholder he or she can constitute the entire board and hold all the offices. The shareholder will still be required to hold “meetings” and keep minutes, but obviously the proceedings are going to be simple.

For a corporation owned by a few relatives, the required meetings can take place around a kitchen table or at a favorite restaurant or bar. If the business does well, the meetings can be held in Hawaii!

Nevertheless, failure to observe corporate formalities creates serious problems. See the following section.

B. Limited personal liability

Both C and S corps provide limited liability protection. Shareholders, board members, and officers are not personally liable for the corporation’s debts. The shareholders’ investment, the amount they paid for the corporation’s stock, is always at risk. But corporate creditors cannot take shareholders’ personal assets.

There are practical and legal limitations on the protection from personal liability provided by small corporations. See pages 11-12. Corporate formalities play a key role in maintaining limited liability. If the shareholders do not observe the required legal formalities, they may find themselves personally liable for the corporation’s debts.

C Self-employment tax

A shareholder who is also an employee will pay employment taxes on his or her salary. Roughly half of the total will be withheld from his or her paycheck by the corporation, and the corporation will match that amount. Of course, since the shareholder owns the corporation the corporate match will come out of his or her pocket too.

However, there is no self-employment tax on dividends from a C corp.

An S corp will not pay dividends. Any net profit after payment of expenses (including compensation for shareholder-employees) is allocated among the shareholders according to their share of the corporate stock. See pages 33-34 below. Any allocation that is not compensation will not be subject to self-employment tax.

To sum up: Shareholders employed by their corporation will pay employment tax on any compensation they receive. But any corporate payment or allocation to stockholders that is not compensation is not subject to self-employment tax. Not paying self-employment tax on this portion of the company's profit will save shareholders about 15.3 percent.

A thoughtful person might ask: If I form a corporation, why pay myself any compensation at all? Why not just distribute or allocate all the profit to myself and avoid employment taxes altogether?

The answer is that the IRS will not allow you to do this. Shareholders who work for their corporation must pay themselves "reasonable" compensation. And compensation is always subject to self-employment tax. What is reasonable depends on what people doing similar work in your community are making.

For many microentrepreneurs there is not much left over after paying themselves reasonable compensation. In their early years most businesses lose money. So shareholders will not be able to shelter any profit from self-employment tax.

But once a business gets to the point that it has profit after paying its owners reasonable compensation, the ability to reduce self-employment tax becomes a major advantage. (Of course, the less one pays in self-employment tax, the less one will receive in Social Security benefits after retirement.)

The ability to shelter some profit from self-employment tax gives corporations a major advantage over sole proprietorships, general partnerships, and LLCs. **However, LLCs and partnerships can also protect some profit from self-employment tax by electing to be taxed as if they were an S corp.** See "Limited Liability Companies," page 39.

D Transfer

Shareholders of closely held corporations face the same transferability problems as other closely held businesses. See "Closely held businesses," pages 6-10 and the discussion of transferability in the partnership section, page 23. In addition, if you choose an S corporation you will, with some exceptions, only be able to transfer or sell shares to individuals. See the next section, Limitations on S corp ownership and stock.

Bylaws and buy-sell agreements are structured to deal with these issues in much the same way that a partnership agreement can.

9. C Corp and S Corp Differences

A. Limitations on S Corp ownership and stock

One person can own an S corp or a C corp. S corp ownership is capped at 100 shareholders. This is more than adequate for most microenterprises. The actual number of individual shareholders may be higher because a family counts as one shareholder. For example, if two parents and their three children all own shares in an S corp, they only count as one shareholder. There is no upper limit on owners in a C corp.

With some limited exceptions, S corp shareholders must be individuals. Corporations, multi-owner LLCs, partnerships, and most trusts may not own shares in an S corp. (Single owner LLCs may own S corp shares.) This can be important because it limits the number of potential investors in the S corp. Many investors do business through a corporation, partnership, or multi-owner LLC. If they invest in your business, they will want to use their LLC, etc. If your business is an S corp, they will not be able to do that.

A “nonresident alien” cannot own shares in an S corp. A nonresident alien is someone who is not an American citizen and does not reside in the U.S. A French citizen, for example, can own S corp shares as long as he or she is living in the US. If he or she returns to France or moves to Canada, however, then he becomes a nonresident alien. That would destroy the S corp, with unpleasant tax consequences for the owners.

An American citizen living abroad is not an alien and may be an S corp owner.

An S corp can only have one class of stock. Distributions must be in direct proportion to the number of shares owned by each shareholder. This means that owners of an S corp have much less flexibility than partners do in distributing profits and losses. Partners may decide to give one or more partner(s) a disproportionate share of profits or control. See page 20. S corp shareholders do not have this discretion. If someone owns 10 percent of the issued shares, then 10 percent of the company’s gains and losses must be allocated to that person.

There are no limits on the types or numbers of owners that C corps can have. C corps can be owned by other corporations, LLCs, and partnerships as well as individuals. Thus, C corps have a larger market for their shares than S corps.

C corps can also have multiple classes of stock, such as common and preferred shares. Preferred stock typically pays a fixed rate of return, but does not have voting rights. Common stock has voting rights, but the rate of return varies from year to year.

B: Income tax, including tax basis

C corps and S Corps are taxed very differently.

A C corp is subject to “double taxation.” It pays its own income taxes on any profits, using federal Form 1120. The mere fact that the C corp has a profit or loss does not trigger any tax consequences for the individual shareholders. However, if the C corp chooses to distribute earnings to shareholders in the form of dividends, shareholders must pay income tax on the dividends. The individual shareholder reports the dividends on federal Schedule B and Form 1040.

This means that any dividends to C corp shareholders are subjected to income tax twice. They are taxed first as income to the C corp and then taxed a second time as income to individual shareholders. That reduces the net amount that finally finds its way into a shareholder’s pockets after taxes.

Assume that a C corp has taxable income (profit) of \$100,000 for the year 2012. The corporation would pay \$22,250 in federal income tax, which would work out to 22.25% of its taxable income. After federal income tax, the corporation would have \$77,750 of profit left.

Also assume that that the shareholders decide to pay the entire \$77,750 to themselves as dividends. Currently, dividends are taxed at a preferential rate of 15%. So the shareholders would pay an additional 15% or about \$11,663 in individual federal income tax.

By the time the C corp’s profit was paid to its shareholders as dividends, a total of \$33,913 would have been paid in corporate and individual federal income taxes. The effective “double” tax rate would be 33.9%.

For many closely held C corps, double taxation is more theoretical than real. C corp shareholders may also be corporate employees. The shareholder’s salary and benefits are deductible expenses for the corporation. It is possible that a closely-held C corp will have little or no net gain after these deductions. If so, the corporation will not owe income tax. The company’s profits will be paid out as salaries and benefits and will be taxed only once, at the shareholder-employee’s level. Employment tax would also have to be paid on the salaries.

S corps were created to avoid the potential for double taxation for small businesses. Like partnerships, S corps are pass-through tax entities. See page 3 and pages 22-23. The S corp does not pay income tax itself. Instead, its gains and losses are allocated among its shareholders each year. Each shareholder reports this income or loss on his or her personal return.

S corp profits are subject to income tax only once—at the individual shareholder level. There is no double taxation.

As with partnerships, S corp shareholders will be taxed on their allocated share of gains even if the gains are not distributed to them. Distributions are tax-free.

This tax treatment is not automatic. An S corp has to notify the IRS that it chooses to be taxed this way by filing IRS form 2553, "Election by a Small Business Corporation." Form 2553 has to be signed by all of the shareholders. The form 2553 must be filed within 2 months and 15 days after the beginning of the tax year in which the election is made. For newly formed S corps, this means Form 2553 should be filed within 2 months and 15 days after the Secretary of State accepts the articles of incorporation for filing. The penalty for late filing is that the corporation will be taxed as C corp for that year.

The owners' basis in an S corporation will be adjusted each year, using the same formula as partnerships:

Price of stock
+ Allocated share of gains
- Allocated share of losses
- Distributions
= Adjusted basis

See page 22.

Basis in a C corp is not adjusted each year. It will always be the price paid for shares. A shareholder may buy shares at different times for different prices. But the basis for each share will be what the shareholder paid for it.

C corps have an advantage when it comes to fringe benefits such as group health insurance. Most fringe benefits are fully deductible by the C corp. This includes fringe benefits for owners who are also employees. The deduction reduces the C corp's profits and income taxes.

For S corps fringe benefits paid to owner-employees who own two percent or more of the S corp are not deductible. Because most owners of closely-held businesses own more than two percent of the company, S corps usually cannot deduct fringe benefits paid to owners.

If you are considering whether to become an S corp, you should consult your accountant or a lawyer specializing in taxation to be sure that this will result in reduced taxes.

C. Estate planning

If estate planning is a major factor in your choice of a business form, the S corp form has problems. Estate plans often include trusts. Many types of trusts are excluded from S corp ownership. Decedent's estates are allowed to be shareholders in an S corp, but only for the time reasonably necessary to close the estate.

On the other hand, it may be easier to give shares in an S corp to family members during your lifetime than it would be to give them an interest in a partnership or LLC. Partnerships and multi-member LLCs are subject to “family partnership” limitations that do not apply to S corps or C corps.

Trusts may own C corps. C corps may issue more than one class of stock, which allows transfers of shares with and without management rights.

Gifts of shares in closely held companies, including corporations, can take advantage of several gift tax discounts. See pages 40-41.

D. C corp pros & cons

C corp pros:

- Clearest case of independent legal entity
- Limited liability
- No restrictions on ownership
- No self-employment tax on dividends
- Owners’ benefits deductible

C corp cons:

- Less flexibility; more statutory requirements than partnership or LLC
- Extensive record keeping and formalities
- Double taxation
- Basis not adjusted according to performance of business

E. S corp pros & cons

S corp pros:

- Limited liability
- Pass-through taxation; no double taxation
- No self-employment tax on gains as opposed to compensation

S corp cons:

- Less flexibility; more statutory requirements than partnership or LLC
- Extensive record keeping and formalities
- No multi-owner LLCs, partnerships, or corporations may be shareholders.
- Basis adjusted each year
- Benefits for owners with 2 percent stake or more not deductible

10. Limited Liability Companies

A limited liability company (LLC) is a hybrid that combines the easy creation and flexible operation of a general partnership with the limited liability protection of a corporation. Owners of an LLC are called “members.” An LLC may have one member or many members. There is no upper limit. Owners may be other LLCs, corporations, and partnerships as well as individuals.

A. Formalities to create and operate

An LLC is formed by filing a “Certificate of Organization” with the Secretary of State. The Certificate is a very simple document. All that is required is:

- The name of the company, which has to include either the words “limited liability company” or an abbreviation such as LLC.
- The street and mailing address of the initial “designated office” (the address of the business).
- The name and street and mailing addresses, and the post office box number, if any, of the agent for service of process. This is the person who will receive legal notices, including summonses, for the company.
- If the LLC is a professional LLC (for example a law firm or real estate brokerage) the professional service it will provide.

The filing fee for a Certificate of Organization is \$100 plus another \$5 a page. Certificates are ordinarily one page long. For another \$10, the Secretary will issue a certificate to the effect that the company was duly formed as of the date of filing. If you want the certificate, the total charge is \$115.

Like a corporation, a new LLC must publish notice of its creation. Once the Certificate has been filed, notice must be published in a local newspaper once a week for three weeks.

Unlike a corporation, an LLC is not required to hold an organizational meeting, to name a board of directors, or to elect officers. An LLC is not required to have annual meetings of the members or to keep minutes of meetings. An LLC could choose to do all of these things, but it is not required to do so. Many people are attracted by the lack of formalities in an LLC.

LLCs are governed by an agreement among the members called an “**operating agreement.**” Every LLC has an operating agreement even if its members don’t know it. Operating agreements may be written, verbal, or—worst case—implied from the members’ conduct. However, to take full advantage of the benefits that an LLC offers the members should have a **written** agreement. This will minimize the possibilities for disagreement and litigation if problems develop.

LLC operating agreements provide the same flexibility as partnership agreements. Nebraska’s Uniform Limited Liability Act is a “default” Act. With very few

exceptions, members can structure their deal as they like, and the law will honor their deal even if it is contrary to the statutes. Contract law, not the Act, will govern the LLC.

The Act only kicks in if an operating agreement does not spell out how to deal with a situation or event. You may not like the default solution. The Act has many of the same default provisions found in the Partnership Act. See page 19.

The operating agreement should be as comprehensive as possible. It can resolve all the potential problems addressed by a partnership agreement: management authority, treatment of a deceased member's estate, restrictions on a member's ability to transfer an interest, setting the value of a member's interest, allocations of losses and gains, etc. See Partnership section, pages 18-20. You should consult an attorney to write your operating agreement to be sure that it deals with all the possible issues.

Most microenterprise LLCs are managed by their members. However, the operating agreement can also provide for management by people who are not members of the LLC. This type of LLC is called a "manager-managed" LLC.

Regardless of whether the LLC is managed by its members or by outside managers, the members as a whole will want to reserve to themselves the power to make fundamental decisions such as whether to admit new members or sell the business.

B. Limited personal liability

Like a corporation, an LLC provides limited liability protection. LLC members are not personally liable for the debts or obligations of the LLC solely because of being members. Members can lose the money they've invested in the LLC—their "capital contribution." But creditors of the LLC cannot take the members' separate property. The protection provided by an LLC is exactly the same as that provided by a corporation. See page 31.

Please see the discussion under "Limitation of Liability," pages 11-12 for the practical limitations on and exceptions to limited personal liability. In particular, it is essential to maintain separate financial accounts and records for the LLC. Failing to do this may make the members personally liable for the LLC's debts.

C. Income tax, including tax basis

The Internal Revenue Code does not have a separate section for LLCs as it does for partnerships, C corps, and S corps. Instead, the IRS treats LLCs that are owned by one person as sole proprietorships. LLCs with two or more owners are treated as if they were partnerships.

IRS treatment does not affect the status of LLCs under state law. LLCs still provide limited liability protection for their members even if the IRS taxes them as if they were sole proprietorships or partnerships.

So if you are the only owner of your LLC, you will pay income tax in the same way as if you were a sole proprietor. See the discussion at page 17.

An LLC with two or more owners will be taxed in the same way as a partnership. It will be a pass through entity. For tax purposes, all of the LLC's gains and losses will pass through to the members each year. Remember that LLC members will pay income tax on their share of any LLC profit even if the profit is not distributed to them. Distributions will usually be tax-free because members will have already paid income tax on their allocated share of the profit. See pages 21-22.

Basis is set the same way for LLCs owned by one person and LLCs owned by multiple people. In both cases, basis is calculated according to the same formula used for partnerships:

Contributions (money or value of property invested in business)
+ Allocated share of gains
- Allocated share of losses
- Distributions
= Adjusted basis

See page 22.

An LLC may elect to be taxed as an S corp if this is advantageous. This may reduce self-employment tax in some cases. See the next section.

D. Self-employment tax

Whether an LLC member will pay self-employment tax depends on whether he is an "active" or "passive" member. An active LLC member is engaged in the operation or management of the LLC. The business is often his or her primary livelihood, and it will succeed or fail in large part because of the member's efforts. An active member will pay self-employment tax on all his share of the LLC's profit.

A passive member is an investor who buys a share of the LLC but does not work for or manage it. The general rule is that someone who works for the LLC less than 500 hours a year and does not have authority to make contracts for the LLC is a passive member. A passive member pays no self-employment tax because the member is not "employed" in running the LLC. She or he has simply invested money in it.

However, LLC members may elect to be taxed as if their LLC was an S corp. If the members choose to make this election, then they can take advantage of the favorable S corp treatment of self-employment. The LLC will still be an LLC for all

purposes except income taxation. Members will not be required to comply with corporate formalities such as a board of directors.

Members can make this election by filing IRS Form 2553. The election has to be unanimous. Once made, the election cannot be changed for five years

An LLC that elects to be taxed as if it were an S corp has to comply with the S corp limitations on ownership. See pages 32-33. The LLC will also have to meet the “one class of stock” requirement. This means that gains and losses from the LLC must be allocated in proportion to each member’s share of the business. If you want to preserve this option, be careful to observe the S corp ownership and stock rules.

Even a one-owner LLC can elect to be taxed as an S corp.

This election will not be worthwhile as long as an LLC does not have profit or as long as reasonable compensation swallows up all the LLC’s profit. But once the LLC is doing well enough that the members can pay themselves reasonable compensation with some profit left over, the election may be beneficial. See pages 31-32.

E. Transfer

When it comes to transferability, LLCs face the same potential problems and competing interests as other closely held businesses. See pages 6-9 and 22. Operating agreements can be written to resolve these problems in virtually any way the members want. If the LLC operating agreement does not deal with transfers, then the LLC Act will govern.

In either case, there will be limits on a member’s power to sell an interest in the LLC without the permission of other members. In particular, a transfer that does not comply with the operating agreement may result in a buyer who has only an “economic interest,” without any management rights. This will make it difficult to sell. See page 23.

If you are considering whether to buy an interest in an existing LLC, insist on a copy of the operating agreement. Be sure that the sale complies with the operating agreement and that you will get full membership with management rights as opposed to an economic interest.

F. Estate planning

A good operating agreement is essential to guarantee that your heirs will get a fair shake from the LLC. An interest in an LLC is personal property, like cash or bonds. Under the default rules, a deceased member’s interest will pass to his or her estate. But the estate will have only an “economic interest” in the LLC. It will not have any management rights. The surviving members of the LLC are not obligated to buy out the

estate or to make distributions. The deceased partner's estate would be at the mercy of the surviving partners.

No one would want this outcome for their family. If you choose to become a LLC, make sure that the operating agreement treats the heirs of a deceased partner fairly. For example, an operating agreement can provide that an estate will receive the value of the deceased member's interest over a period of years with interest. It can specify how the value and interest rate are to be determined and how long the LLC has to pay.

That said, LLCs can be a valuable tool in estate planning because they can facilitate gradual transfer of a business during your lifetime. As of January 2013 federal tax law provides that gifts of up to \$13,000 a year will not result in any gift tax for the donor. The law also allows for a cumulative exclusion of up to \$5,000,000 in gifts over \$13,000 a year. These provisions are coordinated with estate tax.

In calculating the value of a gift of an interest in a closely held business the IRS permits discounts for minority interests and marketability. Say, for example, that Father transfers a 25% interest in a closely held LLC worth \$400,000 to Son. Son's interest is apparently worth \$100,000. For gift and estate tax purposes, however, the value of the gift would be reduced because Son has received a minority interest (and cannot control the LLC) and because there is no public market for LLC interests. After applying these discounts, the value of the gift for gift tax purposes may be significantly reduced. The net effect is to increase the actual value of gifts that can be given during one's lifetime without triggering gift tax for the donor.

However, there are special rules for family gifts or transfers of interests in LLCs. Also, gift and estate tax rules are complex and often change from year to year. Be sure to consult an estate expert before implementing an estate plan that includes LLCs.

Multiple LLCs can also be created to facilitate transfers. For example, LLCs could be created to separate management of a business from some of its income streams, such as rent. LLC founders could continue to control the business while transferring some of the wealth to their children.

LLC operating agreements can also be written to provide that some or all of a member's heirs will become full-fledged members with management rights on the member's death. Such provisions often include a requirement that the heir or heirs either are actively involved in the LLC or become actively involved within a certain time period.

G. LLC pros & cons

Pros:

- Limited liability

- Simple formalities to create
- Operating agreement extremely flexible
- Pass-through taxation/no double taxation.
- May elect to be taxed as S corp to reduce self-employment tax

Cons:

- Restricted power to transfer interest
- Self-employment tax for active members if no S corp election

11. Overall Comparison

The choice between sole proprietorship and general partnership on the one hand or LLC and corporation on the other usually depends on limited personal liability. If your business will create very little risk, and you want to avoid formalities altogether, then a sole proprietorship or general partnership may be appropriate. But if limited personal liability is important to you, then you will want to create either an LLC or a corporation. (You could also create a limited liability partnership by complying with a couple of formalities. See pages 24-26.)

A C corp may be the best choice if you want to keep your personal finances and taxes completely separate from your business' finances and taxes. Unlike pass-through tax entities, a C corp's gains and losses have no effect on the owners unless and until the owners decide to distribute profits to themselves in the form of dividends. The C corp also has an advantage when it comes to deducting the cost of fringe benefits.

However, owners of a C corp will face double taxation on any profits paid out as dividends. Another disadvantage is that the tax basis of their shares will not be adjusted each year in light of the business' gains, losses, and distributions.

Most microentrepreneurs who choose to form a corporation choose the S corp.

The LLC is the most popular form of business now, but the S corp also attracts many. The following chart lays out the pros and cons of these two business forms.

12. Comparison Chart: LLC & S Corp

Feature	LLC	S corp	Advantage
<i>Required filing NE Secretary of State</i>	Certificate of Organization (\$115)	Articles of Organization (\$85 if 10,000 shares or less)	LLC simpler
<i>Publication</i>	Once a week, 3	Once a week, 3	Even

	weeks (\$60 or less)	weeks (\$60 or less)	
<i>Internal rules (private documents)</i>	Operating Agreement	Bylaws & Buy/Sell Agreement	More flexibility with LLC
<i>Additional legal filings with SOS</i>	Biennial Report (odd numbered years, \$25)	Biennial Report (even numbered years, \$25)	Even
<i>Formalities (legal requirements to maintain existence)</i>	None	Organizational meeting, Board of Directors, Officers, Annual meetings, Written minutes & resolutions	LLC
<i>Number of owners</i>	Can be one. No upper limit.	Can be one. Upper limit 100. No nonresident noncitizens.	Even (as long as owners don't include noncitizens)
<i>Types of owners</i>	No limits	Mostly individuals. No multi-owner LLCs, corporations, partnerships.	LLC
<i>Distributions out of proportion to investment permitted?</i>	Yes	No One class of stock	LLC
<i>Overall advantage in flexibility?</i>			Advantage LLC
<i>Limited personal liability</i>	Yes	Yes	Even
<i>Exceptions to limited personal liability</i>	Personal guarantee; Personal negligence; Undercapitalization; Commingling of personal & business assets	Same as LLC plus failure to comply with formalities	LLC because no formalities required
<i>Income taxation</i>	Pass-through taxation Single owner: treated as sole proprietorship. Multiple owners: treated as	Pass-through taxation	Even

	partnership		
<i>Income tax on undistributed profit?</i>	Yes	Yes	Even
<i>Income tax on distributions?</i>	No (as long as capital account is positive)	No (as long as capital account is positive)	Even
<i>Tax basis</i>	Adjusted each year	Adjusted each year	Even
<i>Self-employment tax on owner compensation?</i>	Yes	Yes	Even
<i>Self-employment tax on profit after expenses?</i>	Active member: yes. Passive member: no. But LLC can elect S corp taxation	No	S corp
<i>Transfer</i>	Operating agreement controls	Bylaws or buy/sell agreement controls	Even
<i>Estate planning: family partnership rules apply?</i>	Yes	No	S corp
<i>Estate planning: trusts allowed to own?</i>	Yes	Usually not	LLC

13. Conclusion

Remember that no single form works for all businesses and all business owners. Each has advantages and disadvantages. Choosing the best business structure for you is a matter of weighing the considerations discussed in this chapter and deciding which are most important to you. If you choose a partnership, corporation, or LLC, be sure to get a written agreement dealing with the potential problems for closely held businesses.

CHAPTER EIGHT: CONTRACTS

1. Introduction

Legally enforceable contracts are vital to a successful business. Even if your business is retail sales, you may need contracts with suppliers or a lease for your store. Whenever possible, you will want a written contract signed and dated by all the parties that covers all aspects of your deal and resolves potential problems. Sometimes the law requires a written contract. You should consult an attorney whenever possible.

The best solution is form contracts tailored to your business and customers. If you're in the business of arranging weddings, for example, you will not want to use the stern language found in a contract between two businesses. But you will want the terms to be enforceable. Having the form available will save you time and make your business more efficient. A lawyer can help, and this could be a one-time expense.

The nature and pace of your business may not allow for comprehensive written contracts in all cases. Even a simple document can create an enforceable contract. And verbal contracts may also be enforceable (though there will be problems if the parties disagree about what was said).

This chapter sets out the minimum requirements for an enforceable contract in the hope that it will prove useful when a comprehensive contract is not feasible. It will also provide models of some standard provisions found in most contracts.

2. Written contract required

Some contracts must be in writing in order to be enforceable. Some examples are:

- Any contract to sell land or create an interest in land (except a lease for a year or less). Neb. Rev. Stat. §36-103
- Contracts for the sale of goods for \$500 or more. Uniform Commercial Code §2-201.
- Any agreement that "by its terms is not to be performed within one year from the making thereof." Neb. Rev. Stat. §36-202.

3. Essential terms

There is no "magic language" required to make a contract binding. Most contracts need not be notarized or witnessed. People can contract verbally or with a handshake. Regardless of its form, a contract must include the following:

- Names of the parties
- Goods sold or services performed

- Quantity of goods or services
- Time for performance
- Price

There are some situations in which a court will enforce an agreement even if one of these terms is omitted. For example, a contract that lacks a price may be enforceable if the price can be determined from an established market or a price list. If time of performance isn't specified, a court could determine a "reasonable" time. But these cases wind up in court, something you want to avoid. Be sure that any agreement includes at least the essential information listed above.

Sometimes contracts can be formed through a series of written or verbal offers and counteroffers until a deal is reached. A chain of e-mails is a good example. If the chain as a whole sets out an agreement including the parties, goods or services, quantity, time for performance, and price, then there is a contract. It doesn't matter if the time for performance is agreed on in the third e-mail and the price in the tenth. As long as all the required terms are agreed to eventually, you've made a contract.

But you want **certainty**. And the best way to get it is through a single document including at least the minimum terms. The document does not need to be typed or divided into sections or numbered paragraphs. It could be hand-written and signed on a scratch pad and still be enforceable. In the case of an e-mail chain, conclude with a final e-mail summing up the agreement and asking the other party to acknowledge it.

4. Read, understand, demand changes

Once signed, a written contract will be binding. A court will not allow you to change the contract because you didn't read it or because you relied on verbal promises from the other side.

Reading the contract is only the first step. You have to understand it and make sure it includes all the terms you've agreed on. Ask questions. Insist that the contract as written reflects your deal. **Never rely on the other party's promise to disregard a provision or change it later.** Make the changes **before** you sign. If the other party honestly intends to drop or change a provision, there's no reason why he or she should be reluctant to make the change before you sign.

You should be careful even if your attorney prepares the contract. Lawyers sometimes misunderstand or make mistakes just like everybody else.

5. Model language common contract provisions

The sheer variety of possible contracts and provisions makes it unwise to provide a form even for what is usually a simple agreement such as a contract for the sale of goods. A sales contract should specify whether the seller will deliver the goods or the

buyer will pick them up. It should include any warranties or explicitly exclude them. Resolution of these and other issues will depend on the relative leverage and bargaining skills of the parties.

However, there are some provisions that are useful regardless of the other terms of the contract. These provisions, while standard, are **not required** and are not applicable to all situations. Examples follow.

Signature block.

If the other party is agreeable, sign as a representative of your business, not in your individual capacity. If you have chosen a business form that protects you against personal liability—such as an LLC or a corporation—signing this way will protect you. If you sign as an individual, you will be personally liable regardless of what business form you use.

For example, sign this way:

Best Lawn Care Ever, LLC

By: _____
Joe Smith, Member

Don't sign this way:

Joe Smith

Integration clause: “Entire Agreement. This Agreement constitutes the entire agreement and understanding between the parties regarding these matters. It supersedes and replaces any prior agreements and understandings, whether oral or written between them regarding these matters. The provisions of this Agreement may be waived or modified only by a subsequent written Agreement signed and dated by all parties.”

This clause provides that interpretation of the contract is limited to its written terms, as opposed to verbal statements or promises before or after the contract is signed. If the contract is to be changed, any changes have to be made in writing and signed by the parties.

No Implied Waiver: “The failure of either party at any time to require performance by the other party of any provision hereof shall not affect in any way the right to require such performance at any time thereafter, nor shall the waiver by either party of a breach of any provision hereof be taken or held to be a waiver of any subsequent breach of the same provision or any other provision.”

This clause protects a party who does not insist on invoking a contract remedy for the other party's breach of the agreement. For example, a seller could accept late payment on one occasion without forfeiting the right to timely payment in the future.

Severability: “If a court decides that any part of this Agreement is not enforceable, that part may be modified by the court to make it enforceable or it may be severed and the other parts of the Agreement shall remain enforceable.”

This clause provides that one unenforceable or unlawful provision in the contract will not wipe out the rest of the contract. The unacceptable provision can be modified by the court to make it enforceable or deleted from the agreement altogether.

Applicable law: “This Agreement shall be governed by and construed in accord with the laws of the State of Nebraska, applicable to contracts between Nebraska residents entered into and to be performed entirely within the State of Nebraska.”

This clause would be helpful if some of your customers are outside Nebraska. Of course, the out-of-state party would have to be willing to accept this.

Choice of venue: “Venue for any litigation regarding this Agreement shall be in _____ County, Nebraska.”

Venue is the place where a court case is filed and tried. This provision would be useful if you do business with customers in Nebraska counties outside your base. If the contract doesn’t specify venue in your home county, then you might be required to defend a lawsuit in a distant county.

Assignment: To “assign” a contract is to sell or transfer a party’s rights and obligations under the contract to somebody else. A contract can permit or prohibit assignment.

Assignment may be beneficial. If you sign a contract with a supplier you may want that contract to be binding on somebody that buys the supplier. In other cases you may want to limit the contract to a particular person or company. Generally speaking, if you make a contract that will require close collaboration with the other party, you will want to prohibit assignment.

Clause providing for assignment: “SUCCESSOR AND ASSIGNS. This Agreement shall be binding upon and inure to the benefit of the Parties hereto and their legal representations, successors and assigns forever.”

Clause prohibiting assignment: “**No assignment:** This Agreement shall not be assignable, in whole or in part, directly or indirectly, by any party without the prior written consent of the other party, and any attempt to assign any rights or obligations arising under this Agreement without such consent shall be void.”

CHAPTER NINE: INSURANCE

Liability insurance protects businesses against negligence claims such as personal injuries and property damage. Liability coverage sometimes covers the cost of defending lawsuits. A common provision requires the insurance company to provide an attorney in case of litigation. The company gets to pick the attorney and pays him or her.

Businesses should have liability insurance. Insurance is particularly important if you are operating as a sole proprietorship or general partnership because these business forms do not provide limited liability protection. Losing a lawsuit could bankrupt the business and its owners.

But liability insurance is also important for businesses such as LLCs, limited liability partnerships, and corporations. It provides an additional layer of protection for the owners.

Also, the business itself will need liability insurance to protect business assets against negligence claims.

Some businesses are particularly risky. A lot of things can go wrong at a day care center, for example, or a restaurant. The risk is smaller for a retail clothing business, but there's still the chance of a "slip and fall" accident. You will want to consult an insurance company or agent to see what kind of insurance will best cover you. You should shop around to get the best price.

Be careful about home-based businesses. Contrary to popular belief, homeowners' insurance generally does not cover a home-based business. In fact, operating a business out of your home may undercut or eliminate some homeowners' insurance coverage. Some homeowners' policies include a promise not to conduct a business in the home. You should read your policy carefully and check with your insurance agent to determine if you need additional insurance for your business.

There are many specialized forms of insurance coverage that you may want in addition to general liability insurance, for example:

- Product liability
- Web-based business
- Key person
- Fire, storm, etc.
- Malpractice for attorneys, accountants, doctors
- Theft and embezzlement

Whether these kinds of insurance are necessary for your business is something you should discuss with your insurance agent.

CHAPTER TEN: EMPLOYEES AND INDEPENDENT CONTRACTORS

1. Employees: withholding and matching requirements

Whether and when to hire employees is an extremely important decision. Regardless of whether you are a sole proprietorship, partnership, LLC, or corporation, hiring employees will mean additional work and increased expense for you. Of course, it will also mean expanding your business and opening the door to greater income.

Additional work will include withholding federal and state income taxes and Social Security and Medicare taxes from your employees' earnings and depositing these funds with the state and federal government. Additional expenses include the employer's obligation to match the employee's Social Security and Medicare contribution. Employers must also pay unemployment taxes and obtain workers' compensation insurance in most cases.

The IRS, (www.irs.gov), the Nebraska Department of Revenue (www.revenue.ne.gov), and the Nebraska Department of Labor (www.dol.nebraska.gov) have helpful websites. Useful IRS materials include Publication 15, Employer's Tax Guide and Publication 15-A, Employer's Supplemental Tax Guide. The Nebraska Department of Revenue website includes the Nebraska Tax Application, Form 20, which has to be filed by any business that has employees or collects sales tax.

You will need a signed W-4 form from each new employee. If a new employee does not give you one, check the IRS website to see how you should handle this. A W-4 form remains in effect until the employee gives you a new one. It is a good practice to require a new W-4 form each calendar year, but you are not required to do this. Nebraska relies on the federal W-4.

The amount of any federal and state income tax withholding must be calculated based on marital status and number of exemptions in the W-4. Tables are provided by the IRS and the Nebraska Department of Revenue. Employees may not set a specific amount or percentage to be withheld. (However, an employee may specify a dollar amount to be withheld in addition to the amount of withholding set by the tables.)

Employees may claim fewer withholding allowances than they are entitled to claim. For example, employees may choose not to claim any exemptions or dependents to ensure that they receive a tax refund or to offset the tax on other sources of taxable income that are not subject to withholding such as dividends or interest.

In addition to income taxes, you will have to withhold and transmit social security and Medicare taxes. These taxes must be withheld regardless of the employee's age and even if the employee is already receiving social security benefits. As an employer you are also required to match the employees' social security and Medicare tax

amounts, roughly 7.65 percent of earnings. Social Security taxes are charged up to a maximum amount of earnings that is adjusted each year. Medicare taxes are paid on all an employee's wages.

You will also have to pay federal unemployment taxes or FUTA.

Most businesses have to deposit any funds withheld and their own contributions with the federal government on either a monthly or biweekly basis. Employers who fail to withhold and deposit required taxes **may be 100% liable** for the taxes that should have been paid

For purposes of withholding and depositing taxes, it does not matter whether your employees are employed full or part-time or whether they only work for you briefly. It does not matter whether the worker has another job. The same rules apply.

2. Independent contractor vs. employee

Using independent contractors as opposed to employees is an attractive option for many microenterprises. Businesses are not required to withhold any taxes from their payments to independent contractors. Independent contractors pay their own Social Security and Medicare taxes without any contribution from the businesses that hire them. Businesses simply give the independent contractor a federal form 1099 setting out the amount the business paid him or her.

Be careful about classifying a worker as an independent contractor. Making a mistake can be disastrous. Generally, employers who fail to withhold and submit employee taxes may be liable for **100%** of the taxes. Even if a business is organized as a corporation or LLC, the owners may still be personally liable for this tax debt.

If you fail to withhold and submit taxes because you believed the worker was an independent contractor, you will be subject to this penalty unless you had a "reasonable basis" for concluding the worker was an independent contractor. And the IRS decides if you had a reasonable basis.

A. Control

The substance of the relationship, not the label attached to it, is what governs a worker's status. The issue is control. If a business controls the means and methods that a worker uses to produce a result, then the worker is an employee. If the business controls only the result while leaving the means and method to the worker, the worker is an independent contractor.

The IRS looks at three general categories to determine whether a worker is an employee or independent contractor:

- Behavioral control
- Financial control
- Relationship of the parties

The same analysis is used regardless of whether the worker is full-time or part-time.

B. Behavioral control

In terms of “behavioral control,” the IRS looks at whether the employer or the worker controls the following aspects of the job:

- When and where the worker will do the work
- What tools or equipment the worker will use
- Whether other workers will be used to assist in the project
- What supplies and services will be purchased and from whom
- The order or stages of work and who specifically will perform them
- Whether the employer provides training to the worker

To the extent that the employer makes these decisions, it is more likely that the worker will be classified as an employee. If the worker makes these decisions, it is more likely that he or she is an independent contractor.

C. Financial control

With regard to “financial control,” The IRS looks at the following factors:

- Does the company reimburse the worker for expenses?
- Does the worker work only for a particular company or for other companies too?
- Is the worker paid a flat fee or a guaranteed hourly rate?
- Can the worker make a profit or lose money on the job depending on how quickly the work is done and how much it costs the worker?

Again, the issue is control. If the business controls how much the worker will make, then it is more likely that the worker is an employee. If, on the other hand, the worker is to be paid a flat fee for the job and is responsible for the cost of the job, then it appears that the worker is in business for her or himself. The worker may make a profit or suffer a loss. That makes it likely that the worker is an independent contractor.

D. Relationship of the parties

Finally, the IRS considers the “relationship of the parties,” including the following:

- Is there a written contract describing the terms of the relationship the parties intended to create?
- Does the business supply the worker with employee-type benefits such as paid vacation, health insurance, or sick leave?
- The permanency of the relationship. If the worker is hired for an indefinite time, he or she is more likely to be an employee.
- Whether the worker is key to the business. If the worker is essential to the business, it is more likely that the worker is an employee.

The difficulty for employers is that none of these factors is determinative. There is no checklist that will give the employer a definite answer. Instead the IRS applies and weighs these factors according to the particular facts of each situation. The overall question remains whether the employer has “the right to control or direct only the result of the work and not the means and methods of accomplishing the result.”

An employer can ask the IRS to rule on whether a worker is an employee or independent contractor. You can use Form SS-8 to do this. Form SS-8 is available through the IRS website at www.irs.gov.

CHAPTER ELEVEN: INTELLECTUAL PROPERTY

1. Introduction

Your business' property may include intangible items such as its trade name, logo, website postings, and inventions. This kind of property is called "intellectual property." You should protect it just as you do tangible business property.

Protection for intellectual property comes in four forms according to the type of property: trade name, trademark, copyright, and patent. Trade name and trademark refer to your company name and logo. Copyright protects original literary, musical, or dramatic works, all of which are defined very broadly. Patent law protects newly invented articles of manufacture and means of manufacture.

This chapter discusses trade name, trademark, and copyright. Patent law is an extremely specialized area of the law that requires additional certification beyond a law degree and a license to practice law in a particular state. The Clinic does not practice patent law. The best advice we can give you is to seek qualified representation. A list of patent attorneys and agents by state can be found at: <https://oedci.uspto.gov/OEDCI>.

Useful information about trade names, trademarks, and copyright can be found at the following websites:

United States Patent and Trademark Office.: www.uspto.gov.

Nebraska Secretary of State (state trade name and trademark): www.sos.state.ne.us.

Federal copyright: www.copyright.gov.

2. Trade name

Nebraska defines a trade name as "every name under which any person does or transacts any business in this state other than the true name of such person." Neb. Rev. Stat. §87-208. The law **requires** businesses to register trade names. The documents creating an LLC or corporation will include the business' name, and separate trade name registration is not required. If you are a sole proprietor or a partner you have to file an Application for Registration of Trade Name form with the Secretary of State.

The state filing fee for the trade name registration is \$100.00. You also have to publish notice once according to the instructions on the form. Registration is good for 10 years, after which it has to be renewed. The form is simple; filing does not require an attorney. You can find the Application for Registration of Trade Name on-line at the Secretary of State's website.

A trade name is created by use in commerce. That is, you have to be in business using the name before you can register it. This prevents registration of a catchy name in the hope of selling it later to someone who is actually in business. You can reserve a name for an LLC or a corporation for six months if you plan to be in business by the end of the six months.

Regardless of what legal form your business takes, be sure that the name you've chosen is not already in use before opening business. You can check on-line through the Secretary's website above. The surest method is to fax a name to the Secretary at the number given on the webpage. The Secretary will respond quickly to let you know if the name is available.

If you do business under a name that someone else was using before you, then you may be forced to stop using the name. This could cost you years of good will and reputation built up under that name. There are situations in which first use trumps registration. But this may result in expensive litigation, and you might lose. It makes more sense to protect your name by registering it. The \$100.00 filing fee works out to \$10.00 a year over the ten years covered by each registration.

Nebraska registration only protects use in Nebraska. It's a good idea to do an internet search of names to see if they are being used anywhere else.

3. Trademarks

A trademark often consists of a distinctive presentation or logo including a trade name. It could also be a mark or slogan associated with your business apart from the name. Federal law distinguishes five categories of potential trademarks based on how distinctive they are. The more distinctive a category, the more protection it gets. The last of the five categories, generic, lacks any distinctiveness and gets no protection at all. The five categories in order of strength are:

- Fanciful marks are coined or invented names without any independent meaning such as Clorox® or Pepsi®.
- Arbitrary marks are words in common usage that have no innate association with the product or business using them such as Domino's Pizza® or Sonic Restaurants®.
- Suggestive trademarks suggest some of a product's or service's qualities without directly describing them such as Holiday Inn®. A term is suggestive if it requires imagination, thought, and perception to associate it with the product or service.
- Descriptive marks describe a product or service in some way. Descriptive marks are not protected from the outset. They have to acquire some "secondary meaning" through repeated use in connection with a particular product. Once they acquire secondary meaning, however, descriptive marks can be strong. Kentucky Fried Chicken® is a good example.
- Generic terms such as restaurant or dry cleaner cannot become trademarks.

If trademark is an important element of your business plan, take care to develop a distinctive mark that is not already in use. Firms specializing in trademark, including law firms, can help with this.

Even a fanciful mark is not enough to create a trademark in itself. Rather, **marks are created by their use in “commerce.”** It’s not enough to have created a colorful, distinctive logo. One must actually be using the logo in business. For example, the name Clorox could not have been registered as a mark unless it was actually being used by a brand of bleach.

What constitutes using a mark in commerce can be a complicated question. It’s enough if you actually have goods or services to offer and you are offering them for sale. Actual sales are not required. Neither are profits. But if you are using the logo on a website or promotional materials before you actually have something to sell, that’s probably not enough.

You should use the trademark symbol--TM--as soon as you start using the mark. **You do not have to register the mark to use this symbol.** You should attach the symbol to the mark every time the mark appears. This is notice that you claim the exclusive right to use the mark.

Registration at the state or federal level does not create a mark, but it is very helpful in protecting the mark. If no one challenges a mark within five years of its federal registration, this precludes any other user from asserting prior use as a defense to trademark infringement. A business could have used a mark first, but still be precluded from continued use if the registration is not challenged within five years.

Federal registration is essential for protection outside Nebraska. Federal registration also gives you the right to use the ® symbol with your mark

Preserve records documenting the date of your first use in commerce and continued use up to the present. If you use the mark on the net, make it a habit to preserve a picture of your website each month. Companies will do this for you for a fee. If there’s a dispute, you will be able to prove that you were the first to use the mark.

If you register a mark, you will also have to defend it. That means that you will have to demand that another business stop using the mark if its use will create confusion among consumers. Confusion is likely if a mark similar to yours is being used by someone in your area selling a product or service similar to yours.

The owner of a trademark is not required to insist that any and all businesses stop using a similar mark. If you don’t do business in Florida, then you are not required to defend your mark there. (But if you sell on the internet, you may have a national market.) If you use the mark in connection with ice cream and someone uses a similar mark in connection with flower bouquets, there may not be any confusion in that case either.

Instructions for state and federal registration can be found at the websites mentioned above.

4. Copyright

Copyright protects “original works of authorship” that have been fixed in a tangible form of expression, including literary, musical, recorded, graphic, architectural, and dramatic works. These terms are defined very broadly and are not limited to artistic or unique works. “Original” includes work like this handbook that is a new arrangement or explanation of material that is already well known. Software is a literary work for copyright purposes, and a map may be copyrighted as a graphic work.

Copyright does not protect facts, ideas, or systems of operation, but it may protect the way in which they are expressed.

A work must be presented in a tangible form to qualify for copyright protection. Tangible forms include choreography and musical scores as well as forms such as film that require equipment to be perceived.

Copyright protection does not require registration. Copyright arises when the original work is created and fixed in a tangible form. Even if a copyright is not registered, the author should use the copyright symbol: ©. You should be careful to record and document the date of creation and first publication, if any.

For works created after January 1, 1978, copyright arises at creation of the work and lasts for the life of the author plus seventy (70) years.

Federal registration has several advantages. It makes the copyright a matter of public record, and therefore puts everyone on constructive notice that the work is unique and belongs to you. Registration is required if the author wishes to sue for infringement.

If a copyright has been registered, then the author may use the ® symbol. Information about the cost and process for federal registration can be found at the website given above.

CHAPTER TWELVE : WHAT WE DO AND HOW TO REACH US

1. What we do

The Community Economic Development Clinic (CED Clinic or Clinic) is a component of Creighton University School of Law, funded through the US Department Commerce, Economic Development Administration. It has been in operation since 2005. Each semester up to eight senior-certified law students work in the Clinic under the supervision of the Clinic attorney/director. Students earn law school credits and get valuable hands-on experience while assisting microentrepreneurs and community nonprofit organizations.

We serve clients from all over Nebraska and western Iowa.

Clinic services are free. We do not charge for attorney or student time. Clients are responsible for costs such as the filing fees required by the Nebraska Secretary of State and charges for published notices required by law. We don't have income or asset ceilings as such, but we try to limit ourselves to people who cannot afford private representation.

Clients receive first-rate advice and representation on issues such as choice of a business entity, tax considerations, contracts, intellectual property, and employment law. Representation includes preparation and filing of necessary documents such as articles of incorporation. Representation continues from semester to semester and over the summer term if necessary.

The Clinic also represents community nonprofit organizations. Representation includes formation of nonprofit corporations and obtaining IRS recognition as tax-exempt 501 (c) (3) organizations.

The CED Clinic attorney/director also does community education presentations and workshops on small business-related topics. This Handbook is an effort to provide information to the public.

The Clinic is designed to complement the efforts of small business development organizations by providing legal services to their clients. Many of our clients are referred by such organizations, but this is not a requirement for representation.

2. How to reach us

You can reach the CED Clinic by calling 402-280-3068 between the hours of 8:30 a.m. and 4:30 p.m. Monday through Friday. When students are available they will take an application over the phone immediately. If a student is not available, we will take your number and a student will call you back. The Clinic will then notify the client in writing whether we have accepted their case. While school is not in session or when

the volume of calls is high, clients may be placed on a waiting list. We will give you an estimate of how long the wait will be.

If you are calling about a community education presentation or workshop, please explain that and ask to speak to the Clinic attorney/director.