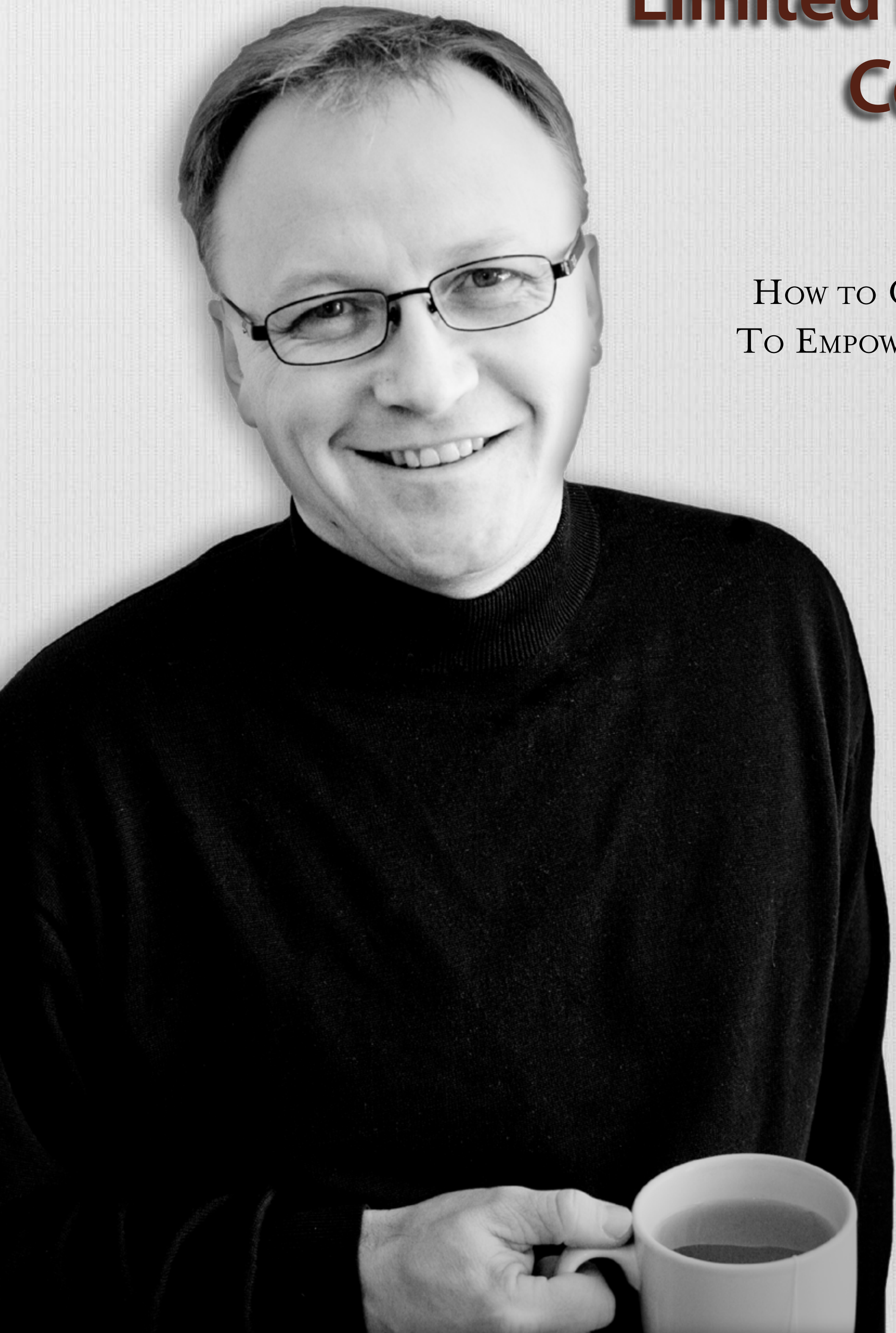
Houchin & Associates
GUIDING VALUE

YOUR Limited Liability Company (LLC)

How to Craft a Company To Empower Your Success



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Motivation

Every week entrepreneurs contact me to help them create companies that will enable their personal success. Many are "information entrepreneurs" who are creating incredibly profitable Web sites, building their own "Expert" brands, selling funky new products, or finding some other way to align their personal spark of divine creative spirit with how they make a living. I have a really fund job.

Sometimes this process can be a little confusing because there are so many variables to consider. Don't worry, it doesn't have to be confusing, or even very expensive to form your own company and start your own "real" business. You just need to think through a few things right off the bat in order to build a company that will not just server your needs now, but EMPOWER you to reach your goals and give you the flexibility update your plans and change your goals as quickly as the market changes around you and opportunities arise.

Unlike a lot of lawyers out there, I won't bog you down in a lot of legal jargon. My goal is to simplify concepts so that you can ask informed questions to your own lawyer. And, if you don't have a lawyer of your own, make informed decisions about hiring a trusted advisor instead of just a head-on-a-stick.

We're focusing on a form of business known as a Limited Liability Company - or "LLC" because it makes the most sense for creative start-up companies. There are very few situations these days that justify a Corporation, so get your head around the LLC and we'll get busy.

Feel free to contact me if you have questions. Email works best.

Sincerely,

Kevin E. Houchin, Esq.
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Why Form a Company?

How do you form a business anyway? Easy. You just SAY you're in business. Yup, that's really all it takes. It's been that way for centuries. You say you make the best spears and someone will trade you their chicken eggs for your spears. You say you make the best fish nets and someone will trade you some of the fish they catch. Going into business is still as simple as that. It's called a "Sole Proprietorship."

In the modern world, forming a Sole Proprietorship is just as easy. It's just a difference of what name goes on a few spaces of some order forms. Isn't it? Well, yes, and no.

Yes, having a business is just that easy. No, if you want to do more with your business than just trade someone for their chicken eggs, you're going to want to form a business "Entity." This is especially true if you want to team up with a friend, or several hundred friends (called "investors") and work together to tackle a larger business goal.

Forming a new company, an "entity" separate from you as a person, is like giving birth—only way faster and less painful. You are creating a new "entity" complete with a duty to pay its own taxes and make its own decisions. The only difference is that your "entity" doesn't have to die. That's nice.

There are several other benefits that come along with forming a new entity through which to conduct your business.

1. Limited Liability: You want to limit your liability exposure to only what you have invested in the company and "shield" your personal assets whenever possible.

2. Professional Image: Even if you're a single-owner company, it always makes a better professional impression to hand out your card as President & Founder of XYZ Company than just, well, you.

3. Better Partnering Relationship: Beyond the professional image benefits, having a separate business entity provides a better context for discussing deals when you need to partner up with someone to reach mutual goals.

4. Tax Advantages: Forming a company gives you a large number of potential ways to cut your tax bill. Having half of your self-employment tax paid by the company as an expense is just one of those - and just that one could save you THOUSANDS of dollars every year.

5. Creating an Asset: Finally, a business entity other than yourself allows you to build equity in an asset that you might later sell. It also makes that future transaction far less expensive to implement.

Forming a separate Enity is a no-brainer, now you just have to choose the right form for your company.

Which Type of Company: Corporation or LLC?

In the days before LLCs, which really were not that long ago, one could basically choose between a Partnership or a Corporation and many forms of businesses, such as law, accounting, medical, dental or other "professional" firms, were not legally allowed to limit liability and were required to operate as Sole Proprietors or Partnerships. Everyone else had the option to form a Corporation and the "S-Corp" (short for "subchapter S" of the IRS Code) was usually the way to go.

The keys for most small businesses are limited liability and "pass-through" taxation, meaning that the profits & losses were "passed through" to the individual owners' personal tax returns rather than being taxed to the company and then AGAIN to the individual owners - which is known as "double-taxation."

Obviously, double-taxation and general liability are bad things. In SOME situations, a single-owner business may still be better off as an S-Corporation, but most people forming small businesses alone or with a few friends/investors are now choosing to form LLCs because the LLC offers some flexibility that the S-Corporation does not, including multiple "classifications" of shares, the ability to accept foreign investors, and the ability to accept investment through your investors' companies without losing the pass-through taxation and while still limiting the liability for all the investors to only the level of what they have invested in the Company.

Everyone's situation is unique, so it always pays to get legal advice based on the details of your circumstance, but know that most of the time people opt to form an LLC instead of a corporation. Know that BOTH can work, but we're going to focus on the LLC in this ebook.

What & Why of LLCs

So, let's go through those LLC benefits again. First, "Limited Liability."

Limited Liability Companies are just that—companies with Limited Liability. Duh.

But what does that mean?

"Limited Liability" means that if the company screws up and gets sued, the liability (what you would have to pay out) or "exposure" is limited to the assets of the company, rather than all the assets of the owner.

This is a big deal.

If you DON'T have limited liability and something happens that has you on the hook for a million bucks, all of your personal assets - yes, your house, car, 401K, stock investments, baseball card collection and everything of personal value is on the hook to pay the bill. That's pretty scary.

So the first goal of any entrepreneur is to set up a "liability shield" that isolates the owners' investment in the company from the personal assets of the owner. Before the LLC was invented as a form of business, one could do this only through forming a corporation. "Partnerships" were, and still are just ways to pool your money with someone else to accomplish a goal. The really scary thing about Partnerships is that they do not isolate the owners' personal assets from liability springing from the action of the company.

In fact, in a Partnership, you could lose YOUR house if your partner screws up. That's not good. The even scarier part is that you don't even have to intend to form a Partnership to find yourself exposed by your unintended partner's actions.

This liability stuff is important and scary. So, even though you will always be on the hook for your own personal mistakes (you can't save your house from being on the line if you cause a car accident on company business), it's simple and cheap enough to form a company these days that you really shouldn't be doing business as a sole proprietor anymore.

When it comes to partnering with other people, the LLC comes in handy again because you can separate the variables of your discussion and handle them individually. Most people get frustrated and confused when they start discussing ownership percentages, management roles, salaries, and duties all in one big mud pie. The secret is isolating the roles and balancing them individually.

For instance, if YOU are going to be running the daily decisions of the company and your partner is just investing money, then you need to separate the management role from the investment role. In this case, the partner would ONLY have a say in things that everyone has agreed need to be decided by the owners and not the day-to-day managers of the company.

If your working day-to-day as partners, but you haven't invested evenly, then you need to define certain things where you make decisions equally, but some (more important) decisions that the majority owner has the power to veto.

Let's take a look at how one forms an LLC and discuss some additional examples in the context of the project.

Forming An LLC

Forming a new LLC just takes a few steps, which is why so many people think they've done it right, but mess it up. Especially those who are going into business with someone else. Even if you're setting up a company where you are the sole owner, you should do all of the following things.

STEPS TO FORMING AN LLC.

1. **File "Articles of Organization" with your Secretary of State.**

Each State is different. In Colorado, the filing fee to set up a new company is only $50.00. In other states it can be much higher. My default is to set up each company in the owner's home state. If the owners are in multiple states, I choose the leader's home state. If there is no obvious choice, and the company is an information seller doing mostly online business without hard product or brick-and-mortar locations, then you may want to consider Nevada as the home state for the company because Nevada does not charge state-level income tax and has some other advantages. Know that in the vast majority of start-ups, your personal home state is going to make the most sense, so we'll assume that.

I almost always choose to form "Manager-Managed" LLCs when given the option in the filing to choose between "Manager-Managed" and "Member-Managed" Companies. It may seem like a silly distinction, but it makes a big difference because it separates the roles of manager from the role of owner (owners are called "members" in an LLC), which can give you a lot more flexibility when teaming up with other people to reach your goals.

If you're doing this yourself, read the instructions carefully. You are usually required to include "LLC" in the NAME field of the form. You'll have to designate at least one Member (owner) of the Company. You'll need to designate a "Registered Agent" separate from the company itself upon whom official "Service" can be made if someone wants to sue the company. It's OK for this to be you, but most people decide to have that Agent be their attorney. And, finally, you'll want to select "Manager Managed" if given the option. Your state may have other confusing questions. They may also require you to file via mail instead of online, which will slow the process down.

If you have multiple owners in your initial founding, you might find it good for the relationship to list them all, but most states will not require you to file a complete list of owners. You can always add owners or have people sell out of the company down the road. It's not the Secretary of State's job to track your owners, that job is yours. So, get used to keeping records of how much people have put into the company and how much they own.

When you've filed your Articles of Organization, you are technically in business, but you can't really do anything official until you have moved on to Step 2. But, feel good about yourself and consider the Articles of Organization as the "birth certificate" of your company. Awe, isn't it cute?

Oh, and a bit on naming – just because you get a clear name with the Secretary of State, doesn't mean you won't get into trademark trouble. Read my No Lame Names book before deciding on a name.

2. Get an Employer Identification Number (EIN) from the IRS.

Next you'll head to www.irs.gov and file the SS-4 form to apply for an Employer Identification Number (EIN) for you company. Think of this as the Social Security Number for you business. You can apply right on line and the IRS has really done a great job stepping you element by element through the application. On the LAST page of the process, you'll be issued an EIN. WRITE IT DOWN & PRINT THE PAGE because you can't get back to this online and if you're in a hurry (we always are aren't we?) you'll have to wait several days before the hard copy shows up in your mailbox.

3. Start a Bank Account in the name of the Company.

Take the Birth Certificate (your Articles of Organization) and the EIN to the bank you want to use and set up a business account. ALL the money you make from your business, and all the expenses that come up as payable in your business should go through this account. Keep a balanced register and set up a Quickbooks or other book-keeping system to manage your money. If you're like me, you should do this better than you do at home. If you don't like book-keeping, pay someone to do it for you. I hate it. So, I pay someone around $40/hour to come in once a week and make sure the numbers are up to date. It's some of the best money I've ever spent.

(Many people stop there – which can be a huge mistake. It's really best to talk with your Lawyer and Accountant on the next few elements to have a solid foundation for success.)

4. Secure the local business permits/licenses that you need in your specific situation.

I don't know what kind of business you're starting. If it's an internet marketing company, you probably don't need any local permits or licenses, but you need to check. If you're starting a restaurant or Medical Marijuana dispensary, then you've got some regulatory hoops to jump through.

5. **Get a sales tax permit if you're selling products.**

If you're selling any products, you need to discuss sales tax with your accountant. If you're ordering computers online, there's a tax for that. Talk with your accountant.

6. **Create a Capitalization Table**

Who owns how much of your company? You need to keep a very accurate track of that ownership. This is why I like to set up LLCs using "Ownership Units" to represent the current ownership percentages.

We all dream of someone coming along and asking if they can invest $1,000,000 in our company in exchange for 5% ownership. Do you want your company set up to move quickly on that transaction? Of course you do! Using "Ownership Units" helps because if you're smart, you'll set up your company using a concept I call "hip pocket shares." Here's how it works.

When I form an LLC I make a mental note of 100,000 Units Of Ownership. This doesn't have to be "officially authorized" like you would have had to have done in a corporation, but it's a good number to keep in your head. Then I "Issue" a total of 60,000 of those units to the founders. At founding, those 60,000 units equals 100% ownership, which can get "diluted" down over time as new owners purchase units of ownership. In this model, the founders will not give up "control" of the company until after they pass the 100,000 total issued units mark. At 100,000 units issued, we have a mental "speed bump" on the path of growth that says we need to be very careful as we move forward.

So, the shows the name of the owner (individual or another business entity), what value the provided for their stake (called "consideration"), the number of units they were issued, and the % of the current total of outstanding units.

When you set up the LLC this way, you don't have to take units from a current owner to give to a new owner and rebalance everything. That saves you time and money in the transaction of letting someone buy-in. Always use the hip-pocket method.

7. **Create an Operating Agreement.**

If there is more than one owner, you really need to document your working relationship in an Operating Agreement. Operating Agreements answer important questions?

When are you going to pay yourselves?

Who's going to do what?

How do you bring in someone new?

How do you kick someone out? For what?

What happens if an owner gets hurt or killed?

What happens if an owner gets divorced?

What happens if you disagree on something really important?

What happens if you have a great idea for a new venture?

How much time do you expect each owner to devote to the Company?

What, Where, When, Why, How, How Much, How Often?

I think you can see how this would be important. And, I think you can see why talking about these emotionally-charged issues is far more productive (and less expensive) when you're in the honeymoon phase of starting-up than later down the road when the shine is worn off and you're upset with your co-owners or they're upset with you.

Think of the Operating Agreement as your prenuptial agreement and know that when you can't kiss and make up with your business partners the way you can with a spouse, minor differences of opinion (we all have them) can quickly fester into a terminal disease that can bring your company to it's knees faster than any change in the marketplace can ever hope to.

Businesses fail because the relationships fail more than anything else. Protect your relationship with a good operating agreement, or you'll quickly be using the next document, the buy-sell agreement.

You can get a copy of my:

✓ Operating Agreement (with Buy-Sell Provision)

✓ Capitalization Table

✓ Subscription Agreement

✓ Formation Minutes

at:

www.houchinllcdocs.com

7. **Create a Buy-Sell Agreement.**

When the day comes that you're asking "how much would it cost me to never have to work with that S.O.B. again?!" you'll want an answer. In my experience, NOT having a quick and easy answer, even if you don't like it, will end up costing you WAY more than doing this work up front. If you don't KNOW, you're going to think your stake in the company is worth more than it really is worth. Your partners are going to think their stakes in the company are worth tons more than you think they're worth. Most of the time, we get ticked off at our partners because we think we're doing more than they are. So, we need an answer.

The answer is at the core of a buy-sell agreement. The agreement states very clearly what can trigger a buy-out of one of the owners, how you will agree upon a price, and how that price may be paid to the exiting Member. Those are all critical. They don't have to be complex, they just have to BE. Invest in this without fail if you are working with a co-owner that is not your spouse. Remember that you don't get to kiss and make up.

8. **Document Your Start-up Resolutions.**

This is a simple formation document that has the Company resolving things like who the officers of the company are, what they're powers are, which bank it will use, accepting the individual investment deals with the owners, and giving the right people the power to act in the name of the company. You should update these resolutions at least every year and do a special resolution document to record all major decisions your management team makes.

9. **Accepting Subscriptions and Issuing Ownership Unit Certificates.**

Each investor should sign a "subscription agreement" with the company that states what they are putting into the company in return for their ownership stake, that they aren't looking to flip the shares and know there are restrictions on how they can buy or sell shares (see the buy-sell agreement above), and that they have enough information to make an informed decision. My subscription agreements even have the investor say they are asking the company to be ALLOWED to invest instead of the company asking them. This way, if the venture fails, the investors can't come back and say "you duped me and tricked me out of my money! I want it all back!"

Only upon receipt of the signed subscription agreement should a Member be issued proof of their ownership stake, which should take the form of actual ownership certificates that are embossed with the Company's official Seal so there's no question of authenticity.

10. Talk to Your Accountant to Plan & File the Right Tax Docs.

When you've got all these elements in place, and usually even before everything is in place, you'll want to talk with your accountant again because the Company may decide to be TAXED as an S-Corp. Ta the time of this writing, there are some significant opportunities for tax savings if you make this election, but you definitely want your accountant on board before making this decision.

Afterword

Setting up a multi-owner company can be tricky. Your business is on the line of course, but what's even more important in most cases is your friendship with the people you're going into business with.

It may be an easy thing to blow off talking with a lawyer or accountant to save a few bucks when there's only a few grand on the line in the business, but are you willing to risk your friendship because that friendship isn't worth the time or money to pay a lawyer or accountant for advice?

I hope not. Really.

If you don't already have a trusted advisor for legal issues, and your committed to sharing your creative spark with the world, then I'm happy to help you reach your goals.

Just get in touch through any of the avenues below and I'll be happy to schedule a free 20-minute "Ask Anything" consultation to help get us rolling on a trusted advisor relationship of our own.

My firm focuses on the needs of creative businesses including formation, contracts, copyright, trademark, & marketing coaching.

Oh, and you'll be happy to know that I've eliminated hourly billing from my practice and all my new clients work on a flat-fee per project, or even better - engage in a year-long flat monthly fee for as-needed services. We can talk more about that when we have our call. Set it up today.

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Kevin is an attorney, designer, artist, counselor, speaker, author, husband, and father. He received his Bachelor of Fine Art in Graphic Design from Iowa State University in 1990. From 1990 until starting law school in 2001 he worked in the creative industry as a designer, art director, creative director, account executive, marketing vice president, and consultant. He has managed dozens of product and service launches for projects in the transportation, health care, sporting goods, retail, higher education, financial services, and high tech industries.

Kevin received his JD from The University of Iowa College of Law in 2003. His studies in law school focused on copyright, trademark, and business development. He is licensed in Iowa and in Colorado and is an active member of Colorado Lawyers for the Arts, presenting educational programs and providing pro bono legal services for artists in Northern Colorado.

Kevin lives in Fort Collins, with his wife and 3 young children.