

Five Things to Know Before Starting a Business



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Starting a new business can be a very stressful endeavor, often involving significant financial risk, a possible career change, and sleepless nights ensuring your business plan is ironclad. Adding to this stress, many new entrepreneurs are often working with an attorney for the first time to assist with the formation of a new entity for the business. Although the legal process can be intimidating, below is a list of five key topics to guide entrepreneurs when starting a new business.

1. Choice of Entity

The number one consideration is determining which type of business entity to form. There are several different business entities to choose from, including but not limited to a corporation, limited liability company (“LLC”), limited partnership, or even a sole proprietorship. Each entity type provides certain benefits and drawbacks regarding their ease of formation, flexibility, governance, and liability protection.

There are certainly circumstances when it would be appropriate to form a corporation, such as for a tech start up wishing to raise investment money, or create a limited partnership, if structuring a private equity venture, for example. However, the remainder of this discussion focusses on the limited liability company (“LLC”) because it is the most common entity type for most small businesses, due to its flexibility to work for almost any business type. LLCs are most common for businesses involving real estate, services and consulting businesses, and retail stores and restaurants.

In addition to the type of entity to form, you should also determine the appropriate state of organization for your entity. Generally, the logical choice for the state of formation will be the state in which the principal place of business is located. There may be situations, however, that warrant forming the business in a business-friendly state such as Delaware or Nevada, particularly if the business will have multiple investors from other states.

2. Tax Considerations

The type of entity you choose may be influenced by tax considerations. A major benefit of the LLC is its flexibility for tax purposes. The right tax treatment for your business will primarily depend on the business type and the number of owners, or “members.” The default tax treatment for a single-member LLC is as a disregarded entity, meaning all the profits, losses and tax obligations, including self-employment tax, will be reported by the single member on his or her personal income tax return. The default tax status for a multi-member LLC is a partnership, meaning the LLC will file a partnership income tax return, but all the tax obligations still pass through to the members. However, both single and multi-member LLCs may elect to be taxed as a subchapter S Corporation (“S Corp”) or, in less common circumstances, a C Corporation (“C Corp”).

There are several factors to evaluate to determine the appropriate tax status for your business. For example, making an S Corp election for a single-member LLC may be advisable if the LLC is conducting a services-based business or the Member is otherwise acting as an employee of the company, due to the potential for self-employment tax savings. However, it is generally not advisable to make an S Corp election if your LLC will own real estate.

There are additional factors to consider before making an S corporation election, particularly if the LLC has multiple members. For example, for a company to be eligible to make an S Corp election: (1) all members must be US citizens, (2) all members must be individuals or certain types of trusts, and (3) there can only be a single class of ownership interests.

3. Essential Documents

In addition to deciding on the form of entity and its tax treatment, you will need to prepare essential documents needed to form the business and operate it efficiently going forward.

For LLCs, you must first file a Certificate of Organization (or similar document depending on the state of formation) with the Secretary of State to create the entity. When filing the Certificate, you will need to select a business name that is distinguishable from other business names filed of record in the state. You must also name a registered agent with a physical address in the state of registration, and, in most states, at least one member or manager, all of which will be public record. If you are concerned about this information being published, you should consult options for more anonymity, such as utilizing a third-party registered agent company.

Every LLC should also have a written Operating Agreement which outlines the business, financial, and management operations of the business. Although a written operating agreement is not technically required to form an LLC in Arkansas and other states, there are several reasons why a small business owner should create one. First, without an operating agreement, default rules under the governing state's LLC statutes govern your business, so an operating agreement gives you control in deciding how your business will be operated. Second, an operating agreement is almost always required to open a bank account, obtain insurance, purchase real estate, or otherwise deal with third-parties that may require proof of an individual's authority over the company. Third, if the LLC has multiple members, you should have an Operating Agreement that includes provisions addressing the relationship among the members, including:

- Identification of the members and their respective ownership percentages and capital contributions;
- Whether the LLC is member-managed or manager-managed;
- What oversight members have over the manager's authority; and
- Right to transfer ownership, whether voluntarily or upon death or other events.

4. Dispute Resolution

When starting a new business, no one plans for disagreements among business partners to arise.

Unfortunately, business partner disputes are often an unavoidable reality of owning a small business.

When forming your new business, you should discuss potential solutions for future disputes, should they arise, in the Operating Agreement. Depending on the type of planned business activities, the Operating Agreement should address the day-to-day decisions the manager(s) are authorized to make; what types of transactions or activities require approval of the members; and what steps can be taken to avoid dissolution of the business in the event of a deadlock among the decision-makers.

5. Ancillary Issues

Forming the business entity and preparing the initial formation documents is just the first step to starting a new business. Depending on the type of business, there may be several other legal issues to consider, such as:

- Protecting your trademark or other intellectual property rights if you are planning to have a branded product or business held out to the public;
- Federal and state securities compliance, if you are planning to bring in investors;
- Employment laws and guidance, if you are planning to hire employees;
- Real estate considerations, if you are planning to purchase or lease real estate; and
- Preparing contracts such as client services agreements, vendor agreements, and independent contractor agreements.

Member Craig Cockrell and Associate Christina Chen are business attorneys that assist clients with business formations and start-ups.