

A woman with long brown hair is smiling and holding a white rectangular sign with the word "OPEN" printed in large, bold, black capital letters. She is wearing a light-colored top. The background is slightly blurred, showing what appears to be a storefront or office interior.

# OPEN

# Your New LLC

## Preparing You For What Comes Next

*Thoughtfully provided by*



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# From the Desk of Art Weiss

## *Congratulations on your new business enterprise!*

Forming a limited liability company was a good first step in launching your business. An LLC has many advantages in Arizona. Your personal assets are protected from lawsuits, you are taxed as a partnership which means that there is no double taxation and finally, in Arizona there are no annual fees or reports to the state corporation commission as there are in many other states. Elsewhere in this book we will examine the notion of limited liability as well as tax issues for an LLC. In the meantime, I encourage you to grow your business and add to the economic vitality of southern Arizona!

For over a decade I have been privileged to sit down with and counsel many people who either want to start a business or have just started one and want to ensure that they do the right thing. After hundreds of discussions about financial and tax planning, contract law, taxation, leases, employment law, I decided to assemble all those discussions into one easily readable, jargon free book to help those who are just starting out on the road to riches. However, if you are an old hand at this and have started many businesses in the past, I hope that you take the time to peruse this book and that you find at least one thing that you did not know.



Art Weiss  
Attorney at Law



# Business Basics

Businesses either make money or lose money – those are the only two choices. To better understand this we need to work on definitions. How do we define making money or losing money. There are no fast answers here and you will have to decide for yourself how to define these terms. For example, is making money the same as being profitable and what does profit mean?

*Example 1 - Linda quit her \$50,000 a year job with a medical company and invested \$100,000 of her savings to start a home health business. In the first year of operations the business did \$500,000 in revenue and had \$486,000 in expenses. Unfortunately Linda was not able to take home any wages that year. Was the business profitable? Would your answer change if Linda took wages of \$30,000?*

*In year five of operations Linda's business did \$1,000,000 in revenues, had \$1,000,000 in expenses which included Linda's \$50,000 in salary. Profitable?*

*In year ten of operations Linda's business did \$3 million in revenue, had \$2.9 million in expenses including her \$75,000 in salary. Now it appears profitable but was Linda adequately compensated for the risk she took in starting a new business? At the medical company she worked a 40 hour week. At her home health business she worked 12 hour days six days a week. Was she adequately compensated for the hours she put into the business?*

*At the end of year ten Linda sold her business for \$300,000. Good idea? Bad idea? How much should she have gotten for her business in order to make this whole venture worthwhile – consider also that she will need to pay capital gains taxes on the \$200,000 “profit” on the sale.*

## Compensation for Risk

The track record for new businesses is not great. Taking money from your savings or from your retirement plan and opening a restaurant may help you realize your dream of independence, but it should and must be on solid financial ground. Financially we want to be compensated for risk. A treasury bond pays little interest because there is little risk that the US government will pay you back. Lending money to a friend, you may ask for a higher interest rate to compensate for the risk. Your friend may never pay you back and may disappear leaving you with nothing but a worthless IOU. As the risk increases so should your after tax return. The same concept applies to your new business. If your business only pays you a salary then you are not being compensated for risk. You could have kept your job and received a salary. For the risk of opening a business and investing your hard earned savings you should do better, a lot better.

## Measuring Risk

If the percentage return we get on an investment is a function of the risk, then we should be able to look at average returns and see which investments are riskier. For example, a CD (certificate of deposit) may return 3-5% depending on how large it is. Historically the stock market has returned 6-10% over time. Therefore we may conclude that an investment in the stock market is much riskier than buying a CD and we would be correct. So where does your new business fit in? How much return can you expect for the high level of risk you assumed when you cashed out your 401K to pay for deep fat fryers?



# Limited Liability

It's right there in the name of your business, at the very end. But what does it really mean? Most people interpret it as a barrier (called the "corporate veil" by lawyers) protecting their personal assets from a lawsuit or judgment against their business. This is correct. So if your company is sued, theoretically you should not be named as a defendant in the lawsuit. Unfortunately this is not often the case. The corporate veil can be "pierced" in a number of ways. One of the most common ways to pierce the veil is for the lawsuit to allege fraud. The LLC will not protect an individual who runs a business that commits fraud on the public. Makes sense, but then we need to look at what constitutes fraud as it comes in many guises<sup>1</sup>. That may be beyond the scope of this work, indeed it would constitute another book.

But by far the most common method for piercing the veil is for the lawsuit to allege commingling. I constantly advise my clients against this but do they listen? No. Commingling is when you use company funds directly for personal expenses. For example – your spouse and you are out shopping for furniture for your living room and spot exactly what you want. Out comes a credit card to pay for it. If it happens to be your business credit card then you may have a problem in the future when a lawyer seeks to hold you responsible for business liabilities. To prevent any question of commingling take the following steps:

1. Your business card and all stationary, including invoices, should include the letters L.L.C. after your business name.
2. Checks written to your company should be made out in the company name and not to you directly.
3. Keep a separate bank account for your personal and business dealings.
4. All income from the business should be deposited into your business bank account.
5. All expenses for the business should be paid from the business bank account.
6. Do not purchase personal items directly from your business account.
7. Make sure that you have adequately funded your business and that you have insurance to handle any risky activity your business may undertake. For example, if you are a roofing company you cannot rely on the corporate veil to protect your personal assets if you are not fully insured against all risks associated with this type of business. My standard line to clients here is that if you are hauling nuclear waste in the back of a pickup truck, you better have sufficient insurance!
8. Any vehicles that you regularly use for business should be titled in the name of the business.
9. If you plan to make purchases on credit then obtain a separate credit card for your business.

These are just a few preliminary precautions to take to insure that you cannot personally be hauled into court to answer for actions of your business. Do all the above and you will sleep better.

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<sup>1</sup>Arizona law has its own version of consumer fraud and it is one that you must know if you are going to conduct business in the state. Here it is: "The act, use or employment by any person of any deception, deceptive or unfair act or practice, fraud, false pretense, false promise, misrepresentation, or concealment, suppression or omission of any material fact with intent that others rely on such concealment, suppression or omission, in connection with the sale or advertisement of any merchandise whether or not any person has in fact been misled, deceived or damaged thereby, is declared to be an unlawful practice." A.R.S. 44-1521 By the way merchandise includes services as well.

Sources of law for a limited liability company. Very often I get questions about a dispute regarding clients, vendors, partners, members. My first question back is – “what does the contract say?” Then I ask “what does Arizona law say?” People will call me with legal questions that can be answered by reading the statutes, laws, regulations involved. In Arizona the law can be found in the Arizona Limited Liability Company act at title 29 chapter four of the Arizona Revised Statutes. It can be found online very easily at <http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp?Title=29>

# Do I need an Operating Agreement?

So you just opened your business and you need to conserve money to keep it going in the early years. An operating agreement is going to cost money and will probably be just a bunch of boilerplate language that only lawyers understand. I am not unsympathetic to this argument. In many ways it is true. However, let's look at a few examples.

**Example 1** – Moe, Larry and Curly start Three Stages, LLC, a comedy entertainment company with each of them contributing \$100,000 and with each getting one third of the company. They anticipate losses in the first two years and profit in the third year. Year three comes around and business still has not taken off and the end result is a \$90,000 loss. Moe goes to his partners and tells them they will have to contribute another \$30,000 each to make sure all the bills are paid. Larry agrees to contribute \$500 and Curly refuses to contribute anything. What can Moe do now?

**Example 2** – Now instead of losses in year three, there are huge profits. All the bills are paid and there is \$300,000 in the business bank account. Moe suggests expanding the business by opening additional offices in New York and Miami, Larry wants to distribute the money to the partners (\$100,000 each) to buy his wife a new car and pay for his daughter's upcoming wedding. Curly wants to leave the money in the business to protect against unprofitable years in the future. After multiple meetings the partners cannot agree on what to do. They are no longer speaking to one another and communicate only through their attorneys. What happens now?

**Example 3** – Curly wins a small lottery prize and wants to sell his third of the business and retire. His friend Shemp wants to buy it, but Moe is dead set against bringing Shemp into the business. Moe says that Shemp will not be allowed on business property, will not have access to the books and records and will have no say in running the enterprise. Curly and Shemp hire an attorney, Moe does the same. Combined they spend \$40,000 on attorney's fees and the matter is still unresolved. What now?

**Example 4** - One day at work Moe has a great business idea and consults with his friends Abbot and Costello. The three of them decide to proceed with a new and different enterprise. Larry and Curly are upset that this will take Moe's attention away from Three Stages and further that the new enterprise will, in some respects, compete with it. Larry and Curly advise Moe that he is breaching his duty to Three Stages by considering this new enterprise. Moe says he is going to proceed with it anyway. Larry and Curly sue him for breach of duty and self-dealing.

What could have been done to prevent all these scenarios from happening? Had the partners prepared an operating agreement prior to operating the business, all of the above situations would have been addressed in the agreement and instead of spending thousands of dollars on attorneys, they would be using the money to grow their business.

What does an operating agreement cost? Most attorneys charge anywhere from \$300-\$400 an hour (Tucson prices) to draft operating agreements. Some will do it on a flat fee basis. A simple agreement may cost only a few thousand where a complicated multi-partner agreement could cost considerably more.

There is no requirement under Arizona law to have an operating agreement, it is up to you and your partners (if any) to get one. Furthermore while it is recommended that the agreement be in writing, an oral agreement is fully enforceable. However, now you are relying on everyone's memory as to what they agreed to. Memories fail and personal interests can alter what we remember. If you are concerned about any of the above then get it all in writing. A few thousand now can save many thousands in the future.

## Adding and Removing Members

Remember that a partnership has partners, a corporation has shareholders and an LLC has members. When you formed your LLC you either had one member or more than one member. This is important for tax purposes discussed elsewhere in this work. If your LLC has more than one member there may come a time when you need to remove a member if one or more of you decide to leave the business and sell your interest. Things can get complicated fast when this happens. The simplest case is this – two members and one wants to sell his or her interest to the other for a price that is acceptable to both. A contract for the sale of the equity interest needs to be drafted and signed by both members, payment must be made under the terms of the contract and an amendment must be filed with the Arizona Corporation Commission. However what seems like a simple procedure can get messy in a hurry. For example, Harry wants to sell his interest to Sally for \$48,000. Sally will make payments to Harry of \$2,000 a month for 25 months. Can you see the myriad of problems here? Just think of everything that can go wrong – because it probably will go wrong. First question – when does Harry's interest pass to Sally? When they sign the contract or when the payments are complete, two years later? This is very important for tax purposes if nothing else. If at the end of the payment term, is Harry entitled to the profits of the LLC till then? If the LLC is sued, Harry will be named as a defendant even though he sold his interest to Sally. How can Harry prevent that? The LLC hits some rough months and Sally can't make the payments on time. What are Harry's remedies when, not if, that happens? Removing a member is complicated even under the simplest set of facts. Imagine how complicated it can get when there are ten LLC members and some want to sell while others may or may not want to buy. Here is another likely scenario – Harry wants to sell his interest (presumably 50% interest) to his friend Sylvester. Sally is not interested in running the business with Sylvester. What can she do about it? (clue – see section on operating agreement).





# Bookkeeping and Records

New business and money is tight. Having your spouse or nephew or really good friend keep the books for free is a great idea, or is it? I can tell you that in most cases it is not. I have spent many hours with an IRS auditor going over books kept by friends and family and the results are generally disastrous. While accountants and CPA's can be expensive, bookkeepers are generally not. For \$60-70 an hour they will keep your books in good shape for a minimal outlay. It is well worth it, I can assure you. An accurate set of books will also allow you to plan better, to prepare taxes when due and to impress an IRS auditor that everything is in order. IRS penalties and interest will rapidly consume any savings you got from having your sister's kid handle your books. Also, if you need to borrow money to expand your business or to acquire a new business, the lender will require a professionally prepared set of financial statements. Get started from the beginning by having a professional do your books. It will pay dividends well into the future.

## Raising (more) Money for Your New Business

The source of new or more money for your business is limited. You can take it from savings, borrow it, or sponge off of family members. When raising money from whatever source you should take the time and legal steps to make sure that the provider of the funds is fully aware of what they are getting, if anything, in return and when they might expect something back. If your brother gives you \$10,000 to buy new equipment – is that a loan? Is that in return for an equity position in your company? Does he expect the money back and if so when? I guarantee that he will have a different interpretation of the transfer of ten grand than you will. The simple response to this problem is to simply document the transfer of funds. It is not difficult to do and does not require a lawyer. If the transfer is in fact a loan, there are sample promissory notes that you can find online to memorialize it. If it is a gift then prepare a very short deed of gift, also available online. If you are giving him equity in the business then it becomes a little more complicated and I would suggest seeking legal advice to make sure you have covered all the bases. If you watch enough Judge Judy you will hear the litigants claim – it was a gift! It was a loan! Judge Judy always asks if there are any documents. The predictable answer – No. Do not fall into that trap. Document everything. It will keep Thanksgiving dinners more pleasant in your family.

## Borrowing Money

Once you have been in business for a little while you will start getting phone calls, many phone calls, asking you if you want to borrow money. The calls will keep coming no matter how many times you opt out by pressing 9 to be taken off their phone list. Whether you should borrow money at all depends upon the circumstances and the reasons for taking out a loan. If you are borrowing to pay daily bills to suppliers and to keep the electricity going then there is a serious problem. Clearly your revenues are not sufficient enough to cover your expenses. If you did not plan for this by having a rainy day fund to keep your business open during hard times, then you need help.

Borrowing money may or may not be the answer and it may deepen the hole that your company has gotten itself into. While this is the easy answer it is unlikely to be the best one. These loans are generally at very high interest and they usually must be paid back via daily debits to your bank account. This means that every business day the lender will take money from your account. The interest rate they quote you will be a daily interest rate and you will have no idea how much this is costing you on an annual basis. You will be desperate for the money and they will capitalize on that desperation. Be very careful and pay someone a few dollars to review the contract.

On the other hand, your business may be able to pay all of its bills on time with some money to spare. You are considering the loan for an expansion or to upgrade your technology or to open new markets for your goods and services. Any investment in your business should come with a handsome return. If your loan interest is 6% after tax, then the return on your investing this capital should be at least that money and preferably a lot more. Figure it this way – the bank will lend you money at 9.5% APR (notice no daily rate shenanigans here). Your corporate tax rate is 30% making your real interest rate 6.65%. You determined that the investment will result in an increase in profits of 12% or 8.4% after taxes. So your cost to borrow is 6.65% and you will net after taxes 8.4%. You have successfully used someone else's money to make some more for yourself.

Borrowing money is risky, for you and for the lender. You may not be able to pay it back resulting in severe financial distress for you and for the lender. The lender will seek protection from that by asking you to sign a personal guarantee. Now the risk starts to mount.

## Do I need an employer identification number or EIN?

The answer is absolutely yes if you have or plan to have employees. If you are a single member LLC and you are not going to employ anyone at any time, then you could get away with no EIN. However, your bank may request that you get one prior to opening a bank account for you. If you will have a partner (a 'member' in LLC parlance) then you will need an EIN. Luckily obtaining an EIN takes about five minutes and can be done easily online. Go to the IRS website and you can have your EIN in a matter of minutes. Make sure you print out the letter they send you with your EIN on it. Keep it safe with all of your other business records.

## Employees



There is no way to sugarcoat this – having employees is complicated and if you do not follow all the rules, both state and federal, you could end up paying significant amounts in penalties and interest to both the IRS and the Arizona Department of Revenue – not to mention the Arizona Department of Economic Security. What you will find here is not meant to be an exhaustive treatment of employee tax and legal issues. It is only a brief outline of what you need to do to meet a myriad of challenges to keep your business out of trouble.

Let's get one thing straight up front – you are not an employee of your LLC<sup>2</sup>. If you have partners who own a share of the business then they are not employees of the LLC. However, if you hire a receptionist to handle the front desk or some college students to greet customers and make the pizzas then you have employees and the rest of this section applies to you.

One of the first decisions you must make is whether the individual you hire is an employee or an independent contractor. Getting this wrong can be very expensive. In many cases the answer is very clear – you have Harry's Bookkeeping Service do your books. He sends you a bill once a month for \$150 and takes care of your books as he does for a hundred other of his customers. Independent contractor. You hire someone as a chef to come to your restaurant five days a week to prepare luscious meals for your customers. Employee. You have someone come in a couple of times a week to help you with difficult roofing jobs that require an extra set of hands. Employee? Independent contractor? Would it make any difference if it was only three or four times a month? What if he says to you that he wants to be treated as an independent contractor? How does the IRS feel about that? Sometimes the determination is not easy. Many times it's not easy. Unfortunately you have to get it right every time.

If you plan on having employees it is likely there will be only a few. Keeping track of payroll and taxes and the multitude of reports due to the federal and state government is very difficult, time consuming and complicated. I suggest you contact a professional payroll service to handle these very unpleasant tasks. If your bookkeeper is skilled in these matters then it is certainly permissible for him or her to handle this thankless task. There are several important points I would like to emphasize here – running a business is a full time job requiring a broad set of skills. Throughout this document what I recommend is that you outsource tasks to those best equipped to handle them. The cost will be outweighed by the peace of mind and the elimination of penalties and interest you will end up paying. Also, your mental energy should be dedicated to increasing revenues, reducing waste and expanding your business. Filling out complicated tax forms every ninety days should not take up a large part of your radar screen. That being said, preparing and filing these forms IS your responsibility and you must insure that all of these related tasks are done properly accurately and most important of all – timely.

**Employment taxes** – this should be written in all capital letters. Employment taxes are the downfall of many entrepreneurs and I do not want it to be your downfall so let's discuss what they are and how you can avoid trouble. If you have employees then you will have to pay them periodically, whether weekly, biweekly etc. When you pay them at the end of each work period you must withhold from their paychecks a specific amount for social security, Medicare and income tax (both federal and state). As their employer you must match the social security and Medicare withholding with your own money. So if you were supposed to pay your secretary \$1,500 and you withhold (for easy math) \$250 for social security and Medicare as well as \$100 for federal income tax withholding then her actual paycheck is \$1,150. You must now match the \$250 you withheld with your own money and send \$1600 to the IRS according to a very precise and unforgiving schedule. So that \$1,500 paycheck actually cost your business \$1,750. Failure to do this not so simple procedure is very, very expensive. Penalties are most unpleasant and the interest will accrue until the tax is paid. If you cannot afford to pay these obligations when they become due then something is seriously wrong with your business model. Seek the advice of a CPA or business attorney. Ask for a free consultation.

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<sup>2</sup> An exception applies if you have elected to be treated as a corporation rather than an LLC

As with everything else, the IRS and the state of Arizona have several forms you will need to file. In the case of employment taxes you will need to file them quarterly. If you use a payroll service they should file for you, but remember that the ultimate responsibility to file is yours. You must make sure it gets done – on time. Do not forget the Arizona Department of Economic Security when you start filing forms. They want theirs as well.

**The Trust Fund Recovery Penalty** – I hope you never hear these words again. Called the TFRP, this is what happens when you fail to pay over to the IRS the money you withheld from your employees' paychecks together with the amount of the employer contribution. Under federal law you are personally responsible for these taxes for years after your business closes. So five years after your business closed you get a letter from the IRS that with penalties and interest you now owe \$100,000. (Wait till you see what this letter does to your marriage!) This is a very common circumstance – many of my clients have gotten this letter. To avoid it, simply get that free consultation I referred to at the end of the last paragraph. In other words – avoid the problem by not letting it arise in the first place.

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Given that a large percentage of businesses fail within two years, you should take every precaution to use your money wisely and not pay unnecessary and burdensome expenses. One such expense is the penalty for failure to file any tax return. The penalties are steep and the IRS is relentless. A few suggestions – at all costs file every return on time. You may not be able to pay the tax but you can certainly file the return. Do so. The penalty for failure to pay is actually pretty reasonable. The penalty for failure to file is definitely not. File on time all the time.

If you have employees you will need to file a W-3 annually. The penalty for failure to file a W-3 is staggering. Don't leave home without it. Some other pointers about the W-3. (1) Send it certified mail. Every year – certified mail. (2) When you get the green card back scan it to PDF. (3). Email the PDF to yourself and put that email in a special folder. This way if ten years later the IRS claims they never got it you will have proof – and you will need it. I have a client who closed their business in 2010. In 2016 they got a letter from the IRS demanding over ten thousand dollars for a W-3 for 2009. The records were long gone. They used a payroll service that service purged the records years ago. He best they could do now was get on a payment plan. This could all be avoided by following the three steps above.

## Litigation

Being sued is unpleasant. If you have ever been sued then you know what I mean, if not, let's hope it stays that way. In my practice I have sued companies on behalf of clients and I have defended businesses that were sued by their customers. Be aware that doing everything right does not guarantee that you will not be hauled into court. In the spirit of full disclosure let me say that my firm has been sued twice. In one instance I made a mistake – it happens – and we settled the case quickly. In the other instance I did nothing wrong, but I had to hire an attorney to represent my firm and it proceeded to a three day trial after three years of litigious wrangling. I won the case, i.e. I did nothing wrong. Unfortunately I had to pay my attorney \$45,000.

Here's the way it works – someone out there in the universe thinks you did something wrong. Perhaps they think that you misrepresented your products or services and that they relied on your misrepresentation and they suffered an economic loss or damages. They contact an attorney who will review their case and decide whether to take on

the client. If they agree to the representation then they will likely write you a demand letter prior to filing a lawsuit. A demand letter may read as follows:

*Dear Sir or Madam,*

*This firm represents John Johnson a prior client or customer of yours. Mr Johnson purchased some items from you based upon your representation that the products were in excellent condition. It turns out that most of them were in fact in poor condition and furthermore that you should have clearly known that. As a result of your misrepresentations my client has suffered damages in the amount of \$25,000 and has incurred attorney's fees of \$1,500. If you wish to avoid litigating this matter please send \$26,500 to my office at the address above within the next 14 calendar days. If I do not receive that check from you within that time I will assume you want to take this matter to court and I will proceed with filing a lawsuit against you. Please do not contact my client directly. Any communications need to go through my office. If you are represented by an attorney please have him or her contact me directly so that we might resolve this matter in the most expeditious manner.*

*Sincerely,  
Arizona Attorney*

If your attorney does not respond then you may reasonably expect a lawsuit will be filed. There are times though when the complainant is looking for a quick and easy settlement and has no intention of taking it to court. These are called professional plaintiffs who make their money suing people. It happens. If you are sued though, you will have to hire an attorney to respond to the lawsuit and to assess your exposure, if any.

Avoiding litigation is a necessary element of your business plan. Running a successful business is difficult enough without having to pay court costs and attorney's fees. Here are some recommendations to keep you out of court and keep your money in your business where it belongs.

- (1) Understand the terms and conditions of the contracts that you sign. Take the time to read them even though they are filled with jargon and boilerplate. If you are sued under the contract you will read them very carefully. Do not wait until then.
- (2) There may be times when you cannot fulfill the contract terms. It happens. Call the other party or parties to the contract and discuss the situation before it gets out of hand and attorneys are involved.
- (3) Make sure you are licensed to perform any and all services that you offer. If you are a roofing contractor then do not do any electrical work. Make sure you always work within the scope of your license. As an attorney I do not cut my customer's hair. I am not licensed to do so. Straying outside of your license is not looked upon favorably by juries.



- (4) Manage client expectations whether you sell pizza or repair hot water heaters. You are good at what you do as you've been doing it a long time. Your client or customer has not. You will assume that they understand what they are getting for their money because they did not ask any questions. However when they do not understand and do not get what they thought they should, they will call me and will call you. A little extra attention to their expectations will save you money in the long run.

**Mediation and Arbitration** – As a business owner you will likely be involved in disputes misunderstandings and disagreements with customers, vendors, employees and lenders and many others with whom you come into contact. Rather than take every issue to court and spend too much money on lawyers and court fees, there are two methods of alternative dispute resolution (ADR) available. The first is mediation. Mediation generally works like this: the parties to the dispute choose a neutral mediator who will assist them in reaching an agreement to resolve the matter. In my experience the mediator puts the two parties in different rooms and then shuttles back and forth between them listening to the strong and weak points for both sides. Then he starts talking numbers – what will it take to make this go away. He will coax, encourage, cajole and frighten each side. He takes neither side. He will establish a floor and a ceiling and then try to get the parties to come off of their original positions to one in the middle. If he is successful then he will draft an agreement, get both parties to sign and expensive litigation is avoided. That's mediation – arbitration is much different. Arbitration is like a trial. The parties choose a neutral and experienced arbitrator who will listen to and consider evidence from both sides, reach a decision and issue a ruling. In binding arbitration, the parties are bound by the ruling. No appeal, no litigation, the matter is over. If you are not happy, that is too bad. However, in non-binding arbitration the matter may still be brought to court if the losing party is dissatisfied with the ruling. Prior to the actual arbitration hearing the parties will establish whether the arbitration is binding or not. If you are presented with a contract to sign during the course of your business you should see how disputes are to be handled. Some require mediation, some arbitration and some neither one. It is good to know which one applies before you sign.

## Taxes

Remember that you are a limited liability company. As such you will pay a variety of different taxes to different taxing authorities depending upon what you offer to the public. If you sell services but not tangible things then you probably will not have to pay transaction privilege taxes (TPT) also known as sales taxes. If you have employees you will have to make contributions to their social security and Medicare payments. Either way, you will have to pay self-employment taxes on your own income IN ADDITION to income tax. Here's how it works – your business takes in \$100,000 in revenues and has \$60,000 in expenses. The remaining \$40,000 is yours. Unfortunately you have to pay income tax on that amount which may come to let's say 20% of the total. In addition to that you will need to pay self-employment taxes (Medicare and social security) of 15%. Finally you will need to pay the state of Arizona 5%. Totaling that up equals 40%! You may have some personal deductions that will eliminate or reduce the income tax, but they will have no effect on the self-employment taxes. Either way, get ready for a hefty tax bill if your business is profitable. Under federal law you are supposed to make quarterly estimated payments if you anticipate a profit in your business. By making these payments every ninety days (i.e. every quarter) you will have a much smaller or non-existent tax bill when it comes time to file next April 15th.

A very important question is whether you are a single member LLC or a multi member LLC. If you are the only member of your LLC then the LLC is a disregarded entity as far as the IRS is concerned. The LLC financial numbers will appear on your personal tax return. However, if your LLC has more than one member then your accountant will have to prepare a Form 1065 each year to divvy up the income between the multiple partners. You will then receive a K-1 from your accountant to use for your personal tax return.

Tax planning is a very important part of running your business. You always want to have enough cash on hand to pay your business and personal taxes as they come due so as to avoid burdensome penalties. Also, I recommend you examine your profit before and after taxes. The difference will be significant. After all, it is not what you make,

it is what the government will let you keep that is important.

Documentation for tax purposes is absolutely vital. If you are audited you will need to produce receipts for everything. If you cannot produce the receipt you will not get the deduction. Many of my clients think they can throw away the receipts and use the bank or credit card statements as proof of the expense. That will not work. The IRS is not required to accept bank or credit card statements as proof – and they generally do not. To be safe and to save precious dollars for your new business keep all receipts.

Documentation of a loan for tax purposes – if you borrow money from either a friend or a relative make sure you document the transaction with a promissory note (an IOU). Ideally the loan would include a market rate of interest in order for it to be fully recognized by the IRS.

## Contract Issues

It has been said that a company is the nexus of a thousand contracts. That is true. You will enter into many contracts over the life of your business – landlords, customers, suppliers, shippers, utilities, employees - each of these entails a contractual agreement whether written or not. A contract need not be written to be enforceable, indeed a large majority of contracts are verbal. The field of contract law is broad and complicated and we can only touch on a few high points here. There are plenty of popular books available online that will provide you with additional and more detailed information.



Writing contracts is a pain, I know because I do it all the time. Depending upon the scope of the contract it can be time consuming and expensive. However, contracts can also be used to reduce costs and increase the profitability of your business!

The essential purpose of a contract is to assign obligations and benefits between the parties. That means that the contract should state very clearly what you are supposed to do and what benefits you receive if you do it. In a very simple case you want to purchase a deep fat fryer for your business. The contract will spell out how much you are to pay for it (your obligation) and should also include a description of the product (your benefit). As you review contracts in your business make sure that you fully understand what your obligation is and how you will benefit. This seems pretty basic, but it definitely is not. Lawyers make thousands of dollars when contracts are unclear or ambiguous. To keep out of court and to keep your money out of lawyer's hands make sure you read the contract and know what you need to do to honor it. In the case of the deep fat fryer – who pays for delivery? Is there a warranty? Who do you call if it fails to work properly? What happens if it is damaged in shipment? The larger the piece of equipment the more important are these questions.

**Parties to the Contract** – You are a limited liability company and all contracts should be in the name of your company, not you personally. When you sign the contract put the words “Harry Jones, as President of Jones Enterprises L.L.C.” Make sure you know who the other party or parties to the contract are. For example – you are going to enter into a contract for the purchase of \$50,000 in inventory from a supplier. However the contract

contains the name of the salesperson as a party rather than the name of the supplier. Is this enforceable? Do not gloss over the description of the parties thinking it is probably OK. Errors here can be costly.

**Timing** – This is a very important element of contract law. When is your performance due? For example, do you need to pay for the deep fat fryer up front? Upon delivery? Within 30 days of invoice? How about the date of delivery – if you must have it by a certain date is that specified in the contract? Lawyers use the expression – Time is of the Essence. If your contract has that clause then performance is due exactly as specified in the contract, any deviation will likely result in some damage claims in court. Watch for timing provisions in your contracts. Contracts should not contain blank spaces. Seems pretty obvious but we see this all the time. Salespersons are focused on getting the sale and once you agree to the terms they fill out the documents, get your signature and get out of there before you change your mind. The next day you find a half dozen blank spaces. This could be avoided with a little care and attention to detail on your part. Remember that before you sign a contract YOU have all the power in the transaction. After you sign it – not.

If you want something to keep you up at night sign a five-year lease. Given that 80% of businesses fail within the first two years, a five-year obligation will be a great incentive to succeed. One of the problems I regularly see is a lease negotiation where the management company represents both the landlord and the prospective tenant. This should be avoided at all costs. The management company wants one thing, to get the lease signed – this is the only way they get a commission. Seems like a conflict of interest for them to represent you, the tenant. Easy fix – get your own representation. Commercial leases can be 50 pages long and are usually written to shift all risk of the transaction onto you, the tenant. Get yourself an experienced business attorney to push back for you. In most cases you have a lot more bargaining power than you think. Use it and you will sleep better.

Other important points about a lease – (1) the lease document is one of the most important documents you will generate in your business – and you will likely lose it. I get many calls from business owners with questions about their landlord's rights or their rights. My first question is always – what does the lease say? The usual response – it was signed years ago and I do not have a copy of it. Simple fix for this – when you sign it and the landlord has signed it, scan a copy as a PDF and email it to yourself. Put the email in a separate folder named – Lease Documents. You will also want to put in there any walkthroughs that you did prior to the lease term and of course any correspondence between you and your landlord over the years. These documents will come in handy when the air conditioning unit fails and someone needs to pay \$5,000 for a new one. (2) When I teach contract law to business students I stress that the purpose of the contract is to assign rights and obligations to the contracting parties. You have rights under the lease. You also have obligations. I recommend that you take a yellow highlighter and highlight all those provisions in the lease that require you to do something. Note that the obligations will span the lease term, from beginning to end. For example, at the beginning you may need to pay a security deposit and obtain liability insurance. During the lease term you will need to pay rent and may be required to pay for repairs. At the end of the term you will likely need to provide a certain amount of notice to the landlord. At the end you will likely need to insure that the premises is in good condition excepting normal wear and tear. Pay close attention to the requirements for an end of term walkthrough. Make sure you do it and write down the results.

*“Personal guarantees”* is another aspect of contract law that you must consider. In many cases your LLC has assets worth about \$1537. That includes the computer, a desk, paper clips and \$289 in the bank. A lender or landlord will probably not want to do business with you unless you put a little more collateral on the table. That

collateral is your personal guarantee. Now your personal belongings, your spouse's belongings and your salaries (after your business has failed) are all on the table. Some suggestions – if the lease is for 5 years then limit the personal guaranty to two years. Once the two years has expired and you have paid your rent for the 24 months, the guaranty disappears. Next – limit the amount of the guaranty to a specific dollar figure, i.e. guaranty up to \$10,000. Third – limit the guaranty to a specific number of month's rent (not including all the other charges you will pay – just rent). Whether the landlord will accept any of these provisions is an unknown. But if the landlord insists on a personal guaranty then re-read the above – carefully. You do not want your wife's (or husband's) salary garnished for the next five years to satisfy a poorly worded personal guaranty.

Good contract writing and negotiation involves the efficient allocation of risk between the contracting parties. A lease drafted by your landlord will shift all the risk onto you. Your goal is to shove some of the risk back onto the landlord. Take air conditioning units for example. A commercial unit can be very expensive. If it fails and needs to be replaced who is going to pay for that? The lease may have a provision on page 47 that you never read which places the responsibility for the \$15,000 unit on you. Not having read the lease is NOT a defense. You will end up shelling out the \$15 thousand if you want to stay in business. Courts are not going to be sympathetic if it turns out you signed the lease after having the opportunity to review it with counsel. That provision is in there also. Be careful with commercial leases. Example – after two years your business is not doing well and you are considering shutting the doors. Are you responsible for the remaining three years of lease payments? Your landlord will certainly claim that you are. What does the lease say? Did you include a provision whereby you will pay a reasonable termination fee and be done with it? If not, why not?

Taking your business to the next level. I have this conversation often. The first step is to define what the next level is. It may be increasing your sales from your current location or opening up two new locations in central Arizona. It may be adding new products to your inventory or adding a new department to handle repairs and maintenance for your customers. Each "new level" comes with its own analytical needs. New business locations will require scouting for new spaces, leases, new equipment, employees, inventory. Quite an investment. Whereas adding new inventory may be as simple as a few discussions with your suppliers and perhaps an expansion of your credit line. Increasing sales might require expensive advertising, or doing a better job getting free publicity somewhere. Each option comes with choices, expenses, risk, and opportunity. If you are a breakfast and lunch restaurant, is there a profit in opening for dinner? A complete financial and market analysis might be helpful here. They will indeed cost money, but not as much as making the investment without them. The next level may also mean acquisition of an on-going business that fits well with your existing one. Do not consider an acquisition without speaking to an accountant and a lawyer. There are many legal and tax consequences to business acquisitions and a properly executed offer and eventual bill of sale will be your best protection.

The notion of "the next level" is bandied about easily and generally with little thought toward the resources necessary to achieve it, the cost of those resources and the risk involved. Going to the next level should be as riskless as possible. Proper planning and analysis may prevent unpleasant surprises as well as bankruptcy.

Entrepreneurs are optimists by nature. They would not take the risk of opening a new venture if they were not. However, optimism is not a substitute for effective risk reduction techniques. As a business owner you will certainly want to make a good living at it by paying yourself a reasonable salary. Understand though, that the salary does not compensate you for the risk. That compensation is called profit - that is profit over and above your reasonable salary. Be forewarned though that a reasonable salary and profit may not show up for a year or two - indeed it may not show up at all! To meet that risk you will need a backup plan. How are you going to eat and pay your car insurance if your business is not enabling you to bring home a salary?

 Education

You may be a great chef, build the best houses or sell the finest wares in Arizona. Running a business though, requires a lot more. I often hear this phrase – “I am great at what I do, but I am not good at the business side of it.” This I hear from clients whose businesses are experiencing financial distress. To avoid this I suggest you take steps, (small steps are OK) to educate yourself on how to run a business. The local community college offers basic business courses to include accounting and business administration. The internet is full of free courses on basic skills – videos abound on various platforms that will teach you the skills necessary to get your business going. The more you know, the less likely you will find yourself coming to me to straighten things out. I would start with a basic accounting course to learn what your financial statements are saying.

 Advertising Your New Business

Advertising is expensive and frustrating. During the course of my legal career I have advertised on English and Spanish television, radio, newspapers, magazines, various websites and give-away advertising specialty items. It is a crap shoot plain and simple. Some of my advertising worked while some was a complete waste of money. Unfortunately, it is impossible to tell which is which when planning your advertising budget. One of the most important decisions you will make is how much money to allocate to advertising per month. Ideally you will want each dollar of advertising to produce at least a dollar’s worth of business! I remember discussions with one advertising salesperson who promised seven dollars in business for every dollar in advertising. I bought the advertising – did not even break even. So tip number 1 – do not expect advertising to result in a flurry of business. Tip number 2 – Do not expect any response at all for at least three months. Building your brand takes time and a lot of money. All the ad sellers will advise you to track the effectiveness of your advertising, to see what works and what doesn’t. This is a lot more difficult than it seems. Customers generally do not respond to a single ad but after seeing you on television and going to online review sites and seeing some of your print ads, it will be difficult to determine which ad resulted in a sale. It is really the cumulative effect of all your advertising that will get them in your door. Of course do not forget the value of word of mouth advertising. While a great source of business it can also work against you if you fail to live up to client/customer expectations. One unsatisfied customer can wreak havoc on your cash flow so make sure you work very hard to satisfy them all.

 Legal Advice

When do you need a lawyer and what kind of lawyer will you need? Ideally you will want to hire an attorney experienced in business and commercial matters. Your cousin who practices criminal defense will be of little help. You should look for an attorney that will not charge you for every phone call or every fax. If a phone call costs you a hundred dollars you are unlikely to make the call and an important question or issue will remain unresolved, potentially leading to greater problems ahead. I always say it is easier for me to get you around a problem than to solve it once it materializes. A good business attorney should be a sounding board for ideas. As a business owner you will face a myriad of problems, opportunities, disputes. Your attorney should be ready at any time to help you with all of these – and not necessarily charge you for every communication or service. Interview several possible attorneys, ask them lots of questions and find one that best fits you and your business needs. Having experienced legal counsel in your corner at a moment’s notice can be the difference between success and distress.

# ⑧ Assorted FAQ on Limited Liability Companies

*Larry and Harry formed an LLC in Arizona with a contribution of \$100,000 from Larry and a promissory note (IOU) from Harry to contribute \$100,000 upon the sale of some property he owns which is currently up for sale. Can the LLC issue a 50% interest to Harry based upon his promissory note or does it need to wait until he contributes the cash? What happens if the sale occurs in the following tax year?*

**Answer** – under Arizona law Harry gets his 50% interest upon tendering an enforceable promissory note for the \$100,000 contribution. Harry is entitled to 50% of the profits (or losses) upon the tender of the note. The promise must be in writing and must be signed by Harry to be effective.

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*Prior to Harry's contribution the company runs into a little financial trouble with a hard money lender. The lender sues the LLC for the unpaid loan balance which happens to be \$100,000. Can the lender sue Harry individually to force his contribution, which could then be used to pay off the loan?*

**Answer** – No, but maybe. Under Arizona law an unpaid contribution cannot be forced in litigation unless it is provided for in the LLC Operating Agreement or unless Harry previously agreed to enforcement of his contribution by a third party creditor.

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*Sad to say, Harry is killed in a car accident prior to making the contribution. Can the LLC pursue Harry's estate for the \$100,000?*

**Answer** – Yes. Arizona law allows the LLC to enforce the promissory note against the estate.

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*At the end of the first year of operations the LLC has a \$250,000 profit! The LLC plans on distributing \$125,000 cash to each partner. Harry decides that he would rather have a plot of vacant land with a fair market value of \$125,000 owned by the LLC. Can Harry force the LLC to distribute the land instead of the cash?*

**Answer** – No. Harry can only demand payment of the cash, not property of the LLC.

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*After two years of operations the LLC has \$100,000 in the bank, owns property worth \$300,000 and has \$400,000 in liabilities. Harry wants to distribute \$25,000 to each partner (leaving \$50,000 in the bank) on December 31st. Is this OK?*

**Answer** – No. Arizona law prohibits a distribution that would leave the company insolvent (liabilities greater than assets).

*Despite the prohibition discussed above the LLC distributes the \$25,000 to each member, leaving the LLC with more liabilities than assets. Two years later the LLC needs money and demands that the members return the \$25,000 distribution. Can the LLC do that?*

**Answer** – Yes. The members are responsible to the LLC for any unlawful distributions for a period of six years.

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*Two years later Harry decides to retire and assigns his interest in the LLC to his daughter Sally. Sally immediately calls Larry and says she wants to meet with him to discuss some ideas she has to expand the business into Phoenix and Flagstaff. She also wants to insure quarterly distributions to her personal bank account. Can she do either of the above?*

**Answer** – No. As an assignee Sally can only sit by the mailbox awaiting any distribution checks that Larry decides to make. After the assignment Harry remains as a member of the LLC, he is just not entitled to the distributions that he has assigned to Sally. However, if Sally is admitted as a member to the LLC then and only then is Harry's membership terminated.

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*After a long search, Larry finds the love of his life, Mary, and they decide to get married. Larry, who is not getting any younger, wants his interest in the LLC to go to Mary in the event of his death. He wants to establish that the interest is held as “community property with right of survivorship.” In other words, upon his death the interest goes to Mary by operation of law. How can he accomplish this?*

**Answer** – This would have to be done in the operating agreement. If the operating agreement has already been drafted and signed then it would need to be amended, if not, then a simple provision in the agreement that Larry and Mary will hold their interest as community property with right of survivorship will suffice.

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*After Larry and Mary get married Larry finds out that Mary owes the IRS \$250,000 from a business that failed five years before they met that Mary forgot to tell Larry about. Oops. Can the IRS go after the assets of the LLC to satisfy Mary’s tax debt.*

**Answer** – No. But the IRS can go after distributions that would be forthcoming to Larry and Mary. If the IRS has filed a tax lien, that lien will attach to any property that Mary owns. Under basic LLC law, the members do not own LLC property, but they do own rights in the distributions from the LLC. The tax lien will attach to Mary's part of that cash flow. If Mary had told Larry about the tax debt, he most certainly would not have agreed to hold the LLC interest as community property. Whether he would have married her anyway is beyond the scope of this writing.

*After getting permission from Larry, Harry sold 1.5% of his interest in the LLC to his friend Sam, a CPA who was added as a member of the company. Immediately after becoming a member Sam requested to review and copy the financial statements and tax returns of the business. Larry refused to extend these documents to Sam as he only owned a very small percentage of the business. Is Sam entitled to see and copy these records?*

**Answer** – Yes. Arizona law gives Sam and every other member of the LLC the right to review and copy the financial statements and tax returns.

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*After becoming a member, Sam offered to sell a vacant two-acre parcel to the LLC for its fair market value for future development as a convenience store. Can the LLC purchase that parcel from Sam for the asking price?*

**Answer** – Yes. Sam can sell and the LLC may purchase items of real and personal property from its members. Any sale should be well documented and all documents should be saved in perpetuity.

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*My company has ten employees and I am behind in paying their employment taxes to the IRS and to the Arizona Department of Revenue. I filed the quarterly forms but I was not able to pay the amounts due because business has been slow. Can the IRS and the Department of Revenue levy my personal bank accounts to satisfy this obligation?*

**Answer** – Yes. Federal and state law permit the taxing authorities to attach your personal assets in order to satisfy these (actually just a part of these) obligations. If you cannot pay these obligations in a timely manner you need to discuss this with a CPA, Enrolled Agent or attorney immediately before it gets worse.

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*What is a statutory agent and why is one necessary?*

**Answer** – The statutory agent is the individual or company that can accept notices and service of process for the limited liability company. If the company is sued, the statutory agent will be where the lawsuit is served. If someone is required under a contract or other agreement to give notice to the LLC, that notice will be deemed effective if it is sent to the statutory agent. The statutory agent is necessary because many LLC's are simply post office boxes and it would be impossible to serve a lawsuit on a post office box. The statutory agent must have a real physical address in Arizona where the process server can go to deliver lawsuits or other notices.



## Notes



## Notes



## Your Author



*For over a decade I have advised small and medium sized businesses from my law firm located in central Tucson. During that time, I have handled a wide variety of tax problems, finance issues, collections, commercial disputes and other assorted legal matters. This document is really a culmination of the conversations that I have with a client when they tell me that they want to start a new business. In addition to my law degree I have advanced degrees in Accounting and a Master's of Science in Finance – all from the University of Arizona. After twenty years in the USAF, I retired in 1989 and now practice law full time here in the Old Pueblo.*

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