

**W3 Wealth Management,
LLC**
Shelby Morgan
90 N. Miller Road
Akron, OH 44313
330-836-3805
Shelby@W3wealth.com

Starting a Business

Table of Contents

Starting or Buying a Business	6
Start-ups	6
The business plan	6
Buying an existing business	7
Franchises	7
Buying an Existing Business	8
What are the advantages of buying an existing business?	8
What are the disadvantages of buying an existing business?	8
Prepurchase considerations	9
Business valuation	10
Structuring the purchase	11
Negotiating the deal	14
Preparing the business plan	15
Buying a Franchise	16
What is it?	16
Advantages of franchise ownership	16
Disadvantages of franchise ownership	17
The preselection process	18
Available opportunities	18
Selecting a franchise	18
Choosing an Entity for Your Business	21
Sole proprietorship	21
Partnerships	21
Limited partnerships	21
Limited liability partnership	22
Corporations	22
C corporations	22

S corporations	22
Limited liability company	22
Choosing the best form of ownership	23
Advantages and Disadvantages of Self-Employment	24
Can you handle it?	24
Your dream come true	24
On the other hand	25
The bottom line	25
Funding a Business	26
Bank loans	26
Angel investors	26
Venture capital	26
Selling stock	27
Factoring	27
Economic development programs	27
Customer/supplier financing	27
Record Keeping for Your Own Business	28
Your ideal office manager: criteria for record-keeping systems	28
What your records should do for you	28
Be prepared: the taxman cometh	29
Hiring Your First Employee	30
Taking the plunge	30
Getting an Employer Identification Number (EIN)	30
IRS Form W-4, Employee's Withholding Allowance Certificate	30
Understanding your tax obligations	30
Form I-9, Employment Eligibility Verification	31
Complying with your state's new-hire reporting rules	31
Anything else?	31
Properly Insuring Your Business	32

Protect your business from physical destruction 32

Keep your business afloat if you or a key employee dies or becomes disabled 32

Protect your business assets if someone threatens or sues your business 33

Attract and keep employees with insurance-related employee benefits 33

Insuring Your Home Business 34

 Homeowners policy 34

 Home office policy 34

 Business owners policy 34

 Umbrellas and professional liability 34

 Automobile insurance 35

 Workers' compensation 35

 Life insurance 35

 Key person life insurance 35

 Disability insurance 35

 Health insurance 35

 Meet with a trusted insurance advisor 36

Benefit Plans for Small Businesses 37

 Group health insurance 37

 Traditional health insurance 37

 Health maintenance organizations 37

 Preferred provider organizations 37

 Dental insurance 38

 Paying insurance premiums 38

 Group term life insurance 38

 Short-term and long-term group disability insurance 38

 Cafeteria plans 38

Retirement Plans for Small Businesses 40

 Types of plans 40

 Profit-sharing plans 40

401(k) plans 40

Money purchase pension plans 41

Defined benefit plans 41

SIMPLE IRA retirement plans 41

Other plans 42

Finding a plan that's right for you 42

Tax Planning for the Self-Employed43

 Understand self-employment tax and how it's calculated 43

 Make your estimated tax payments on time to avoid penalties43

 Employ family members to save taxes43

 Establish an employer-sponsored retirement plan for tax (and nontax) reasons 43

 Take full advantage of all business deductions to lower taxable income 44

 Deduct health-care related expenses 44

Starting or Buying a Business

Each option involves some element of risk and reward. Whichever option you choose, however, owning your own business offers a chance at more freedom and greater financial rewards. So, you're thinking of going into business for yourself. You have several options available, and all involve some degree of risk. Do you want to create a start-up operation? Perhaps you are planning on buying an existing business. Or, you may be considering the purchase of a franchise operation.

Start-ups

If you are planning on building your business from the ground up, you are taking a bigger risk than if you were buying an existing business or a franchise. Existing businesses and franchises have some operating history that you can use to gauge the likelihood of the success of the business. By comparison, with a start-up business, you naturally think that you will succeed, but there are fewer guarantees.

Most successful start-ups don't actually begin with a new, innovative product. Instead, they begin with a proven product or service (start-up owners often open competing businesses in areas in which they are familiar) and become innovative after the new venture has generated some level of profit and success.

Because your start-up has no previous track record (even if you have had success in your field), you will first need to raise enough financing to make a go of it. Banks or investors will want to see a plan of attack before they will approve a loan for your start-up. Therefore, your first step should be to create a strong business plan.

The business plan

A well-developed business plan serves several useful purposes. It helps to organize thoughts and ideas about how the business should be developed. It also creates a plan of attack that will help you stay focused. And, it will assist you in getting financing. There are several important elements to a well-prepared plan:

- **Strong introduction:** The cover page, executive summary (essentially an overview of the plan), and table of contents will be the first elements that potential financiers or investors will see. If these aren't strong, potential financiers may not take you seriously enough to get to the heart of your plan.
- **Business description:** Whether you are using the business plan to get financing or create a focus of how your business should be run, you need to present a clear vision of what your business will be. The description should include how you want your business to be positioned in your industry, what will make your business unique, the products or services that you will provide, and how you plan on pricing within the industry. Do you want to be the low-cost provider, or the high-end specialist?
- **Market positioning:** If you want to attract investors to your business, you need to convince them that a need in the marketplace exists for what you are proposing. This section needs to include details on the size of the potential market for your business, how your business can benefit through sales inside the market, and how you plan on succeeding against your competitors.
- **Financial objectives:** This is perhaps the most important part of your business plan. Here, you need to convince your potential backers or lenders that your business will make a sound investment. You'll want to show that you have evaluated the attendant risks and rewards of your proposed business. You'll also need to project cash needs and expected income, and present a cash flow statement.
- **Other areas:** A good business plan will also cover in some detail your marketing plan, a discussion of how you plan on developing products to bring to market (if the business is a manufacturing concern), and so on.

Buying an existing business

The obvious advantage to buying an existing business is that it has a proven track record of success. But that doesn't mean that there are no possible pitfalls that you should avoid.

Perhaps the greatest problem in buying an existing business is that you might not acquire the expertise and services of the existing owners, who have often accumulated goodwill with their customers or clients. However, when a business is bought, it is not unusual for the previous owners to stay on for a period of time to assist with the transition and to make introductions to clients in an attempt to transfer some of that goodwill.

Consult qualified professionals to properly evaluate the information that the owners of the existing business may provide you. Also, make sure that the reasons why the business is on the market are true. Is the owner really planning on retiring to Florida, or is he or she just trying to escape the crushing debt that the business has accumulated over the last few years?

Also, keep in mind that you may be taking on a heavy load of debt in acquiring the business. A business that is marginally profitable may not be able to both pay off the debt service on the loan and pay you a living wage.

Franchises

When you buy a franchise, you also buy marketing support, business strategy, name recognition, and assistance with site location (if it's a retail operation), among other things.

However, you also give up some things. You will never have the final say in all decisions, because franchisors typically retain rights to ensure that your business is run their way. Also, you won't be entitled to all of the profits of your business, because franchisors typically take a percentage as part of their fees. Finally, you may be limited in your decision-making processes (e.g., some franchisors require you to buy materials from their suppliers).

If you are thinking of purchasing a franchise, it is very important to thoroughly investigate the company. Remember, you are doing more than just purchasing a name--the franchisor is going to be your business partner. Make sure that he or she doesn't want only your money and then move on to the next potential buyer.

Franchisors are required to disclose lots of information to potential franchisees. Do your homework. Talk not only to successful franchisees but also to ones who have failed. If several former franchisees tell you that the company didn't fulfill the promises of the franchise agreement, beware.

Make sure every representation is made to you in writing before you purchase. Take notes of everything said to you, and have the franchisor sign off on them. That way, you will have a record of what was represented to you if things go wrong.

Buying an Existing Business

What are the advantages of buying an existing business?

The advantages of buying an existing business include:

- Established product or service
- Established "goodwill"
- Management team in place
- Existing collateral
- Reduced start-up time and cost

Unlike a new business, an existing business will likely have a product or service that is familiar to consumers, suppliers, lenders, and employees. Similarly, the business will, hopefully, have established "goodwill": the intangible value of an esteemed business, typically measured by the amount of money for which the business is sold beyond the cost of its assets. In other words, a business's goodwill is the goodwill that the business engenders among those with whom it conducts business. Goodwill adds value to the business, and for this, you pay extra. A further advantage is the business's management team. Since the business will likely have experienced managers already employed, you will save time and money in training, and if you are unfamiliar with the business, you will have an invaluable source of business knowledge at hand. An existing business can also provide the collateral to secure the necessary funds for your purchase. Last but not least, primarily because of the advantages discussed, is the reduced start-up time and cost involved in buying an existing business. Since the business is already established, you will likely need only to infuse the funds required to continue operation.

What are the disadvantages of buying an existing business?

Buying an existing business is not without its disadvantages, however. These disadvantages may include:

- Low supply of qualified businesses for sale
- "Negative goodwill"
- Poor or technologically antiquated assets
- Buying the seller's headaches
- Difficult-to-change business culture

A primary problem with buying an existing business is finding a good one that's for sale. Many businesses that are for sale are not good buys for the same reasons for which they are being sold. Just as a business may have goodwill, it may have "negative goodwill." The business may not be very highly esteemed within its business community. Sometimes, a seller fails to update his or her equipment because of the expense required to do so. If this is the case, the business may have become inefficient. Indeed, a seller may be getting rid of a headache, the cause of which may include the problem of antiquated equipment (or other assets). Furthermore, an existing business will likely have a difficult-to-change business culture. If this culture hinders rather than promotes productive practices, you will have to change it for the better. These disadvantages must be considered.

Prepurchase considerations

Deciding to buy

When deciding to purchase a business, there are some questions you should consider:

- How will you select a business?
- How will you find a business that matches your needs?
- How will you identify potential sellers?

Selecting the right business is far from simple. The right business for you is the one that fits with your personal, business, and financial goals. To select the right business for you, consider your strengths and weaknesses. Are you confident and persistent? Do you have good organizational, management, and professional skills? Compare your skills and traits with the needs of your target industry and company. Do you have a match? Once you have evaluated your strengths and weaknesses, you'll need to seek out potential sellers. To do so, you should consult the following sources, among others:

- Attorney
- Accountant
- Insurance agent
- Real estate agent
- Financial professional (e.g., financial planner)
- Banks
- Small Business Administration (SBA)
- Trade associations

Preparing to buy

When you have chosen your target business, you will need to make some preparations before you buy:

- Identify financial resources
- Assemble a team of professionals
- Develop goals and a timetable
- Conduct a due diligence review

Lack of financing is probably the most common obstacle to buying a business. You will need to make an initial assessment of the funding sources. For more information, see *Raising Capital for Your Business*. Next, you will need to assemble a team of professionals. This team should include an attorney and an accountant. It may also include experts from other fields, such as real estate and finance. Then, you will need to prioritize the process involved with the purchase by setting the dates by which specific tasks are to be accomplished. Furthermore, you must conduct, with help from your team of professionals, a due diligence review--a review of the financial worthiness of your target business. This review should include, among other things, a review of the business's

past and current financial data, internal control structure, management information systems, accounting policies and procedures, and all of its legal matters. Your investigation may involve interviews with the seller, competitors, management, and customers. It may also include a review of relevant trade literature.

Business valuation

There are two things you should know about business valuation. First, business valuation is extremely complex. This is especially so for buyers who may be unfamiliar with the business and the industry itself. For this reason, you should consider adding a valuation expert to your team of professionals. The second thing you should know about business valuation is that there are various methods by which you can value a business. Both of these issues are addressed in the following sections.

Selecting a valuation expert

Be sure that you hire an expert. Most importantly, get an expert who is aware of, and subscribes to, the Appraisal Standards Board (ASB), the American Society of Appraisers (ASA), and the standards they have issued: Uniform Standards and Principles of Appraisal Practice (USPAP) and Business Valuation Standards (BVS), respectively.

Where can you get a valuation expert? Call the following associations:

- Association for Investment Management and Research--(800) 247-8132
- Institute of Business Appraisers--(954) 584-1144
- Institute of Management Accountants--(800) 638-4427
- American Institute of Certified Public Accountants--(212) 596-6200
- American Society of Appraisers--(800) 272-8258

Valuation methods

Different standards or definitions of value have emerged. The most common definition, and the only one receiving mention here, is fair market value (FMV). This standard is widely recognized in business valuations. According to the IRS, FMV is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

So, how do you calculate the FMV of a business? There are various approaches and there are no set definitions for any. Generally, valuation can be determined using any of the following three general methods.

A. Asset approach: Sometimes, a business is worth only what it owns. The asset approach is used to value such businesses, including:

1. Businesses that do not engage in "significant activities" (e.g., investment or holding companies)
2. Businesses that are generating losses
3. Businesses that are in (or will be in) liquidation

The asset approach probably isn't appropriate for active businesses because such businesses are typically worth more than their assets. Some experts believe that the contrary is true, where the active business is not using its assets to their full potential and the business would be worth more if liquidated (all of its assets sold). There are some variations within the asset approach. They are:

1. The adjusted net assets method: This method determines the value of assets and then subtracts outstanding liabilities

2. The adjusted book value method: This method determines the book value (total assets minus total liabilities) of all tangible assets, then adds the value of intangible assets (e.g., copyrights, trademarks, patents)
3. The liquidation value: This method determines the price at which the assets could be sold for in a liquidation sale (sale of all assets)

B. Income approach: This approach determines FMV by calculating the income that the business is expected to generate in the future. In most cases, this approach is the most effective. Therefore, the income approach is commonly used, especially in service-based businesses. As with the asset approach, the income approach has its variations:

1. The capitalization of earnings method: This method determines value by capitalizing earnings. Past earnings are capitalized by dividing them by a capitalization rate, a number that represents the investor's perceived risks and the expected growth of the business.
2. The discounted earnings method: This method uses expected future earnings rather than past earnings. Expected future earnings are calculated and then "discounted" to present-day dollars.
3. The dividend paying capacity method: By comparing a company's working capital needs with those of public companies in the same industry, a company's dividend paying capacity or dividend rate can be calculated. This rate is based on a percentage of the dividends paid by the public companies relative to their earnings.

C. Market comparison approach: According to this approach, the FMV of a business is determined by comparing it with companies engaged in the same or similar line of business (called guideline companies). When seeking guideline companies, the valuation expert will likely consider the following characteristics:

1. Industry: The company operates within the same or very similar industry
2. Size: The company is similarly sized
3. Market activity: The trading activity of each company's stocks is similar
4. Availability of information: Adequate information is available for a proper comparison
5. Trends: Each company has had similar performance trends

Under the market comparison approach, comparisons can be made either to the market price of guideline company stock or to the sale price of guideline companies.

Structuring the purchase

How will you structure the purchase? Will you buy most or all of the company's stock, or will you instead purchase the company's assets? Where will you get the funds? Unfortunately, as a buyer, you may not get to structure the purchase entirely as you'd like. The seller will surely have his or her own ideas as to how the purchase should be accomplished. Nonetheless, the following is a list of your primary considerations when contemplating the structure of your purchase, followed by a brief discussion of each.

- Stock purchase
- Asset purchase
- Financing the purchase

Stock purchase

Since the corporate form is probably the most common, a stock purchase will be an option for many buyers. The advantages and disadvantages of such a purchase are discussed as follows. (This discussion assumes that the buyer is an individual and not a corporation.)

Advantages--Most of the advantages (and disadvantages, for that matter) of a stock purchase arise from issues of tax, liability, accounting, and financing. The advantages may include the following:

- The business and its legal structure continue without interruption.
- The company's assets (tangible and intangible) remain intact.
- You, the buyer, will get a basis in the stock equivalent to its FMV. This can result in a lower capital gains liability when you sell the stock than if you had acquired the stock at its par value.
- The company's accounting systems continue uninterrupted.
- If you are buying a small business, you might be entitled to favorable tax treatment.

Disadvantages--The disadvantages of a stock purchase may include the following:

- Unless you elect otherwise (or are treated as having made such an election), the business may not get a step-up in basis for the assets of the acquired company. Basis is important for, among other things, depreciation calculations.
- You, not the business, will be borrowing the funds required for the purchase, and therefore both corporate and personal guarantees will likely be required.
- The corporation's contractual arrangements remain intact, including those you would rather do without.
- All corporate assets, including those that are unwanted, remain with the business.
- Liabilities carry over to you and any other new owner(s).
- Contracts and agreements, including leases, may require the consent of the other party before being transferred.

Special tax considerations arise when you are acquiring stock in an S corporation. A brief discussion follows.

A. Cash for stock in S corporation: You may exchange cash or property for stock in an S corporation. You do not have to pay taxes on the value of the stock that you received if you paid cash. Instead, the tax that you would otherwise have paid is deferred (postponed) until you decide to liquidate (sell) your asset. At liquidation, you would pay a tax on the profit you make (the price you were paid for the stock when you sold it minus the price you paid for the stock when you purchased it).

For example, you decide to form a corporation with Ron. You contribute appreciated property and Ron contributes cash. In return, each of you receives 50 percent of the stock. You do not have to report as income the value of the stock you received. (You do not have to recognize gain.) You will pay taxes (or declare a loss) when you turn around and sell your stock later.

B. Property for stock in S corporation: You do not have to pay taxes on the stock you received in exchange for property if all of the shareholders who contributed property for stock (as a group) control the corporation immediately after the exchange. The contributors of property do not control the corporation if (combined) they do not own stock possessing at least 80 percent of the total voting power and at least 80 percent of the total number of all other classes of stock.

C. Services for stock in S corporation: If you contribute services for stock, you must recognize gain on the transaction equivalent to the fair market value (FMV) of the services.

For example, assume the same facts as the preceding example except that in exchange for stock you contribute your services. In this case, Ron will recognize gain (report the stock as income to be taxed) on the exchange because he, as the sole contributor of property, owns less than 80 percent of the stock (no control). As you will see next, you too will recognize gain on the stock you received as compensation for your services.

D. Property for stock and other property: If you contribute property in return for stock in a corporation, plus other property or cash, you must recognize gain to the extent of the other property or cash. This other property or cash is known as boot. For example, you contribute an office building in exchange for both stock and cash. You are required to report the cash (not the stock) on your tax return as income.

Asset purchase

Unlike a stock purchase, in an asset purchase you must consider how you will allocate your purchase price among the company's assets. You may, for example, allocate your purchase price to depreciable assets with short lives. This is advantageous because it allows you to recoup a portion of your investment in the form of tax deductions over a short number of years. (Get advice from your tax or legal professional.) You may, if you choose, change the legal structure, or entity (see Choosing an Entity), of your new business. For example, if the acquired company was a corporation, you can instead form a limited liability company (LLC). However, this matter, like the allocation issue, is best left to your tax or legal professional. With that said, some of the advantages and disadvantages of an asset purchase are as follows:

Advantages:

- You can choose your own type of entity (e.g., LLC)
- You do not have to buy unwanted assets
- You do not have to assume unwanted liabilities
- You will not be subject to the contracts or other agreements established by the acquired company (which could also be a disadvantage if such contracts or agreements were on favorable terms)
- You can structure the financing as you wish--use debt financing, equity financing, or any mix of both

Disadvantages:

- You may not be able to use the accounting methods employed in the acquired company
- Intangible assets such as copyrights and patents must be purchased separately
- There will be tax consequences for both buyer and seller
- If you buy the assets at "bargain prices," you may be subject to unfavorable tax treatment

Financing the purchase

The sources of financing are many. In addition to choosing from whom you will acquire financing, however--and sometimes as a prerequisite to doing so--you must decide how to structure the financing. Will you borrow (debt financing) or will you instead exchange ownership interests in your business for funds from investors (equity financing)? For a full discussion on these two issues--the available sources of financing and the debt/equity distinction--see *Raising Capital for Your Business*.

Negotiating the deal

Before you begin negotiations, you should be prepared to:

- Assemble the negotiating team
- Document the agreement
- Consider legal issues

Before these matters are addressed, however, some initial points about negotiating are worth mentioning. First, as a buyer, you'll need to know your limitations. What terms will you never accept? What price is too high? Make sure that you know your ceiling--you will be a much more effective negotiator if you do. Second, know the seller's motives for the sale and understand his or her objectives in the negotiations. How can you do this? Simple--listen, that's how. Listen to all that the seller says and doesn't say. Third, dictate your terms: when, where, and how the negotiations are to be completed. Though the seller may have much to say on these issues as well, you should not be reluctant to assert your preferences. For example, you may wish to choose the location for any "home field advantage," establish a time frame beyond which negotiations will not continue, limit the persons allowed at the negotiating table, and prioritize the order in which issues are to be negotiated.

Assemble the negotiating team

An effective negotiator is one who is both well informed and in possession of the necessary skills to negotiate successfully. Only then can a buyer make informed decisions during the negotiation process. In addition to you (the buyer and primary negotiator), your negotiation team should, at the least, include the following:

- **Financial professional:** A certified public accountant or financial advisor experienced in business acquisition is definitely a plus. You should consider having this professional attend every negotiation session if possible.
- **Attorney:** Yes, you'll need a lawyer--an experienced one. An experienced attorney can be very helpful during the negotiation. The attorney can, for example, identify the legal consequences of the seller's proposals and assist in developing counterproposals.

Document the agreement

As negotiations progress, you will reach agreement on important issues. You and the seller should document one another's understanding of the terms agreed upon. Hence the letter of intent and the formal offer letter:

- **Letter of intent:** This document is usually written at either the early or later stages of the negotiations. When written at the early stages, the letter usually expresses the buyer's intent to purchase the business and represents a request for information that will be utilized in the due diligence review. When written at the latter stages--typically because general agreement has not been reached--the letter of intent restates the buyer's intent to purchase, memorializes previous discussions, and identifies significant issues to be resolved.
- **Formal offer letter:** This document is an offer to buy. If accepted by the seller, the formal offer letter becomes a legally binding contract. For this reason, an experienced attorney should prepare this document.

Consider legal issues

Before negotiations are entered into, you must consider the laws and regulations--whether local, state, or federal--that may significantly affect the transaction. The following is a list of the primary legal issues that you'll

need to be aware of:

- **Securities laws and regulations:** The federal government as well as each state regulates the purchase, sale, and exchange of securities (e.g., stocks and bonds).
- **Employee health and safety regulations:** You will have to abide by health and safety regulations once you've become the owner of your business. The Occupational Safety and Health Administration (OSHA) is one agency that regulates health and safety standards in the workplace.
- **Banking regulations:** Since you will be undergoing financing negotiations at some time, you should know that banks, from which you will likely be borrowing, are closely regulated by state and federal agencies. The type of loan offered and the documentation required by a bank are examples of conduct subject to regulation.
- **Property taxes:** To approximate your future property tax expense as a business owner, you may wish to examine past tax bills. Be aware, however, of any changes (e.g., the amount of tax) that have taken place since these bills were assessed.
- **Zoning laws:** Also pay close attention to the zoning laws in effect. Be sure that your future intentions can be fulfilled without impediment.
- **Real and contingent liabilities:** Be sure that you and your attorney carefully review the liabilities that you will incur with the purchase of the business. Retirement plans and pensions are examples of such liabilities, the continuation or termination of which may be expensive.

Preparing the business plan

The business plan is by far one of the most important keys to a successful business. The primary objective of a business plan is to develop a blueprint of your company. This blueprint will guide the future of the business as well as serve as a means to measure its success. The steps for preparing a business plan are as follows:

- **Step 1:** Identify your objectives.
- **Step 2:** Identify who will be using the plan (e.g., investors).
- **Step 3:** Review the business's historical information (e.g., balance sheets, tax returns).
- **Step 4:** Conduct market research to determine the business's market potential.
- **Step 5:** Interview target company's key employees, suppliers, and customers.
- **Step 6:** Prepare financial projections and determine financing requirements.
- **Step 7:** Draft the business plan. For more information on drafting a business plan, see *The Business Plan*.

Buying a Franchise

What is it?

If you would like to work for yourself but would rather not start your own business, then purchasing a franchise might be a solution. Though far from simple, franchising permits you, the franchisee, to own a business with both a proven method of operation and a familiar name and trademark. That is, broadly, the definition of a franchise. The following discussion explores the advantages and disadvantages of franchise ownership, the preselection process, and the method by which you might select the franchise that's right for you.

Advantages of franchise ownership

Is franchise ownership right for you? To answer this question you'll need to know, among other things, what franchise ownership offers and what it does not. Remember, however, that the decision of whether the advantages of franchise ownership outweigh the disadvantages is a personal one.

Managerial assistance provided

Most franchisors offer managerial assistance to franchisees. Their general business knowledge can be an invaluable source for franchisees. This expertise, indispensable to inexperienced entrepreneurs, can sometimes mean the life or death of the business. Therefore, with help from your franchisor, you will likely make fewer mistakes than if you had started your own business. As a result, your chances for success will likely increase. Indeed, franchisees often fare much better than entrepreneurs who start a business from scratch.

Business "goodwill" and a trusted product or service

Most franchisors have been in business for some time. Their product or service has been tested in the marketplace and has succeeded. Local, regional, or national consumers are familiar with it. Suppliers, employees, lenders, and others (upon whom survival of the company may depend) respect it.

Greater purchasing power

Franchisors usually restrict franchisees from buying supplies from anyone else. Franchisors can therefore employ group purchasing power to buy lower-cost items. Usually, this savings is passed on to you, the franchisee.

Proven operating system

Especially attractive are the proven operating systems of a franchise. Ideally, these systems have been established and refined over the years. The more franchises that are operating, the more highly refined the franchisor's operating systems are likely to be.

Professional advertising

As a franchisee, you will typically pay 1 percent to 5 percent of your gross income for advertising expenses. The franchisor combines this money with contributions from other franchisees to conduct professional advertising campaigns, usually on a national or regional level. In addition, the franchisor is available for advice should you wish to advertise locally.

Financial assistance

Some franchisors will assist you in obtaining financing for your franchise. The franchisor will likely have established relationships with lending institutions, which may, because of that relationship, be inclined to lend money to you. Though you will ultimately be responsible for repaying the debt, the franchisor's involvement may facilitate the lending process. For more information on financing your purchase, see *Raising Capital for Your*

Business.

Disadvantages of franchise ownership

Fees

In exchange for your franchise, the franchisor may require you to pay the following fees:

- **Franchise fee.** A franchise fee is a one-time, nonrefundable payment to the franchisor. The fee charged depends on the franchisor, though the usual range is between \$10,000 and \$50,000. In addition, you might have to dole out funds to rent, build, renovate, or equip your franchise, as well as to acquire your initial inventory, licenses, and insurance.
- **Royalty fees.** This fee, usually 3 percent to 5 percent of your weekly or monthly gross income, represents your continued payments for the use of the franchise name. Keep in mind that royalty fees must be paid regardless of how meager your income, and notwithstanding that the franchisor may have failed to provide promised services.
- **Advertising fees.** You will likely be required to contribute to an advertising pool. As a franchisee, you should inquire as to the allocation of these funds. How much is spent on administrative costs? Will you and other franchisees exercise any control over how advertising dollars are spent? How much is spent in your area . . . on national advertising . . . on regional advertising . . . on selling more franchises?

Control by franchisor

For the sake of uniformity among all outlets, franchisors often exercise significant control over franchisees. The extent of such control varies, but it usually includes the following:

- **Appearance.** The franchisor may dictate how your outlet should appear, both internally and externally. Some may even require occasional modifications. Keeping pace with standards of appearance can therefore be a significant expense.
- **Restrictions on goods/services sold.** The franchisor will likely restrict the goods or services you can sell. This restriction will disallow any product or service additions regardless of the potential for profit.
- **Operational restrictions.** The franchisor will have an established method of operation from which you will not be permitted to deviate. The franchisor may require that you purchase supplies from a particular supplier, hire employees in accordance with its hiring policies, operate your outlet during specified hours, hang only preapproved signs, or issue your employees standard uniforms. These restrictions may restrain you from operating your franchise as you see fit.
- **Selling restrictions.** The franchisor may prohibit sales beyond a specified territory. These restrictions usually ensure that other outlets will not compete with yours, but they prohibit expansion, not a good thing if your territory is minimally profitable.
- **Business location.** The franchisor may reserve the right to disapprove of the site you choose for your franchise, or may pick the location outright.

Renewal of franchise

Franchise contracts are for a limited time only, typically 15 to 20 years. Because there is no guarantee that the contract will be renewed, you may be denied renewal once that time has expired. This is not a very pleasant thought, especially if your outlet has become very profitable. Even if your contract is renewed, your franchisor can impose higher fees or more severe restrictions.

The preselection process

Before choosing a franchise, consider your interests, experience, knowledge, and personality. Though your franchisor will likely offer managerial support and training, you will likely be more successful if you have an interest in, or experience with, the business in which your chosen franchise operates. For example, a former restaurant manager would likely be more successful if he or she acquired a fast-food restaurant rather than, perhaps, a muffler shop.

Don't forget the fees and restrictions that come with franchise ownership. Do you mind paying royalties or relinquishing some control over your business to the franchisor? If you do mind, then franchising may not be for you. If that doesn't bother you, then you might want to seriously consider a franchise.

Available opportunities

Franchise opportunities are endless. Because the number of available franchises is so large, a list of franchises cannot be included here. For information on franchise opportunities, inquire about relevant publications by contacting these sources:

- The International Franchise Association (www.franchise.org)
- Superintendent of Documents U.S. Government Printing Office (www.access.gpo.gov)

The Department of Commerce publishes an especially useful book titled Franchise Opportunities Handbook. The book can be found at your local library or by contacting the Superintendent of Documents. It contains information on government and nongovernment assistance programs as well as franchise company data on thousands of franchises throughout the nation. The book will assist you in selecting possible franchise opportunities.

Selecting a franchise

When you have chosen one or more franchises in which you are particularly interested, you'll need to examine each more closely. Your examination should include a careful review of the franchisor's Uniform Franchise Offering Circular (UFOC)--a document containing information that the franchisor is required by law to provide to you before you sign a contract. In addition, you should investigate the franchisor's credibility by contacting other franchisees and any consumer agency that compiles information that can help in this regard (e.g., the Better Business Bureau). Last but not least, you should assemble a team of professionals (e.g., a lawyer) to assist you each step of the way. The following checklists are provided as a guide.

Request a copy of each franchisor's Uniform Franchise Offering Circular (UFOC)

This document contains information that the franchisor is required by law to deliver to potential franchisees prior to the signing of a franchise contract. (Some franchisors may require, however, that they conduct an initial review of your qualifications prior to providing you with a UFOC.) The UFOC should:

- Identify the franchisor and his or her affiliates
- Identify the franchisor's key employees (directors, officers, managers)
- Describe the business experience of the franchisor and his or her key employees
- Describe the litigation history of the franchisor and his or her key employees
- Identify any prior bankruptcies of the franchisor or his or her key employees
- Provide the financial statements of the franchisor

- Identify the costs (franchise fee, royalty fees, costs for licenses, advertising, insurance, employee benefits, etc.)
- Describe the restrictions to which you will be subjected as franchisee (e.g., territorial restrictions, or restrictions on the types of goods sold and from whom purchased)
- Describe the extent to which you are required to participate in franchise operations
- Describe any financial, managerial, training, building construction, or site-location assistance offered by the franchisor
- Identify the conditions under which the franchise can be terminated, modified, renewed, or transferred to a third party
- Identify the number of franchises that currently operate, are projected for the future, have been terminated, have not been renewed, and have been purchased back by the franchisor
- Substantiate any claims regarding the expected earnings as a franchisee that the franchisor may have made to you
- Identify the names and addresses of other franchisees

Examine the UFOC and consider

- The experience of the franchisor and his or her key employees
- The number of franchises operating versus those no longer in operation
- The level of competition from competing companies, fellow franchisees, and franchisor-owned outlets
- The years the franchisor has been operating
- The franchisor's financial stability
- The extent and quality of training, and any managerial, financial, site-location, and building construction assistance offered
- The projected operating losses of the franchise
- The potential profits of the franchise
- The reputation of the franchisor among franchisees
- The demand for the franchisor's product or service
- The franchisor's ability to continue to support its franchisees as they grow

Contact other franchisees and ask

- What did they do prior to acquiring the franchise?
- How long have they operated the franchise?
- What was their total investment?
- Were all of the costs and fees disclosed up front?

- How long did it take to realize a profit?
- Are they completely satisfied with the goods or service they sell?
- What do they think about the training and other assistance offered by the franchisor? Was it adequate?
-
- Does the franchisor continue to support them? How?
- Are they satisfied with the advertising campaigns conducted by the franchisor?
- Has the franchisor ever reneged on a promise or breached a contractual provision?
- If they could start over, would they still purchase this franchise? What would they do differently?
- In light of your personal goals, interests, and experience, would they recommend this franchise to you?
-

Investigate the credibility and reliability of the franchisor

Contact the Better Business Bureau (check your local telephone directory for the number) and contact Dun & Bradstreet at (800) 234-3867. Ask them to provide any information they have on the franchisor you are examining.

Solicit the advice of professionals

- Consult an attorney. Have him or her review the franchise agreement (your contract with the franchisor). Are there any problems with the contract? Does it include all of the verbal promises made by the franchisor? Keep in mind that, especially with larger franchisors, deviation from the standard form of franchise agreement is often not an option--in such cases, your attorney will be able to explain the ramifications of all the provisions of the agreement.
- Consult an accountant. Have him or her examine the company's financial statement included in the UFOC and give a written opinion on the financial potential of the business. Are the franchise, royalty, and other fees reasonable? What will your financial position be during the first four years? Is the investment risk reasonable?
- Consult a banker. Have him or her review the franchise, its financial performance, and your financial position. Would the banker consider giving you a loan? Does the banker think the franchisor is credible? What does he or she think are the franchisor's strengths and weaknesses?

Choosing an Entity for Your Business

Basically, three separate categories of entities exist: partnerships, corporations, and limited liability companies. Each category has its own advantages, disadvantages, and special rules. It is also possible to operate your business as a sole proprietorship without organizing as a separate business entity. Now that you've decided to start a new business or buy an existing one, you need to consider the form of business entity that's right for you.

Sole proprietorship

A sole proprietorship is the most straightforward way to structure your business entity. Sole proprietorships are easy to set up--no separate entity must be formed. A sole proprietor's business is simply an extension of the sole proprietor.

Sole proprietors are liable for all business debts and other obligations the business might incur. This means that your personal assets (e.g., your family's home) can be subject to the claims of your business's creditors.

For federal income tax purposes, all business income, gains, deductions, or losses are reported on Schedule C of your Form 1040. A sole proprietorship is not subject to corporate income tax. However, some expenses that might be deductible by a corporate business may not be deductible by a business structured as a sole proprietorship. For example, health insurance premiums, as of this writing, are not fully deductible for a sole proprietor.

Partnerships

If two or more people are the owners of a business, then a partnership is a viable option to consider. Partnerships are organized in accordance with state statutes. However, certain arrangements, like joint ventures, may be treated as partnerships for federal income tax purposes, even if they do not comply with state law requirements for a partnership.

A partnership may not be the best choice of entity for a business that anticipates an initial public offering (IPO) in the near future. Although there are publicly traded partnerships, most IPO candidates are organized as corporations.

In a partnership, two or more people form a business for mutual profit. In a general partnership, all partners have the capacity to act on behalf of one another in furtherance of business objectives. This also means that each partner is personally liable for any acts of the others, and all partners are personally responsible for the debts and liabilities of the business.

It is not necessary that each partner contribute equally or that all partners share equally. The partnership agreement controls how profits are to be divided. It is not uncommon for one partner to contribute a majority of the capital while another contributes the business acumen or contacts, and the two share the profits equally.

Partnerships are a recognized entity in the sense that the entity can obtain credit, file for bankruptcy, transfer property, and so on. However, the partnership itself is generally not subject to federal income taxes (it does, however, file a federal income tax return). Instead, the income, gains, deductions, and losses of the partnership are generally reported on the partners' individual federal income tax returns. The allocation of these items among the partners is governed by the partnership agreement, subject to certain limitations.

Limited partnerships

A limited partnership differs from a general partnership in that a limited partnership has more than one class of partners. A limited partnership must have at least one general partner (who is usually the managing partner), but it also has one or more limited partner. The limited partner(s) does not participate in the day-to-day running of the business and has no personal liability beyond the amount of his or her agreed cash or other capital investment in

the partnership.

Limited liability partnership

Some states have enacted statutes that provide for a new type of partnership, the limited liability partnership (LLP). An LLP is a general partnership that provides individual partners protection against personal liability for certain partnership obligations. Exactly what is shielded from personal liability depends on state law. Since state laws on LLPs vary, make sure you consult competent legal counsel to understand the ramifications in your jurisdiction.

Corporations

Corporations offer some advantages over sole proprietorships and partnerships, along with several important drawbacks. The two greatest advantages of incorporating are that corporations provide the greatest shield from individual liability and are the easiest type of entity to use to raise capital and to transfer (the majority stockholder can usually sell his or her stock without restrictions).

However, corporations are generally subject to federal income tax. So, the distributed earnings of your incorporated business may be subject to corporate income tax as well as individual income tax.

C corporations

A corporation that has not elected to be treated as an S corporation for federal income tax purposes is typically known as a C corporation. Traditionally, most incorporated businesses have been C corporations. C corporations are not subject to the same qualification rules as S corporations and thus typically offer more flexibility in terms of stock ownership and equity structure. Another advantage that a C corporation has over an S corporation is that a C corporation can fully deduct most reasonable employee benefit costs, while an S corporation may not be able to deduct the full cost of certain benefits provided to 2 percent shareholders. Virtually all large corporations are C corporations.

S corporations

A corporation must satisfy several requirements to be eligible for treatment as an S corporation for federal income tax purposes. However, qualification as an S corporation offers a potential tax benefit unavailable to a C corporation. If a qualifying corporation elects to be treated as an S corporation for federal income tax purposes, then the income, gains, deductions, and losses of the corporation are generally passed through to the shareholders. Thus, shareholders report the S corporation's income, gains, deductions, and losses on their individual federal income tax returns, eliminating the potential for double taxation of corporate earnings in most circumstances.

However, many employee benefit deductions are not available for benefits provided to 2 percent shareholders of an S corporation. For example, an S corporation can provide a cafeteria plan to its employees, but the 2 percent shareholders cannot participate and receive the tax advantages that such a plan provides.

It is important to note that S corporation treatment is not available to all corporations. It is available only to qualifying corporations that file an election with the IRS. Qualifying corporations must satisfy several requirements, including limitations on the number and type of shareholders and on who can own stock in the corporation.

Limited liability company

A limited liability company (LLC) is a type of entity that provides limitation of liability for owners, like a corporation. However, state law generally provides much more flexibility in the structuring and governance of an LLC as opposed to a corporation. In addition, most LLCs are treated as partnerships for federal income tax purposes, thus providing LLC members with pass-through tax treatment. Moreover, LLCs are not subject to the

same qualification requirements that apply to S corporations. However, it should be noted that a corporation may be a better choice of entity than an LLC if an IPO is anticipated.

Choosing the best form of ownership

There is no single best form of ownership for a business. That's partly because the limitations of a particular form of ownership can often be compensated for. For instance, a sole proprietor can often buy insurance coverage to reduce liability exposure, rather than form a limited liability entity.

Even after you have established your business as a particular entity, you may need to re-evaluate your choice of entity as the business evolves. An experienced attorney and tax advisor can help you decide which form of ownership is best for your business.

Advantages and Disadvantages of Self-Employment

You've grown tired of commuting to a job where you sit in a cubicle and do someone else's bidding. You've got a better idea, you can build a better mousetrap, you know you have the knack for being in the right place at the right time, and so you're thinking of self-employment. But how do you determine if this is a pipe dream or an idea worth pursuing?

Can you handle it?

Whether you're running your own business or working as an independent contractor, you'll soon realize that working for yourself isn't just another job, it's a way of life.

Are you someone who likes a nine-to-five routine and collecting a regular paycheck? When you're self-employed, you must be willing to make sacrifices for the sake of the job. You're going to work long hours, which means that you won't have as much time as you used to for family or leisure activities. And if the cash flow becomes a trickle, you're going to be the last one to get paid.

Can you get along well with all types of people? Being self-employed is all about managing relationships--with your clients or customers, your suppliers, perhaps with your employees, certainly with your family, and probably with your banker, lawyer, and accountant, too. If you're the type who wants to be alone to do the few things that you're good at, then you should do that--for someone else.

Are you a disciplined self-starter? Being self-employed means that you're your own boss. There may be days when you'll have to make yourself sit at your desk instead of going for a long lunch, or (especially if you work out of your home) place those business calls instead of reading the newspaper.

Finally, do you enjoy wearing many hats? Depending on your line of work, you may be involved in handling marketing and sales duties, financial planning and accounting responsibilities, administrative and personnel management chores--or all of the above.

Your dream come true

Think about how great it will feel to get paid to do what you'd love to do anyway. If you're working for yourself, chances are you'll be doing work that you enjoy. You'll get to pick who you'll work for or with, and in most cases you'll work with your customers or clients directly--no go-betweens muddying the waters. As a result, you may have days when it hardly feels as if you're working at all. Such harmony between your working life and the rest of your life is what attracted you to self-employment in the first place.

Being your own boss means that you'll be in control of all of the decisions affecting your working life. You'll decide on your business plan, your quality assurance procedures, your pricing and marketing strategies--everything. You'll have job security; you can't be fired for doing things your way. As you perform a variety of tasks related to your work, you'll learn new skills and broaden your abilities.

You'll even have the flexibility to decide your own hours of operation, working conditions, and business location. If you're working out of your home, your start-up costs may be reduced. You'll also experience lower operating costs; after all, you'll be paying for the rent and utilities anyway. If the location of your work isn't important (perhaps you're a freelance writer or a consultant), you can live wherever you want. At any rate, if you work at home, you'll greatly reduce your daily commuting time and expense.

If all goes well and you're making money, chances are you can make more than you did working for someone else. And since you're working for yourself, you may not have to share the proceeds with anyone else. The fruits of your labor will be all yours, because you own the vineyard.

On the other hand . . .

When you're self-employed, particularly if you're starting your own business, you may have to take on a substantial financial risk. If you need to raise additional money to get started, you may need a cosigner or collateral (such as your home) for a loan. Depending on how much or little work you can line up, you may find that your cash flow varies from a flood to a trickle. You'll need a cash backup so you can pay your bills while you're waiting for business to come in or waiting to be paid for completed work. Since you'll have to pay your own creditors first, this means that sometimes you may eat cereal instead of steak.

Remember that you're not making any money if you're not working. You don't have any employer benefit package, which means that it's going to be hard for you to go on vacation, take a day off, or even stay home sick without losing income. It also means that you'll have to provide your own health insurance and retirement plan. Remember, too, that you can choose your clients or customers, but you can't control their expectations or actions. If you don't come through for them, or if you do something that offends them, you might not get paid for your work.

Because you're working for yourself, you're going to have to take care of everything yourself, from figuring your taxes to watering the office plants. You'll probably need some new skills, such as bookkeeping and filing quarterly taxes. You can learn to do these things yourself--many software programs are designed just for this market--or you can hire others (e.g., an accountant) to take care of them for you. If you're not careful, however, you may find that you're spending more time on the business of being in business for yourself than you are on the work that attracted you to self-employment in the first place.

The bottom line

If you can work long and hard, tolerate risk and stress, cope well with potential disaster and failure, and work well alone and with others, then perhaps self-employment is right for you. If not, then perhaps you should keep that job in the cubicle.

Funding a Business

Aside from using your own funds and borrowing from friends and family, there are numerous routes that you can take, and each has its advantages and disadvantages. Here are some of the major options available for funding your small business, and some of the pitfalls to avoid. You've got your business plan written. You're excited about your business idea, and now it's time to get started. One problem: You don't have the financing to fully realize your idea. What are your options?

Bank loans

Getting a loan from a local bank is the first option that most people think of when funding a new business. But it's often difficult to obtain a bank loan on the basis of a business plan alone. Banks can't take your idea as collateral for the loan.

If you are thinking of getting a bank loan, you will likely need to secure the loan through other means, such as putting up your home as collateral. A bank loan may be more feasible, though, if you are purchasing an ongoing business outright. In that case, the assets or the business itself can be used to secure the loan.

In any case, the advantage of a bank loan is that you won't have to give away any equity if your business succeeds. You will simply repay the loan and own your business outright. If your business fails, however, you may end up losing more than your business assets, depending on the terms of the loan.

Angel investors

Angel investors are private investors who contribute money to a business in exchange for an ownership interest. The obvious advantage of utilizing angel investors is that you don't have to repay a loan. However, you may have to give up a significant amount of equity (and control, depending on the security issued) to the angel investors. Angel investors typically expect to receive preferred equity security in exchange for their investment.

Perhaps the greatest obstacle is to find the right angels. There are many people out there who want to invest in small businesses, but it's not easy to find the right fit. If you opt for this route, make sure that all parties have the same expectations regarding the prospect of success. You need to agree on how long you expect it will take for the business to be profitable (be aware that most small business plans are overly optimistic as to profit expectations) and whether your angels will hang in there with you if it takes longer than expected.

Venture capital

We've all heard a great deal about venture capital firms over the past few years. The ups and downs of some of these companies have been well documented. But are venture capital firms a potential source of financing for your business?

Venture capital may be a viable financing source for your business but, then again, it may not. Like angel investors, venture capitalists typically take an equity stake in your company, and most expect to receive preferred equity security in exchange for their investment. Most venture capitalists specialize in certain industries, and many provide corporate direction as well as financing (some angel investors may provide such direction, as well).

It is this aspect of specialization that makes venture capital financing difficult for most new businesses to obtain. If your new business doesn't fit into the right niche, your company might not be a candidate for funding.

What fields do venture capital firms focus on? Most venture capital firms specialize in high-tech, computer, and Internet services. Others specialize in scientific projects and inventions that require a lot of cash. So, if you're looking to open your own transmission shop, a venture capital firm probably isn't the right financing alternative for you.

Selling stock

Selling stock in your company can take several different forms. We've all heard and read a lot about initial public offerings (IPOs). IPOs are stock sales in which previously private companies go public. An IPO is a possibility for an ongoing business, but it isn't likely to be a viable alternative for your new company.

A private placement is less complex than an IPO and involves selling shares of stock to a select group of equity investors. The investors typically exercise control over the company in direct proportion to the number of shares that they own.

Selling stock or other securities in your business generally requires compliance with federal and state securities laws. Seek the advice of an attorney experienced in these laws before your business issues any stock or securities.

Factoring

You've been in business for a while and you have customers, but your collections have been bad. You need cash now, but your lack of cash inflow is holding you back. What can you do?

A common solution to this problem is factoring. Basically, you secure a loan (usually at a high interest rate) against your accounts receivable. Factoring companies aren't hard to find, and some offer better deals than others, but they are almost always going to charge you a much higher rate of interest than your bank. Thus, factoring is usually considered as an option only after all others have been exhausted.

Economic development programs

Many federal, state, and local government loan programs are available to small businesses. The U.S. Small Business Administration is a good place to start.

Don't overlook your local government loan programs, though. Local governments often offer incentives such as tax breaks or a discounted loan rate if you locate your business in their jurisdiction, often in an area zoned for economic redevelopment.

Customer/supplier financing

This is an option for a business that has a poor credit rating, and a realistic option that many small businesses overlook. In essence, your business bills for part of the services or products that it supplies up front. The rest of the fees are paid as the products are delivered or as the services are completed.

This strategy is aggressive, but many of your customers can appreciate the need that a small business has to keep cash flow current, and won't object to your asking for partial payment up front.

Record Keeping for Your Own Business

Keeping good business records will not only help you stay in business but may also help you increase profits. Your business records let you analyze where your business is and where it's going. They point out potential trouble spots and serve as a guide to where you want your business to be.

Your ideal office manager: criteria for record-keeping systems

Like a valued office manager, your record-keeping system should have good work habits. It should be simple to use. If it's too complicated, it might be neglected, defeating its purpose. It should reflect information accurately, completely, and consistently throughout all of its applications, and it should do so in a timely fashion; you don't want to base important business decisions on partial or outdated information. Finally, it should present results in an easily understandable manner. If you can't comprehend the data that your record-keeping system provides, you might ignore their implications.

Commercial record-keeping systems are available in both manual and computerized versions. Some are generic in format and applicable to many types of business. Others are designed for specific types of business operations (e.g., retail sales and manufacturing). Those available as software generally have the ability to summarize your business activity with appropriate periodic financial reports. Many websites allow you to see a demonstration version before you purchase the software.

You can decide whether to keep your own books or hire someone to do it for you. Your decision depends in part on how much time and ability you have for the task. You can hire a company that specializes in payroll services to handle the paperwork and withholdings for your employees. Most small-business advisors suggest that you have an accountant prepare your tax returns and year-end statements. In many cases, an accountant can also offer advice on various aspects of financial management, such as cash flow analysis, borrowing for the business, tax considerations, and suggestions for which software to buy for record keeping. Whichever way you go, you should stay involved in the record-keeping process. After all, it's your business, and you are responsible for its success or failure.

What your records should do for you

Like a medical diagnostic tool, your records help you assess the health of your business.

- Bank statements measure cash on hand, and accounts receivable predict future income. Together, these records help determine cash flow requirements and may point to a need for short-term borrowing.
- In addition to providing income tax information to your employees, payroll records help you determine the appropriateness of your pricing and customer billing policies.
- If your business keeps merchandise on hand, your records help you manage the size of your inventory, thus avoiding the loss of profits from obsolescence, deterioration, or simply being out of stock.
- Expense records help you plan to meet obligations in a timely fashion. They also help you assess whether the income generated supports the expense involved.
- Statements of income, or profit and loss statements, help pinpoint unprofitable departments, products, or services, alerting you to make changes or eliminations if necessary.
- The balance sheet captures the condition of your business at a given moment in time, allowing you to measure its reality against either your own budget projections or similar businesses.

Be prepared: the taxman cometh

One of the most important functions of business records is to prepare you (or your accountant) for filing tax returns for the business. Thus, you may want to set up a record-keeping system that captures information in a way that matches the demands of the IRS. As a sole proprietor, you want to familiarize yourself with the requirements for completing Form 1040, Schedule C. Here are some tax considerations to remember in relation to your record-keeping system design:

- If the annual gross income of the business for the past three tax years is \$1 million or less, you may use the cash method of accounting, and you won't be required to account for inventories
- If you use the cash method of accounting and are required to determine inventory valuation, you must use the cost valuation method
- The business-related portion of deductible car or truck expenses may be the actual expenses incurred (including gas, oil, tires, repairs, insurance, depreciation, and rent or lease payments), or you may elect to take the standard mileage rate (50.5 cents per business mile in 2008).
- Depreciation may be taken on passenger cars, property used for entertainment or recreational purposes (such as photographic or phonographic equipment), and cell phones and computers, among other items, as long as you bought the items only for use in your business
- You may deduct any contributions to employee benefit plans (such as health insurance plans) or contributions to pension or profit-sharing plans that are for the benefit of employees
- You may deduct sales taxes paid, real estate or personal property taxes on business assets, Social Security and Medicaid taxes paid to match required withholdings on employee wages, and federal unemployment taxes paid
- Depending on whether you use your home or other real estate for business purposes, you may deduct some or all of any mortgage interest paid, as well as some or all of the maintenance and repair expenses associated with the property
- You may deduct the cost of business supplies purchased during the tax year
- You may deduct the cost of utilities associated with business use
- You can deduct professional fees, such as those paid to your accountant
- You may deduct 50 percent of meal and entertainment expenses directly associated with the conduct of your business

Remember to save any records and underlying documentation, such as invoices or receipts, relevant to your tax return for at least three years. Ask your accountant how long he or she suggests keeping the documentation.

Hiring Your First Employee

As a sole proprietor, you handle all business matters--from producing and marketing your goods or services to fixing paper jams in the copier. Your business has grown and now you're stretched too thin. Business is being lost because you just can't do it all yourself. It's time to consider hiring your first employee.

Taking the plunge

Having a new employee--an extra pair of hands--should increase your revenue enough to pay the employee's salary and benefits, plus add to your profits. If you're not quite ready for a full-time employee, think about hiring part-time help, temporary help, or independent contractors, or getting help from family and friends.

Besides salary and benefits, don't forget that the cost of hiring includes the time it takes you to train a new person. During this training, you'll have less time to devote to other aspects of the business. Filing government reports and keeping proper records will consume some of your time as well.

Hiring an employee requires that you complete paperwork and do certain tasks that weren't necessary when you were operating alone. For example, you'll have to:

- Obtain an Employer Identification Number (EIN) from the IRS
- Obtain IRS Form W-4, Employee's Withholding Allowance Certificate
- Obtain Form I-9, Employment Eligibility Verification, from the U.S. Citizenship and Immigration Services (USCIS)
- Comply with your state's new-hire reporting rules

Getting an Employer Identification Number (EIN)

Because you may be withholding taxes from your employee's wages, you must get an EIN (also known as a Taxpayer Identification Number, or TIN). Your EIN identifies your business to the IRS in the same way your own Social Security number identifies you. Applying for an EIN is a straightforward process: Simply complete Form SS-4, Application for Employer Identification Number, and submit it according to the instructions for the form. You can get both Form SS-4 and the instructions on the IRS website.

IRS Form W-4, Employee's Withholding Allowance Certificate

On his or her first day of work, your employee should complete Form W-4 so that you can determine how much federal income tax to withhold. You keep the form in your files; it doesn't have to be sent to the IRS unless:

- Your employee claims more than 10 withholding allowances
- Your employee claims exemption from withholding, and his or her wages are expected to be \$200 or more per week

Understanding your tax obligations

IRS Publication 15 Circular E, Employer's Tax Guide, provides information on employers' tax obligations, such as withholding Social Security and paying federal unemployment taxes. This publication is very important reading for anyone who is considering hiring an employee. To download or order Publication 15, go to the IRS website at

www.irs.gov, or call (800) 829-1040 or (800) 829-4059 TDD.

Most states and certain municipalities also impose income taxes and require employers to withhold taxes from employees' pay. Contact your local taxing authorities to find out the specific requirements.

You may want to think about hiring a payroll service to handle paperwork and tax withholding for you. Research available services and consider whether the time that you would save justifies the cost of the service.

Form I-9, Employment Eligibility Verification

You're also required to verify that your employee is legally eligible to work in the United States. This means completing INS Form I-9, Employment Eligibility Verification, and keeping it on file. You have to establish your employee's identity and eligibility for employment by reviewing certain documents, such as a driver's license and Social Security card, or a U.S. passport. The instructions for Form I-9 also list a number of other acceptable documents. It's a good idea to photocopy these documents, but you are not required to. You can find Form I-9 and instructions on the USCIS website at www.uscis.gov, or call (800) 870-3676.

Complying with your state's new-hire reporting rules

Each state gathers data on people hired within the state. The information is the same as that provided on Form W-4 (which many states use). You have only a short period of time (20 days or less) to supply the required information to the appropriate state agency. Although the responsible agency varies by state, it's often the department that administers unemployment compensation or child support enforcement.

Anything else?

A lot. Remember, you can't exclude any job candidate from consideration on the basis of race, religion, gender, national origin, age, or disability. Be sure to keep records of all phases of the hiring process, from the advertisements that you place to the reasons why you made your ultimate selection.

State law may require you to purchase workers' compensation insurance to protect full-time employees in case of work-related injuries. You should also think about purchasing insurance to protect yourself if you are held liable for the actions of your employee. Check with your insurance agent.

Your best bet is to seek the advice of an expert, such as an attorney, accountant, or business consultant, to make sure that you are taking all of the required steps in hiring your first employee.

Properly Insuring Your Business

No matter how careful you are in running your business, accidents happen. And no matter how big or small your business, you'll have to plan for these and other risks if you want your business to thrive. One way to do this is with insurance.

Imagine this: Your custom-made cabinetry business is thriving. You have a handful of talented employees and a stack of orders. Then, the unthinkable happens. You or one of your employees is severely injured using the equipment. Or a fire damages all of the cabinets you've spent the last few months building. Or a customer calls to tell you that the new cabinets you installed yesterday just fell and crashed onto her kitchen floor.

Protect your business from physical destruction

Your business is situated somewhere--an office park, a warehouse, a barn. And just like your home, this structure (and all of its contents) is susceptible to damage from many causes. Property and casualty insurance provides coverage for losses due to the physical damage or destruction of your business. With the right policy, neither fire nor exploded boiler can put you out of business. Everything from your office building to your cabinets to your water cooler can be covered.

You can buy various types of insurance protection separately, or you can purchase one package that covers many potential hazards. Among the forms of coverage you can purchase are:

- Building and equipment insurance: This protects you if your facility or equipment is damaged or destroyed
- Valuable papers insurance: This protects you if the documentation supporting your accounts receivable or other valuable business records is lost or destroyed
- Crime insurance: This protects your business in case of theft
- Business interruption insurance: This protects you by replacing some or all of your operating cash flow if your business is unable to maintain its normal operations for a period of time due to a covered event

Keep your business afloat if you or a key employee dies or becomes disabled

If you were to die prematurely or become permanently disabled and could no longer work, would your business survive financially? It's easy to believe that such a tragedy won't befall you. But remember, accidents happen not only on the job but also at home, and illness can strike anyone. Though the death or disability of an owner may be a minor issue for large businesses, small businesses may find themselves in a bind. And if you're a sole proprietor, you're personally responsible for all of the debts of your business, so everything you own could be repossessed if you're unable to pay your bills.

To survive a money crunch, your business can purchase life insurance and disability insurance to cover you, with the business named as the beneficiary. Upon a triggering event (death or disability), the policy will pay your business a certain amount of money, which it can use to cover its normal operating expenses like rent, utilities, employee salaries, advertising, and maintenance costs.

Your business can also purchase life insurance and disability insurance on a key employee--someone who is key to the success of your business (i.e., this employee brings in substantial accounts or has specialized knowledge or talent). Again, on the triggering event, your business would receive a sum of money to compensate for the lost income generated by the employee, or for the cost of replacing the employee.

Note: These types of policies are different from workers' compensation insurance, which all states require businesses to have. Workers' compensation insurance provides compensation to your employees if they're injured at work or get sick from job-related causes. Once an employee opts to receive benefits under such a policy, he or she is usually prohibited from suing your business for the same injuries.

Protect your business assets if someone threatens or sues your business

If your cabinet installation goes awry and your best customer (or so you thought) calls screaming at you on the phone, what will you do? With a liability insurance policy, the insurance company will pay (up to policy limits) third parties who claim they were injured or their property damaged by your product or service. If a lawsuit is threatened or filed, the insurance company will hire and pay (again, up to policy limits) a lawyer to defend you.

You can purchase general business liability insurance separately or as part of a commercial package policy, which combines this coverage with other types of coverages, such as property and casualty insurance. Certain small businesses, including retail outfits, can buy a business owners policy, which includes a general liability insurance line. If your business needs broader coverage or higher liability limits than these policies offer, you can purchase supplemental liability insurance with a commercial umbrella policy.

An important point: If you provide professional services (e.g., doctor, lawyer, accountant), a general liability policy doesn't cover you for losses incurred by third parties arising from your professional acts. In this case, you may need to buy professional liability insurance such as malpractice insurance, which protects you against liability for injury done to others due to your misconduct or lack of skill; or errors and omissions insurance, which protects you against liability for things that you did improperly or failed to do.

Attract and keep employees with insurance-related employee benefits

Nowadays, insurance is a crucial component of most employee benefit packages. In fact, the types of insurance that you offer (and pay for) might be a key factor in a person's decision to accept a job with you or an employee's desire to work for your business long term. Insurance helps employees feel secure, and this security can translate into loyalty and strong job performance. Here is a list of group plans that you might decide to offer as part of your employee benefits package:

- Health insurance
- Dental and vision insurance
- Life insurance
- Disability insurance
- Long-term care insurance

In each case, the employee receives all of the benefits under the policy.

Insuring Your Home Business

If you have recently started your own business and work out of your home, you'll probably need to upgrade your insurance program. At-home business owners often make the mistake of assuming that their homeowners policy covers their business equipment. In fact, your homeowners policy may include little or no coverage for your business property and business liability exposure. You also should consider the need for business interruption insurance, workers' compensation coverage, and business automobile coverage. Finally, you should examine your need for life, health, and disability insurance.

Homeowners policy

Homeowners policies generally cover business property on your premises only to a certain limit, usually about \$2,500. Coverage for business property away from your premises is even more limited, with most policies having a \$250 maximum. That is the extent of insurance coverage for your business in the typical homeowners policy. You are not covered for business liabilities, including such things as a delivery person or a client injuring themselves while on your property.

For a higher premium, some insurance companies offer an endorsement that you can add to the standard homeowners policy. An endorsement allows you to increase the liability limit for business property and add a small amount of general liability coverage. The endorsement is designed for very small businesses. However, even with an endorsement, your business is left with uncovered exposures.

Home office policy

Many insurance companies now offer the home office policy, which is a combination of a homeowners policy and a business owners policy. This policy provides adequate business liability coverage, business interruption coverages, and increased limits for your business property, along with the traditional coverages found in a homeowners policy.

The business property limits typically begin at \$10,000. Depending on the policy, the business liability limits may range from \$300,000 to \$1 million. The policy covers lost income and continuing expenses for up to one year in the event your home is damaged and you're unable to work. The policy also covers loss of valuable papers and accounts receivable, while offering higher limits for equipment breakdown coverage and business property used off-premises.

Business owners policy

This type of commercial policy is designed specifically for small businesses. Traditional business owners policies (BOPs) are very comprehensive because they cover buildings, business property used on- and off-premises, and liability. Also covered are computers and other business equipment, software, data, loss of income, continuing expenses, and professional liability for certain occupations.

Some insurance companies have created a new kind of BOP designed specifically for the at-home business. This policy is less expensive, and it provides broad-enough coverage for a larger business without duplicating your coverage. For example, the new BOP would not cover your home structure, because it is already covered by your homeowners policy.

Umbrellas and professional liability

An umbrella policy provides increased liability limits beyond those in separate policies. For example, say you have a BOP with a general liability limit of \$3 million. If you think you'll need more than \$3 million for your business, an umbrella policy will pick up where the BOP leaves off. If you purchase an umbrella policy with a \$5 million limit, your total limit of liability would be \$8 million.

For those in occupations that are particularly vulnerable to professional liability, a separate professional liability policy, usually called malpractice coverage or errors and omissions coverage, is a must. Examples of such professions include law, medicine, architecture, day care, and personal beauty.

Automobile insurance

If you use your personal automobile extensively for your own business, you'll probably need to purchase a commercial automobile insurance policy. Examples of such small businesses are painters, caterers, and contractors. If you use your automobile as part of your business (e.g., a taxi service), you definitely need a commercial policy.

If you rent automobiles in the course of traveling for your own business, check your personal auto policy to see if it covers nonowned autos. Your auto insurance provider can help you determine the extent of your coverage and fill in any gaps.

Workers' compensation

Even if you have only one employee, you need workers' compensation insurance. Each state has its own minimum requirements for this type of coverage--contact your insurance agent or state insurance department for details.

Life insurance

Chances are, you already have a life insurance program in place. Though your individual life insurance needs may not change when you start an at-home business, the amount of insurance you have may change. For example, if you lost employer-sponsored coverage when you left your previous job, you may want to make up the difference so that you're still adequately protected. You may also need more insurance to cover any debts or liabilities you took on to develop your business.

Key person life insurance

Key person life insurance covers financial loss to your business due to the death of your partner or a key employee. If the covered individual dies, your company receives a death benefit. There are several creative ways you can set up a key person life insurance plan. Contact your financial advisor to set up the best arrangement for your business.

Disability insurance

This type of insurance is very important to consider when you have your own business. Ask yourself if you have enough resources to support your family if you became disabled and could not work. If you do have some savings, how long would they last? Would you be depleting savings that are earmarked for your retirement or your kids' college education? Most people need disability insurance to protect against the loss of income that can result from disability. Your ability to produce an income is an asset that should be covered like your house and your car.

Health insurance

Health insurance for the self-employed can be expensive and difficult to find. One affordable alternative may be to join a professional association that offers group health insurance to its members. Chances are, your profession has its own specific association in your area or state. If not, there are associations for small-business owners in general. Finally, your local chamber of commerce may have a health insurance program for its members.

Individual health insurance is very expensive. What's more, some states have made the laws so restrictive for individual health insurance that many insurance companies in those states no longer offer them. However, one

way to buy yourself protection before finding a permanent health plan may be to purchase short-term health insurance, if these policies are allowed in your state. These policies run from one to six months and are relatively inexpensive. Contact your insurance professional to find out how you can get short-term medical coverage.

Meet with a trusted insurance advisor

With all you have to think about in starting and running your own business, reviewing and updating your insurance program can seem like an overwhelming task. Your first step should be to talk with an experienced and licensed insurance professional. He or she can identify your needs, familiarize you with the relevant state laws, and recommend a suitable insurance program to meet them.

Benefit Plans for Small Businesses

If you own a small business, you may be finding it increasingly necessary to implement a benefit program to attract and maintain employees. For small businesses, benefit plans generally consist of some of the major insurance benefits, discussed here, as well as employer-sponsored retirement plans.

Group health insurance

By far the most common benefit offered by employers, and the one most requested by employees, health insurance comes in many forms and with widely varying levels of benefits. The most frequently offered forms of health insurance are traditional, Blue Cross/Blue Shield types of plans and health maintenance organizations (HMOs).

Traditional health insurance

Under a traditional employer-provided health insurance plan, you, as the employer, contract with an insurer to provide health insurance benefits for you and your employees (and often for your employees' dependents as well). A typical plan will pay claims as a percentage of the normal and customary charge for a given procedure in a particular region (typically, the insurance company pays 75 to 80 percent of a covered claim).

A covered employee generally must pay a standard deductible before benefits become payable by the insurer. Deductibles typically range between \$200 and \$1,000. The higher the initial deductible, the lower the insurance premium. This is because the covered employees are taking on a larger portion of the insurance risk by paying the higher amount, and saving the insurance company the costs of processing smaller claims.

Health maintenance organizations

HMOs have grown tremendously in popularity over the last 20 years or so. There is still some debate as to whether these plans have actually helped in lowering costs while providing a high level of care to the patient, but there is little doubt that HMOs are here to stay.

HMOs will often offer a lower-cost option for you, the employer, as well as for your employees. Costs are reduced because the HMO typically restricts the doctors a patient can see to those within its provider network. However, in limited circumstances--as set out by the HMO--participants can generally go out of the provider network, and the HMO still picks up the cost.

HMO doctors are typically paid a set fee per patient. This fee is paid whether a patient actually seeks treatment or not. Doctors in the HMO network handle all procedures and tests. Thus, the HMO is able to control the entire spectrum of tasks necessary to keep a patient well. In theory, the HMO is also able to control costs by giving doctors incentives to keep costs low. A doctor has no financial incentive to conduct unnecessary tests (the doctor will receive the preset fee and no more), so it is up to the doctor to help control patient costs. Typically, HMOs charge very small co-payments (as low as \$5 or \$10 per visit).

Preferred provider organizations

The preferred provider organization (PPO), a less common type of plan, is also available in many areas. PPOs operate much like a hybrid of the two more frequently seen employer-provided health insurance plans.

A PPO is actually a group of doctors and/or hospitals that provides medical service only to a specific group or association. The PPO may be sponsored by a particular insurance company, by one or more employers, or by some other type of organization. PPO physicians provide medical services to the policyholders, employees, or members of the sponsor(s) at discounted rates and may set up utilization control programs to help reduce the overall cost of medical care. In return, the sponsor(s) attempts to increase patient volume by creating an incentive

for employees or policyholders to use the physicians and facilities within the PPO network.

Dental insurance

This benefit has grown in popularity among small businesses. Dental insurance is really more of a co-payment plan than an actual insurance plan. This is because, typically, there are annual limits of a few thousand dollars on the amount of benefits an individual may receive under the plan (unlike health insurance, which may have a lifetime limit of several hundred thousand to millions of dollars for benefits paid).

Nonetheless, dental insurance is highly valued by employees, because dental procedures are often among the most expensive medical charges an individual will incur in a given year.

Paying insurance premiums

Whatever type of health plan(s) you select, it's fairly typical for an employer to pay a portion (or all) of the employee cost of the plan. If an employee also wants to cover his or her family, the additional cost is often paid for entirely by the employee.

Group term life insurance

Group term life (GTL) insurance is another popular benefit offered by more and more small businesses.

Typical GTL plans offer employees insurance in either a set amount (e.g., all employees receive \$10,000 of insurance, regardless of income level) or an amount based on their salary level (e.g., each employee receives insurance equal to two times current salary).

GTL benefits are tax free up to \$50,000 of coverage (assuming that the benefits are provided under a policy that qualifies as GTL insurance for tax purposes). If you provide employees with more than that amount of coverage under a qualifying GTL policy, your employees must pay taxes on the amount of the premium attributable to insurance coverage in excess of \$50,000. However, the amount of additional income recognized by employees as a result of employer-provided GTL coverage in excess of \$50,000 is typically very small (especially for younger employees). Therefore, the additional taxable income should not, by itself, be a disincentive for providing higher amounts of GTL coverage for your employees if you're so inclined.

Short-term and long-term group disability insurance

A disability plan is designed to provide an employee with an income stream should he or she become disabled.

Short-term disability plans provide benefits (usually a fixed percentage of the employee's salary) for a set number of days (typically 180). After that period of time, assuming the employee is still disabled, long-term disability insurance (if available) kicks in, and the employee receives benefits under that program until he or she is no longer disabled.

Typically, under a group plan, these benefits are fixed and not adjusted for inflation (in contrast, individual policies often offer an inflation rider). And if an employer pays all or a portion of the premium for disability coverage, then the portion of the benefits paid to employees that is attributable to the employer's contribution is considered taxable income.

Cafeteria plans

Though not an insurance plan per se, a cafeteria plan can offer employees a way to pay their portion of insurance premiums with pretax dollars. If you implement a cafeteria plan as part of your business's benefits program and the plan satisfies certain requirements, employees can elect to forgo a portion of their salary and have that money instead go to pay for their premium payments, without the amount being included in their taxable income.

Employees save money because their taxable income is reduced, yet benefits remain the same. The employer's payroll taxes are reduced as well, because the employees are receiving lower salaries than they were before the cafeteria plan was implemented.

In order for a plan to qualify as a cafeteria plan under the Internal Revenue Code, it must satisfy certain requirements. In addition, an employer that has established a cafeteria plan is required to annually file a Form 5500 tax return for the plan.

Retirement Plans for Small Businesses

As a business owner, you should carefully consider the advantages of establishing an employer-sponsored retirement plan. Generally, you're allowed a deduction for contributions you make to an employer-sponsored retirement plan. In return, however, you're required to include certain employees in the plan, and to give a portion of the contributions you make to those participating employees. Nevertheless, a retirement plan can provide you with a tax-advantaged method to save funds for your own retirement, while providing your employees with a powerful and appreciated benefit.

Types of plans

There are several types of retirement plans to choose from, and each type of plan has advantages and disadvantages. This discussion covers the most popular plans. You should also know that the law may permit you to have more than one retirement plan, and with sophisticated planning, a combination of plans might best suit your business's needs.

Profit-sharing plans

Profit-sharing plans are among the most popular employer-sponsored retirement plans. These straightforward plans allow you, as an employer, to make a contribution that is spread among the plan participants. You are not required to make an annual contribution in any given year. However, contributions must be made on a regular basis.

With a profit-sharing plan, a separate account is established for each plan participant, and contributions are allocated to each participant based on the plan's formula (this formula can be amended from time to time). As with all retirement plans, the contributions must be prudently invested. Each participant's account must also be credited with his or her share of investment income (or loss).

For 2008, no individual is allowed to receive contributions for his or her account that exceed the lesser of 100 percent of his or her earnings for that year or \$46,000. Your total deductible contributions to a profit-sharing plan may not exceed 25 percent of the total compensation of all the plan participants in that year. So, if there were four plan participants each earning \$50,000, your total deductible contribution to the plan could not exceed \$50,000 ($\$50,000 \times 4 = \$200,000$; $\$200,000 \times 25\% = \$50,000$). (When calculating your deductible contribution, you can only count compensation up to \$230,000 (in 2008) for any individual employee.)

401(k) plans

A type of deferred compensation plan, and now the most popular type of plan by far, the 401(k) plan allows contributions to be funded by the participants themselves, rather than by the employer. Employees elect to forgo a portion of their salary and have it put in the plan instead. These plans can be expensive to administer, but the employer's contribution cost is generally very small (employers often offer to match employee deferrals as an incentive for employees to participate). Thus, in the long run, 401(k) plans tend to be relatively inexpensive for the employer.

The requirements for 401(k) plans are complicated, and several tests must be met for the plan to remain in force. For example, the higher paid employees' deferral percentage cannot be disproportionate to the rank-and-file's percentage of compensation deferred.

However, you don't have to perform discrimination testing if you adopt a "safe harbor" 401(k) plan. With a safe harbor 401(k) plan, you generally have to either match your employees' contributions (100% of employee deferrals up to 3% of compensation, and 50% of deferrals between 3 and 5% of compensation), or make a fixed contribution of 3% of compensation for all eligible employees, regardless of whether they contribute to the plan. Your contributions must be fully vested. Another way to avoid discrimination testing is by adopting a SIMPLE 401(k) plan. These plans are similar to SIMPLE IRAs (see below), but can also allow loans and Roth

contributions. Because they're still qualified plans (and therefore more complicated than SIMPLE IRAs), and allow less deferrals than traditional 401(k)s, SIMPLE 401(k)s haven't become a popular option.

If you don't have any employees (or your spouse is your only employee) a 401(k) plan (an "individual 401(k)" or "solo 401(k)" plan) may be especially attractive. Because you have no employees, you won't need to perform discrimination testing, and your plan will be exempt from the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). You can make a deductible profit-sharing contribution of up to 25% of pay (to \$230,000) on your own behalf in 2008, and in addition you can make deductible pre-tax contributions of up to \$15,500 in 2008 (plus an additional \$5,000 of pre-tax catch-up contributions if you're age 50 or older). However, total annual additions to your account in 2008 can't exceed \$46,000 (plus any age-50 catch-up contributions).

Note: A 401(k) plan can let employees designate all or part of their elective deferrals as Roth 401(k) contributions. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. Unlike pre-tax contributions to a 401(k) plan, there's no up-front tax benefit--contributions are deducted from pay and transferred to the plan after taxes are calculated. Because taxes have already been paid on these amounts, a distribution of Roth 401(k) contributions is always free from federal income tax. And all earnings on Roth 401(k) contributions are free from federal income tax if received in a "qualified distribution."

Note: 401(k) plans are generally established as part of a profit-sharing plan.

Money purchase pension plans

Money purchase pension plans are similar to profit-sharing plans, but employers are required to make an annual contribution. Participants receive their respective share according to the plan document's formula.

As with profit-sharing plans, money purchase pension plans cap individual contributions at 100 percent of earnings or \$46,000 annually (in 2008), while employers are allowed to make deductible contributions up to 25 percent of the total compensation of all plan participants. (To go back to the previous example, the total deductible contribution would again be \$50,000: $(\$50,000 \times 4) \times 25\% = \$50,000$.)

Like profit-sharing plans, money purchase pension plans are relatively straightforward and inexpensive to maintain. However, they are less popular than profit-sharing or 401(k) plans because of the annual contribution requirement.

Defined benefit plans

By far the most sophisticated type of retirement plan, a defined benefit program sets out a formula that defines how much each participant will receive annually after retirement if he or she works until retirement age. This is generally stated as a percentage of pay, and can be as much as 100 percent of final average pay at retirement.

An actuary certifies how much will be required each year to fund the projected retirement payments for all employees. The employer then must make the contribution based on the actuarial determination. In 2008, the maximum annual retirement benefit an individual may receive is \$185,000 or 100 percent of final average pay at retirement.

Unlike defined contribution plans, there is no limit on the contribution. The employer's total contribution is based on the projected benefits. Therefore, defined benefit plans potentially offer the largest contribution deduction and the highest retirement benefits to business owners.

SIMPLE IRA retirement plans

Actually a sophisticated type of individual retirement account (IRA), the SIMPLE (Savings Incentive Match Plan for Employees) IRA plan allows employees to defer up to \$10,500 (for 2008) of annual compensation by contributing it to an IRA. In addition, employees age 50 and over may make an extra "catch-up" contribution of \$2,500 for 2008. Employers are required to match deferrals, up to 3 percent of the contributing employee's wages (or make a fixed contribution of 2 percent to the accounts of all participating employees whether or not they defer

to the SIMPLE plan).

SIMPLE plans work much like 401(k) plans, but do not have all the testing requirements. So, they're cheaper to maintain. There are several drawbacks, however. First, all contributions are immediately vested, meaning any money contributed by the employer immediately belongs to the employee (employer contributions are usually "earned" over a period of years in other retirement plans). Second, the amount of contributions the highly paid employees (usually the owners) can receive is severely limited compared to other plans. Finally, the employer cannot maintain any other retirement plans. SIMPLE plans cannot be utilized by employers with more than 100 employees.

Other plans

The above sections are not exhaustive, but represent the most popular plans in use today. Recent tax law changes have given retirement plan professionals new and creative ways to write plan formulas and combine different types of plans, in order to maximize contributions and benefits for higher paid employees.

Finding a plan that's right for you

If you are considering a retirement plan for your business, ask a plan professional to help you determine what works best for you and your business needs. The rules regarding employer-sponsored retirement plans are very complex and easy to misinterpret. In addition, even after you've decided on a specific type of plan, you will often have a number of options in terms of how the plan is designed and operated. These options can have a significant and direct impact on the number of employees that have to be covered, the amount of contributions that have to be made, and the way those contributions are allocated (for example, the amount that is allocated to you, as an owner).

Tax Planning for the Self-Employed

Self-employment . . . the opportunity to be your own boss, to come and go as you please, and oh yes, to establish a lifelong bond with your accountant. If you're self-employed, you'll need to pay your own FICA taxes and take charge of your own retirement plan, among other things. Here are some planning tips.

Understand self-employment tax and how it's calculated

As a starting point, make sure that you understand (and comply with) your federal tax responsibilities. The federal government uses self-employment tax to fund Social Security and Medicare benefits. You must pay this tax if you have more than a minimal amount of self-employment income. If you file a Schedule C as a sole proprietor, independent contractor, or statutory nonemployee, the net profit listed on your Schedule C (or Schedule C-EZ) is self-employment income and must be included on Schedule SE, which is filed with your federal Form 1040. Schedule SE is used both to calculate self-employment tax and to report the amount of tax owed. For more information, see IRS Publication 533.

Make your estimated tax payments on time to avoid penalties

Employees generally have income tax, Social Security tax, and Medicare tax withheld from their paychecks. But if you're self-employed, it's likely that no one is withholding federal and state taxes from your income. As a result, you'll need to make quarterly estimated tax payments on your own (using IRS Form 1040-ES) to cover your federal income tax and self-employment tax liability. You'll probably have to make state estimated tax payments, as well. If you don't make estimated tax payments, you may be subject to penalties, interest, and a big tax bill at the end of the year. For more information about estimated tax, see IRS Publication 505.

If you have employees, you'll have additional periodic tax responsibilities. You'll have to pay federal employment taxes and report certain information. Stay on top of your responsibilities and see IRS Publication 15 for details.

Employ family members to save taxes

Hiring a family member to work for your business can create tax savings for you; in effect, you shift business income to your relative. Your business can take a deduction for reasonable compensation paid to an employee, which in turn reduces the amount of taxable business income that flows through to you. Be aware, though, that the IRS can question compensation paid to a family member if the amount doesn't seem reasonable, considering the services actually performed. Also, when hiring a family member who's a minor, be sure that your business complies with child labor laws.

As a business owner, you're responsible for paying FICA (Social Security and Medicare) taxes on wages paid to your employees. The payment of these taxes will be a deductible business expense for tax purposes. However, if your business is a sole proprietorship and you hire your child who is under age 18, the wages that you pay your child won't be subject to FICA taxes.

As is the case with wages paid to all employees, wages paid to family members are subject to withholding of federal income and employment taxes, as well as certain taxes in some states.

Establish an employer-sponsored retirement plan for tax (and nontax) reasons

Because you're self-employed, you'll need to take care of your own retirement needs. You can do this by establishing an employer-sponsored retirement plan, which can provide you with a number of tax and nontax benefits. With such a plan, your business may be allowed an immediate federal income tax deduction for funding the plan. You can also generally place pretax dollars into a retirement account to grow tax deferred until withdrawal. You may want to use one of the following types of retirement plans:

- Keogh plan
- Simplified employee pension (SEP)
- SIMPLE IRA
- SIMPLE 401(k)
- Individual (or "solo") 401(k)

The type of retirement plan that your business should establish depends on your specific circumstances. Explore all of your options and consider the complexity of each plan. And bear in mind that if your business has employees, you may have to provide coverage for them as well. For more information about your retirement plan options, consult a tax professional or see IRS Publication 560.

Take full advantage of all business deductions to lower taxable income

Because deductions lower your taxable income, you should make sure that your business is taking advantage of any business deductions to which it is entitled. You may be able to deduct a variety of business expenses, including rent or home office expenses, and the costs of office equipment, furniture, supplies, and utilities. To be deductible, business expenses must be both ordinary (common and accepted in your trade or business) and necessary (appropriate and helpful for your trade or business). If your expenses are incurred partly for business purposes and partly for personal purposes, you can deduct only the business-related portion.

If you're concerned about lowering your taxable income this year, consider the following possibilities:

- Deduct the business expenses associated with your motor vehicle, using either the standard mileage allowance or your actual business-related vehicle expenses to calculate your deduction
- Buy supplies for your business late this year that you would normally order early next year
- Purchase depreciable business equipment, furnishings, and vehicles this year
- Deduct the appropriate portion of business meals, travel, and entertainment expenses
- Write off any bad business debts

Self-employed taxpayers who use the cash method of accounting have the most flexibility to maneuver at year-end. See a tax specialist for more information.

Deduct health-care related expenses

If you qualify, you may be able to benefit from the self-employed health insurance deduction, which would enable you to deduct up to 100 percent of the cost of health insurance that you provide for yourself, your spouse, and your dependents. This deduction is taken on the front of your federal Form 1040 (i.e., "above-the-line") when computing your adjusted gross income, so it's available whether you itemize or not. The portion of your health insurance premiums that is not deductible there can be added to your total medical expenses itemized in Schedule A.

Contributions you make to a health savings account (HSA) are also deductible "above-the-line." An HSA is a tax-exempt trust or custodial account you can establish in conjunction with a high-deductible health plan to set aside tax-free funds for health-care expenses.

**W3 Wealth Management,
LLC**
Shelby Morgan
90 N. Miller Road
Akron, OH 44313
330-836-3805
Shelby@W3wealth.com

Neither Forefield Inc. nor Forefield Advisor provides legal, taxation, or investment advice. All content provided by Forefield is protected by copyright. Forefield claims no liability for any modifications to its content and/or information provided by other sources.