INCORPORATING 101

ADVANTAGES OF INCORPORATING

When it comes to forming a corporation, it would appear that for many business owners the advantages may far exceed the disadvantages:

- Sole Proprietorships and partnerships are subject to unlimited personal liability when it comes to business debt. Creditors of the business can hold the owners of the business personally liable for debt and can move to seize the proprietor's or partner's home, savings or other personal assets. The shareholder of a corporation has only the money he has put into the company to lose, and usually no more.

- A corporation is the most enduring legal business structure. If a sole proprietor or partner dies, the business ends or it may become involved in various legal entanglements. Since a corporation has a life of its own, it may continue on regardless of what may happen to its individual officers, managers or shareholders. Also, ownership of the business may be transferred without disrupting operations through the sale of stock.

- Capital can be more easily raised with a corporation. This may be accomplished through the sale of stock or other equity interests. With sole proprietorships and partnerships, investors are much harder to attract because of the personal liability issue. For example, if the investor in a sole proprietorship (or some forms or partnerships) wants a share of the business for his capital contribution, he could become subject to a demand on his personal assets from creditors if the business becomes insolvent.

- With partnerships, each individual general partner may bind the business to arrangements that may result in serious financial difficulty. A corporation's shareholders cannot commit the company by their acts simply because they have invested in it.

- Corporations can offer anonymity to its owners. For example, if a business person wants to open an independent small business of any kind and does not want his/her involvement to be public knowledge, the best choice is to incorporate. If opened as a sole proprietorship, he/she will clearly be identified as the owner. Also, if they are in a partnership, this will most likely become a matter of record.

- Corporations offer the advantage of allowing tax-deductible benefits such as health and life insurance and travel and entertainment deductions, as well as providing an increased tax shelter for retirement plans.

DISADVANTAGES OF INCORPORATING

While it would appear that the argument for incorporating is strong, it is not necessarily the best business structure for everyone. You may decide not to incorporate due to one of the following reasons:

- Maintaining a corporation requires more paperwork and record-keeping than sole proprietorships. Each individual state has its own legal procedures and regulations for forming and maintaining a corporation in good standing. Also, it is usually more costly to set-up a corporation than any of the other major business structures. If you incorporate with a lawyer, fees could run between $500 to $2,000 and more.

- If the profit from the business is not significant, there may not be enough income to take advantage of the tax and other benefits of a corporation.

GENERAL CORPORATION

This is the most common corporate structure. The corporation is a separate legal entity that is owned by stockholders. A general corporation may have an unlimited number of stockholders that, due to the separate legal nature of the corporation, are protected from the creditors of the business. A stockholder's personal liability is usually limited to the amount of investment in the corporation and no more.

Advantages

- Owners' personal assets are protected from business debt and liability
- Corporations have unlimited life extending beyond the illness or death of the owners
- Tax-free benefits such as insurance, travel, and retirement plan deductions
- Transfer of ownership facilitated by sale of stock
- Change of ownership need not affect management
- Easier to raise capital through sale of stocks and bonds
- Most widely recognized corporate structure

Disadvantages

- More expensive to form than proprietorship or partnerships
- More legal formality
- More state and federal rules and regulations

S-CORPORATION

S-corporations have the same basic advantages and disadvantages of general or close corporations except that this form of corporation allows stockholders to pass all profits or losses from the business directly to their personal income tax return.

The S-corporation eliminates federal corporate income taxes and, as a result, avoids the "double taxation" problems (taxed once at the corporation level and again at the personal income level) of general corporations.

To start an S-corporation, you must first form a general or close corporation. Within 75 days of forming the corporation, the stockholders must elect the S-corporation status by filing federal form 2553 with the IRS. In addition, you may be required to file S-corporation election forms with your state authorities. Check with your accountant or other business advisor in your state for further details. The corporation must meet certain requirements before qualifying for S-corporation status:

S-corporation restrictions

- It must be a domestic corporation
- Only one class of stock is permitted
- There can be no more than 75 stockholders
- Only individuals may be stockholders
- All stockholders must be U.S. Citizens

Please note, due to recent changes in the federal law governing S-corporation that become effective January 1, 1997, several of the above listed restrictions may no longer apply or may be modified.

LIMITED LIABILITY COMPANY

The Limited Liability Company (LLC) is a rather new business entity in the U.S., having been introduced in the early 1980s. Since their introduction, LLCs have become quite popular with business advisors due to combining many advantages of corporations, such as limited personal liability, with the tax advantages of partnerships. Like most partnerships and S corporations, LLCs are able to have business income, or loss, reported only on the federal tax reports of the individual owners of the LLC, thus avoiding the double taxation encountered by corporations.

Limited Liability Companies that are properly formed in accordance with state and federal guidelines can offer individuals and small businesses a clear and, frequently, a superior alternative to general corporations, partnerships or other business entities. Many business advisors believe LLCs could ultimately replace general and limited partnerships, joint ventures, general and S-corporations, as the business entity of choice for many entrepreneurs and small businesses. LLCs also offer distinct advantages over sole proprietorships, and corporations with closely-held stock.

NON-PROFIT CORPORATION

As the name indicates, non-profit, also known as not-for-profit, corporations are organized under the non-profit corporation statutes of each state. A non-profit corporation may, and many do, make money and record a profit. However, any funds or funds or profits received by the corporation are to be used for the promotion of the corporation's specific purpose and not for the enrichment of its owners, directors, members, or officers. Reasonable salaries may be paid to officers and employees in exchange for their services.

The documents required to form a non-profit are very similar to those used for standard for-profit corporations. The documents must specify the corporate name, initial director(s), Registered Agent, and certain other details as required by each state. Non-profit corporations, however, must also state the specific purpose for which the corporation is being formed. In most states, this purpose is limited to charitable, educational, religious, scientific, or fraternal activities. It is important to note that not all non-profit corporations are tax-exempt and not all tax-exempt organizations are incorporated. You should consult with a business advisor who is familiar with non-profit and tax-exempt rules and guidelines to determine the ideal structure for your endeavors.

Non-profit corporations are also eligible to apply for exemption from federal and, in some cases, state income taxes. In order to obtain this tax-exempt status, the corporation must first be formed as a non-profit corporation in a particular state according to the state and federal guidelines. Then the corporation must file the necessary applications for tax-exempt status. This process can be quite lengthy and should be completed with the assistance of a qualified attorney or other business advisor.

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