INCORPORATING YOUR BUSINESS IS POTENTIALLY THE SINGLE MOST IMPORTANT THING A BUSINESS OWNER CAN DO

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1. **ADVANTAGES OF INCORPORATING**.

Anyone who operates a business, alone or with others, should explore incorporating their business. The following benefits are available through incorporating:

a. Reduces Personal Liability. Incorporating helps separate your personal identity from that of your business. Sole proprietors and partners are subject to **unlimited personal liability** for business debts or law suits against their company. Creditors of the sole proprietorship or partnership can bring suit against the owners of the business and can move to seize the owners' homes, cars, savings or other personal assets. Once incorporated, however, the shareholders of a corporation have only the money they put into the company to lose, and usually no more. This keeps personal assets out of the creditors line of fire.

b. Adds Credibility. A corporate structure communicates permanence, credibility and stability. Even if you are the only stockholder or employee, your incorporated business may be perceived as a much larger and more credible company. Seeing "inc." or "corp." at the end of your business name can send a powerful message to your customers, suppliers, and other business associates about your commitment to the ongoing success of your venture.

c. Tax Advantages - Deductible Employee Benefits and Lower FICA Taxes. Incorporating usually provides tax-deductible benefits for you and your employees. Even if you are the only shareholder and employee of your business, benefits such as health insurance, life insurance, travel and entertainment expenses may now be deductible. Corporations usually provide an increased tax shelter for qualified pensions plans or retirement plans (e.g. 401K's). Also, the potential exists for lowering the FICA withholdings while conducting business as a sole proprietor.

d. Easier Access to Capital Funding. Needed capital for your business can be more easily raised with a corporation through the sale of stock. With sole proprietorships and partnerships, investors are much likely to purchase shares in a corporation where there usually is a separation between personal and business assets. Also, some banks prefer to lend money to corporations.

e. An Enduring Structure. A corporation is the most enduring of all legal business structures. Corporations may continue on regardless of what happens to its individual directors, officers, managers or shareholders. If a sole proprietor or partner dies, the business may automatically end or it may become involved in various legal entanglements. Corporations can have unlimited life, extending beyond the illness or death of the owners.

f. Easier Transfer of Ownership. Ownership of a corporation may be transferred, without substantially disrupting operations through the sale of stock.

g. Anonymity. Corporations can offer anonymity to its owners. For example, if you want to open an independent small business of any kind and do not want your involvement to be public knowledge, your best choice may be to incorporate. If you open as a sole proprietorship, it is hard to hide the fact that you are the owner. As a partnership, you will most likely be required to register your name and the names of your partners with the state and/or county officials in which you are doing business.

h. Centralized Management. With a corporation's centralized management, all decisions are made by your board of directors. Your shareholders cannot unilaterally bind your company by their acts simply because of their investment. With partnerships, each individual general partner may make binding agreements on behalf of the business that may result in serious financial difficulty to you or the partnership as a whole.

2. TYPES OF CORPORATIONS

Businesses may choose from a variety of corporate entities, based on their needs. Below are useful descriptions. If you have further questions, we can help you decide which type of structure best suits your business needs.

a. General Corporation ("C" corporation). A general corporation, known as a "C" corporation, is the most common corporate structure. A general corporation may have an unlimited number of stockholders. Consequently, it is usually chosen by those companies planning to have more than 30 stockholders or large public stock offerings. Since a corporation is a separate legal entity, a stockholder's personal liability is usually limited to the amount of investment in the corporation and no more.

b. Close Corporation. A close corporation is most appropriate for the individual starting a company alone or with a small number of people. These are a few significant differences between a general corporation and a close corporation. A close corporation limits stockholders to a maximum of 30. In addition, many close corporation statutes require that the directors of a close corporation must first offer the shares to existing stockholders before selling to new stockholders. Not all states recognize close corporations.

c. Subchapter "S" Corporation. A Subchapter S Corporation is a general corporation that has elected a special tax status with the IRS after the corporation has been formed. Subchapter S corporations are most appropriate for small business owners and entrepreneurs who prefer to be taxed as if they were still sole proprietors or partners. When a general corporation makes a profit, it pays a federal corporate income tax on the profit. If the company also declares a dividend, the stockholders must report the dividend as personal income and pay more taxes. S Corporations avoid this "double taxation" (once at the corporate level and again at the personal level) because all income or loss is reported only once on the personal tax returns of the stockholders. For many small businesses., the S Corporation offers the best of both worlds, combining the tax advantages of a sole proprietorship or partnership with the limited liability and enduring life of a corporate structure.

(i) S Corporation Restrictions. To elect S Corporation status, your corporation must meet specific guidelines.

1. All stockholders must be citizens or permanent resident of the United States.
2. The maximum number of stockholders for an S Corporation is 100.
3. If an S Corporation is held by an "electing small business trust," then all beneficiaries of the trust must be individuals, estates or charitable organizations. Interests in the trust cannot be purchased.
4. S Corporations may only issue one class of stock.
5. No more than 25 percent of the gross corporate income may be derived from passive income.
6. Not all domestic general business corporations are eligible for S Corporation Status.

(ii) S Corporation Exclusions:

1. A financial institution that is a bank
2. An insurance company taxed under Subchapter L
3. A domestic International Sales Corporation
4. Certain affiliated groups of corporations

d. Limited Liability Company (LLC). Many people have questions about the differences between a corporation and an LLC. An LLC is not a corporation, but offers many of the same advantages. Many small business owners and entrepreneurs prefer LLC's because they combine the limited liability protection of a corporation with the "pass through" taxation of a sole proprietorship or partnership.

(i) LLC's have additional advantages over corporations.

(ii) LLC's allow greater flexibility in management and business organization.

(iii) LLC's do not have the ownership restrictions of S Corporations, making them ideal business structures for foreign investors.

(iv) LLC's accomplish these aims without the IRS' restrictions of an S Corporation.

(v) LLC's are now available in all 50 states and Washington, D.C.

3. WHICH STATE TO INCORPORATE IN

a. Forming a Corporation or LLC in California. Many small businesses prefer to incorporate or form an LLC in their home state. Typically, it is least complicated and most cost effective to incorporate in the state where you are planning to operate your business. If you incorporate outside your home state, you still may be required to qualify to do business in your home state. The cost of a local incorporation will usually be less than incorporating in another state and then qualifying to do business in your home state as a "foreign" (out of state) corporation. Also, you will avoid paying franchise taxes and filing annual reports in two different states.

b. <u>Advantages of a Delaware Corporation or LLC</u>. Over 505 of the NY Stock Exchange companies are Delaware corporations. Delaware has a long heritage as a business-friendly state and may be a good choice if you intend to take your company public and offer publicly traded stock. Delaware has many other advantages, including low incorporation fees, low annual franchise taxes, and no state corporate income tax for corporations that operate outside of Delaware. Furthermore, Delaware maintains a separate court system for business, called the "Court of Chancery." This Court is known for its well-established record of decisions and speed at which it handles disputes. So instead of spending your valuable time in court, you can spend it running your business. Be aware, however, that if you incorporate in Delaware while your business is located outside of Delaware, you may need to qualify to do business in your home jurisdiction. This may require an extra step and fee to your home state.

c. <u>Advantages of a Nevada Corporation or LLC</u>. Nevada has become increasingly friendly to corporations with its privacy and liability protection status as well as certain tax advantages. Nevada has no state tax on corporate profits, no state annual franchise tax, or no state personal income tax. Stockholders of a Nevada corporation are not public record, allowing complete anonymity. However, if you incorporate in Nevada while your business is located in another state, you may need to qualify to do business in your home state. This may require an extra step and an additional fee to your home state.

d. <u>Can a Delaware or Nevada Corporation or LLC Do Business in Other States?</u> Yes. As noted above, nearly half of the corporations listed on the New York Stock Exchange are Delaware corporations and numerous large businesses are relocating to Nevada. These large companies conduct business throughout the U.S. and abroad. They must, of course, conform to the laws of any jurisdiction they enter. Many states require that any foreign (out of state) corporation qualify to do business in their state prior to actually conducting business there.

e. <u>Doing Business in More Than One State</u>. Many companies conduct business throughout the U.S. and abroad. A corporation having business locations in multiple states will typically incorporate or form an LLC in a single state, then "qualify to do business" in the other states. This means they formally register in these other states, paying additional franchise taxes and filing annual reports, as required.

Our Firm's up-front involvement in the business decisions of our clients allows for the **early identification** and **minimization of potential problems**. Through implementing our recommended strategies, our clients have saved **hundreds of thousands of dollars** in costly decisions and litigation!

To schedule an appointment to set up a corporation or to obtain more information on legal issues of interest to your business, please contact Mark D. Klein at (949) 453-7979 or email us at mark@kleinlawcorp.com