

Your Biz, Inc.

Is incorporation right for your biz? This comprehensive article will walk you through the ins and outs of going Inc.

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The term *corporation* comes from the Latin *corpus*, which means *body*. A corporation is a body--it is a legal person in the eyes of the law. It can bring lawsuits, can buy and sell property, contract, be taxed, and even commit crimes. It's most notable feature: a corporation protects its owners from personal liability for corporate debts and obligations--within limits.

The corporation is considered an artificially created legal entity that exists separate and apart from those individuals who created it and carry on its operations. With as little as one incorporator, a corporation can be formed by simply filing an application for a charter with the respective state. By filing this application, the incorporator will put on record facts, such as:

- the purpose of the intended corporation,
- the names and addresses of the incorporators,
- the amount and types of capital stock the corporation will be authorized to issue, and
- the rights and privileges of the holders of each class of stock.

Why Incorporate?

It is true that operating as a corporation has its share of drawbacks in certain situations. For example, as a business owner, you would be responsible for additional record keeping requirements and administrative details. More important, in some cases, operating as a corporation can create an additional tax burden. This is the last thing a business owner needs, especially in the early stages of operation.

Remember, aside from tax reasons, the most common motivation for incurring the cost of setting up a corporation is the recognition that the shareholder is not legally liable for the actions of the corporation. This is because the corporation has its own separate existence wholly apart from those who run it. However, let's examine three other reasons why the corporation proves to be an attractive vehicle for carrying on a business.

- **Unlimited life.** Unlike proprietorships and partnerships, the life of the corporation is not dependent on the life of a particular individual or individuals. It can continue indefinitely until it accomplishes its objective, merges with another business, or goes bankrupt. Unless stated otherwise, it could go on indefinitely.

- **Transferability of shares.** It is always nice to know that the ownership interest you have in a business can be readily sold, transferred, or given away to another family member. The process of divesting yourself of ownership in proprietorships and partnerships can be cumbersome and costly. Property has to be retitled, new deeds drawn, and other administrative steps taken any time the slightest change of ownership occurs. With corporations, all of the individual owners' rights and privileges are represented by the shares of stock they hold. The key to a quick and efficient transfer of ownership of the business is found on the back of each stock certificate, where there is usually a place indicated for the shareholder to endorse and sign over any shares that are to be sold or otherwise disposed of.
- **Ability to raise investment capital.** It is usually much easier to attract new investors into a corporate entity because of limited liability and the easy transferability of shares. Shares of stock can be transferred directly to new investors, or when larger offerings to the public are involved, the services of brokerage firms and stock exchanges are called upon.

Advantages of Incorporating

- Owners are protected from personal liability from company debts and obligations.
- Corporations have a reliable body of legal precedent to guide owners and managers.
- Corporations are the best vehicle for eventual public companies.
- Corporations can more easily raise capital through the sale of securities.
- Corporations can easily transfer ownership through the transfer of securities.
- Corporations can have an unlimited life.
- Corporations can create tax benefits under certain circumstances, but note that C corporations may be subject to "double taxation" on profits. To avoid this, many business owners elect to operate their corporations under subchapter S of the Internal Code. Also known as an S corporation, this entity allows income to pass through to the individual shareholders.

Disadvantages of Incorporating

- Corporations require annual meetings and require owners and directors to observe certain formalities.
- Corporations are more expensive to set up than partnerships and sole proprietorships.
- Corporations require periodic filings with the state and annual fees.

Getting Started

To start the process of incorporating, contact the secretary of state or the state office that is responsible for registering corporations in your state. Ask for instructions, forms and fee schedules on business incorporation. It is possible to file for incorporation without the help of an attorney by using books and software to guide you along. Your expense will be the cost of these resources, the filing fees, and other

costs associated with incorporating in your state.

If you do file for incorporation yourself, you'll save the expense of using a lawyer, which can cost from \$500 to \$1,000. The disadvantage of going this route is that the process may take you some time to accomplish. There's also a chance you could miss some small but important detail in your state's law. You may also choose to use an incorporation service company to prepare and file the documents with the state.

One of the first steps you must take in the incorporation process is to prepare a certificate or articles of incorporation. Some states will provide you with a printed form for this, which either you or your attorney can complete. The information requested includes the proposed name of the corporation, the purpose of the corporation, the names and addresses of the parties incorporating, and the location of the principal office of the corporation.

The corporation will also need a set of bylaws that describe in greater detail than the articles how the corporation will run, including the responsibilities of the shareholders, directors and officers; when stockholder meetings will be held; and other details important to running the company. Once your articles of incorporation are accepted, the secretary of state's office will send you a certificate of incorporation.

Where to Incorporate

One major decision to make when incorporating involves selecting the proper state of incorporation. You're not required to incorporate in the state where your business operates; you can choose from any one of the 50 states or the District of Columbia.

A corporation is referred to as a foreign corporation in all states except for the state where it is incorporated. If a corporation is transacting business in a state other than where it was incorporated, it may be required to register for a certificate of authority to transact business (also called foreign qualification) in the other state. If a corporation is transacting business and fails to register as a foreign corporation, it may lose access to that state's courts and face tax fines and penalties.

A foreign corporation that registers for a certificate of authority in another state must pay state filing fees for the qualification filing; these fees are typically more expensive than the cost of filing for a domestic corporation. Also, foreign qualified corporations are subject to taxes and annual report fees from both the state of incorporation and the qualifying state. Thus, the actual advantage of incorporating in a state with very low initial filing fees and low corporate income tax is not as great as it appears if your business must still qualify to do business in its state of operations.

The definition of "transacting business" depends on the state and the situation. Consult your attorney to determine how the law applies to your situation. In general, though, some factors that a state considers when determining whether a corporation is transacting business in a state include:

1. Does the corporation have a physical presence in the state?
2. Does the corporation have employees in the state?
3. Does the corporation accept orders in the state?
4. Does the corporation have a bank account in the state?

Note that simply transacting business via mail order or the Internet typically does not equal transacting business; however, the determination is made on a case-by-case basis. Again, consult your attorney for specifics, as this list is not intended to be comprehensive.

How Incorporating Affects Funding

If you plan to seek investment, the preferred entity of most investors and VCs is the C corporation, which is the standard corporation formed by incorporating. Limited Liability Companies, Limited Liability Partnerships and other entities are not favored due to the variation in rules between states and because they do not have the legal structure of shareholders, a board of directors and officers, which are standard components of investment.

If you have less than 35 shareholders, you'll probably want to elect to be an S corporation for tax purposes. You must file the election form 2553 within a short time after incorporating, so be sure to check with the IRS regarding the filing and the deadlines. If you need to expand beyond 35 shareholders in the future, you can change your tax status back to a C corporation to do so.

Anytime you're dealing with investor-related agreements and stock grants, you'll want to work with a securities attorney. These areas are complex and vital to making sure you retain control and future benefits from your company. As a side note, the attorney you work with usually should not be a shareholder or a board member of the company. If he or she suggests this, then you should discuss the Professional Responsibility Rules of his or her State Bar with the attorney, phone the State Bar attorney complaint line to discuss the situation and make sure his or her actions are ethical.

Running Your Corporation

Here's a rundown of who plays what roles in a corporation:

- **Board of directors:** The original directors are designated in the Articles of Incorporation, which is the document filed with the state to legally form the entity. Directors oversee the officers of the company and assure that it operates according to law and corporate procedures. Directors have a fiduciary duty to the corporation to act in the corporation's best interest, not to their own best interest, among other legal duties. These duties are to protect the shareholders' investments in the corporation. Investors often want at least one representative on the board of directors, since the board formally controls the decisions of the company. However, sometimes investors avoid having any directors and arrange other contractual alternatives in order to avoid the fiduciary duty requirements to act for the

benefit of the corporation rather than themselves. The board of directors appoints and may fire the corporation's officers, who are responsible for the day-to-day operations of the company.

- **Shareholders:** Shareholders are people who've been granted stock by the corporation in exchange for money paid or services performed for the corporation. The shareholders meet annually, at the corporation's annual meeting, to elect the board of directors. Shareholders are not financially liable for the debts of the corporation and are not legally liable for any wrongdoing of the corporation. Investors will be granted shares in exchange for their investment. Typically, they will want "preferred shares, which means that if there are minimal dividends or other negative financial events, they will have priority in getting their money over the "common stock" shareholders.
- **Officers:** Officers typically include at least a CEO and/or president, secretary and treasurer/CFO. Officers do not have the same heightened level of fiduciary duties to the corporation that the board of directors has.

After You've Incorporated

Once you're incorporated, be sure to follow the rules of incorporation. If you don't, a court can pierce the corporate veil and hold you and the other owners personally liable for the business's debts.

It is important to follow all the rules required by state law. You should keep accurate financial records for the corporation, showing a separation between the corporation's income and expenses and that of the owners'.

The corporation should also issue stock, file annual reports and hold yearly meetings to elect officers and directors, even if they're the same people as the shareholders. Be sure to keep minutes of these meetings. On all references to your business, make certain to identify it as a corporation, using Inc. or Corp., whichever your state requires. You also want to make sure that whomever you deal with, such as your banker or clients, knows that you are an officer of a corporation.

To make sure your corporation stays on the right side of the law, heed the following guidelines:

- Call the secretary of state each year to check your corporate status.
- Put the annual meetings (shareholders' and directors') on tickler cards.
- Check all contracts to ensure the proper name is used in each. The signature line should read "John Doe, President, XYZ Corp.," never just "John Doe."
- Never use your name followed by "dba" (doing business as) on a contract. Renegotiate any old ones that do.
- Before undertaking any activity out of the normal course of business--like purchasing major assets--

write a corporate resolution permitting it. Keep all completed forms in the corporate book.

- Never use corporate checks for personal debts and vice versa.
- Get professional advice about continued retained earnings not needed for immediate operating expenses.

This article was excerpted from the books Start Your Own Business and Entrepreneur Magazine's Ultimate Book on Forming Corporations, LLC's, Sole Proprietorships and Partnerships, and the articles "Incorporation: Giving Form to Your Business" by [Judith Silver](#) and "Incorporating Your Business" by [Rick Oster](#).

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