The Smart Guide To Incorporating

A Smart Solutions Publication

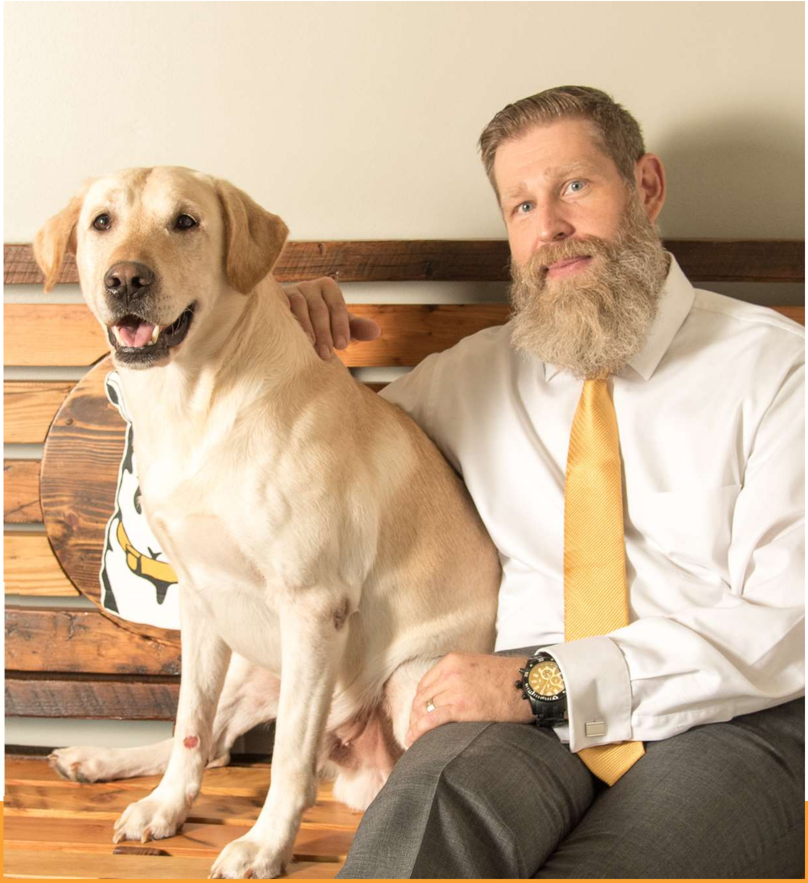
About The Author

Charles Watson is the fearless leader and founder of Smart Accounting Solutions. After years in the corporate world, he felt the calling to help small businesses succeed like the big guys! His insight and planning is what makes SMART different from any other accounting firm around. When he's not in the office doing magic with numbers and formulas, Charles is an avid outdoorsman.

He spends. a lot of time with his retrievers, who became so well known the company logo was fashioned after them.

And one last thing to add about Charles… he has a beard. He loves his beard. Thinks it's the greatest thing ever. He tells stories about his beard. Thinks it gives him super powers. Just ask him.

Charles T. Watson



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INCORPORATION 101

If you're reading this there's a good chance you own a small business. There's also a really good chance you are running that business as a sole proprietor. Meaning you and the business are one in the same. There is no legal distinction between the two.

The most common question I receive from owners in your very situation is "Should I incorporate?" Ninety percent of the time the answer is yes. The reasons are simple:

- Legal Protection
- Tax Advantages
- Better Financing Options
- Perpetual Existence
- Credibility and Prestige

We'll cover each of the advantages to being incorporated in a lot more detail later. But first I need to explain what the term 'incorporation' really means. Quite simply it's the process a business goes through to define itself legally in front of it's particular secretary of state. When a business is incorporated a separate and distinct legal entity is created. Meaning the business can now operate independently of its owners. This is much different than a sole proprietor where there is no distinction between the owner and the business.

I also want to note that I use the term 'incorporating' whether I'm talking about setting up a corporation or an LLC. Technically, when filing paper work with the Secretary of State, you organize an LLC and incorporate a corporation. But for the purpose of this book I will refer to both processes simply as "incorporating".

BENEFITS OF INCORPORATING

Alright let's take a look at each of the advantages of incorporating and see how they might apply to your particular business.

Legal Protection

First and foremost in a business owner's mind is the desire to protect their personal assets. You want to protect your personal home, vehicles and investments. That's exactly what happens once you've incorporated, because you have the protection of what's often referred to as the "corporate veil". In legal terms this means your company is solely responsible for its own debts and obligations. If for some reason the company can not meet those obligations, i.e. can't pay off loan, the creditors can not come after the owners. It also means there is protection in the case the business was sued.

Unfortunately, if everything is not done properly, the corporate veil can be pierced. Simply filling out some paperwork and sending some money to the Secretary of State is not enough. There is a little more that needs to be done.

The corporation must be set up properly, and I'm not just referring to filling out the paperwork properly. That is important. But proper set up also includes going through the physical act of issuing stock to separate the owners and the business. Also most states require corporations to maintain a corporate book where organizational meetings are recorded at least on an annual basis. If for some reason these things are not done, a judge might see it as a defective corporation and expose the owners of the business to liability.

Just as there are things that must be done, there are things that must not be done. Do not sign a contract with only your name. If the contract is with the business entity whoever signs the contract must place their title and entity below their name. Never pay for any personal expense out of the corporate account. If you as the owner need extra money make sure you do it as an extra dividend or distribution.

Tax Advantages

Beyond legal protection incorporating also offers many tax advantages. Probably the biggest tax advantage incorporating offers is sheltering income from self employment tax. As a sole proprietor every dollar of net income is subject to self employment tax of 15.3%. That's on top of federal tax and state tax. Incorporating allows owners to take money out of their business that is not subject to self employment tax. You would only have to pay self employment tax on the portion you take out as salary, saving 15.3% on the rest.

Generally a corporation qualifies for tax benefits and deductions that aren't available to individuals operating as sole proprietors. Corporations also have the ability to carry forward losses of previous years to offset profits in following years. Furthermore, once your business is profitable incorporation becomes extremely advantageous due to the availability of tax deferrals. Because a corporation is a separate legal entity, you can control how much you pay yourself in a given year and how much of the profits are left in the corporation. This means that you can control how much revenue you take and as a result, how much personal income tax you pay. Personal income tax on the money held in the corporation will be deferred until you choose to take it out of the corporation. In the meantime, the corporation can invest this money or use it to grow the business.

Better Financing Options

A corporation is a separate legal entity, therefore it is not dependent on your credit as the owner. The business will have its own credit. This opens up more options for potential sources of financing. The most obvious would be the company could raise money by taking on investors or selling stock. Even loans through banks can be easier to get as they view business loans less risky.

Perpetual Existence

A corporation's life becomes it's own and is not dependent on the life of it's owner. Therefore the death or withdrawal of an owner does not end the company. It would simply pass to the owners heirs.

Credibility and Prestige

It is generally accepted that an incorporated business is more serious and stable than those that are not. The benefit here is really about how the business is viewed by potential customers and lenders. Adding and INC or LLC to the end of your business name increases its credibility. With that comes the potential for increased sales as customers view your business as being more legitimate. It also may open doors to suppliers who feel more comfortable working with businesses that are incorporated.

Filing articles of incorporation serves to strengthen and protect your businesses name. It prevents other businesses in your state from using the name of your business as their own. This in turn can improve marketing, branding and general name recognition.

Corporation or LLC

By now you should be convinced that incorporating your small business is probably the best thing to do. But you are probably also wondering what type of corporation you should be. This may be the most important business decision you ever make. So let's get started helping you make that decision.

Legal Entity vs Tax Entity

Before we go any further I really need to make sure you understand the difference between a legal entity and a tax entity. It's easy to get confused by these concepts.

> *Tax Entity – This is simply the way the IRS sees the business for tax purposes*
>
> *Legal Entity – This is how everybody else, like creditors and courts, see the business*

So when considering what type of entity to be, you have to choose what type of legal entity is best and then choose how you would like to be taxed by the IRS. So a Corporation can be taxed as either a C-Corp or an S-Corp. While an LLC can be taxed as a C-Corp, S-Corp, sole proprietor or Partnership. Because of the penalizing nature of the self employment tax that is subject in both sole props and partnerships, I did not include them in the upcoming comparisons. There are unique instances where being a sole prop or a partnership might be more advantageous. Most of the time a C-Corp or an S-Corp status is the most beneficial and those are the ones I cover in this book.

	C-Corp	S-Corp	Sole Prop	Partnership
Corporation	X	X		
LLC	X	X	X	X

Legal Advantages – Corporation vs LLC

The corporate legal format has been around for centuries. This really has allowed the laws that govern them to be very uniform. There are reams of case law and precedent that courts can look to.

LLC's on the other hand have only been around since the 1970's. There just isn't as much precedent. Because of this, states differ in their treatment of LLC's. This may mean it's more beneficial for businesses to be LLC's in one state and corporations in another. So the reality is you must look at how your particular state treats corporations and how they treat LLC's. If the laws in your particular state are more beneficial for one than the other, this will play a deciding role in what type of legal entity you choose to be.

Tax Advantages - C-Corp vs S-Corp

Once you have determined what legal form your business will take. You now have to determine how you want to be taxed.

A major disadvantage of being taxed as a C-Corp is what people normally call "double taxation". A C-corporation's is first taxed on its profits when the business files its corporate tax return. Then the shareholders pay taxes again when the profits are distributed as dividends.

S-corps on the other hand are considered "pass through" entities. This means the business entity does not pay tax on the profits. The profits "pass through" to the owners where they are taxed on the owner's personal tax returns. This usually means the profits are taxed at a lower rate. More importantly it insures they are only taxed once.

I have yet to meet a business owner who liked the idea of paying taxes twice on the same profit. That's why most owners often choose the S-Corp tax status. However, very recently the IRS passed a law that allows the owners of companies taxed as a C-Corp to sell their company and escape any and all taxes on the profits of that sale. This brings up some very interesting possibilities. If you are planning on building up your business and selling it for sizeable profits in the future, you might consider being a C-Corp to save taxes on the sale. However, if you are building a legacy business and you plan on passing it on to heirs, then an S-Corp is probably the better option.

Corporate Ownership

The last factor you must consider when determining how to structure your business is ownership. There are differences in how a corporation and an LLC can be structured. The owners of a corporation are shareholders. The owners of an LLC are members. This distinction becomes very important when profits are being distributed from the business. An LLC has the freedom to distribute profits to its members regardless how much capital each member has contributed. So, even though a member may not have invested as much cash as another member, there can be an agreement that states each member gets an equal share of the profits.

A corporation could theoretically do the same thing by issuing separate “classes” of stock. However only C-Corps are allowed to create a unique stock class structure. If a business would like to set itself up as an S-Corp in order to avoid double taxation it can only have one class of stock. That means when the business distributes profits, they have to be distributed in proportion to each shareholders capital investment.

We run into this a lot when one owner has all the capital to start the business and the other potential owner is going to simply put in “sweat equity”. In cases such as this, the investing owner does not actually plan to work in the business. Essentially, the one owner will be doing all the work and their sweat is their equity contribution. In this case, the investing owner usually wants a controlling percentage of the stock. He or she puts in all of the cash and they want to protect it as best as they can. However, in order to incentivize their partners to put in as much sweat as possible, they are willing to take a lower percentage of the profit distributions. Under the rules of an S-Corp this simply is not allowed. In cases like this the business would have to be set up as either an LCC or C-Corp. Or the sweat equity partners would have to be paid a greater portion of the profits in the form of salaries and wages.

CORPORATE SET UP CHECKLIST

Company Name ______________________________

1. Pick a winning name for your business. This can be a creative challenge, but its worth the time. You'll need to check with your particular Secretary of State and make sure the name is available.

URL / Domain www.______________________________

2. Check with one of the many domain name registration companies to see if your domain name is available. Depending on availability you may change the business name until you have one that matches.

Determine Legal Structure (circle one) Corporation / LLC

3. Based on all the information you know, determine if your businesses legal structure should be a corporation or an LLC

Register With Secretary of State ______________________________

4. Now that you have a business name that matches your URL and you know what type of entity you want to setup, your ready to go to your Secretary of State register your business.

Obtain an EIN from the IRS ______ - ______________

5. Up until this point everything you have done is setting up the legal structure of the business. Now you need start the process of making sure you are tax status is set up.

Determine Your Tax Status (circle one) C-Corp / S-Corp

6. This is where you tell the IRS how you want the business associated with the EIN you just set up to be taxed. It will require filing IRS form 2553 and/or 8832.

Open a Separate Bank Account ______________________________

7. Now that you are incorporated your personal and business funds must be separate. Take your documents from the Secretary of State and the EIN letter from the IRS an open a new bank account.

Keep Proper Documentation

8. Make sure you have a written operating agreement. Go to the trouble of issuing stock, even if it is just to yourself. Have annual corporate meeting and record those your minutes book.

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