The Benefits of Incorporation, a primer
presented by
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**Limited Liability.** You may have heard through popular lore that one of the major advantages of incorporation is shareholders and investors are not personally liable for corporate debts. You got it right—it is true. In general, the liability for corporate debt is limited to the amount of money each owner has contributed. This means personal assets (home, car, savings, etc.) of the owners are not at risk if the corporation fails or cannot pay its bills. They stand to lose only the monies they have invested.

**Example:** Joe and Martin are in the advertising-consulting business and purchased an expensive software program to run the business and monitor their clients’ marketing efforts. The program cost $15,000 and they made a down payment of $2,000. They were able to make the payments for the first year, but then fell behind and defaulted on the contract. The creditor can only go against the assets of the corporation.

**Example:** Mary operates a women’s clothing store and to purchase inventory and refurbish her shop, she has borrowed heavily on three business credit cards. Unfortunately, she has had to close down her business because of the economy, and form a new partnership with a friend at a different location across town. Because the obligations are corporate credit cards, the creditors can only go against whatever assets are remaining and not personal assets.

**Example:** Charles is a distributor of beauty supplies. He sells these items to retail beauty outlets throughout the south. He deals with a major supplier, ABC Wholesale. The more he buys, the cheaper the cost. During one quarter, he bought an exceptionally large amount of inventory at a special discount price. Not only was the pricing low, but he also got a special in making installment payments. Unfortunately, he was required to hire a number of field sales reps to sell the inventory and this became quite expensive. Finally, he had to lay off these employees, consolidate, close the business, and go back to what he did before—a one man sole proprietorship. After he closes down, he will not be personally liable for the unpaid inventory.

Note the insulation from individual liability is not applicable to personal negligence or misconduct, unrelated to operating the business. If Charles above is involved in an automobile accident, he is personally liable. Or if someone slips
and falls at his home, he is similarly liable. However, it may be a moot point, because he could be covered by an auto and homeowners’ policy.

But what about signing a lease or taking out a business loan? It is well known that personal guarantees are required in such instances. That certainly is true, but remember the majority of debt is typically corporate and not personally guaranteed. That certainly is better than a sole proprietorship or partnership, in which all debt is subject to personal liability.

**Be Careful How You Sign Your Contracts.** All this assumes you are signing contracts on behalf of the corporation and not individually. Here is the good and bad of how you should be signing contracts:

**Good Ways to Sign Contracts:**

1. ABC Corporation
   By __________________________
   (John Smith, its President)

2. “John Smith President, for ABC Corporation”

3. “John Smith President, on behalf of ABC Corporation”

**Bad Ways to Sign Contracts:**

1. “John Smith”

2. “John Smith, President”

3. “John Smith, individually and as President of ABC Corporation”

4. “ABC Corporation
   By __________________________
   (John Smith, its President)

   __________________________
   (John Smith)”

All this assumes you have set up and run your corporation correctly. If you fail to have the first meeting of directors, the annual meeting of shareholders and directors, never issue stock, mingle personal and corporate assets, do not
acknowledge the corporation as a separate entity, never have a single meeting or records, thinly capitalise (putting little or no money or property into the corporation), or use it to commit fraud on your creditors, none of these rules will help you. If there is a lawsuit, the attorney for the creditor can claim he or she is entitled to “pierce the corporate veil” and seize after judgment personal assets of the shareholders. But the good news is such corporate formalities are either done for you or accomplished in minutes by using the templates supplied in our incorporation Kit.

**Reduced Payroll Taxes.** We’re talking the big stuff now. This provides a tremendous tax advantage. Per the IRS, owners of a S corporation must be considered employees and follow the usual rules of quarterly returns and pay the dreaded payroll taxes, especially Social Security and Medicare. This is now running 15.3% plus, as a self-employment tax. There is nothing you can do about that.

But now the good news. If you make a “distribution” of net profits, as opposed to your salary, this is not subject to self-employment payroll taxes. For example, this would apply to a bonus, dividend, or end-of-the-year profit distribution. To demonstrate how graphically delicious this is, consider this:

**Example:** You have a consulting business and help mid-size corporations set-up and run software for encryption and security purposes. You make about $100,000 a year. If you were operating as a sole proprietorship, you would pay approximately $15,000 in self-employment taxes. But using an S corporation, you can split the earnings into two piles. One will be $50,000 as wages and the other $50,000 in distributions. When doing so, you save about $7,500 annually. People absolutely love this rule, and for good reason.

But you can’t get too crazy. The IRS insists that officers and employees of the corporation receive at least “reasonable compensation” in wages or salary. So what in the world is “reasonable”? There is no bright line and even the IRS is somewhat vague. Recently they admitted: “There are no specific guidelines for reasonable compensation in the Code or Regulations.” (FS-2008, updated 10/5/11). This has prompted some tax experts to say the IRS is not really pushing this much. Probably the best way to determine reasonable compensation is to ask what it would cost to pay an employee to do the same work as the owner of the corporation. In your consulting business above, you could prove $50,000 or less would be paid to someone else to do the same work. And, in the beginning years when profits are lean, you might claim little if anything is payable in wages.

Think of this in terms of lost investment opportunity. Annually saving $7,500 over decades could literally grow to millions of dollars of investment portfolio value (retirement, college, etc).
The bottom line. All experts agree this is a tremendous advantage to setting up a corporation.

Paid-For Health Insurance Premiums. With rising Healthcare costs and everyone living longer, good health coverage is paramount in the minds of Americans. Your corporation can pay 100% of such premiums. This is how it works. The corporation “establishes” the plan and pays the premiums for the health coverage. You must own at least 2% of the corporate stock. The coverage is in your name (director or officer) as beneficiary. The corporation reports these premiums as wages on your W-2. You report this as gross income on your 1040. But at the same time you get an “above the line” full deduction on that 1040. Net effect: the corporation is paying for your health care. If you were a sole proprietorship, you would have to pay the premiums with after tax dollars.

These same rules apply to group life insurance and accident plans.

Paid-For Retirement. Similar to health premiums, the corporation can pay into a SEP-IRA retirement account for either 25% of wages or $49,000.00, whichever is less. Again, your corporation will end up paying for your retirement account. And unlike 401 K’s, you do not have to contribute a cent and there are no administrative fees.

Tax Benefits—Now We’re Talking. This is one the reasons people set up an S corporation. A regular C corporation pays taxes at the corporate level and then after making a distribution, the individual shareholders also pay taxes on their 1040. This is double taxation on the same dollars. Not so with an S corporation. It does not pay Federal income taxes at the corporate level. The taxable net profits “pass through” the corporation directly into the hands of the shareholders who pay taxes only once at their individual level.

Most States follow the federal lead and do not separately tax S corporations. Exceptions:

1. New Hampshire has corporate income taxes.

2. Some states impose income taxes at the business entity level such as the Michigan Business Tax or Illinois Personal Property Replacement Tax.

3. Then there are business gross income or net income taxes in Washington, D.C., Washington state, New York City (8.85%), Texas, Kentucky, Ohio, and Washington state. As some form of saving grace, the Texas franchise tax and Kentucky tax both exempt small businesses with under $1 million or $3 million of gross receipts, respectively. New Mexico and Hawaii also impose business gross receipts taxes that are in lieu of sales taxes.
4. California has a franchise tax of 1.5% of net income, with a minimum of $800.

In summary, for tax purposes the S corporation acts like a partnership as to taxes, but with the benefits of limited liability as to debts.

**Attract Investors.** Many people lack the personal savings to start a small business on their own. They naturally rely upon relatives, retirement, the balance of savings, and recently credit cards. After the financial crash of September 2008, few banks are making unsecured business loans or lines of credit (we should know, the owner NationalLawDocs is the #1 SBA lender in the Nation and a leading small business advocate). So, when this is not enough, it is common to secure private investors.

Since a corporation by definition issues stock, it is the perfect vehicle for taking on an investor. So when Uncle Harry offers to invest $10,000 in your business, you can give him 2,000 shares of common stock at par value of $5.00 each. He is happy, and you have a precise measurement of his interest in the business. For example, if you are a sole proprietorship, other than setting up a new partnership, there is no specific “piece of paper” you can hand Harry evidencing his interest (assume he is not making a loan).

**Stock Bonuses and Options for Officers and Employees.** Talk about incentives: here is something everybody can get their arms around. Giving employees yearly rights to exercise a stock option or simply distributing shares as a bonus, catapults morale to a high level. What better way to give someone a piece of a corporation that issuing a set number of shares?

Stock options (Incentive Stock Options—ISO’s; Non-Qualified Stock Options— NSO’s) grant an employee the right to buy shares at a fixed price today (the grant price) for a set number of years into the future (the exercise term). This is subject to vesting, so an employee might get the right to purchase 25% of the shares available under the option grant after two years, 50% after three, 75% after four, and 100% after five. The exercise term most commonly is 10 years.

Studies also show there is better performance by employees who own part of the business. Frank from Pottstown, PA told us the other day that his employees now really have something to work for to increase productivity because the shares pay-out only if there is a profit.

**Live Forever.** If you have a sole proprietorship or partnership, upon the death, disability, or retirement of one of the principals, the business is dissolved unless a new partner or owner steps in. In case of a partnership, this would be mean drafting a new partnership agreement. Not so with a corporation. It has what is called “perpetual existence”. Because it is a separate legal entity, it will technically last forever. So, if Frank leaves the corporation and is bought-out, his
shares are exchanged and the corporation’s existence is never interrupted. This is important since you have built up goodwill, customer relations, business credit, contracts with suppliers, and do not have to start all over.

**Example:** Kurt Johnson and Fred Williams have been running a successful partnership in the name of Johnson & Williams Associates for many years. They have a popular web site, tons of marketing materials (business cards, brochures, signs, handouts, promo kits, marketing CDs, radio advertising, and their office itself), and a good name in the community. Fred decides to leave the venture and go out on his own selling solar foot tanners door to door (good luck). Kurt can no longer use the business name and it’s good image. If it were a corporation, nothing would have changed. The shares would have been sold and few would know the difference.

**It’s Good to be a Loser (at least for write-offs with the IRS).** Another benefit of an S corporation is that business losses will pass through to the individual shareholders who can deduct them against their personal income.

**Example:** Mitch and Joan have set up an airport charter service that takes people to and from major airports. For the first few years, because of the capital outlay of charter vans and buses, as well as employee costs, they have had continued losses, although they are expecting a return next year. Both have day jobs and can deduct these losses on their individual 1040’s. In essence, the business has reduced their individual tax liability.

But it gets even better. Let’s assume just the opposite: Mitch and Joan have to close the business after five years and their stock is worthless. But they had both put in almost $100,000 over the years. Most S corporations make what is called a 1244 election with the IRS (included in the first meeting of the Board of Directors in your packet). Once done, the losses from the sale, exchange, or worthlessness of stock can be used as a direct deduction on the individuals’ 1040. Although not a favorable way of looking at things, they are able to “capitalize” on these losses and shelter some of their personal income.

There are conditions to claiming these losses, but they are relatively easy to meet. For example, the shares must have been issued initially for money or property and the corporation must be defined as a “small business corporation”; meaning the total amount of money or value of the property received by the corporation for stock cannot exceed 1 million.

**Freedom to Sell-Out.** In a partnership, no one can become a new partner without the consent of the other partners; hence that interest cannot be freely sold or transferred. A corporation is completely different. Most buy-sell agreements allow, under certain conditions, including the corporation’s right of first refusal, a shareholder to sell his or her interest to a third party.
Example: Daren was involved in a serious automobile accident and although he has recovered, he doesn't quite have the energy as before. He decides to start a new business out of his home which is less stressful. He has found someone to buy his interest, but he is in a general partnership and his other partners are not keen on the idea. Without the other partners’ consent, he is stuck. If it was a corporation, he would probably have a buy-sell agreement which set the price of the shares and the procedure to be followed in selling his interest.

Funding a Buy-Sell Agreement. You have heard about these agreements—they set the buy-out price when a shareholder or director retires, withdraws, becomes disabled, is terminated, or passes away. To prevent a big hassle and thousands of dollars in attorneys’ fees, the corporation sets up beforehand a precise buy-out amount. But you have to have something tangible to buy, and that is where the shares come in. So, if John after ten hard years with the corporation decides to move on, we know exactly how much he is worth because we know precisely how many shares he has—in this case 10,000.

I’m in Charge Here. Taking on an investor is a good idea and helps start or expand your business. But you do not want to unnecessarily give away too much control. After all, the original shareholders know the industry best and should be making the major decisions. The corporation can solve this problem by letting you remain in control, not the investors.

Example: Carol and Howard form a small corporation that rents bicycles near a popular national park. They are now so busy, they have to buy more bicycles and equipment. Bert agrees to invest $25,000 for that purpose and is given a seat on the board of directors. This allows him to be present at important meetings, but major decisions can always be made by Carol and Howard who can outvote him as directors.

Division of labor—Let the Worker Bees Take Charge. One of the benefits of a corporation is it has different levels of responsibility. If you are in a general partnership, each partner has an equal voice and responsibility, although human nature being what it is, this is rarely productive. In the example above of the bicycle shop, assume Bert is the third director but he spends little time with the business. Instead, he decides to be a professional bicyclist in Italy and give seminars in transcendental meditation. He only works part time at the shop. Simple: Carol is president, Howard vice-president and treasurer, and Bert can have the less significant role as secretary.

Be Nice to Grandma at Christmas. Grandma Joan does not have to stress about what is on her Christmas list—she inherited a medium size business from her late husband which is now managed by her elder son. Since she holds the major shares of stock, she gives each of her children and grandchildren a certain
number of stock certificates each year for Christmas. Each year thereafter it spins off dividends. The children and grandchildren love it. Thanks Grandma.

**You've Got Clout.** Now for the image you wish to portray. There is something intangible about having a corporation. It makes you appear more organized, stronger, more legitimate, and worthy of a bit more respect. It is simply a psychological advantage.

A sole proprietorship with a good business name, a strong partnership, or a LLC, just doesn't have the same punch. When Frank meets his buddies at the next general meeting and trade show, they don’t say: “Hi Frank, how’s the sole proprietorship going?” They ask: “Hi Frank, how’s that new corporation doing?”

This instant respect is across the board: it can impress suppliers, customers, leasing companies, perspective employees, and even a banker or too.

**I'm Not a Small Fry Anymore.** We are asked all the time: what kind of person(s) set up a corporation, as opposed to a sole proprietorship or partnership? It is typically people who think big. Although there are some exceptions, you rarely see a medium to large size business that is not a corporation. An LLC is great, but it tends to be reserved for those just starting out or who are happy staying small.

**Easier to be Hired as a Consultant or Independent Contractor by a Large Corporation.** Many small corporations hire themselves out as independent contractors or consultants to larger corporations. Typically they are in the service business. They work on computers, software, telecommunications, marketing—you name it. But large corporations stay up at night worrying about having to pay exorbitant employee fringe benefits and payroll taxes. If they hire you, it is usually on an independent contractor basis. But many large corporations go one step further and prefer that you have your own corporation, thinking it would be less likely for the IRS to construe you as their employee.

**It is Easy to Sell Assets of an Existing Business to the New Corporation Without Paying Immediate Tax.** Many entrepreneurs incorporate their existing business, from either a sole proprietorship or partnership. Are there any immediate tax consequences? Not if it is done correctly. Under Section 351 of the IRS Code, you can transfer the existing assets to the new corporation in a tax free exchange for a new stock if, after the transfer, the shareholders are in control of the least 80% of the total combined voting power of all classes of issued stock. This is easily accomplished because the same owners of the old business become shareholders in the new corporation.

Taxes come into play only after you sell the stock in the new corporation. The tax free exchange defers the payment of taxes until you sell your shares later, because the basis in the assets is transferred to the new corporation ownership.
Future Flexibility for Issuing Additional Shares. You are the type that not only thinks positively about the future, but wants to make plans for a successful expansion of your business. For example, you contemplate taking on additional directors and even investors. No problem. When you start out, you have a large number of authorized shares, but don’t issue them all at once. You keep them for the future.

Example: Kathy and Mark are in the organic power bar business. Although they sell only to local regional stores at this point, they contemplate getting a large contract with at least one large supermarket chain. At that point they will be taking on additional investors because of the cost of raw materials. So, they start the corporation by authorizing 100,000 shares but only issue 50,000 to themselves. They now have plenty of “wiggle room” to issue additional shares in the future. This cannot be accomplished with a partnership or sole proprietorship.

Make Your Shareholder’s Happy-Indemnify them. Many persons are reluctant to become shareholders, officers, or directors of a corporation for fear of being sued, especially as to actions taken by the board of which they were not directly involved. There is a solution and it is called indemnification. Such provisions are already contained in the bylaws which you have purchased with this package.

It is beyond the scope of this manual to discuss how and when such persons can be sued under state law. But assuming they are, the corporation can agree to reimburse them for their costs, attorneys’ fees, and even judgments, as long as they have not fraudulently or intentionally breached their fiduciary duties. Having a corporation makes it easier to grant this protection.

Hold Stock For the Benefit of Loved Ones. When you have an interest in a partnership, it is individual ownership and there are questions as to what will happen when you pass away. Can it be worded as joint tenancy or marital property? The answer is somewhat gray. But not as to corporate stock. It can specifically state, for example, that it is held in joint tenancy, meaning it automatically goes to a loved one without probate. Further, many persons can designate the stock as community property so that the spouse is protected.

Conclusion

Easy to Qualify for an S Corporation. Qualifying for S corporation status under 26 U.S.C. 1631 is almost a legal no brainer. You form a corporation, and then within 45 days file IRS form 2553 which can be faxed to regional IRS centers. This form is included in your packet. There are some technical limitations, but they are hardly burdensome: 1) there can only be one class of stock (most people just have common stock anyway and not preferred), 2) no more than 100
shareholders, and 3) shareholders must be the U.S. citizens or permanent residents. Not so bad, is it?

**Easy to Set Up and Easy to run.** We hear people say: “That is all well and good, but there is nothing easier than setting up a sole proprietorship and not having to go to the hassles of running a corporation.” Give us a break! That’s why we created NationalLawDocs. With the forms and clauses already prepared for you, it is just as simple as running a one person sole proprietorship or partnership. And you don’t have to go through several meetings with your attorney to set it up. Everything is done for you.

But what about the stories of arduous paperwork and corporate decisions made by formal meetings of directors and shareholders after giving written advance notice? Sound like a real hassle. First, the forms included in our package allow waiver of such formal notice and also contain a Shareholder’s Agreement which states, other than annual meetings, decisions do not have to be made by a formally noticed meeting with resolutions.

**It is no Longer Expensive to Set-up a Corporation.** In days gone by, corporations were set up almost exclusively by lawyers and the fees were typically in the $1,500 + range. The Internet has changed all this. Setting up a corporation is now very inexpensive. Currently you can do this in the $125 plus state fees range. The trick is to find a site that is inexpensive and at the same time has highly professional forms. We fit that bill. Otherwise you are just throwing your money away with outdated stationary store forms prepared by layman, and worse yet, having it redone by an attorney later—exactly what you wanted to avoid in the first place.