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INCORPORATING YOUR START-UP BUSINESS

You have a great new business concept (or even better, you're buying someone else's great business concept), a cool name, and plans to be in business by next month. Maybe you have even met with an accountant to review your business plan and set up your books, which is always a good idea. You've noticed that lots of business names seem to end in an "Inc." or an "LLC", and think that might be a good idea for your business too, but you're not sure how much it will cost and whether it is worthwhile. You could research it yourself, but this may be the only time in your life that you incorporate a business, so there are probably better places to invest your time. If any of this is you, read on.

Why Incorporate?

Starting with the basics, you have several choices of types of business entity in which to operate. Operating without any form of business entity is not an option, since the law will classify you regardless of your wishes. By default, you will operate as a sole proprietorship (if only one owner) or a partnership (if more than one owner), if you do not file for anything else. Sole proprietors and partners are personally liable for all the debts and obligations of their businesses, a primary reason why many business owners elect to incorporate. (I use the term "incorporate" generically to refer to the process for both corporations and LLC's, although technically it only applies to corporations. As if anyone other than a lawyer would care!)

For some small business owners with no employees, operating as a sole proprietorship may be fine. It is the simplest and least expensive operating structure, requiring no filing or annual maintenance fees. Taxes are reported on Schedule C of the owner's personal tax return. Because lenders, suppliers, landlords and other creditors generally require personal guarantees from owners, incorporating would not provide personal asset protection from those types of liabilities. Also, a single business owner who is negligent in carrying on his or her business will likely be personally liable anyway, so incorporating may not provide much protection.

On the other hand, you may be able to sign on suppliers and trade creditors, possibly even an ill-advised landlord, without personal guarantees, so in those circumstances it would be helpful to insulate the business debts in a limited liability business entity – just in case your business doesn't make it. Also, if you as business owner will be responsible for the acts or omissions of anyone else involved in the operation of your business, you should incorporate. This includes employees, agents, contractors or partners. Many business owners do not realize that if they are doing business with a partner, they are personally liable for anything their partner may do in the conduct of that business, whether they have authorized it or not. For example, if your partner decides to borrow money, buy equipment on credit, or accidentally run over someone's pet in their car while making a sales call, you – not just your business - may be personally responsible, whether you know about it or not. Seem unfair? Yes, it probably is unfair, but it's simple enough to protect yourself. Here is a simple rule to follow: If you and at least one other person (whether you would call them your "partner" or not) are engaged in business, you should

incorporate before engaging in any business. If you're already in business with a partner and not incorporated, you should camp outside your attorney's office tomorrow morning and get it done.

What Type of Business Entity?

So you've decided that you want to protect your personal assets, and operating as a sole proprietorship presents too much risk. You have several choices to consider. First, if you are engaged in certain regulated professional practices (for example, physicians, dentists, accountants, engineers, architects, attorneys), you are probably aware that you will need to incorporate as a Professional Association (P.A.) or a Professional Limited Liability Company (PLLC). Other than a few additional hoops to jump through, these types of business entities are basically the same as their non-professional counterparts, described in more detail below. Your regulating board will have to approve your Articles of Incorporation or Articles of Organization and confirm active licensure of the owners, and there may be restrictions on the business names available for you to use.

If you are not a regulated professional (or maybe not professional at all – regulated or otherwise), and yours is a for-profit organization, your real-world choices in North Carolina are a corporation or a limited liability company. (If yours is a not-for-profit organization, that's easy – you will incorporate a non-profit corporation.) There are a few other business entity choices, but frankly, almost no one uses them. It's been probably twelve years since I organized any other type of business entity, and even then that was probably a mistake (just joking – no need to alert the malpractice carrier!) In North Carolina and in most states, LLCs have thus far been determined to offer limited liability protection similar to corporations. Corporations and LLCs offer limited liability protection to owners, so long as the company is adequately established, respected and maintained. (See your attorney for guidance on how to do this.)

Limited Liability Companies

There are a few common circumstances in which my clients have preferred to organize a limited liability company, or "LLC". First, if you are a sole proprietor and you want personal liability protection, or maybe just prefer the professional look of a business entity, but you want to keep it simple, you may prefer an LLC. The Internal Revenue Service and the State of North Carolina ignore the LLC for tax purposes, so they treat your business just like a sole proprietorship. Your business revenues and expenses are reported on Schedule C of your personal tax return, so a separate business tax return is not required. No annual meetings or corporate formalities are required, so LLC's are fairly simple to maintain. The current filing fee is \$125 to organize an LLC, and a \$200 annual report filing fee is payable each April 15th after initial organization, so they are fairly inexpensive to maintain. (A word of caution: the Secretary of State has determined that the \$200 filing fee is due every April 15th, so even if you initially file your paperwork on April 14th, your first annual report will be due on the 15th! You can specify an effective date of April 16th when filing, which I would recommend if the timing is close.)

If your business will own real estate, you too will likely prefer an LLC. In fact, many business owners will own an operating business in a Subchapter S corporation, and will own real estate related to the business in a separate limited liability company. One reason for this is that a corporation cannot

distribute appreciated property that it owns to a shareholder without triggering potential tax liability, which makes corporate ownership inflexible, but there are other tax reasons as well. If you plan to own real estate that is related to an operating business, I would highly recommend that you review the structure with your CPA to ensure that you obtain maximum tax benefit.

A limited liability company may also be preferred in more complicated business structures. For example, if your business plan includes investors with varying economic interests (for example, both common equity and preferred return or convertible debt interests), you will need to consider either an LLC or a Subchapter C corporation, since Subchapter S corporations cannot issue stock with varying economic rights. Also, if a business entity will be an owner of your business, you will likely not qualify for Subchapter S status. The majority of small business start-ups will not fall into these categories, and so a Subchapter S corporation may be the best fit.

Subchapter S Corporations

A limited liability company structure is extremely flexible and can be adapted to fit nearly any business structure, but there may be reasons to prefer a corporation, which is more restricted by statute. While LLC members can agree by contract to pretty much anything they like related to control, management, allocations of profits, distributions, etc., you may not want to invest the time and money to address these issues in detail while you are trying to get your new business off the ground. Corporations have been around longer than any of us, and they are fairly well understood as to how they operate. Basically, the corporation issues stock to its shareholders, and the shareholders control the business and are allocated earnings based on the proportionate number of shares issued to each. The shareholders elect directors to govern the corporation at a high level, and the directors appoint officers to manage the business day-to-day. Of course, in a small business all of this is compressed, with the same individuals often wearing shareholder, director and officer hats. The statutes in North Carolina governing corporations are much more detailed than those governing LLCs, and so the governance of a corporation and relations among shareholders, directors and officers is fairly well-established. For these reasons, a corporation is often a good fit for multiple-owner businesses desiring a simple structure and limited liability protection.

There are also tax reasons why many business owners prefer a corporation to an LLC, even if they are a single owner. But first, it may be helpful review the distinction between “C” corporations and “S” corporations. A “C” corporation is simply a corporation that has been incorporated under the laws of any state or the District of Columbia (or possibly a foreign country, but no need to go there). By filing Form 2553 with the I.R.S., a corporation can elect to be taxed as an “S” corporation, so called because the corporation is thereby electing to be taxed under Subchapter S of the appropriate income tax sections of the Internal Revenue Code. So why would you want to file that election? To keep it simple (way too simple to constitute tax advice), an S corporation’s profits and losses will flow through directly to the shareholders – similar to an LLC, partnership or sole proprietorship – and the corporation will not pay corporate-level taxes. This is in contrast to a C corporation, in which the profits are taxed first at the corporate level, then again as dividends to the shareholders when cash is actually distributed. While a C

corporation may be appropriate or even necessary in certain circumstances, for the vast majority of small business start-ups, your advisors are likely to recommend an S corporation.

If the “S” election simply leveled the playing field with single-member LLCs (generally taxed as sole proprietorships) and multiple-member LLCs (generally taxes as partnerships) by eliminating two layers of taxation, then one might ask why S corporations seem to be so frequently preferred for operating businesses. As your accountant will tell you, it’s the self-employment taxes. Currently assessed at a rate of 15.3% (including 12.4% social security and 2.9% for Medicare), self-employment taxes demand attention. “Only” (as the I.R.S. puts it) the first \$106,800 of the self-employed individual’s wages, tips and earnings are subject to the social security (12.4%) component for 2009, so the rate drops to 2.4% for wages, tips and earnings above that amount. Clearly, an element of tax planning is involved in all of this, but in simple terms, here is the key to this analysis. All of the net earnings of a sole proprietorship or partnership (including LLC’s that do not file a special election to be taxed under Subchapter S) are subject to self-employment taxes. In contrast, an S corporation can pay a reasonable salary (wages) to its owner, which will be subject to self-employment taxes, and any earnings of the business above that reasonable salary will not be subject to self-employment/FICA taxes. This structure can afford significant tax savings and is completely legitimate, but a word of caution: you must pay yourself a “reasonable” salary and pay self-employment/FICA taxes on that amount. Of course, you will want to see that figure lower, and the I.R.S. will want to see that figure higher, so there is clearly a need for some restraint here. Again, I refer you to your trusted accountant or tax advisor for further guidance. You may also want to refer to I.R.S. Publication 535, which provides some guidance concerning “reasonableness” of compensation.

To complicate things a little further, it should be noted that an LLC can also choose to be taxed as a corporation simply by filing an election. In my experience this is rarely done, but there is one scenario in which I have advised this structure for a client. If you will be investing in substantial business assets that will provide for your livelihood, consider protecting the business assets against claims that might be made against you personally. You might think of this as “reverse” asset protection. The explanation is too involved for this article, but I would be happy to review it in more detail with anyone interested.

The Final Analysis

In the end, most business start-ups will be established as Subchapter S corporations or limited liability companies. There are valid reasons and justifications for each. The best way to determine the ideal structure for your business is to review your business plans and projections with your accountant, attorney or other tax advisor, before you incorporate. We may be able to help you fix mistakes later, but it is far better (and less expensive) not to make them at all!

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