

A Guide To **Incorporating Your Business**

How to Form a Corporation or LLC



- ***Reduce Your Taxes***
- ***Protect Your Assets***
- ***Minimize Your Liability***
- ***Improve Financial Flexibility***

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LegalZoom's Incorporation Service

If you're a business owner, you need to protect your personal assets. Incorporating your business, or forming an LLC, are two of the best ways to do just that. In addition, the corporate business structure can save you money in taxes, give you greater business flexibility and make it easier for you to raise capital.

LegalZoom.com makes forming a corporation or LLC simple, fast and affordable. Our 3-step process allows you to incorporate your business from your home or office for as little as **\$139 plus state fees**.

1. Complete an Online Questionnaire

Fill out our easy-to-understand questionnaire. It should take you less than 15 minutes.

2. We File the Incorporation Papers

We prepare the required documents and file it with the proper government agency.

3. Your Corporation is Complete!

We deliver the filed Articles of Incorporation to you, along with customized corporate bylaws. We can even obtain your Federal Tax ID Number.



This guide contains the information you need to get started. For example, you will learn the benefits of incorporating, differences between corporations and LLCs, tax-saving strategies and procedures for maintaining your corporate entity.

So go ahead, read through the guide. And let us know when you're ready to get started.

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Introduction

Paying taxes is not fun, so why pay more than you have to? You may have heard that incorporating your business can help you save thousands of dollars in taxes. It's true. Even if your corporation has just one employee (yourself), you can still enjoy significant tax savings. Just as important, you will have peace of mind, knowing that your personal assets are protected from business liabilities.

Sole Proprietorships and General Partnerships

A sole proprietorship and a general partnership are the simplest and least expensive forms of businesses. If you currently operate a small business on your own and report your business income on Schedule C, then you are a sole proprietorship – it's that easy. A general partnership is automatically created when two or more people go into business together. Because of this simplicity, most businesses are sole proprietorships or general partnerships.

However, even with low start-up costs and ease of operation, other factors can make these the **most expensive** business structures in the long run. First, your liability for business debts is **unlimited**. These entities cannot shield you, as the owner, from liabilities that could literally cost you and your family everything. For instance, if you have significant business losses or an adverse legal judgment, creditors can force you to sell your home and personal property to cover the claim.

“SOLE PROPRIETORSHIPS CAN BECOME THE MOST EXPENSIVE TYPE OF ENTITY IN THE LONG RUN.”

Second, you may be hurting yourself tax-wise since corporations have a variety of tax advantages, such as the ability to reduce self-employment taxes. Furthermore, there are no business entities more highly scrutinized by the IRS than sole proprietorships. Finally, when it comes time to selling or passing on your sole proprietorship, it can be tedious.

Corporations

The most dynamic and flexible business entity is a corporation. ***The primary advantage of a corporation is that its owners, known as stockholders or shareholders, are not personally liable for the debts and liabilities of the corporation.***

Once brought to life by filing Articles of Incorporation with the state, a corporation can act much like a person. It can own and operate a business, hire employees, buy and sell goods and services, enter into contracts, lease or buy real estate, maintain its own checking and savings accounts, and sue and be sued. A corporation is not affected by the death or bankruptcy of any shareholder, officer or director. Instead, it continues to exist as long as it complies with the state requirements and corporate formalities.

You may have heard of the term “S-corporation” and “C-corporation.” They are actually both the same type business entity, but an S-corporation has simply made a special IRS election to be

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treated as a pass-through entity for tax purposes, much like a sole proprietorship or partnership. In other words, corporate profits “pass through” to the owners, who pay taxes on the profits at their individual tax rates.

“THE MOST DYNAMIC AND FLEXIBLE ENTITY IS A CORPORATION.”

C-corporations, on the other hand, are traditional corporations with two potential levels of tax. A C-corporation pays tax on its corporate income (the first tax). Then, if a C-corporation distributes profits to its stockholders, the stockholders pay personal

income tax on those dividends (the second tax). Although this may seem like a significant disadvantage, C-corporations actually have greater tax flexibility than S-corporations and can easily minimize any “double taxation” problems.

Advantages of Incorporating Your Business

Liability and Asset Protection

Sole proprietors and partners risk everything they personally own when they operate a business. If a judgment is awarded against the business, the owner’s personal assets can be used to satisfy payment. Your home, car, savings and investments could all be taken from you should your business be sued or go into debt.

When you have a general partnership, each partner can solely make decisions that have joint consequences for the partnership. So, even if one partner makes a bad decision, both partners are liable for the entire amount of any damages.

Unlike a sole proprietorship or general partnership, a corporation is a separate legal entity apart from the individuals who own or operate it. Because of this, the personal assets of the shareholders, directors and officers of a corporation are generally not at risk when the corporation is sued or goes bankrupt. If you own property or other significant assets, forming a corporation is one of the easiest ways to protect them. If you plan to hire employees, a corporate entity will protect you personally from employee lawsuits.

“WITH A CORPORATION, YOUR PERSONAL ASSETS ARE NOT AT RISK.”

The only way an individual can be liable for corporate debts is through a legal action commonly referred to as “piercing the corporate veil.” This occurs when a court looks at the corporation not as a separate entity, but as an extension of the individual. Piercing the corporate veil is rare. Generally, it only occurs through fraud or failure to treat the corporation as a separate entity, such as not having a separate corporate bank account. Properly maintaining your corporation usually prevents a piercing of the corporate veil.

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Tax Savings

A sole proprietorship or general partnership will also miss out on some important tax advantages available only to corporations.

- **Reduction in Self-Employment Tax.** When you operate as a sole proprietorship, your first \$102,000 of earnings for tax year 2008 is subject to self-employment taxes (Social Security and Medicare), which is currently a combined 15.3%. With a corporation, only salaries are subject to such taxes. By allocating a corporation's earnings between a reasonable salary and profit, you can generate significant tax savings.

For example, if you earn \$80,000 as a sole proprietor, you would pay self-employment on all \$80,000. However, if you are incorporated and took \$35,000 in salary, the remaining \$45,000 in profit would NOT be subject to the self-employment tax. With an S-corporation, this saves you over \$5,000.

- **Medical Expenses.** C-corporations can offer a medical reimbursement plan for their officers, employees and owners, which allows you to deduct medical costs not covered by insurance. With a sole proprietorship, medical reimbursement plans may cover employees, but not the owner. Therefore, unreimbursed medical expenses are deductible only if they exceed 7.5% of Adjusted Gross Income.

- **Retirement Plans and Fringe Benefits.** There are a number of fringe tax benefits which favor corporations over sole proprietorships. For example, corporate tax-deferred retirement plans, such as defined contribution and defined benefit plans can be more flexible and can have higher contribution limits. Corporations are also allowed to pay for (and deduct) certain childcare expenses, term group life insurance premiums, group disability insurance premiums and certain travel expenses associated with directors' and shareholders' meetings.

Ease of Transfer

Corporate ownership interests can generally be sold to third parties without disturbing daily operations. The business of a sole proprietorship, on the other hand, cannot be sold as a whole. Instead, each of its assets, licenses and permits must be individually transferred. A new bank account and tax identification number would be required.

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Other Benefits

On top of the numerous benefits listed above, the corporate form has other distinct advantages. Typically, it's easier to raise money if your business is incorporated. A corporation also gives your business legitimacy when dealing with other companies, banks and potential partners.

Example of Tax Savings

The following chart illustrates some of the tax benefits that can be achieved by incorporating:

John, who is married, operates a sole proprietorship that earns \$80,000 per year. If he incorporated, assume that John would take an annual salary of \$35,000. For this illustration, assume no state income tax and 2008 tax rates.

	Sole Proprietorship	S-corporation
<u>Income:</u>		
Salary	\$ 0	\$ 35,000
Profits	\$ 80,000	\$ 45,000
GROSS INCOME	\$ 80,000	\$ 80,000
<u>Deductions:</u>		
½ of Self-Employment Tax	\$ 6,120	N/A
½ Social Sec. & Medicare	N/A	\$ 2,678
TOTAL DEDUCTIONS	\$ 6,120	\$ 2,678
ADJUSTED GROSS INCOME	\$ 73,880	\$ 77,322
<u>Taxes Paid:</u>		
Self-Employment Tax	\$ 12,240	N/A
Social Security & Medicare	N/A	\$ 5,355
Income Tax	\$ 11,945	\$ 12,805
TOTAL TAXES PAID	\$ 24,185	\$ 18,160
<u>TOTAL TAX SAVINGS</u>		<u>\$ 6,025</u>

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In order to properly maintain your corporation and ensure personal liability protection, you will have to comply with certain corporate formalities. Some of the most important ones are described below.

Director and Shareholder Meetings

Corporate shareholders must typically meet annually to elect corporate directors. It's the job of the directors to meet at least annually to elect corporate officers. You may also need to hold special meetings to approve special actions like purchasing another company, amending charter documents, adding a new shareholder and approving actions that fall outside of the normal course of business. Written minutes should be kept which record the actions taken at the meeting.

CORPORATE FORMALITIES:

- I. DIRECTOR AND SHAREHOLDER MEETINGS
- II. SEPARATE FINANCIALS
- III. ANNUAL REPORTING
- IV. CORPORATE TAX RETURN

While it may sound daunting, this doesn't have to be a hassle. LegalZoom offers a maintenance service for recording corporate minutes, and meetings can be held by conference call or in writing. Even if you decide to hold an actual meeting, this can be accomplished in the company's offices or anywhere else allowed by law.

Separate Personal and Business Finances

Since a corporation is a separate legal entity, corporate finances must be kept separate from your own personal finances. It's essential to have a corporate bank account, and you will need a separate federal tax ID number. When you incorporate with LegalZoom, we can obtain your tax ID number for you.

Annual Reports

After the initial government filings, most states require an annual report which lists the corporation's business address and the names of the directors and officers. Typically, the state requires a filing fee with the annual report.

Tax Returns

Corporations must file a separate federal corporate tax return, either on Form 1120S for S-corporations or Form 1120 for C-corporations.

Comparison of C-corporations and S-corporations

As previously mentioned, a corporation that elects to be treated as a pass-through entity for tax purposes is known as an "S-corporation." In an S-corporation, profits pass through to the shareholders who then report the income on their individual tax returns. This can simplify a corporation's tax reporting. In addition, it allows you to write off any losses against ordinary income. S-corporations make sense for small business owners who want the protection and tax advantages of a corporation but have no intent of raising significant capital or going public in the future.

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S-corporation Eligibility

To become an S-corporation, you need to file Form 2553 with the IRS. Most small businesses can qualify, and LegalZoom can prepare this form for you. Generally, you are limited to 100 shareholders, and all of them must be citizens or residents of the United States. Furthermore, the corporation may issue only one class of stock. S-corporations may always switch and become C-corporations in the future.

C-corporations - Maximum Flexibility

If you do not make the special IRS election, then the corporation is a “C-corporation” by default. In a C-corporation, profits are taxed at the corporate rate. If the corporation pays stockholder dividends, the individual stockholders will be responsible for this income on their individual tax returns.

Although C-corporations are subject to this double taxation, proper financial management can solve this problem. Most importantly, any corporate profit can easily be reduced by paying a bonus to corporate officers (including yourself).

In addition, this two-part tax mechanism actually creates an opportunity for even greater tax flexibility. With a C-corporation, you can use income shifting to take advantage of lower tax brackets. To illustrate, let's take the example of a business that earns \$100,000. With a sole proprietorship, an owner who is married (filing jointly) would be in the 25% income tax bracket. If the business was a C-corporation, the business owner could take \$50,000 in salary and leave \$50,000 in the corporation as a corporate profit. The federal corporate tax rate on the \$50,000 profit is 15%. Furthermore, the business owner is now in a lower tax bracket for his or her personal income tax. This can reduce your overall tax liability by over \$8,000.

LLCS HAVE BECOME
POPULAR BECAUSE THEY
OFFER FLEXIBILITY WITH
SIMPLICITY

Limited Liability Companies (LLCs)

Like a corporation, a limited liability company is a separate business entity. They have become quite popular because they combine the personal liability protection of a corporation with the tax simplicity of a sole proprietorship or a partnership. In other words, the owners (or “members”) of an LLC are not personally liable for its debts and liabilities, and there is only one level of taxation. Moreover, LLCs are more flexible and require less ongoing paperwork than an S-corporation.

LLCs Compared to S-Corporations:

- **Fewer corporate formalities.** Corporations must hold regular meetings of the board of directors and shareholders and keep written corporate minutes. On the other hand, the members and managers of an LLC need not hold regular meetings, which reduces complications and paperwork.

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- **Simpler management structure.** LLCs are not required to have a formal Board of Directors (known as “Managers” in an LLC). The owners and officers of an LLC can make all important company decisions directly.
- **No ownership restrictions.** S-corporations cannot have more than 100 stockholders, and each stockholder must be a resident or citizen of the United States. There are no such restrictions placed on an LLC.
- **Potential Tax Disadvantage.** By default, LLCs are treated as a pass-through entity for tax purposes, like a sole proprietorship or partnership. Unfortunately, an LLC does not enjoy the same self-employment tax savings as an S-corporation. Instead, single-member LLCs must pay self-employment tax on both salary and profit. An LLC can, however, make an election with the IRS to be treated like a corporation for tax purposes, whether as a C-corporation or an S-corporation.
- **Greater Acceptance of Corporations.** Since limited liability companies are still relatively new, not everyone is familiar with them. In some cases, banks or vendors may be reluctant to extend credit to LLCs. In addition, some states restrict the types of business an LLC may conduct.

Where Should I Form My Corporation or LLC?

Most people choose to form their corporation or LLC in their home state because it’s the easiest and often the most cost-effective. If you incorporate in a different state, you often need to register as a “foreign corporation” in your home state, which requires a separate filing fee and subjects you to your home state’s taxes. In addition, you can save money by serving as your own registered agent.

Delaware, Nevada and Other “Business-Friendly” States

If your home state has a high corporate income tax or high state fee, and your corporation will not “do business” in your home state, it may be wise to incorporate in a tax-free state. Nevada does not have a state income tax, and Delaware does not tax out-of-state business activities.

Typically, this strategy works best with companies that have offices in multiple states, or with passive investment companies. “Doing business” means more than just selling products or making passive investments. It usually requires occupying an office or otherwise having an active business presence.

Furthermore, by incorporating in a different state, your corporation becomes subject to the corporate laws of that state. Delaware and Nevada are known for their business-friendly laws and courts. While it is possible to reduce your taxes through this method, we recommend that you to consult with a tax adviser to see if it is appropriate for your business. LegalZoom can help you form a corporation or LLC in all 50 states.

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BUSINESS ENTITY COMPARISON CHART

	Sole Proprietorship / General Partnership	S-corporation	C-corporation	Limited Liability Company
Formation	No filing required, unless doing business under an assumed name.	State filing required; Subchapter S election typically must be made within 60 days of formation	State filing required.	State filing required.
Personal Liability	Owners have unlimited liability.	Shareholders are typically not personally liable for corporate debts.	Shareholders are typically not personally liable for corporate debts.	Members are not typically liable for the debts of the LLC.
Formalities and Record-Keeping	Relatively few legal requirements.	Formal board and shareholder meetings and minutes are required, and annual state reports required.	Formal board and shareholder meetings and minutes are required, and annual state reports required.	Formal meetings and minutes are not required; however annual state reports are required.
Management and Operation	Sole proprietor has full control. Partnerships have a flexible management and operational structure.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operation.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operations.	Management is flexible, like a partnership; typically, an operating agreement outlines management duties. A board of managers is optional.
Taxation	Not a separate taxable entity. Income/loss is passed through to the owners	No tax at the entity level. Income/loss is passed through to the shareholders	Taxed at the entity level. If dividends are distributed to shareholders, dividend income is also taxed at the individual level.	By default, there is no tax at the entity level; income/loss is passed through to members, like a sole proprietorship or partnership
Tax Reporting	Sole Proprietorships: All income is reported on Form 1040, Schedule C. Partnerships report income on Form 1065, with profit distributions on Schedule K-1.	S-corporations report income on Form 1120S, with salaries reported on Form W-2 and profit distributions on Schedule K-1.	C-corporations report income on Form 1120, with salaries reported on Form W-2 and any profit distributions on Form 1099-DIV.	See Sole Proprietorship/General Partnership; LLCs may also elect to be taxed as a C- or S-corporation.
Recommended for:	Owners wanting minimal formalities, maximum flexibility, and not worried about personal liability.	Owners wanting the liability protection of a corporation, with the simplicity of pass-through taxation of income.	Owners needing maximum tax and ownership flexibility, combined with liability protection.	Owners wanting the liability protection of a corporation with less corporate formalities, and the simplicity of pass-through taxation of income.

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