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ENTREPRENEUR'S ENTITY FORMATION QUICK-GUIDE

The following **Quick-Guide** was created to offer a brief overview of the formation process as well as some answers to the more common questions entrepreneurs ask with respect to forming their new companies. Note that this is merely a short summary and is in no way a substitute for legal advice. While Natoli-Lapin, LLC certainly welcomes the opportunity to work with you, we strongly encourage you to seek qualified advice and guidance with this process even if it is not provided by us.

The information offered in this guide should serve as a good first step in understanding the process. Note also that our "Start-Up" formation package comes with a customized and detailed Guide-Letter that walks you through some of the important operations and procedures, not addressed here, that you are required to adhere to in order to keep your company in good standing. Further, some information herein, such as state filing fees, etc., is subject to change and should be verified before relying on it. After you review this information, we encourage you to contact us to set up a brief consult so we can address any other questions or concerns you may have and to begin the process to create your new enterprise!

WHY SHOULD I FORM AN ENTITY?

LIABILTIY, LIABILTIY & LIABILITY! The primary reason a separate entity is necessary for you to conduct your business activities is to shield yourself personally and your assets from the business you are conducting. This is with respect to your personal liability concerning business debts, torts (law suits), and contractual obligations.

It is important to understand that liability protection for corporation owners is not total. While a corporation is a legal entity separate from its owners, this separation must be maintained. Legal errors, personal dealings, ignoring formalities, failure to pay taxes, and other mistakes or bad acts can destroy the legal protection afforded to corporation and LLC shareholders, thereby exposing them to liability. These "formalities" are more austere in the traditional "incorporated" form.

One of the reasons the Limited Liability Company (LLC) has become so popular with start-up or closely held companies is because there is much less formality to adhere to, at least as compared with a Corporation (there are still taxes, yearly informational reports, etc. that need to be managed and the LLC corporate veil can still be pierced). The following points are offered as some of the more important elements in properly maintaining your Liability Protection:

Maintain the highest degree of separateness between owner and entity

- Keep detailed records and proper minutes of meetings
- Appoint independent officers and directors
- Never commingle funds (keep separate bank accounts and accounting procedures)
- Always follow your own corporation's bylaws or LLC's operating agreement

Pay your creditors first before you pay owners

- Owners of a corporation are obligated to pay creditors before distributing profits
- Courts may require companies to give back distributions of profits made to owners in lieu of paying creditors

Hold yourself out as an officer/manager of the entity not as an individual

- Sign all documents as a representative of your entity and NOT personally
- Make sure to identify your INC or LLC status on all your identifying materials (business cards, letterhead, advertisements, websites, etc.).

Keep your company in good standing with the State of organization

- Pay taxes, file reports, and make sure your Registered Agent account is current

If you are going to dissolve – Do it properly!

- Seek help if you can, or at least make sure to follow your State's procedures
- Failure to dissolve properly can result in debts being imputed to you personally

WHAT TYPE OF ENTITY SHOULD I FORM?

The Corporation:

The word "corporation" comes from the Latin meaning: body. A corporation is just like 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. A corporation has a perpetual life, meaning shareholders can pass on their shares to others to keep the company going. A corporation is owned by its shareholders, managed by its board of directors, and in most cases operated by its officers. The shareholders elect the directors, who in turn appoint the corporate officers. In small corporations, the same person may serve multiple roles shareholder, director, and officer.

Advantages of the Corporation

- Protection from personal liability for company debts and obligations
- Reliable body of legal precedent to guide owners and managers
- Corporations are the best vehicle for eventual public companies
- Easier to raise capital through the sale of securities
- Easier to transfer ownership through the transfer of securities
- Unlimited life
- Creation of tax benefits under certain circumstances

Disadvantages of the Corporation

- Corporations require owners and directors to observe certain formalities
- More expensive to set up than partnerships and sole proprietorships
- Corporations require periodic filings with the state and much higher annual fees
- Some jurisdictions require a minimum capital investment in order to form
- DOUBLE TAXATION!

The Limited Liability Company (LLC):

The LLC is the newest form of business organization. Now, each state has enacted a Statute that recognizes it as a legitimate business form and it is quickly growing as the most popular form of entity. There is little historical precedent for LLCs and the Courts are still just beginning to create a body of law specific to the LLC. The LLC combines the liability protection of a corporation with the tax treatment and ease of administration of a partnership. As the name suggests, it offers liability protection to its owners for company debts and liabilities.

Another exciting feature of the LLC is that it offers the liability protection benefits of the corporation without the corporation's burdensome formalities. It is this simplicity that has made the LLC an immensely popular business form with businesspersons operating smaller companies. It is also important to note that the LLC comes with tremendous flexibility with respect to operations and they are generally much easier to organize.

LLC management can elect to be taxed either as partnerships or as corporations (very little reason to ever elect to be taxed as a corporation). LLCs can be managed like partnerships (a member-managed LLC) or like corporations (manager-managed LLC). LLCs can create a board of directors, and can have a president and officers just like a corporation. LLCs can choose to have periodic meetings of their membership, or they can choose to ignore such formalities altogether. It is also possible to convert an LLC into a corporation (or vice-versa). Thus, some small companies begin life as LLCs and then the LLC's owners transfer the assets of the LLC to a newly formed corporation with the same owners as the LLC. Thereby, the LLC is converted to a corporation when the need to grow requires it. This is why LLCs are the favorite choice for entities with just one or a few owners and who are not planning to grow significantly or raise significant amounts of capital right away. As you begin to increase the number of owners in your LLC, you should begin to consider a transfer to a Corporation.

Advantages of the LLC

- LLCs do not require annual meetings and require few ongoing formalities
- Owners are protected from personal liability for company debts and obligations
- LLCs enjoy partnership-style, pass-through taxation, which is favorable to many small businesses

Disadvantages of the LLC

- LLC law is just becoming more reliable as time passes, but not as developed as Corporate Law
- Not recommended for businesses seeking to become public in the short-term, or to raise money in the capital markets
- Usually requires periodic filings with the state and annual fees
- Some states do not allow the organization of LLCs for certain professions

The S-Corporation:

A subchapter S-Corporation (S-Corp) is just like a regular standard C-Corporation, but one that has elected a special tax status with the IRS. This tax status allows for pass-through taxation on profits similar to partnerships or LLCs thus avoiding the double-taxation that attends all C-Corporations. An S-Corp basically shares the same benefits as regular Corporations such as liability protection for shareholders, unlimited life and some tax deductions, but the primary difference is the way they are taxed and certain ownership restrictions placed on S-Corps. Not all C-Corporations can elect S-Corp status and they must meet the following conditions:

- Shareholders must number fewer than 75, and all shareholders must consent in writing to the S-Corporation election
- Shareholders must be individuals, estates, or certain qualified trusts (not other Corporations)
- Shareholders cannot be non-resident aliens
- S-Corporations can have only one class of stock (disregarding voting rights)

The above requirements may render the election of S-Corp status impossible for some companies. To be classified as an S-Corp, a corporation must make a timely filing of Form 2553 with the IRS. IRS instructions indicate that the form must be completed and filed:

- A.** At any time before the 16th day of the 3rd month of the tax year if filed during the tax year the election is to take effect, or
- B.** At any time during the preceding tax year. An election made no later than 2 months and 15 days after the beginning of a tax year that is less than 2.5 months long is treated as timely made

for that tax year.

An election made after the 15th day of the 3rd month but before the end of the tax year is effective for the next year. For example, if a calendar tax year corporation makes the election in April 2007, it is effective for the corporation's 2008 calendar tax year.

*****Note that this information is subject to change at any time and you should NOT rely on its accuracy. Check with the US Internal Revenue Service or seek professional advice before undertaking such an election.***

WHERE SHOULD I FORM MY COMPANY?

Where to form your new company is probably one of the most pressing questions of the entire process. We all hear a variety of things about different jurisdictions (Delaware, Nevada, Wyoming); but does it really matter? Well, in short: Yes.

For LLCs & Corporations:

For LLCs or smaller Corporations planning to do business in only one state, the general "best" practice is to organize in that state. This is because the regulatory regime of that state will still expect you to file and pay taxes there if you are actively transacting business there. Corporate Law governing incorporated entities may vary a great deal and many larger companies can find great benefits by forum shopping, like in Delaware or Nevada. Of course, other jurisdictions will require a corporation to pay fees, taxes, etc. in those states where it is conducting business, and that can get costly. That said, other considerations include: the initial filing fees, yearly or bi-annual reporting fees and/or franchise or state corporate taxes, and other state-specific issues such as privacy rights, availability of close corporation or solo status.

But what if my company will be doing business in several states?

While you are free to conduct business anywhere or set up a principal place of business in other jurisdictions, you may be required to "register" as a Foreign Entity (basically, a guest doing business in that state) if you are doing any business there. This would require you to file any necessary reports, taxes, etc. and to pay any fees associated with doing business in that state.

States require this as a prophylactic measure to better protect their citizens from companies with bad intentions. When you register, you also open your company to the personal jurisdiction of that state's courts. Often, if you fail to register as a foreign entity, you may lose the privilege of utilizing that state's courts to seek action against a party in that state (basically, that state simply does not recognize you). This can be the case even in the state where you are principally located if you have not properly filed with that state.

What does "doing business" really mean?

Every state has a different definition of what this means. Some states, like California, define it to mean practically any and all activity even if it is one transaction! The safe bet is to just assume you are doing business there if you are conducting any activity – save for a short visit.

Do all companies file as Foreign Entities?

This is often impossible for most new, smaller companies. And with so many internet firms organizing and presumably doing business everywhere online, more and more companies choose to ignore the foreign entity filing requirements altogether. Also, the body of law governing business online is still developing and in the "gray area" further complicating the matter for new companies seeking to comply. Keep in mind too that many states have carved out exceptions for strictly internet business, but each state is different. While we strongly urge that all entities strive to follow the requirements, know that many smaller companies simply cannot afford to do this even if they wanted to.

Brief Points on the Popular States for Formation:

DELAWARE

Advantages Disadvantages

Inexpensive corporate franchise tax - \$35.00 for most companies Overly complicated franchise tax form – you will need to calculate using complicated formula

DE law allows directors a shield from personal liability resulting from their actions as directors DE has yet to advance their website to include more user friendly features

DE has the Court of Chancery and a very highly developed body of Corporate Law

Corporations enjoy a great degree of anonymity

No minimum capital investment required to form a DE corporation

NEVADA

Advantages Disadvantages

NV has no low corporate taxes; no corporate income tax; no tax on corporate shares and no franchise tax. While NV is lower than DE, there is an annual fee due with the report of officers NV requires that you to select and name your initial directors in your articles of incorporation thus mitigating privacy

NV law allows a great deal of protection to corporate officers and directors from personal liability resulting from "lawful" corporate duties There is often an unpleasant stigma attached to NV corporations because it is often used as the state of choice for unscrupulous firms seeking to hide assets, etc.

NV offers a great deal of anonymity and privacy

NO information sharing with the IRS (for LLCs – this means no state required 1065 Forms (only required for federal income purposes)

WYOMING

Advantages Disadvantages

No information sharing with the IRS No Prestige – such as DE (at least not yet)

Great privacy with minimal disclosure requirements for officers and directors

Voted "the most business friendly tax system" by the not-for-profit: The Tax Foundation

Tremendous flexibility with very low periodic fees and reporting burdens (which make it slightly more attractive than NV)

Just a Quick Note on New York and California

Both of these states are incredibly burdensome and expensive to organize in.

New York requires a minimum franchise tax for LLCs of \$335 up to \$10,000 depending on the number of members. It also requires an absolutely draconian "publication" requirement for all newly formed LLCs. This requires new LLCs to post a notice in two local publications for six weeks and can cost up to \$1,500. It must be done within (approximately) 4 months of filing. On the corporation side, NY poses a myriad of fees and taxes (maintenance, license, organization, etc.) making the environment very unfriendly for business.

California is not much better, and it imposes the highest minimum tax in the nation for C-Corps, S-Corps and LLCs at \$800. It also imposes its 1.5% franchise tax on LLCs as well as corporations. At present, this is being fought in court as unconstitutional as against LLCs. It is possible that it may be repealed.

As a general rule, for smaller companies doing business in only one state, it is still recommended that if your state happens to be NY or CA that you still consider organizing there. But, for many new companies understand that you have options and you should explore them thoroughly before

making a decision. This why we are here to help!

OTHER IMPORTANT CONSIDERATIONS

Registered Agents

A Registered Agent is a person or entity that is authorized to receive all legal papers on behalf of your company. The Registered Agent (RA) will be identified in your articles of incorporation or organization, and the most important address the state requires for use of "service of process." The RA must have a bona fide address within the state of organization (not a Post Office Box). While you can, and are encouraged under many circumstances, to use a professional RA service, it can also be you, a friend, relative, officer, lawyer, etc. But note that this is a great responsibility and whoever you choose must make certain to forward all papers to you promptly. Note also that the RA's address will appear in the public record.

A very good RA service we often recommend cost only \$149 per year, is available in all 50 states, and comes with access to an online compliance dashboard that sends you filing and tax alerts and has several other valuable features, especially if you are planning on organizing more than one company.

TRADEMARKS & COMPANY NAMES

Before you file and begin to spend any money on your company name or branding and marketing activities (even product names, slogans, etc.), you are strongly advised to have a comprehensive trademark search conducted. While no search can guarantee that it will uncover all possible uses of a similar trade or service mark, the cost of having such a search done versus making a significant investment only to find that you are infringing on someone else's mark is obviously worth it. The standard procedure for filing new entities only includes a search of your state of organization's database to see if there are any "direct" conflicts with your new company's name. This search, unfortunately, offers very little if any useful trademark research because the states use a very liberal standard for allowing trade names to be filed.

It is important to note that while access to the United States Patent & Trademark Office (USPTO) database is available to all for free, it is usually well worth it to use a professional, who not only can conduct the search correctly, but who likewise understands how to interpret the results generated - The key to trademark is in the analysis.

The other important task is to have a full, comprehensive trademark search conducted that includes all state databases, domain/business directories, search engines, general internet and some key foreign databases such as Canada. The reason is simple; searching the USPTO database will only reveal what has been filed (pending, active or dead) with the USPTO. But trademark rights under the Common Law extend to unregistered users and the USPTO attorneys will not look beyond their database when vetting your application. This means that you can still be hit with a cease & desist letter for trademark infringement even if you have successfully acquired a federal trademark. Thus, it is of great importance to find out what is in your marketplace before you expend large sums of money.

Trademark can be a complicated matter. We offer a variety of services including comprehensive searches, filings, monitoring and more. Other important intellectual property services to consider are copyright (website content, programs, materials, creative works, etc.), Provisional Patent Applications (patent pending status in one easy filing for up to 12 months while you shop your invention) and custom tailored Non-Disclosure Agreements (for use with investors, employees, service providers, etc.).

To learn more about our Entity Formation and other services please visit our website here:

http://www.lanternlegal.com/entity_formation.php

PLEASE FEEL FREE TO **CONTACT US** ANYTIME FOR A FREE CONSULT!



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