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SOME MAJOR ISSUES TO CONSIDER WHEN INCORPORATING

Once the decision to incorporate has been made, there are a number of important issues that require consideration. Like most things in life, incorporating involves making choices on options. Sometimes it means trying to look into the future as well as the present to effectively make these choices. However, it is important for a business owner to have a working knowledge of some of the major issues that must be faced in this incorporation decision-making process, hence the purpose of this report.

What Is A Corporation And How Is It Formed?

For income tax purposes, a corporation is a separate legal entity which is organized according to state statutes to transact business. It is authorized to perform primarily all the business activities an individual can, including such things as paying taxes, signing contracts, loan agreements, and filing its own tax returns. In effect, a corporation conducts business activities, pays taxes on the realized taxable net income, and is allowed to distribute profits to shareholders.

The creation of this legal association is done through the issuance of stock to the shareholders who contribute capital. These shareholders own the corporation.

Since state laws and statutes control the formation of a corporation, the prospective organizers/shareholders apply to the chosen state and pay the required filing fees. This application process is usually handled by the combined efforts of professional advisors such as attorneys and accountants. Usually the most successful and efficient formation of a corporation involves coordinating numerous legal and financial/tax implications so these advisors can play a valuable role before, during, and after the process.

The actual state process involves filing so-called "articles of incorporation" for approval of the state corporate charter. These are usually signed by all of the original shareholders or incorporators. These articles identify the incorporators, the business purpose, the initial capitalization details, the officers and directors. Once the state issues formal approval for the proposed starting date, the corporation is in existence.

With few exceptions, a corporation must then file with the state on a periodic basis(usually annually) to reaffirm certain aspects of its charter including such things as disclosures on directors, officers, and any changes for the year related to organizational or operational changes in the original charter. Failure to timely file this type of report can lead to a technical dissolution of the corporation, so corporate owners should make sure this does not slip between the cracks after the corporation is formed.

Four Main Features Of A Standard Corporation

Businesses look to a corporate structure for the potential benefits. Although there may be many, the major ones from a legal and long-term planning aspect are:

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Limited Liability: If handled correctly, shareholders may enjoy the protection of limited liability in which their main risk is the stock investment. In regard to closely held corporations, however, this advantage may not always hold true. If the corporate veil is pierced, if negligence is proven, if unpaid withholding taxes develop, or if personal guarantees have been granted by shareholders, this limited liability protection goes out the window.

Continuity: Since a corporation is a separate legal entity, it has no finite end so it can survive the shareholders and continue indefinitely until a legal dissolution occurs.
Transferability Of Interest: Since the corporation is formed with stock and securities, a shareholder can transfer shares in one form or another.

Centralized Management: A board of directors is elected by the shareholders to manage the corporation. This is a technical separation of ownership and management, and is called centralized management.

Tax Treatment Of A Corporation

As was mentioned, for tax purposes a corporation is considered a separate legal entity that is responsible for filing appropriate tax returns on the federal and state level. Gross income and allowable expenses are recorded to arrive at a net income figure for tax calculation purposes.

Once this net income figure for tax purposes is calculated, the actual process of paying federal and state income taxes may vary according to the type of corporation that was established. This will be discussed in more detail shortly, but for now, the issue is whether or not the corporation is a regular "C" type or a special "Sub S" type. On the federal level, a regular corporation pays its own taxes on the net income, but a Sub S type passes this net income and tax liability onto the shareholders instead. In effect, it is a form of a conduit for the income and deductions. On the state level the treatment follows the same pattern for those states that also recognize Sub S status.

For the corporation type that pays its own income taxes, this is done by paying estimated taxes on a periodic basis. The obligation of the corporation is to estimate its tax liability for the coming year, and make payments accordingly to the federal and state governments. Failure to properly make these estimated taxes can result in penalty and interest charges for underpayment of estimated taxes. Basically, the governments want the use of this tax money in advance, and this is their way of encouraging the corporation to comply.

The corporation tax return is usually due on or before 2 ½ months from the close of its accounting year, unless allowable extensions of time to file are used. In the case of an extension, an extra 6 months is usually granted. Note that, unlike an individual, a corporation does not necessarily have to use a calendar year ending December 31 for tax return filing purposes. It may be allowed to use a fiscal year instead, depending on the type of qualifying corporation set up.

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Types Of Corporations

There are two primary types of corporations: Regular "C" types, and "Sub S" types. A regular C type is just as it states. It's a stand alone tax-paying corporation as we have seen. Technically, there is actually a further division within a C type if the "personal service corporation" rules apply. In this case, although it still falls within the C type definition, the corporation may face limitations in certain areas(such as passive loss deductions, choice of tax year, and cash method of accounting, related party losses, and tax rates that may apply). However, it is not a true division from a legal entity position.

A Sub S corporation is a regular corporation that has qualified under an election(for federal it is a Form 2553 Election) to be taxed in a way different from C corporations. The corporation elects to pass through to the individual shareholders the income, losses, deductions and credits. Thus, instead of the corporation paying the tax liability, it is shifted to the individual shareholders in an allocation that is prorated based on ownership percentage for the year in question.

The tax effect of this is somewhat like that of a partnership whereby the S corporation becomes more of a conduit. Unlike a general partnership, however, the S corporation provides some degree of limited liability and continuity to the shareholders.

To qualify for this election, certain parameters must be met according to the current year 2000 tax codes:

It must be a domestic US corporation.

There can be no more than 75 qualified shareholders. In this regard, a husband and wife(and their estate if deceased) are considered as one.

There can only be one legal class of common stock, although voting right differences can exist as long as the same ownership rights are maintained.

The shareholders must be US citizens, or residents. Under certain provisions, estates and some trusts may also qualify.

The Federal election on Form 2553 must be signed by all of the shareholders. If any shareholder refutes the election, it may cause a termination of the status for all.

The corporation agrees to use a permitted or regular tax year which is generally a calendar year basis. There are some exceptions to this where IRS permission may be obtained to use another fiscal tax year, but it is not the norm.

The election to qualify as a Sub S corporation must be filed on or before the 15th day of the third month of the tax year for which the election is to apply. If it is filed later than that, the election would take effect for the next applicable year.

Once this election has been achieved, it doesn't mean it has to be forever. Situations may occur where the Sub S status no longer has benefit. In that case, a revocation procedure exists, and the corporation reverts to a regular C type.

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Advantages/Disadvantages Of S Corporations Compared To C Corporations

Deciding on which type of corporation to have requires a knowledge of present and future details in a number of areas to fully maximize the benefits. Within the lifetime of the corporation many changes may develop along the way which would necessitate changing from a C to an S or vice versa. In some ways this means you almost need a "crystal ball" at the beginning to fully anticipate all the changes. While this may not be practical, there are some general guidelines to follow when making the choice.

Advantages Of An S Corporation vs A C Corporation

Since the S Corporation is a conduit unlike a regular corporation, any qualified losses from the business get transferred to the shareholders individual tax return. This can save a considerable amount of taxes, especially if the shareholders are in higher tax brackets. Since many businesses are in loss situations(especially in the early stages), this can be a good tax-saving opportunity.

Cash basis accounting may be more possible which can make for easier tax planning opportunities in regard to deferring income.

There is no major threat of a corporate alternative minimum tax trap since it doesn't effectively apply to an S Corporation in most normal situations.

Since the income, or corporate earnings, is passed along to the shareholders, there is usually no problem with an IRS accumulated earnings tax which can be heavy for certain corporations.

Unlike a C type, there is no threat of a personal service tax "penalty" rate for businesses that provide services(like architects, consultants, accountants, lawyers, etc.).

With proper planning, income from the business can be effectively split among family members to reduce the income tax bite.

Since the income is passed along to shareholders, there is little chance the IRS would attack the corporation on the basis of paying "excessive compensation" to controlling shareholders.

Regular corporations may face a double taxation issue in that the corporation pays taxes on the earnings, and then the shareholders pay tax on corporate dividend/distributions from these earnings. A Sub S does not pay taxes on the earnings since it is a conduit.

Less chance of getting hit with a constructive dividend tax charge. If a regular corporation is audited and certain deductions are denied, the IRS may take the position that these deductions benefited the shareholders in such a way that they were really "disguised dividends." The result is a denial of a deduction for the corporation(which results in more taxes to be paid), and a forced increase in income that the shareholders must report(with more taxes to be paid again). This is a form of double taxation.

Deductions such as travel and entertainment, auto write-offs, and fringe benefits are prime candidates for this type of IRS attack. For a Sub S corporation, however, even if the IRS wins in denying the deductions, there can only be one tax charge, not two. So if the corporation is particularly aggressive in these deduction areas and/or has poor records, the Sub S corporation is more advantageous.

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A possible savings of social security and medicare tax may exist on money taken out of an S corp compared to a C corp. A C corp normally has to pay shareholders compensation in the form of a salary which is subject to social security and medicare taxes up to certain limits. This can amount to over 15% of the compensation in extra taxes for both the recipient and the corporation. However, an S corp may be able to make distributions from earnings without it being coded as a salary, thus saving this 15% for the same amount of money using the present 2000 year tax rates. There are caveats, and it may be an aggressive position to take, but it is possible in numerous cases.

Disadvantages Of An S Corporation vs A C Corporation

An S corp cannot have true multi classes of stock so it limits the control aspects, estate planning possibilities, and tax-savings of selling off portions of the stock.

Non-US citizens or residents cannot participate in an S corp. Thus, existing shareholders of an S corp may be limited to whom they can transfer/sell their shares without jeopardizing the Sub S status.

Since S corps are limited to 75 shareholders, it prohibits a wider distribution of ownership that is possible with a C type corporation.

You can't borrow out of an S corporation pension plan like you can with a C corporation.

If the S corporation realizes losses from "passive type" investments like realty, the deductibility of these may be more restricted.

Certain fringe benefits may not be available to shareholders with 2% or more stock from a similar tax-free standpoint compared to a C corp. These are fringes such as accident, health, disability, and life insurance, medical reimbursement plans, cafeteria/ flexible spending accounts, and job-condition meals and lodging payments.

If the Sub S corp net income is high, and the shareholders are in high tax brackets, there is less chance of reducing or equalizing the taxes since the money is automatically taxable to the shareholders whether they take it or not. S corps and their shareholders cannot benefit from retaining earnings.

There are limitations on using other than a calendar year accounting period, so tax deferring techniques in this area are limited unlike many C type corporations that can elect fiscal tax years for filing purposes.

The S corp cannot take advantage of the C corp deduction(which can amount to a savings of up to 80%) on dividends received from other domestic corporations.

An Overview Of Selected Other Issues When Incorporating

Once the decision to incorporate has been established, there are a number of pertinent issues to consider in the process. Some of these may be governed by the type of corporation that has been selected – that is, Sub S or C corporation. But in general terms, a list of the major issues to consider follow:

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SELECTING AN ACCOUNTING METHOD: The two main types are the accrual and the cash method. Unless it qualifies for IRS exceptions, a corporation generally uses an accrual method of accounting. In this method, income is reported in the year it is earned, not necessarily received, and expenses are deducted in the year incurred, not necessarily paid. As we have discovered, most Sub S corporations are precluded from using this method–they must use a cash method instead(unless inventory is a significant factor in the business, or special permission is granted from the IRS).

The cash method is the more well know possible option. In this case, income is reported when actually or constructively received, and expenses are deducted when actually paid or legally charged. Unless inventory is a significant factor, most S corps will use this method, and many C type corps can also qualify if the gross average annual receipts are under $5 million dollars, or if it is a qualified personal service corporation.

SELECTING AN ACCOUNTING YEAR: The two options here are a Calendar year or a Fiscal year. A calendar year is a 12 month period ending with December 31. A fiscal year is a 12 month period ending in a month other than December. A Sub S corporation is usually limited to the use of a calendar year, although some exceptions may exist if the IRS approves. These exceptions relate to the tax year of the major shareholders, and if a "business purpose" for an alternative tax year can be justified. Regular C corporations can elect either fiscal or calendar year periods.

SELECTING AN ACCEPTABLE BOOKKEEPING SYSTEM: Since one of the purposes of a corporation is to try to limit the personal liability of the shareholders, it is essential that the corporation be run properly so that this liability limitation cannot be challenged. A failure to maintain an acceptable set of books is possible grounds for a legal challenge. Further, good, timely recordkeeping helps a business survive and thrive in the competitive world.

Since most corporations must file balance sheets with their tax returns, a double entry type of bookkeeping system is generally used. It is designed to be self-balancing, and every entry involves both a debit and credit to balance. This system involves the use of journals, and ledgers–either manually or computerized–to track profit and loss, and balance sheet items to ascertain assets, liabilities, and capital items. While a double entry system is not required, single entry systems(which concentrate mainly on the recording of income and expense items) make the accurate calculation of corporate balance sheets more difficult.

At the very least, a corporate bookkeeping system should have the following components: Income Register, Disbursements Record, Travel & Entertainment Reports, Equipment Register, Petty Cash Voucher System, Payroll Register, and Accounts Receivable Control Ledger. Because of some of the complexities associated with bookkeeping and accounting for a corporation, and because of the desire to protect the limited liability features, many corporations elect to have some or all of the recordkeeping done by an outside professional.

SHAREHOLDER AGREEMENTS: This should actually be done before officially incorporating. Many businesses with more than one owner dissolve because of misunderstandings about basic issues that weren't adequately spelled out in the beginning. So a "Shareholders' Agreement" should be drafted up to make for provisions regarding these issues such as: work responsibilities, capital contributions, management authority, profit distributions, voting issues, buy-sell agreements, change in ownership issues, arbitration dispute methodology, expense account policies, etc.

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CAPITAL STRUCTURE: The capitalization of a corporation involves deciding on how much money should be contributed as actual capital or as loans instead. This relationship between debt and equity is significant. The more that the corporation is set up with loans, the "thinner" its capitalization is. There may be some advantages to a "thin" corporation:

1) It's easier to get your money back out; normally, corporate capital cannot be drawn back out without major tax or organizational consequences while loans can be repaid tax-free in most cases.
2) A corporation is allowed to accumulate earnings to repay debt, so a thin corporation has less chance of an IRS challenge resulting in a stiff accumulated earnings penalty tax.
3) If the business fails, and a liquidation must occur involving outside lenders, the shareholders may have a better chance of getting their money back if it is loaned to the corporation instead of invested as capital.
4) The corporation can pay a wide range of interest rates back to the shareholders; if done properly, this can be a way of taking money out of the corporation not subject to social security, medicare, and state unemployment taxes–a possible savings of over 15%.

Some possible disadvantages:

1) The balance sheet on the business does not look as strong to outside lenders, so borrowing may be more difficult.
2) Above the $10,000 limit, the IRS usually requires that loans be paid back with statutory interest. Although this interest is deductible by the corporation, it is also taxable to the shareholder in question, and if the shareholder's tax bracket is higher, there could be an unequal tax savings/tax payment swing.
3) If the corporation fails, any losses on the debt would have to be written off as nonbusiness bad debts which are capital losses subject to a maximum of $3000 per year on a stand alone basis. If it were capital instead and the corporation qualified for Section 1244 small business stock treatment, the loss would be considered ordinary, and not limited to just $3000 per year.

CONSIDER SETTING UP WITH 1244 STOCK: If the corporation is capitalized properly, it will normally qualify for this special treatment. The main benefit here is if the corporation fails and the shareholders lose their investment. If it is a Section 1244 stock corporation, the loss on the shareholders investment may be eligible for ordinary loss write-off treatment as opposed to capital losses. This would mean they could deduct up to $50,000($100,000 if married filing jointly) immediately, not merely $3000 like a capital loss using today's 2000 tax rules.

The corporation will qualify for Section 1244 stock if it meets the following criteria: The corporation was formed after 11/6/78; shareholders cannot be other corporations, estates, or trusts; it must be a small business with total capital contributions of less than 1 million dollars; stock was issued for money or property only; original shareholders must retain stock; basis of the 1244 stock is limited to original capital contributions; less than 50% of corporation's receipts are from investments vs regular business activities. Since these criteria are fairly commonplace, the bulk of most small corporations will qualify for this special treatment.

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AVOID THE PERSONAL HOLDING COMPANY TRAP: If trying to achieve limited personal liability is one of the reasons for incorporating, it is imperative that the corporation be run correctly from a legal and tax perspective. If it isn't, you can be attacked on the basis that it wasn't a true corporation, but a personal holding company instead–and the "corporate veil can be pierced." That means the attackers can go after your personal assets as well.

While you cannot absolutely guarantee this type of attack won't occur, you can go a long way towards stopping it by effectively running the corporation with "arms length transactions." Even though you may own it, view it as a separate entity, as if it were actually another employer. Therefore, account to it in writing for all the major activities. Keep the books, records, and tax filings current, and according to adequate accounting rules and regulations. Do all required minutes of meetings on a contemporaneous basis. Properly handle money that you put into it, and take out of it. Properly account to it for the use of its assets whether it be for business or personal. Keep your role as a shareholder separate and distinct from that of an employee/officer/director.

TAKING MONEY OUT OF A CORPORATION: A big mistake many people make when they incorporate is in forgetting that it is not like a sole proprietorship where you can draw money out, and put it in with relative abandon–because it is classified as a drawing account. A corporation is not eligible for this drawing account. You are required by law–and limited accordingly–to take money out in designated ways, the majority of which are: salary/compensation; dividends; stock distributions; loans, loan paybacks and interest payments; expense reimbursements; lease or rental payments; and fringe benefits.

You must properly account for how this is done, and handle the tax consequences(which will differ accordingly) for each. If you improperly take money out of the corporation, and it is challenged, it can result in a denial of the deduction for the corporation, increased income taxable to you personally, possible civil or criminal penalties, and possible loss of the corporate charter privileges and protections. If in doubt about how to take money out of the business, always check with your financial adviser first–not after the fact.

TRANSFERRING ASSETS TO A CORPORATION: There are occasions when a shareholder/owner will want to transfer assets into the corporate structure–equipment, furnishings, realty, etc. Ordinarily the IRS considers the transfer of property in exchange for stock or increased value in a corporation a possible taxable event if there is a gain or loss differential between the two values. However, there is a possible exception to this under IRS Code Section 351 which allows for transfer without immediate tax consequences.

To qualify, the non-recognition of gain or loss must be from a transfer of property solely in exchange for the corporation's stock or qualified securities if the transferring party is in control of the corporation immediately after the exchange. No additional money or property can be received from the corporation.

The property that is allowed to be transferred in this regard includes: real estate and personal property, and cash/cash equivalents. Services to the corporation(current or future) in exchange for stock do not qualify.

The parties involved must record this transaction in the form of a statement listing all the pertinent details, including any liabilities that have been assumed. These statements are generally filed with the tax returns of the corporation and the shareholders.

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This Section 351 transfer provision can be very significant in the situation where an ongoing business is converting into a corporation. An example would be a sole proprietor or a partnership converting into a corporation. Without Section 351, there could be major problems with capital gains, or depreciation recapture because the law would then treat the transaction as if the business property had been sold. It could make the reorganization to a corporate structure cost-prohibitive.

Conclusion

Incorporating a business involves understanding the options and how they interact with each other, and with the tax and financial details of the shareholders. Some of the choices also would benefit from being able to see into the future so they may require more careful thought than just a look at the immediate concerns.

Once the decision to incorporate has been made, deciding on the type of corporation, accounting methods, and accounting tax year become priorities. If assets are being transferred in from an existing business, or from shareholders, how this is handled requires timely decision making as well. Hopefully a good shareholders' agreement was already established before the actual incorporation. If not, it should be done before any disputes among owners arise, not after.

The type of bookkeeping system has far-ranging implications from a tax, management and analysis perspective. Even if you are intending to do the bookkeeping "in-house" you should still consider getting professional advise up front before the checks start being written and the income starts being posted.

In situations where a corporation is being formed to provide liability protection to the shareholders/owners, one of the more critical aspects is to run the business in such a way as to avoid falling into any personal holding company traps. Otherwise, the corporate "veil" may be pierced, defeating the whole purpose.

As you can see, setting up a corporation effectively involves numerous decisions which must be made on a timely basis. Although this set-up process can be complicated and running a corporation can be complicated from a tax accounting standpoint, if done correctly with proper forethought it can play a major roll in the success of your business.

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