PacificCPE

COURSE

82602A

Forming Corporations and Limited Liability Companies

Whether your client is drawn to the corporate structure or the flexibility of an LLC, knowing how each entity is created and governed is essential to providing sound advice. This course covers the practical steps involved in forming both corporations and limited liability companies, including key structural considerations that affect taxation and liability. A solid resource for practitioners who regularly assist clients with new business formation or entity conversion decisions.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the requirements for electing to become an S corporation.
- Recognize the various requirements for setting up an LLC.

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Chapter 1: CREATING A CORPORATION

Chapter Objective

After completing this chapter, you should be able to:

- Identify the requirements for electing to become an S corporation.

Chapter 1 of course 82601A introduced the basic business entities—the sole proprietorship, the partnership, the limited liability company, and the corporation. This chapter tells you more about setting up a corporation, starting with the structure of a corporation, including the roles of the key players: the incorporators, shareholders, directors, officers, and employees. Then it looks at corporate finance—how you get money into the corporation and how you take it out. Next is a step-by-step explanation of the procedures for setting up a corporation. Finally, we'll examine some sound corporate business practices.

The material in this chapter applies to most, but not all, new corporations. Generally, this material will apply to you if your proposed corporation fits the following profile:

- A relatively small number of people—about 10 or fewer—will own the corporate stock.
- All or most of the owners will participate directly in managing and running the business; investors who don't directly participate will generally be limited to friends or family members.
- All of the owners will live in the state in which you form your corporation and conduct your business.

Lawyers often call a small corporation that fits this profile a "closely held corporation." We'll borrow this term in its most general, nontechnical sense.

Classifying your corporation at the outset is important because if you're a closely held corporation and sell stock to only a few friends or family members, normally you'll be exempt from all but the most routine requirements of federal and state securities laws.

But if you sell stock in your corporation to outside investors—people who won't help run the business or aren't closely tied to people who are—you must comply with those laws. So if you want to sell stock to a wider range of people, especially if any of them live in a different state, you'll need to learn more about the requirements of the securities laws. Many states have generous exemptions that allow sales of stock to as many as 35 investors without complicated paperwork. But because this is such a technical area and laws vary from state to state, you should seek legal advice from a lawyer knowledgeable about securities laws before you offer stock to outsiders.

Law From the Real World

Keeping a Hand in the Business

Anne opened a small business providing customized bookkeeping software for manicurists. For several years she struggled financially as she tried to convince small nail shops that buying her computerized system would ultimately be far cheaper than keeping records in a shoe box. Finally, when a trade magazine gave her system a rave review, business took off. Suddenly Anne found herself hiring employees, upgrading and customizing her software, and greatly increasing her marketing activities.

Anne soon realized that she couldn't do it all herself. Her key employees were increasingly critical to her success. To help ensure their loyalty and hard work, Anne decided to give them an ownership interest in the business. She accomplished this by forming a closely held corporation, Digital Nail, Inc. Initially Anne owned 100% of the stock, but under the terms of a shareholders' agreement, half a dozen or so key employees receive stock each year.

Although Anne will always remain the majority owner, the longtime employees will gain a significant share of the business over time. If an employee leaves the company, their stock must be sold back to Digital Nail at its book (asset) value—considerably less than its market value (assuming the business continued to prosper and was sold or went public). In short, not only does Anne's plan give key employees a stake in the success of the company, it provides a powerful incentive for them to stick with Digital Nail.

Resource

Looking for a lawyer? Asking for a referral to an attorney from someone you trust can be a good way to find legal help. Also, Lawyers.com and Avvo.com, provide excellent and free lawyer directories. These directories allow you to search by location and area of law, and list detailed information about and reviews of lawyers.

Whether you're just starting your lawyer search or researching particular attorneys, visit www.lawyers.com/find-a-lawyer and www.avvo.com/find-a-lawyer.

THE STRUCTURE OF A CORPORATION

Corporations are controlled primarily by state, not federal, law. So, 50 different sets of rules cover how corporations are created. Terminology differs from state to state. For example, most states use the term "articles of incorporation" to refer to the basic document creating the corporation, but some states (including Connecticut, Delaware, New York, and Oklahoma) use the term "certificate of

incorporation." Tennessee calls it a "charter" and Massachusetts uses the term "articles of organization." Fortunately, the similarities in corporate procedure outweigh the differences, so most of what you find in this chapter will apply to your situation. Nevertheless, watch out for the differences.

People involved in a corporation traditionally play different legal roles: incorporator, shareholder, director, officer, or employee. We'll look at those roles here. And, in virtually every state, there's a way that you can set up a corporation in which one or two people play all roles.

Incorporators

The "incorporators" (called the "promoters" in some states) do the preparatory work. This prep work might include bringing together the people and the money to create the corporation. It always includes preparing and filing the articles of incorporation—the formal incorporation document that is filed with a state office, such as the secretary of state. Although several people can serve as incorporators and sign the articles of incorporation, only one incorporator is required by law. Once the articles of incorporation are filed, the incorporator's job is nearly done. The only remaining tasks are to select the first board of directors and to adopt the corporate bylaws (although, in some states, bylaws may be adopted by the directors).

Shareholders

The "shareholders" own the stock of the corporation. One person can own 100% of the stock. Among other things, shareholders can:

- Elect directors (although the initial board of directors is usually selected by the incorporator or promoter)
- Amend bylaws
- Approve the sale of all or substantially all of the corporate assets
- Approve mergers and reorganizations
- Amend the articles of incorporation
- Remove directors, and
- Dissolve the corporation.

State laws typically require that the shareholders hold an annual meeting. However, in many states, a consent action or consent resolution—a document signed by all of the shareholders—can be used in place of a formal meeting.

For the corporation to elect S corporation status under federal tax laws, all shareholders must sign the election form that's filed with the IRS. (For more on this, see "Eleven Basic Steps to Incorporate," below.)

Directors

The “directors” manage the corporation and make major policy decisions. Directors authorize the issuance of stock, decide on whether to mortgage, sell, or lease real estate, and elect the corporate officers. Directors may hold regular or special meetings (or both). However, in many states, it’s simpler and just as effective for the directors to take actions by signing a document called a consent resolution or consent action.

The incorporators or shareholders decide how many directors the corporation will have. The number of directors is usually stated in the articles of incorporation or in the corporate bylaws. Most states specifically permit corporations to have just one director. In the remaining states, the requirement is that there be at least three directors, but there’s an exception for corporations with fewer than three shareholders. If a corporation has only two shareholders, the corporation can operate with two directors; if it has only one shareholder, the corporation needs only one director.

Example 1

Anita, Barry, and Clint create a corporation in Michigan. They choose Anita to be the sole director. They can do this because the law in Michigan—as in many other states —permits a corporation to function with a single director regardless of the number of shareholders.

Example 2

Dustin, Erwin, and Faye create a corporation in California. They would like Dustin to be the sole director, but California law requires them to have at least three directors if there are three or more shareholders. So, Dustin, Erwin, and Faye create a three-person board of directors and appoint themselves to those positions.

Officers

The “officers” are normally responsible for the day-today operation of the corporation. State laws usually require that the corporation have at least a president, secretary, and treasurer. The “president” is usually the chief operating officer of the corporation. The “secretary” is responsible for the corporate records. The “treasurer,” of course, is responsible for the corporate finances, although it’s common to hand day-to-day duties to a bookkeeper. The corporation can have other officers—such as a vice president—as well. In most states, one person can hold all of the required offices.

Example

Abdul forms a Texas corporation. He provides for the two corporate offices—president and secretary—that are required by Texas law. He appoints himself to both offices. This is legal in Texas and in most other states.

Employees

Employees work for the corporation in return for compensation. In small corporations, the owners (shareholders) are usually also employees of the corporation.

As a corporate employee, it's through your salary and other compensation that you'll receive most of your financial benefits from the business. Often the person who runs the business day to day gets the most compensation. This person may or may not be the president.

How It All Fits Together

If you're new to all of this, the numerous components of a corporation might seem unduly complicated for a small business. Fortunately, it all fits together quite smoothly and easily.

Example

Al, Bev, and Carla decide to form a corporation to run a fitness center. Their plan is to invest $10,000 apiece and be equal owners. Because state law requires only one person to sign the papers setting up the corporation, Bev signs the articles of incorporation for ABC Fitness Center, Inc., and sends them to the secretary of state's office along with the filing fee. Bev is the incorporator.

Next, Bev adopts bylaws for the corporation calling for a three-person board of directors. She elects herself, Al, and Carla to serve as the first directors. The three of them then elect Bev to be the president, Al to be the secretary, and Carla to be the treasurer—so the three of them are then the officers of the corporation.

When Al, Bev, and Carla each pay $10,000 into the corporate bank account, they each receive a stock certificate for 10,000 shares of corporate stock; at that moment, they become shareholders.

All three are active in running the business, working 50 hours a week and receiving a salary. Al and Bev, who have experience as personal trainers, take charge of training customers and supervising a small staff of other workers. Carla, who studied business in college, looks after the finances—billing customers, marketing, ordering supplies. In addition to their other roles in the corporation, Al, Bev, and Carla are employees.

FINANCING YOUR CORPORATION

It doesn't take an MBA to grasp the fundamentals of corporate finance in the typical small business. Assets come into the corporation in two forms: equity and debt. Let's look at each.

Funding Your Corporation with Equity

Basically, "equity" means shareholders contribute cash, valuable property, or services to the company in exchange for stock in the company. The number of shares issued is somewhat arbitrary, but the customary practice in some places is for new corporations to issue one share for each dollar invested.

The most common way to pay for stock is with cash. For example, you may put $5,000 into the company in return for 5,000 shares of corporate stock. But money isn't the only thing that you can invest in a company in return for stock. You may also transfer physical assets, such as real estate or equipment, or a copyright, patent, or trademark. Or you may receive stock in return for past services to the corporation.

Caution!

Check before you transfer property for stock. Before you transfer property to your corporation in exchange for stock, remember that if you receive stock for property that has increased in value since you bought it, you may owe taxes.

In some states, you can receive stock in return for promising to perform services to the corporation, or in return for a promissory note. In other words, you might receive 5,000 shares of stock in return for your promise to work for the corporation for 200 hours or to pay the corporation $5,000 six months later. Not all states, however, permit stock to be issued based on a promise of future services or money, so check the rules of your state.

Funding Your Corporation with Debt

The other major way to fund a corporation is through debt—that is, by borrowing money. But you should know that if your corporation borrows from a bank or another outside lender, the lender will probably expect you to personally guarantee to repay the debt should the business be unable to.

Leasing Property to the Corporation

Sometimes you'll want to retain ownership of property being used by the corporation. For example, maybe you own a garage or other small building your company will occupy. With real estate, it's usually better, from a tax standpoint, to have your corporation lease the property from you rather than to transfer the property to the corporation.

Example

Nino forms New Age Innovators, Inc., to develop some practical new technologies for the plumbing industry. He plans to work out of his garage. He leases the garage to his corporation for $500 a month. On his own personal Form 1040, Nino will report the rent as income and will deduct interest expense (for the mortgage on the building) and depreciation. On its corporate tax return, New Age Innovators, Inc., will deduct its rent payments and operating expenses for the garage.

If you lease property to the corporation, have the directors adopt a board resolution approving a lease. Then have the corporation sign the lease as a tenant, with you, of course, as the landlord. This will be helpful in establishing the existence of a lease if the arrangements are questioned by the IRS.

COMPENSATING YOURSELF

We've just discussed how you put money into the corporation. Now let's get to the fun part—how you take it out.

Salary and Bonuses

As a corporate employee, you can receive a reasonable salary plus bonuses, which, for tax purposes, are lumped in with salary. (Many corporate owners prefer to pay themselves conservative salaries and then reward themselves with a year-end bonus if it makes sense economically.) Salaries and bonuses are treated as business expenses of the corporation, which means that the corporation owes no tax on what it pays you (apart from withholding employer taxes). You, in turn, report what you receive as income on your personal income tax return just as you would if you worked for any other employer. The IRS has rules on how much salary is appropriate—the primary one is that the salary must be "reasonable." This is a pretty loose standard and, as a practical matter, doesn't affect most small business owners, because their businesses can't afford to pay them the sort of stratospheric salaries the IRS might consider unreasonable.

Interest on Loans to the Corporation

If you lend money or property to the corporation in exchange for a promissory note, you'll receive interest on your loans. Hopefully, the corporation will repay you the principal amount of the loans as well. But you'll have to pay tax on only the interest you receive—not on the principal portion.