

THE  
STEP-BY-STEP GUIDE TO FORMING  
CORPORATIONS AND LLCs



DECISION MAKING TOOLS AND THE  
BENEFITS OF INCORPORATION

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# INTRODUCTION

Congratulations on getting your small business up and running! Now is a great time to consider whether incorporating or forming an LLC makes sense for your business.

Our incorporation guide will help you answer questions like what to expect when incorporating, what entity type is best for your business (C-Corporation, S-Corporation, or LLC), and what state to form in. This guide introduces several of the most important factors to consider, including:

- The potential risks and liabilities of your business
- The formalities and expenses involved in establishing and maintaining the various business structures
- Your income tax situation, and
- Your investment needs.

## THE MOST COMMON TYPES OF BUSINESSES ARE:

Sole Proprietorship  
General Partnership  
Joint Venture  
Limited Partnership  
Limited Liability Partnership (L.L.P.)  
Limited Liability Company (L.L.C.)  
Corporation  
S Corporation  
Not-for-Profit Corporation  
Professional Corporation

The first step in starting a small business is researching and selecting the appropriate legal business structure that provides the most benefit for your particular needs.

### NOTE:

Almost every business can benefit greatly from the benefits gained by forming an LLC or Corporation.

Our Incorporation guide is designed specifically to help you answer questions you may have about the process of forming a new business and the benefits you gain and your business will gain by doing so.

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# WHY CONSIDER BUSINESS FORMATION?

## NOTE:

You don't have to be a large operation with dozens of employees to benefit from incorporating.

Use the list of questions on this page to quickly help you determine if incorporation is right for you.

**Tax Savings:** As your business income grows, there may be tax advantages to incorporating and paying taxes at corporate rather than personal tax rates. Additionally, if you're paying substantial self-employment taxes today, forming an S-corporation could help you save on income taxes. We'll discuss tax related issues in greater detail in a later section.

**Reduced Chance of Tax Audit:** Historically sole proprietors tend to be more likely to file incorrect returns (many are self-prepared), and tend to underreport revenue or overreport deductions. For these reasons, the IRS has continually audited a much higher percentage of sole proprietor tax filings than corporate filings.

**Establishing a Professional Identity:** Many small businesses choose to incorporate or form an LLC to prove their legitimacy to both customers and suppliers. Including the "Inc." or "LLC" at the end of your business name in all marketing and communications can help to separate you from the competition.

**Raising Capital:** If you are looking to raise capital, incorporating or forming an LLC also increases the legitimacy of your company from an investor's standpoint. Investors are interested in making sure they are investing in a sound business – one that has adhered to the proper formalities (whether you've formed a corporation or an LLC).

## WHO IS INCORPORATION FOR?

Many of MyCorporation's customers are home-based, one-person businesses with less than \$50,000 in revenues—or even no revenues and just getting started. Why do businesses and investors consider incorporating?

There are many benefits:

**Limited Liability:** In our increasingly litigious society, it is becoming ever more important to limit your exposure and protect yourself from liability. As a sole proprietor, your liability for business debt is unlimited, meaning personal assets such as your home, personal bank accounts and other valued assets may be at risk. Forming a corporation or LLC draws a firm line between your personal and business assets, helping protect your personal assets from risks or debts associated with running your business.

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# CHOOSE A STATE OF FORMATION

## NOTE:

Certain states are more popular for corporations and LLCs than others.

Many new business owners are surprised to learn that there are really no legal requirements to form their business in the state where they will conduct business...

## FILING FEES

An out-of-state corporation that will be conducting business in California generally must “qualify” to do business in California. This “qualifying” requires the corporation to pay filing fees to the California Secretary of State in addition to whatever filing fees were paid in the state of incorporation.

## STATE TAXES

An out-of-state corporation/LLC doing business in California will have to pay franchise taxes to California. The corporation may also have to pay franchise taxes in its state of incorporation (even if the corporation is not conducting business in that state). Thus, the corporation is potentially exposed to taxing by more than one state.

## SECURITIES LAWS

The California Corporate Securities Laws apply to any offer or sale of a security “in this state” regardless of the issuer’s state of incorporation.

## CORPORATE RULES

Regardless of where the corporation is formed, many provisions of the California Corporation Law, for example, apply if the corporation has a sufficient “presence” in California.

## A BUSINESS CAN FORM A CORP OR LLC IN ANY STATE

While states other than a company’s home state have been historically recognized as offering significant advantages to corporations/LLCs, some of these “advantages” may not apply to a corporation that maintains “significant business contacts” or “significant presence” within a particular state.

**FOR EXAMPLE:** Forming a California corporation for a small business located in California is usually the logical choice. While it is possible for the business to register somewhere else, there are often reasons why this may not be the best choice. Consider the following drawbacks to forming your business in a different state:

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# NAME THE CORPORATION

## NOTE:

Each state has its own rules for naming a business. Remember to check your state for specifics.

Naming a company is like naming a new baby. It's exciting and you want the new business name to be unique and creatively represent the product or services offered.

## ADVANCED:

Some states may impose additional restrictions where the name implies certain activities that are regulated by state licensing boards. While these names are not prohibited from use, additional steps are required before they may be used in a corporate name. Such words may include: 'Bank', 'Insurance', 'Trust', 'Accounting', and 'Medical'.

## MOST STATES REQUIRE THE NAME CONTAINS ONE OF THE FOLLOWING CORPORATE INDICATORS:

- Incorporated
- Inc
- Corporation
- Corp.
- LLC
- L.L.C
- Limited Liability Company

## PROHIBITED WORDS AND PHRASES

Additionally, most states prohibit the use of a corporate name that is "substantially similar" to that of a corporate or LLC name already in existence or dissolved within the past 2 years. Also, the use of obscenities, profanity, or a name that may be considered "deceptive" is prohibited in most states.

## PROTECTING THE CORPORATE NAME

Generally, incorporating a business under a specific name will only prevent another individual from forming a corporation with the same name in the same state. Thus, it is possible that an individual may incorporate with that corporate name in another state. In some states, it is also possible that an individual may form an LLC or sole proprietorship in the SAME state as the corporation you are naming.

## SECURING A DOMAIN NAME

During the naming process it is important to make sure the names being considered are also available as a domain and register that domain as soon as possible. In addition, one should consider registering its similar variants and different extensions like mycompany.com, mycompany.net, mycompany.biz, etc. This critical step will help protect each company's online identity.

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# CHOOSE AN ENTITY

**NOTE:**

Each entity type has its own strengths and weaknesses that should be taken into consideration.

Business formations come in many different shapes and sizes. A choice should be made depending on your specific needs, within your short and long-term goals.

**MEDICAL/RETIREMENT BENEFITS BY ENTITY**

First, let's take a look at the medical and retirement tax benefits accorded the different entities and how they are then treated by the participating parties.

**BUSINESS ENTITY FILING REQUIREMENTS**

No Filing Required ( no liability protection )

- Sole Proprietor
- General Partnership
- Limited Partnership

State/Federal Filing Required

- C-Corporation
- S-Corporation
- Limited Liability Company
- Professional Corporation
- Non-Profit Corporation

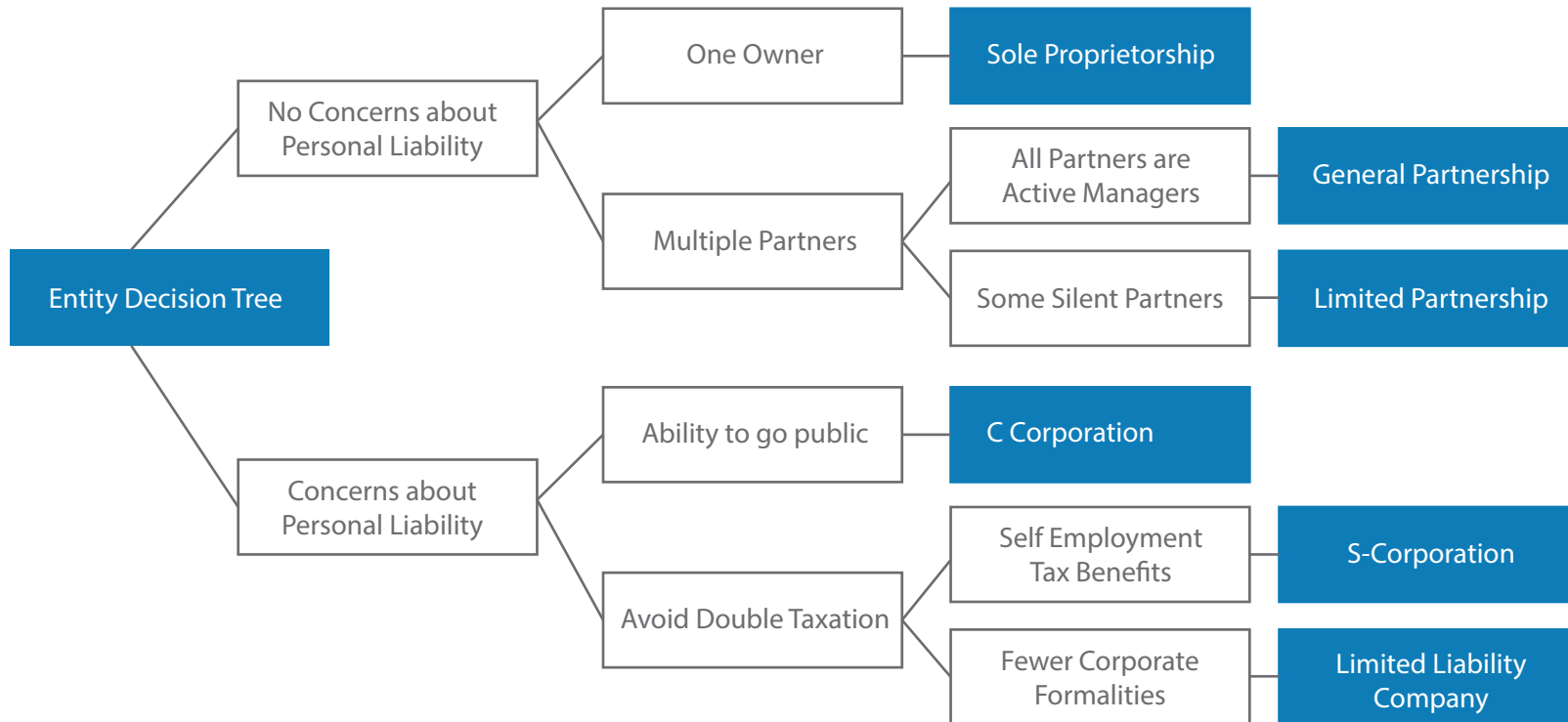
	Partnership/ LLC	S-Corp	C-Corp
<b>Entity Treatment</b>			
<b>Medical Insurance</b>	Deducted as a Guaranteed Payment	Deductible as W-2 wage not subject to FICA/Medicare	Deductible as operating expense in same manner as payments for non shareholder employees
<b>Retirement Contributions</b>	Distribution to partner/ member	Deductible as operating expense in the same manner as non- shareholder employees	Deductible as operating expense in same manner as payments for non shareholder employees
<b>Partner/Member/Shareholder Treatment</b>			
<b>Medical Insurance</b>	Deductible as an adjustment to income on page 1 of Form 1040	Income included in W-2 Box 1, explanation in Box 14; deduct on Form 1040 as SE medical insurance	Not income to employee/ shareholder; no entry on Form 1040
<b>Retirement Contributions</b>	Deductible as an adjustment to income on page 1 of Form 1040	No entry for 1040	No entry for 1040

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# CHOOSE AN ENTITY

## A FEW SIMPLE QUESTIONS

We have developed this easy to use decision tree to illustrate the decision process of choosing the correct entity type. Consider the pros and cons at each juncture and you will be well on your way to choosing the correct entity.



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# CHOOSE AN ENTITY

Let us now take a look at the characteristics and legal factors/ requirements for the various business entities.

## Sole Proprietorship

### Characteristics

Business is operated by a single person.  
The owner is not considered an employee (self employed)  
The simplest form of business.  
Comparatively easier & less expensive to maintain.  
Separate business and personal books are kept.

### Legal Requirements

Individuals can start up a sole proprietorship.  
No legal formalities.  
Business licenses or permits may be required.  
All assets & liabilities of the company are passed to the individual.  
Business income is reported on the individuals' Form 1040, Schedule C.

## General Partnership

### Characteristics

Business is operated by two or more people.  
Partnership agreement should be prepared.  
Partners are not considered employees of the company, but self-employed individuals.

### Legal Requirements

Personal and partnership assets may be at risk.  
Not required to pay separate business income taxes.  
Must file an information return indicating amount of money earned or lost during the year by each partner.  
Each partner is responsible for paying their share of personal income tax.  
May be required to obtain business licenses or permits.  
May be required to file a partnership certificate.

## Limited Partnership

### Characteristics

A partnership that is made up of one or more general partners and one or more limited partners.  
The difference between a general partner and limited partner - the limited partner is not personally liable for debts of the partnership.  
Limited partners can only lose the amount they paid as a capital contribution or received from the partnership.  
A limited partner may not participate in management of the business.  
If a limited partner does participate, he or she may incur personal liability with the same repercussions as a general partner.

### Legal Requirements

Serves as a means to raise money from limited partners -without having to take in new partners as active members in the business or -engage in the complexities of starting a corporation and issuing stock.  
Depending on the business type and location, may be required to obtain business licenses or permits.  
May be required to file a partnership certificate with a public office.

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## C - Corporation

### Characteristics

Considered a separate entity from those who own or operate. Limited personal liability & protection from being liable for debts (e.g., bills for supplies/equipment and injuries to persons involved in business activities that are not adequately covered by standard insurance) One person may own all the stock.

### Legal Requirements

Created under state law (by filing documents with the Secretary of State). Tax must be paid on the income made by the corporation. If income is distributed to shareholders as dividends, the shareholders must pay tax on amount received as dividends.

## S-Corporation

### Characteristics

Limited liability & protection from personal liability for debts. Owners pay personal income taxes. Business losses may be offset against other income - could reduce or eliminate owner's tax burden. Generally not subject to taxation at the federal level. Shareholders are required to pay their share of income tax on the corporation's income, whether or not they received money.

### Legal Requirements

Personal and partnership assets may be at risk. Not required to pay separate business income taxes. Must file an information return indicating amount of money earned or lost during the year by each partner. Each partner is responsible for paying their share of personal income tax. May be required to obtain business licenses or permits. May be required to file a partnership certificate.

## Limited Liability Company

### Characteristics

Limited Liability Companies combine the limited liability advantages of corporations with the control and tax advantages of a partnership. A Limited Liability Company is more complicated than a normal partnership in its formation. Owners are generally not liable for the debts and obligations of the LLC. Can elect how an LLC will be taxed.

### Legal Requirements

The entity is taxed like a partnership - income and losses of the LLC are accounted for on the owner's individual tax returns. Can be owned by non-U.S. citizen /resident aliens and other business entities. Can have unlimited number of members - owners of an LLC are known as members. Less formal than a corporation.

## Professional Corporations & PLLCs

### Characteristics

Certain occupations may incorporate through a professional corporation only. May incorporate as a professional corporation or as a regular corporation. All shareholders must be licensed.

### Legal Requirements

Created under state law. Limited personal liability and protection from being personally liable for debts of other members. Still liable for own malpractice.

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# CHOOSE AN ENTITY

## COMPARING S-CORPORATIONS AND LLCs

### DIFFERENCES

**Ownership** – Owners of LLCs are called members and owners of S Corporations are called shareholders. There are significant differences in ownership rules. S-Corps may not have more than 100 shareholders; LLCs are unlimited. S-Corps are not allowed to have non-U.S. citizens as owners; LLCs can. S-Corps cannot be owned by other companies; LLCs can.

**Formalities** – S-Corps must adhere to certain formalities in order to retain their legal corporate status. LLCs do not have to follow such formalities.

**Transfer of Ownership** - Corporate shareholders may freely transfer their ownership shares. LLCs members usually need approval from the other members.

**Management** – S-Corps have centralized management. An LLC may be managed by its members, in which case it is similar to a partnership. Or it may be managed by appointed managers.

**Allocation of Income** – Income from an S-Corp must be allocated to its shareholders based on stock ownership. LLCs may specially allocate income and losses to its members irrespective of ownership percentage.

**Self-Employment Tax** - S-Corps are not subject to any self-employment tax on their share of income from the corporation. The law is not clear on this issue for LLC members.

### SIMILARITIES

**Formation** – Both entities are separate legal entities created under state law by filing Articles of Incorporation/Organization with Secretary of State.

**Liability** – Both entities provide strong liability protection for owners, meaning the owners are generally not liable for the debt/liabilities of the business.

**Taxation** – Both entities are pass-through entities. The income or loss from the business is passed through to the individual owners who in turn pay any income tax due.

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# LEARNING ABOUT STOCK

## NOTE:

The rights that are afforded to individual shareholders can vary greatly from state to state, from company to company.

When any of the individual shareholders purchases stock via cash or property, this represents equity in the company and does not require repayment.

Where the corporation has fewer than 35 shareholders, a simple, inexpensive model for the structure of corporate stock may be most appropriate. Most small businesses and new corporations issue a single class of common stock in which all shares hold equal value. Each share allows the right to vote on important issues usually determined as one vote per share.

In addition, a savvy business owner will recognize that authorizing a number of shares that will qualify for the minimum annual state filing fee is often a wise, money-saving choice.

After the corporation begins to thrive and is then considering issuing shares to the public, modifying the stock structure can be accomplished by filing an amendment to the articles of incorporation with the state at any time.

## A NOTE ABOUT STOCK

While many advisors use a rule of thumb that says the stock issued should equal 3-6 months of a businesses operating expenses, this isn't necessarily the best for all start ups. Each corporation should look at their own situation and future needs for the stock, and if necessary get appropriate financial and/or legal input.

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# DESIGNATE CORPORATE DIRECTORS

## NOTE:

LLCs are not required to elect this management group.

The Board of Directors is essentially the management body for the corporation. The board establishes all business policies and approves major contracts and undertakings.

## ADVANCED:

Most states now permit single member boards, while others require a minimum of three members.  
An odd number of members reduces the chance of deadlock on important decisions.

Directors must act collectively pursuant to a vote.

The Board of Directors must meet on a regular basis. Monthly or quarterly is acceptable, however, the meeting **MUST** occur at least once per year.

Board members must be trustworthy as they have a duty to act in the best interests of the corporation and cannot put their own interests ahead of corporate interests and concerns.

Board members must be prudent and not act negligently.

Meetings must observe corporate formalities.

## CHOOSING THE MEMBERS OF THE BOARD

Ordinary business practices are carried out by the Officers and employees of the corporation under the directives and supervision of the Board of Directors.

When considering which individuals shall serve on your corporation's Board of Directors, please consider the following:

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# DESIGNATE A REGISTERED AGENT

## NOTE:

In most states you may act as your own registered agent.

A registered agent is an individual or entity that is designated to accept official tax and legal documents on behalf of your business.

## ADVANCED:

Most states now permit single member boards, while others require a minimum of three members.

An odd number of members reduces the chance of deadlock on important decisions.

All states require your business to maintain a registered agent to accept legal and official documents on behalf of your business. Plus, a registered agent allows you a certain amount of protection between you and the public. Benefits include:

- Personal information stays private
- The Agents information becomes public
- Corporate Address can be changed with ease
- Compliance with Registered Agent statutes

## PURPOSE OF A REGISTERED AGENT

A Registered Agent acts as the representative for accepting Service of Process served upon the company within the jurisdiction of any state where the company conducts business. Service of Process is broadly construed to include any legal proceeding, legal notice, or official government communication presented to the company while it is within the jurisdiction of a state.

## FAILING TO DESIGNATE A REGISTERED AGENT

The failure, to register and designate a registered agent, may foreclose or hinder the company's ability to legally enter into contracts and gain access to the state courts. Moreover, it may subject the company to monetary, civil, and possibly criminal sanctions. Also, failure to maintain a registered agent may cause your company to fall out of "good standing" within the state. This will subject your license to do business within a state to forfeiture, with monetary penalties assessed to reinstate your company to a "good standing" again.

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# FILE THE ARTICLES OF INCORPORATION

## NOTE:

Be sure to file your all of your documents each with the correct offices. It varies from state to state.

Similar to a birth certificate, a corporation's comes into existence after the filing of a document entitled "Articles of Incorporation / Organization".

## PRIVACY TIP

The Articles of Incorporation are public documents and for this reason many corporations minimize the amount of information in the Articles putting more sensitive items in the bylaws or minutes.

Once the Articles of Incorporation are filed with the appropriate state offices the corporation comes into existence. The level of complexity for a corporation's Articles of Incorporation can range from very simple to extremely complex.

## WHAT INFORMATION IS REQUIRED?

Generally, most jurisdictions require Articles of Incorporation to contain, at a minimum, the following information:

- Corporate Name which must include the correct indicators and not include prohibited words which vary by state.
- Name and physical address of the Registered Agent.
- Name and address of each incorporator.
- The corporation's business address.
- The number of shares the corporation is authorized to issue and, in most states, the par value per share.

There could be other state specific requirements that must be included along with the Articles of Incorporation such as:

- Duration of the corporation
- Industrial Classifications
- Close corporation language if applicable

Be sure to check the forms from the individual state for the requirements.

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# FIRST MEETING OF BOARD OF DIRECTORS

## NOTE:

Note, in many states, this "Board" may be comprised of one person.

The first meeting of the Board of Directors establishes many of the company's initial corporate policies and will set the tone for the company.

## ACCOUNTANTS:

Meetings don't always have to be formal. Since in many corporations individuals will wear many hats they will probably be working together daily.

Although the recorded minutes and decisions of the meeting generally do not need to be filed with state offices, it is important that the decisions made in this meeting be documented and kept with the company's corporate records. Some small corporations skip the actual meeting, choosing instead to formalize actions through consent resolutions. It is important to consider the value in bringing all of your decision makers together at this key time.

## WHAT SHOULD BE DISCUSSED?

During initial organizational meeting, the Board of Directors will discuss and resolve the following matters:

- Election of directors by the incorporator
- Appointment of officers by directors
- Adopt bylaws
- Approve stock forms and issue shares
- Adopt a corporate seal
- Designate a banking institution
- Authorization to prepare and submit any required tax election forms

Any additional items that relate to the start up activities of the company such as:

- Agreements to borrow money
- Agreements to lend money
- Significant start up expenditures
- Employment agreements
- Applying to do business in another state

This organizational meeting will also generally ratify and authorize any prior acts taken to get the company fully up and running.

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# OPERATE YOUR CORPORATION

## NOTE:

LLCs are not required to elect this management group.

## ADVANCED

Because a corporation is considered to be a separate, legal entity, separate and apart from its owners, directors, officers, and employees, certain formalities must be observed in order to maintain this Good Standing and thus retain a strong "Corporate Shield".

## CORPORATE FORMALITIES CHECKLIST

Proper observance of corporate formalities and record keeping requirements is critical to the continued good standing of a corporation. The checklist below presents issues to consider when observing corporate formalities.

- Are meetings of the Board of Directors regularly scheduled and conducted?
- Are Shareholder meetings regularly scheduled and conducted?
- Do such meetings adequately cover the business that is being conducted in the corporation?
- Do meetings provide Shareholders and / or Directors with agendas and goals along with the necessary background information necessary to make an informed decision?
- Are these materials provided to the Shareholders and/or Directors in advance of the meeting?
- Do Directors have a reasonable opportunity to add items of concern to the meeting's agenda before the Directors meet?
- Are agenda items acted upon; or, rather, are they postponed and advanced to future meetings?
- Does the meeting provide adequate time for Board Members or Shareholders to discuss each agenda item?
- Is each Director and/or Shareholder afforded a reasonable opportunity to discuss each issue?
- Are Corporate Minutes of each meeting accurately recorded by the Secretary?
- Does the Board meet with and/or receive direct reports from legal counsel, accountants, or other outside advisors?
- Are these reports included with the Corporate Minutes?
- Are the Corporate Minutes of Board meetings reviewed at subsequent meetings?
- Are the Corporate Minutes amended or corrected for clarity and accuracy?
- Are the dissents to the Corporate Minutes duly recorded?
- Do Board Meetings adequately cover substantive policy issues involving the corporation, rather than only trivial or administrative detail?
- Is the Board Chairperson effective in conducting Board meetings?

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# OPERATE YOUR CORPORATION

## NOTE:

LLCs are not required to elect this management group.

## CORPORATE SHIELD

Every corporation is considered to be a separate, legal entity, separate and apart from its owners, directors, officers, and employees. Therefore there are certain formalities must be observed in order to maintain this Good Standing and thus retain a strong "Corporate Shield".

## CORPORATE FORMALITIES CHECKLIST

The Model Business Corporation Act (MBCA) says that you must maintain the following records in an organized manner in a safe and secure location:

- Articles of Incorporation
- Articles of Amendment
- Bylaws of the corporation
- Board resolutions regarding stock
- Minutes of shareholder meeting and consent resolutions
- All written communications to corporate shareholders within (generally) the last three years.
- An alphabetical list of shareholders by class or series of shares
- A list of current board and officer names and addresses
- The most recent Annual Report or Statement of Information

Also a good business practice is keeping corporate accounting records in a readily available state. The IRS could request:

- Tax Returns
- Sales Records
- Detailed Financial Information
- Communications records
- Personnel records
- All contract and agreements

## SOME FINAL THINGS TO CONSIDER

A "Corporate/LLC Kit" is a great way to get all of the official documents organized and to maintain them in a professional and presentable manner.

## FEDERAL EIN

An EIN is a federal identification number issued by the IRS to identify a business entity. It is also known as a Tax ID number. Legally, you are required to identify your business with one of two numbers: either your social security number or an EIN.

## BUSINESS LICENSES

Depending on your type of business and location, you may be required to obtain multiple business licenses in order to comply with governmental regulations. Failure to register appropriately can result in penalties and prevent you from operating your business.

## DBA

DBA stands for "doing business as" and is an official registration of your business name. A DBA makes it easy to:

- Open a bank account and collect payments
- Start publishing and advertising
- Discourage others from using your name

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# ABOUT MYCORPORATION

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## **WHAT MAKES MYCORPORATION DIFFERENT?**

Our staff of filing experts truly care about the success of your small business and are excited to help new businesses form and grow. At MyCorporation, we pride ourselves in being an active part of the community. We thank you for visiting our site, and look forward to the opportunity to assist you and your business whenever you need it.

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