CHAPTER 1

Why Should I Incorporate My Business?

The short answer is: It depends on circumstances. Here's one in which the corporation form of doing business helped cut the tax bite.

Many entrepreneurs start their businesses by sliding into them. Paul did that. Three years ago, he started keeping a few plumbing tools and fittings in the back of his minivan, from which he did plumbing repairs for friends and neighbors on weekends. His reputation for quality work spread, so he was soon able to chuck his day job. (It helped that his wife, Yvonne, pulled down $100,000 per year as an advertising rep.) Life was simple then, for he just drove to customers' homes, made plumbing repairs, wrote up bills, and collected his money. Because he took care of his customers (and even responded to emergencies at 3 A.M.), his business grew so that he had to hire two more plumbers, two helpers, and buy three trucks for the crews. Along with the increasing business and higher profits came various hassles, such as license requirements in surrounding towns, satisfying tax collectors and other negative manifestations of our complex society, and hiring an accountant to keep track of his expanding empire.

"You probably could save some taxes by incorporating," said Amos, his accountant, as he handed Paul his tax return on April 15.

"Later," said Paul. "It sounds like more hassle, and more hassle is what I don't need."

Then in the fall of that year, Paul ran into an unfortunate situation with a customer. One of his recently hired plumbers did not stick around and check his work as he should have. The consequence was that the leak in the bathroom, which was to be repaired, apparently was not. The resulting trickle of water soaked the carpet in the hallway, requiring that it be replaced at a cost of $500. Paul paid that out of his pocket, as it was below the deductible amount on his liability insurance policy.

Then, a few months later, Paul received a letter from an attorney representing this customer. She was claiming that she had slipped on the wet carpet before it was replaced and suffered extensive injuries. She was seeking $10 million from Paul.

Fortunately, the company that insured Paul was able to settle the case for $1,000, but in the process, Paul spent many sleepless nights. Again, he heard the same thing from Larry, his lawyer, that he had heard from his accountant: "You should consider incorporating."

"What if that customer had prevailed and you had found yourself facing a judgment for $10 million?" Larry asked. "Your liability insurance policy covers only $1 million. You could lose not only your trucks and other business property, but much of your personal assets, such as investment accounts, your boat, and other items. I can't guarantee it, but if your plumbing business did operate as a corporation, it's very likely that you would be able to keep your personal assets, although the business assets would be gone." Paul listened to that advice with increasing interest but still took no action.

We will come back to Paul and his plumbing business later, after we have discussed the points that his story illustrates thus far.

What a Corporation Is and What It Is Not

Essentially, a corporation is created as a separate entity by a government, such as state, federal, and most foreign governments. Corporations can be formed for a variety of purposes, the most common of which is conducting a profit-making business. They can also be formed as vehicles for conducting nonprofit activities such as charitable organizations, social clubs, political activities, and so on. For the most part, this book is devoted to a discussion of corporations that are in business to earn a profit for their owners, but nonprofit charitable corporations are covered briefly in Chapter 6. Almost all of these corporations are created by one of the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, or Guam. Most foreign governments also provide for the formation of corporations. If you would like a more formal definition of a corporation, here is one:

> CORPORATION A fictitious legal entity/person which has rights and duties independent of the rights and duties of real persons and which is legally authorized to act in its own name through duly appointed

> agents. It is owned by shareholders. Usually created under the authority of state law (*Bouvier's Law Dictionary 1865*).

For many of us, the term *corporation* conjures up images of behemoths such as Microsoft, Wal-Mart, and General Motors. But those corporations have not always been the organizations they are today with thousands of shareholders. The first two started as enterprises owned by one or two people and the third one is a combination of several small companies started in garages by one or two successful dreamers.

Notice that a corporation does *not* exist just because one or a few entrepreneurs hang out a shingle with "Inc." after the name of the business. A corporation exists only by action of the state or other governments just mentioned, as well as the federal government for certain quasi-government purposes.

Who Starts and Who Owns a Corporation?

Corporations come into being because one or more individuals, called *incorporators*, request a state to form a corporation. (The detailed procedure is described in Chapter 6.) The for-profit corporations are owned by stockholders, who may or may not be the same individuals as the incorporators. (The term *stockholders* includes not only individuals but also entities such as other corporations, partnerships, and limited liability companies.) While stockholders share in the hoped-for profits generated by the corporation, nonprofit corporations are not owned by stockholders. The most common use of the latter corporations is for charitable purposes, in which case the theory is that they are owned by the public for the public good.

Reasons to Incorporate Your Business

There are several reasons to incorporate your business. Some entrepreneurs are primarily concerned with limiting their liability for business debts, while others find tax reasons to be the primary motive for incorporating.

Limiting Your Liability for Business Debts

Perhaps the biggest fear of entrepreneurs is that, despite their best efforts, the business will not succeed. If the venture results in failure, that is generally accompanied by excessive debts. The result, for a sole proprietor, is often bankruptcy. That means the entrepreneur faces losing not only business assets, such as equipment and inventory, but personal assets such as savings accounts, securities, vehicles, rental real estate, and possibly his or her residence. (The answer to the question of whether bankruptcy involves loss of residence and certain other assets varies with the laws of each state.)

If, however, you operate your business as a corporation, that may protect you against having to part with personal assets to meet business debts. Remember, a corporation is an entity separate from its owners (stockholders). If I become a spendthrift and run up large bills I cannot pay, you are not responsible for paying my bills (unless you have guaranteed them). Generally, you are not responsible for paying the debts of a corporation, even if you are the sole stockholder, as a corporation is treated as another person. So, if the corporation fails in its business, the creditors of that incorporated business could cause the assets of the corporation to be sold so its debts could be paid, but, with some exceptions, it could not cause your personal assets to be sold to pay corporate debts. (This protection provided by a corporation is often called the *corporate veil*.)

If you buy stock in Ford Motor Company and, due to poor design, someone is injured in one of their products, that injured someone may well collect damages from Ford, but his or her chances of collecting from you as a stockholder are nil, even if the judgment were so large that Ford went bankrupt.

Why do states confer this limited liability on corporations? We have to go back to the 1600s to answer that question. It was the desire of monarchs to increase the economic activity in their kingdoms that prompted the concept of limited liability for business ventures. Monarchs had other uses for the tax revenues, such as fighting wars with neighboring kingdoms. They needed investment money from the rising merchant class to finance such operations as the Hudson's Bay Company, the East India Company, and similar entities. But merchants would not invest because

The IRS and the Corporate Veil

While the IRS normally can look only to the assets of the corporation to collect corporation income taxes, withheld payroll taxes are a different story. Any individual who is responsible for paying over those withheld taxes to the IRS and fails to do so can be held responsible for those taxes, and the IRS can collect by levying on that individual's personal assets. While the responsible individual of a closely held corporation is usually a stockholder, a nonstockholder individual, such as a bookkeeper, could be the responsible person and end up in serious financial straits.

of the high risk of losing their capital and becoming destitute. So the kings and queens promised that the investors could not lose any more money than what they had invested in the exploration and trading venture. Beyond that, the creditors of the venture were out of luck. That is, the investors were promised *limited liability*.

Indeed, without the limited liability of corporations, we could not have the amassing of funds that enables capital-hungry industries, such as railroads, airlines, and many industries, to operate.

Liability of Stockholders Who Are Also Employees of Small Corporations. As we read news accounts of both civil and criminal actions against owners of businesses that operate as corporations, we may arrive at the conclusion that a corporation does not provide a bulletproof corporate veil. Indeed, lawyers for creditors of a corporation will attempt, in any way they can, to pierce the corporate veil. On what basis do they attempt this?

First, they will attempt to prove that the business was not operating as a corporation because the correct procedures to set up a corporation were not followed. For instance, if you fail to register your corporation with the state, you do not have a corporation, and the attorney for your creditors has an easy task in grabbing your personal boat, airplane, and Lamborghini with which to pay the debts of your business. Also, most states require that a corporation hold at least an annual meeting of stockholders and that the minutes of that meeting be recorded. (As a minimum, the minutes should include the annual election of officers, authorization of officer salaries, authorization of distributions to stockholders, and whatever else may be required by the rules of the particular state.)

Second, even though the corporation is properly registered and performing as required, the creditors can claim that you operated outside the corporation. That is, if you write business letters on your personal stationery and sign the letters as an individual, that would be operating outside the corporation. This is particularly important when you sign order blanks that are made out to you personally, rather than to the corporation.

The third way the corporate veil may be pierced is if actions you took personally were illegal, fraudulent, or even with intent to commit fraud. While the most notable of this type of situation involves major corporations, such as Enron, it also applies to small one-owner corporations. While a corporation, as an abstract entity, cannot be put into jail, the corporate officer who directed the illegal act well could spend hard time in some prison.

So, while the corporate veil is not pierced frequently, if you are a *stockholder/employee* of a corporation, your stock holdings are significant, and you are a decision maker. Take pains to dot the *i*'s in corporate documents.

A *stockholder/employee* is a stockholder of the corporation who also is an employee of the corporation. The conventional use of the term appears to assume that the stockholder/employee is in a management position and owns a significant amount of stock. In sections of the Internal Revenue Code, the law regards ownership of more than 2 percent of the outstanding stock as significant.

Two other instances of piercing the corporate veil should be mentioned. One is the situation in which a stockholder voluntarily subjects himself or herself to be exposed to personal liability. The best example of that is a bank loan to the corporation wherein the bank requires that the major stockholder(s) sign a personal guarantee of the loan. The other situation is one in which professionals, such as architects, engineers, accountants, and so on, conduct their professional practice within a corporation. While the corporate form should shield the professional from normal business liabilities, it will not protect against liability for professional malpractice. The professionals must find other ways to protect their assets, such as professional liability insurance or holding assets jointly with spouses or other family members. (The details of the latter are beyond the scope of this book and definitely demand competent legal advice.)

Save Payroll Cash by Incorporating

If you are not yet at the point of having to hire experienced executives and managers to help you run your business, you may arrive at that point soon, we hope. It is difficult to hire these people when you are competing with large corporations and the high salaries they pay for effective managers. But you can compete, if you hire people with some entrepreneurial leanings and reward them with an interest in a piece of your business. That is not to say you should give away your business, but stock and stock options used properly can reduce a need for large cash bundles with which to pay executives. Admittedly, you may not be at this point yet, but when the time comes that you must hire that first executive, you will probably be way too busy and submerged in management tasks to take the time to set up a corporation.

Tax Savings

With proper planning, a corporation can generate a lower tax bill for your enterprise. As is true of any question that deals with the intricacies of the Internal Revenue Code, explanation of an answer will take many words—enough words to be a separate chapter (Chapter 2).

Prestige of a Corporation

Although most of us now realize that the process of incorporation costs very little, and in many cases can be a do-it-yourself project, there is still an air of stability and continuity that is attached to a corporation. If you have paid a sole proprietor for an annual furnace maintenance contract, and he suddenly dies, will someone else perform the maintenance? Maybe the answer is no. If the same business were incorporated, the answer could still be no. However, the fact that it is incorporated makes it more likely that your furnace man paid some attention to planning. That means he probably has provided the means by which his corporation will continue to provide services and collect income for the sake of his heirs.

Ease of Transferring Ownership

Transferring a sole proprietorship from one individual to another is an impossibility, inasmuch as a sole proprietorship is the individual himself or herself. The only way a sole proprietorship business can be bought and sold is by the buyer purchasing the assets of the sole proprietorship. This creates a bookkeeping nightmare for the selling sole proprietor when he or she computes the income tax bill from the sale, and it leaves open the question of the value of goodwill, patents, and trade names that the buyer would want to purchase along with the tangible assets. On the other hand, if the business operates as a corporation, transfer is a simple sale and purchase of the common stock. Also, the gain to the seller should be all long-term capital gain (taxed at a lower rate). It is also much easier to sell or give (as to an adult child) a fraction of the business if it operates as a corporation.

Transferring a partnership interest can be even more complicated. Depending on state law, attempting to transfer more than one-half of a partnership interest actually may cause a partnership to cease existence, and that requires the formation of a new partnership. Obviously, wading through this is going to cost some expensive professional accounting and legal help.

Reasons *Not* to Incorporate Your Business

Many small businesses are sole proprietorships by default. That is, because they have never taken the necessary steps to become a corporation, nor have they taken in a partner, they have always remained a sole proprietor. They are sole proprietors by default. Besides this inertia, there are several reasons offered by people in business for not changing to this other form of conducting business.

Corporations and Other Business Forms Are Too Complicated

Yes, corporations can be complex, but a simple corporation owned by one individual stockholder requires little formality. If there are two or more

Sole proprietorships are also informally known by the initials DBA, which stand for "doing business as," followed by the business name. Because *sole proprietorship* is the term used in legal and tax documents, it is the term used throughout this book. Also, the use of DBA can lead to confusion, as partnerships, corporations, and limited liability companies can also "do business as" some name other than the name of the entity. Example: "The Bicycle Shop, Inc., doing business as Two-wheeled Speed Demons."

owners (stockholders) of the corporation, the formalities are greater, but if the owners did not create a corporation, they would have a partnership, and those animals can be even more complicated than a corporation.

However, keeping it simple can be a valid reason to do business as a sole proprietorship in certain limited and specific circumstances. If the business is tiny, the profits are small, and the proprietor has no other assets than the business assets, going the sole proprietor route may make sense. (In essence, having no assets but those used in the business makes one *judgment proof*. That is, it would not be worthwhile for a creditor to go through the expense of hiring a lawyer and paying court fees when the business owner has nothing that can be turned into money.)

Corporations Cost Too Much to Set Up and Operate

Yes, there is a cost, in both time and money, in operating as a corporation. Operating a corporation entails more income tax forms, more records to keep, and more planning of financial transactions to keep taxes at a minimum. However, if you do have personal assets that are not used for business purposes, such as stocks, bonds, mutual funds, residence, vacation cottage, boat, airplane, jewelry, art works, and so on, then you need to do a little arithmetic. Make a list of all of your nonbusiness assets and for each assign a replacement value. (That is what it would cost you to buy those items at current prices.) Add those values. Then list all mortgages and loans that are secured by those assets, total them, and subtract that total from the total of the asset replacement values. The result is the net replacement value of your assets. Let us say that number is $300,000. Then, ask your lawyer and your accountant how much their fees will increase if you change to the corporate form. Assume their answers total an increase of $3,000. That means that you would be paying $3,000 a year to protect assets with the net value of $300,000. That's only 1 percent of the asset value. Isn't that a nominal fee to protect those assets?

My Business Is Too Small to Incorporate

It's difficult to find any validity in this argument against incorporating. In the first place, the state laws and the bureaucracy that creates corporations do not specify any minimum size of the enterprise. If you wanted to incorporate your 10-year-old daughter's lemonade stand, that could be done. Remember, it's the value of your nonbusiness assets, rather than the size of your business that makes incorporation and the limited liability attractive.

A Corporate Form Does Not Entirely Protect Professionals

This is true. The corporate veil generally will not be effective protection against liability for leaving the sponge in the incision, designing a bridge that falls down, giving grossly incorrect advice, or other acts of malpractice. However, the client who slips on a banana peel or is folded in two by the collapsing waiting room chair is not harmed by professional malpractice, but by corporate negligence. That is, it is the corporation, not the individual owners, who is liable. In other words, the corporate form generally should protect your personal assets in the banana peel situations. (Do not assume, however, that the lawyer for the folded-up former client will not try to collect from you. His or her position could be that you, as an individual, knew or should have known that the chair was in poor condition and should have rectified the situation.) Will the court rule in favor of the client? We do not know until a court decision is handed down, but the fact that you have set up a corporate veil ups your odds for a ruling favorable to you.