All About Incorporation

Choosing the Right Business Structure

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Introduction

Deciding on a business entity type is one of the most important decisions for a business. It affects everything from tax status to ownership, to aspects of day-to-day operation to even how people perceive your business from the outside. And yet, it is a decision that many small business owners don't make—or, rather, don't realize they are making.

If you have started a business, then you also have a business structure. The question is whether that structure is one that you chose after considering all your options or if it is the default selection, made for you because you've never taken formal steps to choose an entity type.

There are many possible entity types. The most important to know are:

- Sole proprietorship
- General partnership
- LLC (Limited Liability Company)
- Corporation (C or S)

The term "incorporation" is used to describe the process where a business chooses to form as either a corporation or LLC. Companies that choose a formal business structure, identified by the simple letters "LLC" or "Inc." after their name, gain more credibility with customers, and have an easier time getting financing.

In this white paper, we'll break down the key features of each business structure, and compare the entity types on important factors. We'll also look at some of the most important considerations you'll face if you decide to incorporate. With that information in hand, you'll be armed with what you need to choose the right structure for your business.

The Entity Types

Sole Proprietorships

The sole proprietorship is the default entity type for a business with one owner. If you start a business by yourself and don't take any steps to adopt a formal business structure, you have a sole proprietorship. It's the simplest business entity for an entrepreneur to operate, since there are no requirements to form or maintain a sole proprietorship. But at the same time, the sole proprietorship is extremely limited in its protections, and does not have the credibility that a more formal entity type confers. A sole proprietorship is fundamentally connected to its owner, and that inseparability is at the heart of the business's strengths and weaknesses.

Pros

- **Easy to create and maintain**. There is no need to formally file with the state, and no required maintenance activities. Be aware, however, that you still have to follow all local requirements. Contact your city and county officials to find out if there are additional requirements you need to know about.

- **Pass-through taxation**. The profits from the business pass through to the owner's tax return; there is no separate filing for the business itself.

Cons

- **Unlimited liability**. Any losses or obligations incurred by the business are inseparable from the owner as an individual. If creditors or lawyers come after the business, they have unlimited access to the owner's personal assets.
- **Limited life**. A sole proprietorship is defined solely by the owner; the business cannot survive the owner's death, nor can the owner sell the business for someone else to continue. The sole proprietorship only lasts as long as the founder is running it. Any "transfer" of the business would require transferring assets associated with the company piece by piece, creating what is actually an entirely new business.

General Partnerships

Like the sole proprietorship, the general partnership is a default business entity. In this case, a general partnership is automatically formed any time two or more people form a business together. There is no paperwork required to form a partnership; all it takes is two people (or three, or four, or…) agreeing among themselves to start a business together. While it is highly recommended for business owners to draft a partnership agreement outlining important details of the business's organization, operation, and partner roles, there is no legal requirement.

As with the sole proprietorship, a general partnership is tied to the partners, for better or for worse.

Pros

- **Easy to create and maintain.** There is no need to formally file with the state, and most states have no required maintenance activities. Be aware, however, that you still have to follow all local requirements. Contact your city and county officials to find out if there are additional requirements you need to know about.
- **Pass-through taxation.** The profits from the business pass through to the owners' personal tax returns; there is no separate filing for the business itself.

Cons

- **Unlimited liability.** Any losses or obligations incurred by the business are inseparable from the partners as individuals. If creditors or lawyers come after the business, they have unlimited access to the partners' personal assets.
- **Limited life.** A general partnership is defined by the partners; absent a partnership agreement spelling out survival procedures, the partnership is terminated when any one of the partners dies or leaves the business.
- **Instability.** Because there are no requirements for organizing and planning details of a partnership, many partnerships ignore them, and get by on an oral agreement and a handshake (if that). This can lead to all kinds of conflicts between the partners, with no legal agreement to settle the dispute.

LLC

An LLC (Limited Liability Company) is something of a hybrid, combining features of a corporation with features of the simpler business entity types. While the LLC is a very new form of business, it is increasingly popular, and is an option for both single- and multi-owner businesses. As a formal business structure, an LLC requires registration with the state in exchange for the various protections and flexibilities not offered to the simple structures. A feature of the LLC is that its owner(s) elect whether to be treated like a sole proprietorship, partnership, or corporation for tax purposes while still receiving LLC protection.

Pros

- **Flexible ownership.** While a sole proprietorship can only be owned by its founder, and a general partnership by default is limited to its founding partners, an LLC provides more flexibility for owners. You can just as easily form a single-member LLC as a multi-owner LLC, and ownership can be transferred from one person to another (although not as easily as with a corporation) with the approval of the other members. The business has a life of its own, and is separate from the lifespan and/or involvement of its founder(s).
- **Flexible tax preparation.** LLCs elect their tax status: whether they will be taxed like corporations, or as a pass-through entity like the sole proprietorship or general partnership. If the LLC elects the pass-through option, then all profits are taxed on the individual LLC member returns, not at the company level.

Note that multi-owner LLCs must still file an informational tax return, even though the profits are not taxed at that level.

- **Limited liability.** As the name suggests, LLCs offer limited liability to their members. As long as the LLC's members follow procedures to keep their business and personal finances separate, members' personal assets are protected from creditors and lawyers. Only the business's assets are at risk.

Cons

- **Formation and maintenance requirements.** While the simpler entities are formed automatically, an LLC requires the business owner(s) to file documents with the state (usually called either a Certificate of Organization or the Articles of Organization) and pay a filing fee. Each year, the LLC will also have to pay a fee or tax (depending on the state and details of the business) to maintain the entity.
- **Compliance procedures.** In order to receive the limited liability protection, members must be careful to keep their personal assets separate from the company assets. If the business's assets are under attack and investigation reveals that there has not been a strict wall of separation, then the corporate veil can be pierced, and liability protection lost.
- **No stock.** Unlike a corporation, an LLC cannot issue stock to raise capital by attracting investors.

C Corporation

A C Corporation (also referred to simply as a corporation) is the most common corporate structure, especially for large companies. Like the LLC, a corporation must be created by the state, and offers protection to its owners, while also incurring obligations from the business to the state in the form of compliance and annual maintenance activities. The C Corporation is especially notable for its unique tax requirements, with double taxation on corporate profits.

Pros

- **Limited liability.** Corporations offer limited liability to their owners. Shareholders are only liable to the amount of their investment in the company; personal assets of shareholders are protected.
- **Issuing stock.** Corporations can issue stock to raise money from investors. The company can have an unlimited number of owners, and ownership is easily transferred by selling shares of stock. Because ownership is defined by shareholders, the business has unlimited life, continuing to exist and run no matter what happens to any individual owner, director, or even founder. Corporations can also have multiple classes of stock, with more voting rights for certain classes.

Cons

- **Double taxation.** Corporate profits are subject to double taxation. Unlike the pass-through entities, corporations are taxed as a separate entity, subject to corporate income tax. Then if the corporation distributes those profits as dividends, shareholders pay a second tax when they report the income on their personal returns.
- **Formation, maintenance, and compliance requirements.** Unlike the simpler entity types, corporations must be created by the state, by filing a document known as either a Certificate of Incorporation or the Articles of Incorporation and paying a filing fee. Each year the corporation must pay a fee to maintain its status, and file annual reports. There are also important compliance rules, including mandatory director and shareholder meetings, with rules about notification and documentation, corporate minutes requirements, and procedures for how shareholders, directors, and officers operate the company. If procedures are not followed, then the corporation runs the risk of piercing the corporate veil.

S Corporation

The S Corporation is a special type of corporation that avoids the double taxation problem of a C Corporation, but in exchange for other strict regulations. The S Corporation designation must be approved in writing by all shareholders, and filed with the state.

Pros

- **Pass-through taxation.** The profits from the S Corporation pass through to the shareholders with no corporate income tax. All taxes are paid at the individual level on the shareholders' personal returns.
- **Limited liability.** S Corporations offer protection to their shareholders for the business's debts and liabilities. Shareholders are only liable to the amount of their investment in the company; personal assets of shareholders are protected.
- **Selling stock.** S Corporations can sell shares of the company's stock to raise capital. Because ownership is defined by shareholders, the business has unlimited life, continuing to exist and run no matter what happens to any individual owner, director, or even founder.

Cons

- **Formation, maintenance, and compliance requirements.** Unlike the simpler entity types, S Corporations must be created by the state, by filing a document known as either a Certificate of Incorporation or the Articles of Incorporation and paying a filing fee. The S Corporation differentiates itself from the C Corporation by also filing Form 2553 with the IRS electing the S Corporation designation. Each year the corporation must pay a fee to maintain its status, and file annual reports.

There are also important compliance rules, including mandatory director and shareholder meetings, with rules about notification and documentation, corporate minutes requirements, and procedures for how shareholders, directors, and officers operate the company. If procedures are not followed, then the corporation runs the risk of piercing the corporate veil.

- **Ownership restrictions.** While the S Corporation can issue any number of shares of stock, divided any number of ways among the shareholders, there is a maximum of 100 total shareholders permitted by law. And those shareholders, 100 or fewer, must all be U.S. citizens or permanent residents of the United States. Estates and certain qualified trusts are also permitted; all others are excluded. And unlike C Corporations, S Corporations may only issue one class of stock.

Critical Factors: Comparing Entities

Liability

One of the most important factors in favor of a formal business structure is the need to limit your personal liability. Are your personal assets at risk when you incur debts and liabilities in your business? Under the default entity types, sole proprietorships and general partnerships, they are. Under those business structures, there is no separation between the business and its owner(s). Everything from bank accounts to homes to all kinds of personal assets are fair game for the business's creditors or legal plaintiffs.

A formal business structure transforms the business into a separate legal entity that is distinct from its owner(s). The business has assets of its own that are considered separate from the owner's assets. The LLC entity is matter-of-factly named after this feature of limited liability, and both C and S Corporations also protect their shareholders from liability for the company's obligations. Protecting assets is perhaps the number one point in favor of incorporation.

It is critically important, however, that a corporation or LLC follow all compliance procedures to protect shareholders and members. If personal and business assets are allowed to mingle, or corporate directors ignore rules that are designed to separate the business from individual shareholders, a court may decide to pierce the corporate veil, a term for deciding to remove the limits on liability for individual members or shareholders.

Tax

Taxation is a distinguishing characteristic separating the C Corporation from the other entity types. Sole proprietorships, general partnerships, and S Corporations undergo pass-through taxation. That means that all profits are taxed at the individual level for the owner, partner, or shareholder. The business itself does not pay any taxes, so there is no corporate tax rate.

For a C Corporation, however, profits are subject to what is referred to as double taxation. All corporate profits are taxed first under the corporate tax rate (at both the federal and state levels).

Then, if the corporation distributes its profits as a dividend to shareholders, those shareholders must also pay taxes on those dividends on their personal returns under the individual income tax rates. For a small corporation, the double taxation issue can be minimized, even though it's not entirely avoided, if shareholders work for the company and take the bulk of their earnings in the form of salary rather than dividends.

LLCs are in a special category because they have the option to choose how they would like to be taxed: whether the company elects to be taxed as a pass-through entity or subject to corporate tax on profits. Most LLCs opt for pass-through taxation. The LLC must still file an informational tax return at the company level, even if it pays no corporate taxes.

Formation and Maintenance

One of the reason most businesses are sole proprietorships or general partnerships is because you don't have to do anything to create them. If you start a business and don't give a second thought to your business structure, then you are automatically put into one of those categories, depending on whether there is one or more owners. Formation is easy, and there are very few (if any) requirements for maintaining the entity. Be sure to follow local rules at the city and county level, with permits and registrations, get an Employer Identification Number from the IRS if you hire employees, and register your business name under a DBA if you want to do business under a company name instead of your personal name (or series of last names, in a partnership)—all requirements you will need to meet no matter what business structure you decide on.

Forming an LLC or Corporation requires filing with the state. An LLC requires a document called, variously, either the Certificate of Organization or the Articles of Organization, plus a filing fee that varies from state to state (from under $100 in some states to a few hundred dollars in other states). A corporation must file a Certificate of Incorporation or Articles of Incorporation, and pay a comparable filing fee. LLCs and corporations must pay annual fees to maintain their status, and file required annual reports. You can choose to either handle all this paperwork yourself, or pay an incorporation services provider to take care of creating and maintaining your business's legal requirements.

Corporations must also follow requirements for holding annual director and shareholder meetings; notifying shareholders about those meetings; recording minutes of all meetings; subjecting important decisions to shareholder vote; and more. The benefits of incorporation are contingent on following these procedures.

Ownership

The ownership of a sole proprietorship or general partnership is clear and simple: they are "owned" by and, more accurately, inseparable from their founder(s). A sole proprietorship or general partnership is not a separate entity that can be sold or transferred to a different owner. A sole proprietorship ceases to exist without its founder, and a general partnership is, by default, dissolved if even one of its members dies or otherwise leaves the business. A partnership can, however, set up rules for maintaining the entity in a partnership agreement.

An LLC or corporation (C- or S-type) is different, in that it is a separate entity that lives independently of its founder or owners. The LLC is owned by its members, whether it is a single-member LLC or a multi-member LLC. Ownership can be transferred with the approval of the members, although it’s not quite as simple as it is for a corporation, and the LLC can live on indefinitely.

The corporation is owned by its shareholders, however many there are owning however many shares the corporation may issue. A C Corporation, in particular, can have unlimited owners, buying and selling shares as they choose. There might be multiple classes of shares, with one class getting more voting rights than others.

An S Corporation is likewise owned by its shareholders, but there are restrictions on those shareholders. There can only be a maximum of 100 shareholders at any one time, even though the number of shares is unregulated. And those shareholders must be U.S. citizens or residents of the United States. Estates and certain qualified trusts are also permitted. And all shares must be in a single class; there cannot be a tiered system of shares. These restrictions are part of the tradeoff allowing S Corporations to be taxed as pass-through entities. Both forms of corporation, though, live on indefinitely, owned by their shareholders and not connected to the life or involvement of any individual.

Choosing to Incorporate: State of Incorporation

If you decide to incorporate your business, that's not the end of the line. You have one more big decision to make, and that's where you will incorporate your business. That's right—a corporation does not have to be formed in your home state. Each state has different costs, tax effects, and rules for corporations, making this an important choice.

Stay at Home, or Not?

Fundamentally, you must decide whether to incorporate in the state where the business is physically located (home state incorporation), or incorporate in another state, even if the company doesn't actually conduct business there. The idea is to save money by filing in the most cost-effective state.

However, it's not enough just to look at the filing costs; if you choose to register in another state, you will have to qualify (or register) as a foreign corporation in your home state. Foreign qualification is a process that your corporation must go through to do business in a state other than the one it is registered in; if you are registered in your home state and want to do business in the next state over, you have to qualify as a foreign corporation. But if you are registered in another state from where the business is located, then you will also have to qualify as a foreign corporation just to do business in your home state. Make sure to include all the costs when you are deciding what state to incorporate in.

Here are the most important factors you should consider:

- **State taxes on corporations and LLCs.** Check whether your state imposes additional taxes on foreign corporations, and whether each state levies an income tax, a minimum tax or fee, or a franchise tax on your chosen entity type. Also project your revenue for the next several years, and get estimates of the total income taxes for each state you're considering.
- **Ongoing tax and filing requirements.** Each state has not only the one-time fee to create the entity, but there is also the ongoing cost of maintaining the corporation or LLC. Combine those costs with the cost of qualifying as a foreign corporation to determine the true cost of incorporation.

Nevada & Delaware: The Most Popular States

Have you ever wondered why so many corporations are based in Delaware or Nevada? These are the two most popular states for businesses that choose to incorporate outside of their home state. While both are common choices, they have different advantages that appeal to different business.

Delaware

- Flexible business law
- Court of chancery: business law handled by judges, not juries
- No state corporate income tax if the company does not do business in Delaware (NB: corporations must still pay a franchise tax)
- Advantageous tax rules for complex capitalization structures or large numbers of stock shares

- No personal income tax for residents of other states
- No state taxes for stock shares owned by residents of other states

Nevada

- No state corporate income tax
- No fees on corporate shares
- No personal income tax or franchise tax
- As with any state you might choose to register in, however, you will still have to qualify as a foreign corporation in all the states where you do business, including your home state if you are not physically based in Delaware or Nevada.

Conclusion

Choosing a formal business structure is an important decision for your business, turning the business from an extension of yourself into its own, distinct entity. The credibility boost of putting "LLC" or "Inc." after your company name can have a strong, positive impact on your company's perception. The choice you make will affect your personal liability, tax status, and the ongoing governance of your business. And when you do choose to incorporate, you have all kinds of other choices to make, including the state of incorporation.

But don't be intimidated!

Our GoSmallBiz.com consultants can help answer questions about which entity type is the best fit for your business, and members can find the forms they need to file their LLC or corporation with the state in our Business & Legal Forms Library.

The protections and benefits of this process can well outweigh the obstacles, and getting a good partner in the incorporation process can make it simple. Online incorporation services providers can guide you to one of the best, most important decisions you'll make as a business owner. So let's go make your business official!