

SHOULD YOU INCORPORATE

By Paul A. Rianda, Esq.

One of the most important things you can do to limit your liability for the debts of your business is to set up a limited liability corporation or corporation. Below, I will discuss issues relating to when you should incorporate, what type of entity you should start, where to incorporate and the costs involved. This article is written for the small business owner, where the owners of the entity and the officers of the entity are one in the same, as is the case with most sales agents.

Why Should You Incorporate:

One of the main reasons to set up a corporation or limited liability company is to avoid personal liability for the debts and obligations of the business. Generally, when you do business as a sole proprietor or general partnership, you are liable for the debts and obligations of your business. What this means is that if your business incurs any debts or obligations, such as lease obligations, payments to vendors or the like, you can be held personally liable to pay for those debts. However, if you properly set up and maintain a corporate entity, you can avoid these types of personal obligations.

In order to fully protect yourself through your corporate entity, you need to make sure that you at all times represent yourself as a corporation or a limited liability partnership. To that end, all contracts that you enter into should be entered into by the corporation or limited liability company. The full name of the entity is including the “Inc.” or “LLC” at the end of the name of your company must be used at all times. In addition, the signature line of any obligation should include your full title as an officer or member as appropriate. Your corporate name should also be reflected on all letterhead, marketing materials and other items that will put the world on notice that they are dealing with a corporate entity and not an individual. However, you may not be able to avoid personal liability for all obligations such as lease obligations that generally require a personal guarantee.

What Type of Entity:

For the most part, I recommend that my small business clients do business as a limited liability company. There are a number of reasons for this choice. First, the operating agreement of a limited liability company is much more flexible than typical by-laws of a corporation. A limited liability company operating agreement allows for customization, to the extent that you can put specific terms in the contract to govern the management of the entity, the split of profits and any other particular terms that are specific to your company. In addition, with a limited liability company, there is no requirement for yearly corporate minutes. This avoids the expense of having to pay an attorney to perform corporate maintenance on your company every year or doing it yourself. Finally, you can still take advantage of the “S” Corporation taxation status by making an “S” Corporation election even though it is a limited liability company.

If you prefer a corporation, it is generally more advisable to have an “S” Corporation than a “C” Corporation. “C” Corporations are generally inappropriate for small businesses given that the profits of the corporation are double taxed: once at the corporate level, and once at the personal level.

By making an “S” Corporation election, you can avoid this double taxation and just be taxed as a partnership.

However, an “S” Corporation is in my opinion generally inferior to a limited liability company. There are additional taxes to be paid on an “S” Corporation, limitations on the number and type of shareholders and you have to do yearly corporate minutes as an “S” Corporation. It is fairly common in my practice for me to see individuals who have failed to keep their corporate formalities up to date, such as by failing to document their yearly corporate minutes which could jeopardize the status of their corporation as a separate legal entity. This is not an issue with a limited liability company.

Where to Incorporate:

It is generally better to incorporate in the state in which your business operates. Many people believe that it is more advantageous to incorporate in Delaware. This is rarely the choice of the small corporation. The seemingly advantageous laws regarding the governance and liability for the directors and officers of the corporation are not relevant if the owner and the officers of the corporation are the same. In addition, if you do incorporate in Delaware, Nevada or another state where you are not operating, you still have to register as a foreign corporation in the state in which you do business as well as pay taxes in that state. In effect, you are now paying two different states for the right to do business in the state when you are only doing business in one of those states.

Cost of Incorporating:

Of course, the protection afforded by a corporation or limited liability company comes at a price. There is generally a filing fee of approximately \$100 to \$150 to file the appropriate documents with the state. In addition, at least in California, there is generally a requirement that a corporation pay a minimum of \$800 per year tax to the State of California. As well as these fees payable to the state, there is the issue of paying for the actual formation of the corporation or limited liability company. This can be done by yourself, and there are forms that you can obtain from the state in order to start accomplish this task. However, this is not without risk. If the corporation is not properly formed, you could lose the protection of the corporate entity and your personal assets could be put in jeopardy. There are also cheap incorporation services that will provide you with a complete set of documents for around \$300 to \$500. These kits are usually fairly well done if properly completed but again you could be opening up yourself to personal liability for failing to properly form and maintain your corporation. You can also engage an attorney to form your entity which usually costs from \$750 to \$1,500 depending upon the complexity of the transaction. This way you insure that the job is done properly albeit at a price.

Overall, incorporating or setting up a limited liability company is a great way to protect your personal assets. You just have to decide whether the price is worth it.

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