

Pros and Cons of Incorporating A Sole Proprietorship

By Laura A. Davis, Esq.

June 14, 2010

The advantages and disadvantages of forming a corporation to hold a sole proprietor's business, and the steps involved, are the subject of frequent inquiries in my practice. Surprisingly, there is no single resource that I have consulted which provides a brief but adequate summary the various factors to be considered.

No one wants to pay hundreds of dollars to an attorney to address threshold matters about incorporating a business. The purpose of this article is to summarize those factors in a single location and with sufficient detail to give an inquiring business owner enough information to decide whether he wants to move forward by bringing his attorney, accountant and investment counsel into the process of a possible incorporation of his business. ^{1/}

FORMATION STEPS

A California corporation is formed upon the filing of 1-page set of Articles of Incorporation with the California Secretary of State, and the payment of the required filing fee (currently \$100, plus an over-the-counter fee of \$15). The author typically uses an attorney service to file her clients' Articles of Incorporation, which costs approximately \$50 extra.

The "organization" of the corporation is completed by the election of a Board of Directors (or sole director, in the case of a single-shareholder corporation), a President (or CEO), Secretary and Treasurer (or CFO), the adoption of a set of Bylaws (effectively, a procedures manual) for the corporation, and the issuance of a stock certificate representing the owner's shares in the corporation.

In addition, the corporation must file a "Notice of Transaction Pursuant to Corporations Code Section 25012(f)" claiming the exemption from the California securities laws in connection with the issuance of stock.^{2/} This must generally be done online, through the California Department of Corporations, unless a hardship can be established. Assuming the business owner is California resident, the transaction is exempt from Federal securities laws as an intrastate (inside California) transaction, and no form needs to be filed to claim the exemption.

The corporation will be a separate taxable entity, with its own Employer (Taxpayer) Identification Number. If the business has an EIN separate from the sole proprietor's Social Security Number, the new corporation will need to obtain yet another one.

Unless the sole proprietor, now shareholder, elects otherwise, the corporation will be considered a "C Corporation", subject to the income tax rules contained in Subchapter C of the Income Tax Law of the Internal Revenue Code. If the shareholder wishes to elect "S Corporation" treatment, which will allow the pass-through of income to him without first being taxed at the corporation's level, a special form will need to be submitted to the IRS.

In addition, the corporation will also need to obtain new business licenses in the corporation's name, establish a new account with the Employment Development Department (EDD), have the corporation re-hire existing employees, and purchase new Worker's Compensation insurance.

Wherever possible, business contracts on which the sole proprietor owes responsibilities should be assigned to (and assumed by) the corporation, and business contracts under which obligations are owed to the proprietor should likewise be assigned to the corporation.

The proprietor will need to make sure that all payments are made to the corporation, that all corporate payments are deposited into the corporation's separate bank account(s), and that all letterhead, business card, bills, checks, invoices, and other Corporation forms show the Corporation's full legal name (and fictitious business name, if any), and the Corporation's current address, telephone number, facsimile number, and email address.

PROS AND CONS

PROS: The most prominent advantages to incorporating a business are: (1) Limited liability; (2) Unlimited life; (3) Centralized management; (4) Professional Appearance; (5) Enhanced ability to raise capital; (6) Enhanced ability to sell business; and (7) No California "gross receipts fee". These features are discussed in more detail below:

1. **Limited Liability.** The shareholders' liability for business debts is limited to the assets of the corporation (i.e., the shareholders' personal assets – homes, cars – and assets of separate business ventures are protected from those debts) provided that the corporation is properly formed, the corporate formalities are observed, corporate identity is maintained as separate from the shareholder's, and the corporation is adequately capitalized.

1.1. **Proper formation.** See discussion of "Formation Steps", above.

1.2. **Corporate formalities observed.** See Discussion of "Corporate Formalities" under "Cons", below.

1.3 **Separate Corporate Identity.** In order to maintain the liability shield between the Corporation and the shareholder's personal assets, it is important for the Corporation to respect the difference between the Corporation's bank accounts, property, equipment and other assets, and the shareholder's personal assets. The shareholder must respect the fact that the Corporation's assets are the property of the Corporation, not the shareholder's personally. Similarly, the shareholder should not commingle his personal assets with the company assets of the Corporation.

The Corporation's books, records, and financial statements should be maintained clearly to reflect the separation of the Corporation's assets from the shareholder's personal assets. The Corporation must conduct business in its own name (not in the individual name of any manager or member). As mentioned above, all letterhead, business card, bills, checks, invoices, and other Corporation forms should show the Corporation's full legal name (and fictitious business

name, if any), and the Corporation's current address, telephone number, facsimile number, and email address.

1.4 Adequate Capitalization. The Corporation should be adequately capitalized to carry on the Corporation's business activities. How much capital is "adequate"? There is no clear answer to this question. One time-honored treatise has stated:

“Although courts frequently cite inadequate capital or capitalization as an important factor, they seldom define the term. Generally, adequacy of capital implies corporate assets sufficient for the conduct of the business. Inadequate assets or excessive debt or liability financing at the time of formation may suggest insufficient protection of creditors or tort victims. Adequate capitalization can be supplied through a mix of equity, indebtedness, insurance, or otherwise.” (2 Ballantine & Sterling, California Corporation Laws § 298.02 (4th ed 1962))

Another well-respected treatise has this to offer:

“Adequate capitalization is a function of the size, nature, and reasonably expected hazards and risks of the specific business being evaluated.... The size and type of business operations and the availability and amount of liability insurance will be important factors in determining how much capital is sufficient. Unfortunately, neither statutory or case law, nor the accounting profession, offer any bright line tests or safe harbors on which one can rely... The authors recommend that businesses make such decisions carefully in consultation with their accountants or financial advisers. It is also prudent for a new business owner (before forming a limited liability entity) to prepare ... [a] budget showing the business's need for equipment, furniture, supplies, and other assets; and [b] forecast of anticipated operating revenue and expenses.” (Organizing Corporations in California § 1A.23 (3d ed Cal CEB 2009)).

While it does not appear that an entity must have reserves for every possible eventuality that might befall it, the combined value of the entity's assets and the amount of insurance, offset by any existing indebtedness, should not from time to time be significantly less than reasonably anticipated expenses and foreseeable liabilities to current and future (potential) creditors.

2. Unlimited Life. Corporations terminate only when they are dissolved, which involves the filing of a Certificate of Dissolution with the Secretary of State. The death of the shareholder, or transfer of stock to another (including buy-out of a co-shareholder), does not trigger a termination, either legally or for tax purposes (as might happen with a partnership or an LLC).

3. Centralized Management. Corporations are owned by shareholders, who elect the Board of Directors, in charge of directing policy and the overall performance of the business. The Board of Directors then elects (and fires, if appropriate) the officers – a President, Secretary and Treasurer/Chief Financial Officer – who are responsible for the business's day-to-day operations. For a single-owner corporation, the sole shareholder may be the sole Director and all of the corporation's officers, so this feature is not as important. For multiple-owner corporations, the division of labor and delegation of responsibility is more apparent. Contrasting this to a partnership, in which management

power and responsibility is spread among all of the general partners, the corporation's centralized management allows a majority shareholder to retain control of the corporation, by controlling who serves on the Board of Directors, and by extension, who are the Officers.

4. Professional Appearance. Incorporating the business probably creates a more professional business image, evidencing a certain degree of financial ability and business sophistication, credibility, reliability, and professionalism not generally attributed to a sole proprietorship.

5. Ability to Raise Capital. The corporation's ability to issue stock – a capital interest in the company, rather than promissory note – is a strong selling point to those willing to invest capital (including the potential upside) of a business venture. The limited liability function of a corporation may give potential investors comfort in the belief that their downside is limited to their investment.

Also, if the business owners may want to solicit venture capital funds as investors in the business, either now or at sometime in the future, the corporate structure makes it easier. Venture capital funds are pooled investments entities which invest primarily in enterprises (frequently start-ups) that are too risky to get conventional financing. Significant sources of capital for these venture capital funds (and other private equity funds) are tax-exempt entities like pension plans, individual retirement accounts, foundations, and endowments. Even though they are tax-exempt with respect to the trade or business that they regularly carry on, these entities are subject to “unrelated business income tax” (UBIT) on their “unrelated business taxable income,” (UBTI), which – as tax exempt entities – they would generally prefer to avoid. As a result, venture capital fund sponsors commonly agree not to incur (or minimize) UBTI, and as a practical matter, shy away from investing in business entities that will generate UBTI. As it turns out, UBTI does not include corporate dividends, interest, capital gains, and certain rents from real property, but it does include income from partnerships or LLCs. Thus, if the business owner wants to attract venture capital at some point, the corporate form (rather than an LLC, which may be taxed like a partnership) will make that a more likely structure to use.

A word of warning: Anytime there will be two or more shareholders, there should be a specific, written agreement (a “buy-sell agreement” outlining the rights of purchase/repurchase on a death, retirement, resignation, termination of employment).

6. Ability to Sell Business. The corporate structure may enhance the business owner's ability to sell the business because of all of the benefits the corporate form entails (see above), and because it is easier to transfer ownership of the stock in the Company than it is to transfer the ownership of each individual asset the Company owns. Even so, a sale of stock includes the assumption of Company liabilities, so there are circumstances in which a buyer may insist on purchasing a corporation's assets only.

Another benefit a corporation offers in connection with the sale of the business is the ability to use an Employee Stock Ownership Plan (ESOP) as an exit strategy. Instead of a direct sale which could result in substantial capital gains taxes, creating an ESOP for the benefit of the employees and selling them a piece of the business may allow the business owner to defer the tax blow. If the transaction qualifies under Internal Revenue Code section 1042, the business owner can defer taxable gains by investing the sales

proceeds in a qualified replacement property (QRP). In that case, the capital gains won't be due until his interest in the QRP is sold.

7. No LLC "Gross Receipts" Fee. An LLC (limited liability company) is often considered an attractive alternative to a corporation, because so-called "corporate formalities" (owner and officer meetings, minutes, etc; See "Cons" below) are not required, yet the owner/members of the LLC receive limited liability like corporate shareholders do. There are two reasons why an LLC may not be favorable: first, a single-member LLC is considered a "disregarded entity" for federal and California tax purposes and will be taxed like a sole proprietorship, so the deductibility of fringe benefits is lost; and second, an California LLC pays a percentage of its gross receipts in excess of \$250,000, currently starting at \$900 and running to a total of \$11,790 per year.

* * *

CONS: The most prominent disadvantages to incorporating a business are: (1) Corporate formalities; (2) Distributions Must Be Proportionate to Ownership; (3) the Annual California Franchise Tax (Income tax); and (4) Double-Taxation of Profits (unless S Corporation treatment is elected). These features, as well as a handful of other administrative matters, are discussed in more detail below:

1. Corporate Formalities. For a corporation to be considered a viable entity, separate from its shareholders for liability protection purposes, corporate formalities must be observed. The term "corporate formalities" normally means adopting bylaws, holding annual meetings (as well as any other regularly scheduled meetings) of the shareholders and directors, providing written notice in advance of such meetings (or obtaining a waiver), and preparing detailed minutes of matters decided upon at such meetings. It is easy – bordering on typical – for small businesses, lacking in administrative time and staff, to remember or set time aside for these functions, but they do so at their own peril.

1.1 Compare: Statutory Close Corporation: If the observance of corporate formalities is anticipated to be a real problem, the business owner may wish to consider forming a "statutory close corporation." This is a special type of small corporation which is permitted to deviate from standard corporate structures and formalities. For example, a close corporation may dispense with meetings, be managed by shareholders rather than a board of directors, and allocate corporate income disproportionately to share holdings. The "close corporation" can have no more than 35 shareholders. The corporate name must include the word "corporation," "incorporated," or "limited," (or an abbreviation of one of these words) the Articles of Incorporation must state that "This corporation is a close corporation," and the stock certificates must contain a specified statement (or "legend") setting forth these requirements.

The primary advantage of a close corporation is its flexibility and informality of management. The primary disadvantage is the possibility of losing close corporation status involuntarily (e.g., through transfers upon insolvency or death of an owner to more than 35 persons). In addition, the structure has apparently been known to limit financing opportunities. Finally, for multiple-owner corporations, the ability of a single shareholder to seek voluntary dissolution creates another risk factor.

Given these disadvantages and the availability of limited liability company (LLC) form of business ownership, fewer and fewer "close corporations" are

being formed. However, for the right situation, the LLC's disadvantages (chiefly the "gross receipts fee" and limited access to venture capital) may make the close corporation a viable option.

2. Annual California Franchise Tax. Each corporation, limited partnership and LLC must pay to the State of California an annual minimum Franchise Tax, currently \$800, for the privilege of doing business in California. The same is true of non-California entities registering to do business in California. Currently, the first year's minimum franchise tax is waived.

3. Double-taxation of Profits, and Related Tax Issues.

3.1 C Corporation versus S Corporation Treatment. A "C Corporation" (one taxed according to Subchapter C of the Federal Income Tax law) pays federal and state income taxes on all of its net taxable income each year. In addition, when profits are distributed to the shareholders (i.e., dividends), the shareholders pay federal and state income tax on these distributions. As a result, unless there are no post-tax distributions made to shareholders (a practice which is discouraged), the profit of the corporation is subject to tax twice – first at the corporation's level (at combined California and Federal rates between 23.84% to 48.84%) and again at the shareholder's level. In addition, if a shareholder is also an employee, that shareholder's wages income is subject to income tax (effectively taxed only once, to the shareholder, because it is deductible by the corporation in determining its taxable income), as well as payroll taxes.

NOTE: If the corporation elects "S Corp" treatment (to be taxed according to the rules of Subchapter S of the Federal Income Tax Law, instead of Subchapter C), there is generally no Federal income tax at the corporation's level, and all profits and losses are passed through to the shareholders for reporting (and taxation) on their personal tax returns.^{3/} Thus, the "double-taxation" of profits experienced by shareholders of a C Corp is avoided by shareholders of an S Corp. If there are losses, these are limited to the shareholder's investment. In addition, California assesses a 1.5% income tax based on revised profits of an S Corporation (minimum \$800).^{4/} As with a C Corporation, all S Corp shareholder-employee wages are also subject to income tax and payroll taxes.^{5/} Note, however, that S Corp income is passed-through for tax purposes even though no cash has been distributed to the shareholders, which could result in so-called "phantom income" to them (income tax liability without the cash income to pay it with). In this sense, the S Corp is similar to a sole proprietorship.

3.2 "Reasonable Compensation" Issues. A corporation is allowed to deduct the payment of "reasonable compensation" to its employees from its gross income when calculating its tax liability each year. A C Corporation, especially a small company composed of shareholder employees, will be inclined to set salaries as high as possible, in order to maximize the income tax deduction and minimize the corporate level income tax on its income.

The inclinations of an S Corporation are opposite. The wages of an S-Corporation's shareholder-employee and the shareholder are subject to a combined 15.3% payroll tax, plus the shareholder's income tax rate. Profit distributions, however, are not subject to payroll taxes; they are subject only to income tax only. This disparity in tax treatment between wages and profits creates

an incentive for an S Corporation shareholder-employee to pay himself a minimal salary, and thereby increase the profit distribution and minimize payroll tax liability.

For both of these situations, the tax laws require that corporations pay their employees "reasonable compensation" for services rendered to the company – not appreciably greater than the industry-average for C Corporations, and not appreciably less than industry-average for S Corporations. This is a frequent audit issue for all corporations. A review and comparison of the salaries received by CEOs of comparable businesses should be undertaken periodically – every couple of years, and on any significant change in CEO's duties, the profitability of the company or circumstances within the industry – so that the corporation will be able to justify the compensation figures reported for tax purposes.

3.3 Quarterly Estimated Tax Payments. C corporations generally must make estimated tax payments. Federal estimated tax payments are made quarterly to an authorized financial institution or Federal Reserve Bank, using Form 1120-W. California estimated tax payments are due quarterly also. They are made with Form 100-ES to the Franchise Tax Board. Penalties may be assessed for failure to pay estimated taxes promptly.

S corporations are required to pay estimated tax on any income that is not passed to shareholders. For purposes of state income tax, an S corporation may carry forward a net operating loss and may use the loss to offset future years' income. However, a net operating loss may not be used to offset tax paid on personal income in previous years.

4. Distributions Must Be Proportionate to Ownership. For multi-shareholder corporations, all distributions of profit and capital must be done in proportion to ownership percentage. This is true both of C Corps and S Corps. However, while there is a single shareholder or if the corporation is a statutory "close corporation", this limitation will not pose a problem.

5. Annual Administrative Matters. Corporations have other administrative responsibilities that sole proprietorships do not. Included among them are the following:

5.1 Annual California Statement of Information. Every corporation organized or doing business in California must file a "Statement of Information" with the California Secretary of State, within 90 days after filing of its original Articles of Incorporation, and annually thereafter during a specific period (the calendar month in which the Articles were filed and the 5 preceding calendar months). This statement identifies the location of the principal executive office, and place of corporate business, the names and addresses of the corporation's officers, the corporation's agent for service of process (e.g., lawsuits), and the type of business the corporation is engaged in.

5.2 Additional Reporting Requirements for Large Corporations. Additional reporting requirements exist for large and publicly traded corporations – such as the requirement that the Board of Directors for a corporation having 100 shareholders or more cause an annual report and financial statements to be sent to the shareholders within 120 days after the end of each fiscal year.

COMPARISON WITH LIMITED LIABILITY COMPANY

The other viable alternative to a sole proprietorship in California is the Limited Liability Company, or LLC.

The LLC can be formed as a single-owner entity in California.

Properly formed and maintained, the LLC offers similar (if not identical) liability protection to the sole-shareholder to that of a corporation.^{6/} While adequate capitalization of the business is still important to maintain the LLC's liability shield, the LLC structure avoids one of the biggest traps encountered by corporate entities – corporate formalities. Unlike a corporation, an LLC is not required to hold annual or other periodic meetings, or to maintain a minute book, unless its Operating Agreement (similar to a corporation's Bylaws) requires them.

The LLC must still file annual Statements of Information and the annual minimum Franchise Tax (currently \$800) must still be paid, but the LLC can avoid the double-taxation burden of a C Corp (unless it elects to be taxed like a corporation).

On the other hand, as pointed out above, the LLC does carry with it the additional tax on profits called the “gross receipts fee” (although that fee caps out at \$11,790 under the current rate table), and an LLC may not be a viable candidate for Venture Capital financing.

CONCLUSION

The foregoing article summarizes many aspects, advantages and disadvantages of the corporate form of entity as compared to a sole proprietorship and an LLC in California. It is not intended to be an exhaustive analysis, but is aimed at giving readers an idea about the major issues and options they face.

Further questions may be addressed to Ms. Davis directly.

Endnotes:

^{1/} Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code, or (ii) promoting, marketing, or recommending to another party any transaction or matter that is contained in this document.

^{2/} In order to qualify for exemption from the California securities laws under Corporations Code section 25102(f), each of these criteria must be met:

“(1) Sales of the security are not made to more than 35 persons...;

(2) All purchasers either have a preexisting personal or business relationship with the [corporation] or any of its partners, officers, directors or controlling persons, ..., or by reason of their business or financial experience or the business or financial experience of their professional advisors who are unaffiliated with and who are not compensated by the [corporation] or any affiliate or selling agent of the [corporation], directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction.

(3) Each purchaser represents that the purchaser is purchasing for the purchaser's own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security.

(4) The offer and sale of the security is not accomplished by the publication of any advertisement, company, and any other purchaser who the commissioner designates by rule....” (California Corporations Code section 25102(f)).”

^{3/} To qualify for S corporation status, the corporation must submit a Form 2553 Election by a Small Business Corporation signed by all the shareholders, and meet the following requirements:

- (1) Be a U.S. corporation;
- (2) Have only allowable shareholders, including individuals, certain trusts, and estates (may not include partnerships, corporations or non-resident alien shareholders);
- (3) Have no more than 100 shareholders;
- (4) Have one class of stock (e.g., not common and preferred, though voting and non-voting common stock are considered a single class of stock for this purpose); and
- (5) Not be an ineligible corporation (i.e. certain financial institutions, insurance companies, and domestic international sales corporations)

^{4/} This \$800 is the same as the \$800 minimum franchise tax discussed above. Note, a corporation that has elected S Corp treatment for Federal tax purposes will be treated as an S Corp for California tax purposes, unless it affirmatively elects otherwise.

^{5/} The wages of an S-Corporation's shareholder-employee and the shareholder are subject to a combined 15.3% payroll tax, plus the shareholder's income tax rate. Profit distributions, however, are not subject to payroll taxes; they are subject only to income tax only. This disparity in tax treatment between wages and profits creates an incentive for a shareholder-employee to pay himself a minimal salary, and thereby increase the profit distribution. Nonetheless, the tax laws require that S-Corporations pay their shareholder-employees "reasonable compensation" for services rendered to the company, and the IRS is actively seeking out S-Corporations which pay below-average wages.

^{6/} Because LLCs are relatively new to California law, there are few cases specifically addressing the limited liability protections the LLC offers. As a consequence, legal practitioners are still somewhat cautious about advertising the LLC as having identical liability protection features to a corporation, though this is changing the longer that the LLC form exists.

© 2010, Laura A. Davis, The Law Offices of Laura A. Davis. All rights reserved. The information contained in this article has been prepared by Laura A. Davis, The Law Offices of Laura Davis, and is not intended to nor does it constitute legal advice on any specific matter. We have used reasonable efforts in collecting, preparing, and providing this information, but do not guarantee its accuracy, completeness, adequacy, or currency. The information is general information only. You should not act or rely on any information contained herein for any specific matter and should seek the advice of a competent attorney licensed to practice in your jurisdictions for your particular problem.