IEEE-CNSV Consultants' Business Seminar

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To Incorporate or Not to Incorporate

Why Form an Entity?

- Liability (exceptions for payroll taxes, your own torts, including professional negligence)
- Company hiring you insists on it
    - This is probably because they are worried about employee classification.
- You'll have multiple owners
- Give equity to employees, vendors, etc.
- Some tax benefits may exist
- You have employees
- To receive investment capital
- Will sell eventually
- Less chance of a tax audit
- Advisors on Board
- Psychology

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Why Not?

- Cost to form
- Minimum franchise tax
- Tax return
- Formalities

What Type?

- Defaults:
  - Sole proprietorship (one owner), General Partnership (multiple owners)
- Mentioned in Passing:
  - Limited Partnership, Statutory close corporation
- Conscious Choices:
  - Closely-Held Corporations- S or C
  - Limited Liability Company
- C Corporation
  - 1 or more owner
  - Potential for double taxation because a separate taxpayer
  - One or more classes of stock allowed
  - No limit on number or types of shareholders
  - Pays $800 minimum tax (Revenue and Taxation Code Section 23153) or 8.84% of net income (Revenue and Taxation Code Section 23151)
  - Shares are securities

- S Corporation
  - 1 or more owner
  - Corporate documents identical to C corporation’s
  - Tax difference only: not a separate taxpayer
  - Limited to 1 class of stock
  - Distributions proportionate to ownership of stock
  - 100 or fewer shareholders (was 75)
  - No corporate shareholders; no nonresident alien shareholders
  - Pays $800 minmum tax (Revenue and Taxation Code Section 23153) or 1.5% of net income (Revenue and Taxation Code Section 23802)
  - Shares are securities
- LLC
  - 1 or more owner (called members)
  - Nonresident alien allowed as owners
  - Multiple classes of interests allowed
  - Taxed like partnership or corporation
  - Managed by all members or specified manager(s)
  - Subject to gross revenues tax in California (Revenue and Taxation Code Section 17942) <u>and</u> $800 tax (Revenue and Taxation Code Section 17941)
  - Ownership interests are securities
  - Some flexibility in allocation of profits, losses, distributions among owners if include complex tax language in agreement

- Rules that apply to all 3:
  - Liability protection is the same
  - Adequate capitalization required
  - Documents must be complete and done properly
  - Owners transfer assets and receive shares or interests
  - Must observe separation
  - Securities issues
  - Tax issues (e.g., stock or membership interests for services, valuation)
- Differences include:
  - Tax- LLC gross revenues fee; $800 minimum franchise tax begins with first year for LLC; differences in deductions for health insurance, self employment taxes; different retirement plan choices
  - Minor difference with regard to formal meeting requirements
  - Cost to establish
  - Number of owners, types of owners, number of classes of interests
  - Some operational differences
- Sometimes facts limit the choices
  - Professional practice involved
  - Too many owners for S
  - Nonresident aliens
  - 2 classes of stock

Where?: California vs. Delaware vs. Nevada

- Foreign corporation or LLC doing business in California must qualify here and pay $800 per year
- Foreign corporation or LLC also pays agent for service in home state
- California taxes income earned here
- Other states may impose different financial requirements (annual fee, etc.)

How to Proceed?

- Gather basic information
- Consult attorney/tax advisor to avoid problems
- Make sure all documents are done properly- professionally prepared or reviewed
- Adequately capitalize
- Meet legal requirements, such as:
    - Number of people on the Board
    - Elect Directors and Officers
    - Issue stock certificates
    - File securities notices
    - Put contracts into entity's name
    - Ongoing minutes and filings
- Negotiate limits on guaranties

Final Thoughts

Don't wait until you have a problem to consult a lawyer. A good business lawyer does much more than prepare documents.