

Factors in Determining Whether to Incorporate

Jeffrey I. Fialky, Esq.



Jeffrey I. Fialky, Esq.

Individuals forming new business enterprises, or perhaps those whose business enterprises have matured to the standpoint of pursuing the next level, often approach their accountants and attorneys when considering whether or not to incorporate. Really, the term 'incorporate' is euphemistic for

whether an individual, and in some cases multiple business partners, should proceed or continue to proceed, on their own behalf, or alternatively, form a limited liability entity pursuant to the laws of the respective jurisdiction. The question of whether to engage in business operations in an individual capacity, or to form a limited liability entity within which to conduct business operations, is generally a question answered by a thorough analysis of the respective liabilities and tax implications.

Sole Proprietorship

The simplest manner of doing business is in the form of a sole proprietorship. That said, a sole proprietorship is a bit misleading by name, in that it is not a business entity, but rather the absence of a business entity. There are no registration or filing requirements, and simply engaging in the business operation commences the sole proprietorship, in the individual's own name, or on their own behalf. As a result, an individual who engages in a business practice as a sole proprietor personally exposes himself to any liabilities that could arise as a result of such business operations without any legal protection from same.

While an individual doing business as a sole proprietor may register a fictitious name in which to conduct his or her business by filing a DBA certificate in the community in which the business operates, from a legal standpoint, the fact that the business operates pursuant to a fictitious name has no bearing or legal affect relative to liability. By way of

example, assume Joe Smith, DBA, 'XYS Construction,' is named in a law suit as a result of an injury occurring to a third party on a job site. A judgment against Joe, personally, could certainly result in a lien against Joe's personal residence, subject to subsequent sale in order to satisfy that judgment.

General Partnership

Another form of business operation is a general partnership. This consists of essentially two or more individual sole proprietors engaging in business operations in a joint capacity. Often a general partnership will be governed pursuant to the terms of a partnership agreement, however, such as with a sole proprietorship, there is no formal legal registration requirement. Additionally, as with a sole proprietorship, the general partnership does not protect the individual partners from personal liability arising out of the business operations. Worse, partners pursuant to a general partnership, are not only liable personally for his or her own acts or omissions relative to the ongoing business venture, but additionally, each is personally liable for the acts of other partners of the partnership.

Corporation

For many reasons, including avoiding the personal liability attributed to sole proprietorships and general partnerships, parties are often counseled to consider forming limited liability legal entities, which provide a barrier of protection for the business owners.

Of the host of legal entities available for formation, the most commonly used in contemporary business are the corporation and limited liability company (LLC.) That said, the term, "corporation, as generally used often includes two specific types of corporations - Subchapter 'C' corporations (C Corps) and Subchapter 'S' corporations (S Corps,) the

distinction of which arises pursuant to the respective subchapter of the IRS tax code.

Generally speaking, a corporation is a legal entity that is formed by the filing of articles of organization, is governed by its bylaws, and which is owned by its stockholders. Corporations are managed by its board of directors, with day to day operations overseen by its officers. Unlike a sole proprietorship or general partnership, a corporation is an independent legal identity, which is independent from that of its stockholders. Accordingly, a substantial degree of protection is afforded to owners of the corporation relative to liabilities arising as a result of the ongoing business operations of the corporation. The tax treatment of a corporation, including the potential tax effect on individual stockholders, varies in accordance with the nature of the corporation formed, specifically, whether it is a C Corp or an S Corp.

C Corporations

Subchapter C corporations, or C corps, enjoy the benefits of limited liability for stockholders, and are operated pursuant to the traditional corporate formality of being governed by their directors and officers. One significant potential tax disadvantage to C corps, however is the potential for double taxation of corporate earnings. C Corps pay tax on income at the corporate level, and in the event in the event that earnings are distributed to stockholders as dividends, the dividends are often subject to tax at the individual shareholder level upon distribution. This so called potential for 'double taxation' can often be avoided by forward thinking and anticipatory tax planning.

S Corporations

Unlike C corps, Subchapter S corporations, or S corps, while providing many of the advantages of the limited liability corporate structure as provided by a C corporation, have the added advantage of not being subject to the potential for double taxation. In fact, income and losses from the business flow through to the individual stockholders and is reported on their personal tax returns. That said, S corps are subject to their own specific limitations and potential disadvantages, most notably, the fact that they are limited to a maximum number of stockholders, that stockholders generally must be

individuals vs. other legal entities, that the S corporation may not have more than one class of stock in, (e.g. common vs. preferred,) and that distributions must be in direct percentage to ownership interest.

LLC

Another commonly utilized business entity is the limited liability company (LLC), which is an entity that shares many characteristics of sole proprietorships and general partnerships, but with the limited liability protection afforded to corporations. The LLC, much like a corporation, is formed by the filing with the Secretary of the respective state jurisdiction, with a simple certificate of organization filing, and payment of the respective registration fee. Unlike a corporation, which is owned by its stockholders, LLC's are owned by its member or members, as opposed to directors and officers, and managed by it manager' or managers.

LLC's afford a great degree of flexibility in that most states have enacted a limited liability company act permitting LLC's to be owned by a single member, to have multiple classes of membership, (e.g. common vs. preferred,) and to determine the capital structure, ownership, and management, all as determined by the business owners. Additionally, unlike S corps, profits and losses may be allocated in a manner that is disproportion to direct percentages of ownership interests.

Unlike a corporation, which is operated pursuant to its Articles and By-Laws, LLCs are operated pursuant to a document called an operating agreement, which is a recitation of the respective rights and obligations of each member and manager of the LLC.

Members of an LLC have additional flexibility relative to taxation, in that members can be taxed much like a sole proprietor or like a partnership, although distributions to members may be subject to self-employment taxes.

As a result of the flexibility of LLCs, and the avoidance of the potential for double taxation, they provide ideal entities for purposes of taking title to real estate holdings and investments. For similar reasons, LLCs are additionally valuable tools for estate planning purposes.

In Sum

As you can see above, the determination of whether to form a limited liability entity, and if so, the choice of entity itself, is a fact-dependent analysis. Naturally, consultation with legal and tax professionals is recommended to ensure that you may enjoy the maximum level of liability protection and most favorable tax consequences for your situation.

Jeffrey Fialky is a shareholder with the regional law firm Bacon Wilson, P.C, specializing in business, corporate,

municipal, and real estate law. A former assistant district attorney in Hampden County, Fialky joined the firm after a decade of holding senior attorney positions within some of the country's most prominent telecommunications and cable television companies, where he negotiated large scale licensing, acquisition, and distribution agreements. 413.562.6611, baconwilson.com/attorneys/fialky