

NEW CORPORATION LETTER

TO INCORPORATE *or* NOT TO INCORPORATE?

Should you incorporate your new or existing business? This newsletter is designed to help you understand, decide, and proceed.

Before giving up on the idea of being a sole proprietor, you should make sure that your decision to incorporate is correct.



TYPES OF CORPORATIONS:

C CORPORATION: All corporations begin as a C Corporations. The C Corporation pays a separate tax on its income. When you take money from your C Corporation profits, the money is taxed again as a dividend. However, as a C Corporation owner, you can partake in a wide variety of employee benefits.

S CORPORATION: You must make a special IRS election to have your corporation be an S corporation. Profits of your S Corporation flow through to your personal tax return and are taxed only once. However, as a shareholder of this corporation your fringe benefits are restricted.

Unless you are incorporating for a benefit package, the S Corporation is probably your best choice.

The sole proprietor is the simplest form of business organization, and is easy to set up and easy to dissolve. As a sole proprietor you have the freedom to operate your business in a relatively easy manner without a lot of rules and regulations. Because you **are** the business, you can use all the earnings of your business whenever you want. By employing your spouse you can provide benefits for your family. And, you can employ your minor children free of employment taxes. As a sole proprietor you can also save both income and self-employment tax by deducting the operating costs of running a business from your personal residence. Why would anyone want anything but the above-mentioned world?

The corporate structure provides some advantages that the sole proprietor lacks:

- The ability to have more than one owner.



- The shareholders have limited liability.
- Some profits may escape taxation by Social Security and Medicare.
- The existence of a separate entity might aid your business in raising capital and getting job contacts.
- A corporation is less likely to be audited.

BASIC CORPORATE STRUCTURE

A corporation is a registered, legal entity that exists until it is dissolved.

You, the owner, purchase stock in the corporation and are a shareholder.

Shareholders who actively participate in the activity of the corporation are employees and must be paid a reasonable salary.

An easy way to view the corporate structure is to consider the company bank account as the corporation. ALL transactions must go through this account. You are an employee of your corporation and you get paid with a payroll check.

GETTING STARTED CHECKLIST



You can use the following checklist to get started. advised with steps 1-6, but it is possible to do them attempt these legal steps on your own, it would be templates for the legal documents and instructions. tion on the *Small Business Administration's* website (www.sba.gov) . It is very important to make sure all of these steps are correctly executed to maintain the liability protection that the corporate entity can provide.

The help of an attorney is yourself. If you decide to wise to purchase a book with There is a wealth of informa-

- 1. Determine the name of your corporation and register it with the Secretary of State in your state.
- 2. Name the officers and directors of your corporation.
- 3. Apply for a corporate charter with your state.
- 4. Adopt the bylaws of your corporation.
- 5. Issue stock in your corporation.
- 6. Hold your first annual shareholder meeting and establish your corporate minutes. It is important that an annual meeting is kept and that minutes are kept. Meetings and minutes are evidence your corporation is legitimate.

An accountant may be able to help you with the following 5 items, but again, it is possible to do them for yourself with a little help from the IRS website (www.irs.gov).

- 7. Obtain a Federal ID number with IRS Form SS-4. You will need this number for corporate tax and Federal withholding tax. The IRS prefers you register on the Internet at its website, www.irs.gov. Just enter EIN as a keyword to begin the process. Or, if you use the following IRS toll-free number (1-800-829-4933), you can obtain your ID number by phone.
- 8. Apply for Subchapter S status on IRS Form 2553 if the S Corporation is your desired choice. Otherwise, your corporation will be a C Corporation by default.
- 9. Obtain a State ID number from your state Department of Revenue for corporate tax, withholding tax, and possibly sales tax.
- 10. Obtain a State Unemployment ID number.
- 11. Determine the appropriate accounting method for your business.

Once you have your corporate charter established and your Federal ID number, you can:

- 12. Set up a bank account and make your initial contribution of money to purchase stock. If you already have a bank account for your existing business, you can not use it for your corporation. You must set up a new one in the corporate name.
- 13. If you are incorporating an existing business, you must transfer any leases, make new billheads, appointment cards, and stationary with the new corporate name. Also notify all suppliers, clients, insurance carriers, and utilities of the new corporate ownership. Terminate your current retirement plan and set up a new plan for the corporation. If your corporation is new, make sure you register for everything in the corporate name. However, it is important to note that if your business is purchasing a building, it is better for you to purchase the building and rent it to the corporation.
- 14. Adopt a benefit package that suits your needs and outline it in your corporate minutes.

After completing the above steps, you will be ready to begin operations.

SIMPLE CORPORATE RECORDKEEPING



It is easy to keep records for your corporation if you never forget that all transactions must go through the bank account.

Deposit **all** income into the corporate account. If you need to loan money to the corporation, label the deposit ap-

propriately in your ledger and make a note outlining the terms of repayment.

Pay for **all** corporate expenses with the corporate account. You may want to acquire a corporate credit card to cover some expenses. Be sure to apply for the card in the corporate name and charge **only** business items. Make payments on the card through the corporate account.

If the corporation needs to borrow money, obtain a loan in the corporate name and deposit the proceeds into

the corporate account. Label the deposit as loan proceeds and make payments from the account on the loan. If you loan money to the corporation, indicate so in your minutes, draw up a note, and outline the repayment procedure.

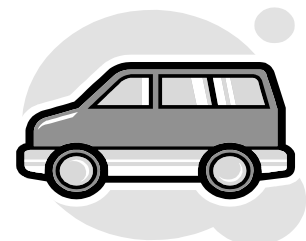
If you incur expenses that you do not pay with a corporate check, or with your corporate card, you must reimburse yourself from the corporate account. It is easy to keep an envelope with receipts for expenses you paid personally, and then reimburse yourself from the corporate account on a monthly basis.

HANDLING VEHICLE ISSUES

You must choose among the following scenarios:

If the company owns a vehicle, the corporation will pay for all vehicle expenses. As an employee of the corporation, you must report your personal mileage to the corporation and impute income on your W-2 at the end of the year for the personal miles that you have driven. This method involves a fair amount of recordkeeping, but works the best if the vehicle involved is heavy or pricey.

If you own the vehicle you use for corporate business, the company can reimburse you for qualified business miles. It is simple to keep track of the mileage and cut yourself a monthly reimbursement check.



It is very important to follow the recordkeeping and accountable plan rules as closely as possible to maintain the liability protection that your corporate entity was formed to provide.

THE ACCOUNTABLE PLAN

In the above vehicle reimbursement arrangement, expenses are incurred by the employee and reported to the corporation. Reimbursement is made for the expenses reported. This is an **accountable plan**. Under this type of plan, the employee is reimbursed and the company deducts the expense.

If the corporation, on the other hand,

just paid a dollar amount to the employee without an accounting, the payment would be taxed as compensation to the employee.

In other words, it would be wise to report your business miles and expenses you incur to the corporation for reimbursement, and cut yourself a check on a monthly basis.



HOW TO GET MONEY FROM YOUR CORPORATION

C Corporation:

As an employee of the corporation, you can withdraw money from your corporation with a payroll check.

- You are also able to partake in a variety of fringe benefits.
- Your corporation can pay rent to you for use of your property. If you own the building where the corporation is located, you can pay yourself rent and take the offsetting expenses. You can also rent equipment and other personal property to the corporation, but you have to pay self-employment tax on the net profit from the equipment rental. If you rent a portion of your home to the corporation, you cannot take any deductions from the rent collected on the personal level.
- Your corporation can loan you money. Make sure you document the loan with a promissory note outlining the repayment period and interest rate to be charged if the loan is over \$10,000.
- A distribution to you from the company's earnings and profits is a dividend and is subject to tax on the personal level and the corporate level. Payments for any of the above reasons that are not properly documented can also be re-characterized by the IRS as

a taxable dividend.

- You can pay yourself back for money you have loaned the corporation according to the schedule you set up in your minutes.

S Corporation:

- As an employee-owner of an S Corporation you must pay yourself a reasonable wage. Because the profits of the S Corporation are not subject to Social Security, it is tempting for an owner to pay as small a wage as possible. The IRS can re-characterize profits as wages if the ratio of profits to wages is too high. Wages should be set at an amount that is reasonable to pay for the work performed.
- As an owner of an S Corporation, your list of eligible fringe benefits is less extensive than that of a C Corporation, but some benefits do exist.
- Rent can be paid to you as an owner of an S Corporation. Your corporation can pay rent to you for use of your property. If you own the building where the corporation is located you can pay yourself rent and take offsetting expenses. You can also rent equipment and other personal property to the corporation, but you have to pay self-employment tax on the net profit from the equipment rental. If



you rent a portion of your home to the corporation you cannot take any deductions from the rent collected on the personal level.

- Your corporation can loan you money. Make sure you document the loan with a promissory note outlining the repayment period and interest rate to be charged if the loan is over \$10,000.
- You can take distributions from the earnings of your S Corporation to the extent they have already been taxed on the personal level. Distributions in excess of that amount are taxed as a capital gain.
- You can pay yourself back for money you have loaned the corporation according to the schedule you set up in your minutes.

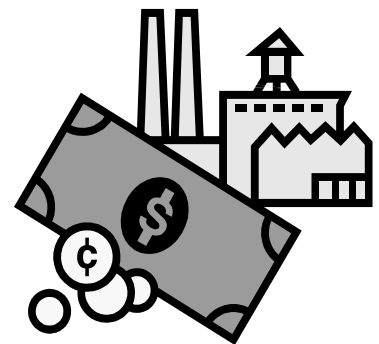
EMPLOYEE BENEFIT PROGRAMS

The following list of employee benefits can be provided to you as owner-employee of your C Corporation or your S Corporation:

- Day care services paid for the care of your dependent while you are at work
- Deferred compensation
- De minimis fringe benefits of small value such as occasional use of company equipment...
- Achievement awards
- Employer provided vehicle used for business
- Job placement assistance
- No additional cost services offered by the employer to the general public
- On premises athletic facilities
- Qualified employer discounts on services the employer offers to the general public
- Qualified moving expense reimbursement
- Qualified retirement plans
- Retirement planning service

The fringe benefits below are for C Corporations or S Corporation employees who own less than 2% of the corporation's stock:

- Accident and health insurance
- Cafeteria plans
- Group term life insurance
- Meals and lodging provided on the employer's premises
- Up to \$255 a month for transit passes Up to \$255 a month for qualified parking
- Up to \$20 a month to cover bicycle commuting expenses



Forming a corporation can be a complicated, but rewarding experience, and this is by no means an exhaustive treatment of the subject. If questions, or the need for assistance should arise, seek help from a qualified legal, tax, or accounting professional.