Why Your Start-up Should Be a Corporation

By Richard D. Harroch

Small business owners often avoid incorporation because of the paperwork and formalities involved. However, before jumping to conclusions, it is important to evaluate different start-up structures and the specific benefits of incorporating. Many small businesses find that the advantages outweigh the complexities.

The first — and most important — step is deciding which type of entity is most advantageous for your business. If you are planning a for-profit venture, your choices are a C or S corporation, a general partnership, a limited liability company (LLC) or a sole proprietorship. The basic differences in the structures are as follows:

- S corporations are often recommended for start-ups and small businesses because profits (and losses) "pass through" to the shareholders to be claimed on individual tax returns. S corporations avoid the so-called "double tax."
- C corporations pay corporate income taxes directly to the government.
- LLC laws vary by state. You are required to file articles of organization and pay filing fees similar to what you do with a conventional corporation. You also have to prepare an "operating agreement," which is like a partnership agreement and takes the place of corporate bylaws.
- General partnerships have the huge disadvantage that the partners are potentially personally responsible for the obligation and liabilities of the business.
- A sole proprietorship entails the least formalities but carries the risk of unlimited personal liability for the debts and liabilities of the business.

There are specific benefits of incorporating that will provide you more protection and flexibility than other business structures. Here are some key reasons below:

Limited Liability: One of the most important reasons for forming a corporation is the limited liability protection it provides. Because a corporation is considered a separate legal entity, the shareholders typically will not have personal liability for the corporation's debts.

Corporate Tax Treatment: Since a corporation is a separate legal entity, it pays taxes separate and apart from its owners (at least in the typical C corporation). Owners of a corporation pay taxes only on corporate dividends. The corporation pays taxes, at the corporate rate, on any profits.

Attractive Investment: The built-in stock structure of a corporation makes it attractive to investors. Venture capital investors, in particular, will not typically invest in an LLC or partnership.

Employee Incentives: The stock structure also allows corporations to attract key and talented employees by offering an ownership interest in the form of stock options or restricted stock subject to vesting.

Owner/Employee: A business owner who works in his or her own business may become an employee and thus be eligible for reimbursement or deduction of many types of expenses.

Operational Structure: Corporations have a set management structure. Shareholders are the owners of a corporation, who elect a Board of Directors, which then elects the officers. The Board of Directors is responsible for managing and exercising the rights and responsibilities of a corporation. The Board sets corporate policy and the strategy for the corporation. The Board elects officers — usually a CEO, Vice President, CFO and Secretary — to follow the policies set by the Board and manage the corporation on a day-to-day basis. In a small corporation, the lines between the shareholders, Board of Directors, and officers tend to blur because the same people may be serving in all capacities.

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Perpetual Existence: A corporation continues to exist until the shareholders decide to dissolve it or merge with another business.

Freely Transferable Shares: Shares of corporations are generally freely transferable because, as a separate entity, the existence of a corporation is not dependent on who the owners or investors are at any one time. A corporation continues to exist as a separate entity and is not terminated or dissolved even when shareholders die or sell their shares. Shares of corporations are freely transferable unless shareholders have "buy-sell" agreements limiting when and to whom shares may be sold or transferred. Also, securities laws may restrict the transferability of shares.

My Recommendation: Bottom line — I would typically stay away from general partnerships and sole proprietorships. LLCs sometimes can get too complicated and expensive to form and maintain. Therefore, I usually recommend that a start-up business be formed as an S corporation or C corporation.

I strongly encourage you to consult a lawyer before deciding which type of entity is best for your company. In addition, having a lawyer set up your corporation will make it far more likely the job is done right. However, in terms of the actual incorporation filing process, you can do it yourself — with software, incorporation guides, or government forms — or you can use a company that will provide the service for you. (such as www.RocketLawyer.com or www.LegalZoom.com).

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