

TO INCORPORATE OR NOT TO INCORPORATE

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What does it mean to incorporate? Why incorporate if you are the sole owner of your company? Why incorporate if you have insurance? Can I use an internet service company to incorporate?

These are some of the more basic questions that are routinely asked at consultations and cocktail parties. Although it is impossible to contemplate every set of facts that would lead someone to ask these questions based on their particular circumstances, it is possible to offer some basic answers to these questions that will help guide the reader in the right direction.

What does it mean to “incorporate”? The term “incorporate” is often used loosely to mean creating a legal entity, separate from the individual owner(s) and/or operator(s) of a company. A legal entity can be set up in a variety of forms depending on what the initial owner(s) or organizer(s) prefer based on their needs, from both a tax and liability perspective. Certain forms are not legally distinct corporate entities under the law from a liability perspective. Some examples include a Sole Proprietorship and Partnership. Under certain states’ laws, if a person or individuals operate a business for a profit, they are by default a sole proprietorship or partnership, respectively, and will be treated as such by the state for liability and tax purposes. Minimal paperwork needs to be filed in most states for these entities to operate. For example, New Jersey requires a company to obtain: (a) a Federal Employer Identification Number (FEIN); and (b) a Registration Number from the Division of Taxation. However, these entities do not enjoy the benefits of one that has filed under state corporate laws. Legally created corporate entities such as a Corporation, Limited Partnership (LP) and Limited Liability Company (LLC) are treated differently under the law. To form a Corporation, LP and LLC, a company must be legally formed by registering with the Department of State as well as a tax authority as described above, by filing certain incorporating or organizational documents, depending on the type of entity.

What are the benefits of incorporating? Keeping it simple, individuals who expect to operate a business for a profit (excluding a non-profit discussion in this article) should incorporate for two main reasons: (1) Tax advantages; and (2) Limited Liability of owners. Although it is a state-by-state creation, developed in the 1990’s and for good reason has become an extremely popular entity choice since then, the LLC is a fairly new legal category for a business. It is created by “organizing” with the state, rather than incorporating, and it is the preferred entity for many start-up and closely-held companies these days that do not expect to take on a large amount of new owners (called “members”) and are not looking to raise a substantial sum of money from a venture capital firm in the near future. An LLC is essentially a

hybrid between a sole proprietorship/partnership for tax purposes and a corporation for liability purposes.

From a tax perspective, the profits and losses of the LLC “flow-through” to the individual owners of the company. The entity itself is not taxed separately, as is the case with a corporation, where two levels of tax are assessed. This means that any money gained or lost can be set-off against any gains or losses from the owner’s personal income from other sources throughout the year. From a liability vantage point, unlike a sole proprietorship, a corporation means that any debts and/or obligations assumed by the company under a company contract or agreement into which a company enters with a third party that were not personally guaranteed by any of the owners, remain a liability of the company and not the owners personally. There are exceptions to these general rules.

A final benefit of an LLC is the flexibility that it provides among its members. For example, although it is advisable, unlike corporations under many states’ laws, minutes of meetings and meetings themselves are not required by law, however, the operating agreement among the members may require otherwise.

Why Form an Entity If You have Insurance? First off, in my experience, most sole proprietors operating for a profit do not carry proper insurance for the business they are operating. When you purchase insurance for your business, depending on the coverage, it will certainly be limited by contract, deductibles and red tape. As the laws were created to encourage and protect small businesses, it is in each individual’s best interest to form some type of corporate legal entity as an added layer of protection. For purposes of illustration, assuming you are a sole proprietor and you are sued for a business-related matter, hopefully your insurance will cover your claim and/or your defense costs. However, if your insurance company rejects your claim, your personal assets will be at stake. Creating an entity which holds all of your company’s liabilities will serve as a back stop to most debts and obligations incurred by and through the company. Again, there are exceptions to this rule.

Can I use an Internet Filing Company As Seen on TV? Although these companies may be efficient, cheap and offer a basic service, companies such as these are simply administrative and are not in a position to provide legal counsel – they are generally not law firms. Creating a company is a legal and tax action, not simply administrative. For example, in certain states, New York among them, an LLC once formed must file a Certificate of Publication with the State. I have dealt with several clients who failed to meet this requirement because they were never advised legally of their obligation. There are many pitfalls and undesirable consequences of failing to follow the law, which vary from state to state.

Forming an entity that meets your specific company's needs is a necessary part of doing business. It is important to get started off on the right foot protecting your personal and business assets and is worth the up-front investment to at least meet with an attorney who will discuss with you all of your options.

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