

Incorporating a Small Business

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Incorporating a Small Business

Prepared by the
Office of the General Counsel
U.S. Small Business Administration

Summary

If you are the owner-manager of a small business you may have been wondering about the advisability of incorporating your business, particularly if you are seeking equity capital.

This Management Aid does not discuss the advantages and disadvantages of the corporate form; its purpose is to acquaint you with some of the basic steps involved once you have decided to incorporate.

This Aid is not to be considered a substitute for professional advice. Legal guidance will insure that (a) the articles of incorporation and the bylaws are tailored to the needs of your particular business enterprise, (b) you understand the various aspects of the tax obligations involved, and (c) you will be in compliance with the State, local, and Federal laws affecting the corporation.

Laws governing the procedure for obtaining a corporate charter vary among States. Detailed information about the requirements of your State can be obtained from the secretary or other official designated to supervise the granting of corporate charters.

Choosing the Location

The majority of small and medium-sized businesses, especially those whose trade is local in nature, find it advisable to obtain their charter from the State in which the greatest part of their business is conducted.

Out-of-State, or "foreign," incorporation often results in the additional payments of taxes and fees in another jurisdiction. Moreover, under the laws of many States the property of a foreign corporation is subject to less favorable treatment, especially in the area of attachment of corporate assets. This legal difference could prove especially hazardous to a small business.

On the other hand, you should look into possible benefits to be gained from incorporation in another State. Such factors as State taxes, restrictions on corporate powers and lines of business in which a company may engage, capital requirements, restrictions upon foreign corporations in your State, and so forth should be taken into consideration in selecting the State of incorporation. For example, you should be aware that some States require a foreign corporation to obtain a certificate to do business in their State. Without such certification the corporation may be deprived of the

right to sue in those States.

The fee or organization tax charged for incorporation varies greatly from State to State.

Certificate Of Incorporation

Generally, the first step in the required procedure is preparation, by the incorporators, of a "certificate of incorporation." Most States used to require that the certificate be prepared by three or more legally qualified persons, but the modern trend is to require only one incorporator. An incorporator may, but not necessarily must, be an individual who will ultimately own stock in the corporation.

For purposes of expediting the filing of articles, "dummy" incorporators are often employed. These dummy incorporators are usually associated with a company that performs this service or with an attorney for the organizers. They typically elect their successors and resign at the meeting of the incorporators.

Many States have a standard certificate of incorporation form which may be used by small businesses. Copies of this form may be obtained from the designated State official who grants charters and, in some States, from local stationers as well. The following information is usually required:

1. The corporate name of the company. Legal requirements generally are (a) that the name chosen must not be so similar to the name of any other corporation authorized to do business in the State as to lead to confusion and (b) that the name chosen must not be deceptive so as to mislead the public. In order to be sure that the name you select is suitable, check out the availability of the name through the designated State official in each State in which you intend to do business before drawing up a certificate of incorporation. This check can be made through a service company. In some States, there is a procedure for reserving a name.

2. Purposes for which corporation is formed. Several States permit very broad language, such as "the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized." However, most States require more specific language in setting forth the purposes of the corporation. Even where State law does not require it, the better practice is to employ a "specific object" clause which spells out in broad descriptive terms the projected business enterprise. At the same time taking care to allow for the possibility of territorial, market, or product expansion. In other words, the language should be broad enough to allow for expansion and yet specific enough to convey a clear idea of the projected enterprise.

The use of a specific object clause, even where not required by State law, is advisable for several reasons. It will convey to

financial institutions a clearer picture of the corporate enterprise and will prevent problems in qualifying the corporation to do business in other jurisdictions. Reference books or certificates of existing corporations can provide examples of such clauses.

3. Length of time for which the corporation is being formed. This may be a period of years or may be perpetual.

4. Names and addresses of incorporators. In certain States one or more of the incorporators is required to be a resident of the State within which the corporation is being organized.

5. Location of the registered office of the corporation in the State of incorporation. If you decide to obtain your charter from another State, you will be required to have an office there. However, instead of establishing an office, you may appoint an agent in that State to act for you. The agent will be required only to represent the corporation, to maintain a duplicate list of stockholders, and to receive or reply to suits brought against the corporation in the State of incorporation.

6. Maximum amount and type of capital stock which the corporation wishes authorization to issue. The proposed capital structure of the corporation should be set forth, including the number and classification of shares and the rights, preferences, and limitations of each class of shares.

7. Capital required at time of incorporation. Some States require that a specified percentage of the par value of the capital stock be paid in cash and banked to the credit of the corporation before the certificate of incorporation is submitted to the designated State official for approval.

8. Provisions for preemptive rights, if any, to be granted to the stockholders and restrictions, if any, on the transfer of shares.

9. Provisions for regulation of the internal affairs of the corporation.

10. Names and addresses of persons who will serve as directors until the first meeting of stockholders or until their successors are elected and qualify.

11. The right to amend, alter, or repeal any provisions contained in the certificate of incorporation. This right is generally statutory, reserved to a majority or two-thirds of the stockholders. Still, it is customary to make it clear in the certificate.

If the designated State official determines that the name of the proposed corporation is satisfactory, that the certificate contains the necessary information and has been properly executed, and that there is nothing in the certificate or the corporation's proposed

activities that violate State law or public policy, the charter will be issued.

Officers and Stockholders

Next, the stockholders must meet to complete the incorporation process. This meeting is extremely important. It is usually conducted by an attorney or someone familiar with corporate organizational procedure.

In the meeting the corporate bylaws are adopted and a board of directors is elected. This board of directors in turn will elect the officers who actually will have charge of the operations of the corporation--for example, the president, secretary, and treasurer. In small corporations, members of the board of directors frequently are elected as officers of the corporation.

Bylaws

The bylaws of the corporation may repeat some of the provisions of the charter and State statute but usually cover such items as the follows:

1. Location of the principal office and other offices of the corporation.
2. Time, place, and required notice of annual and special meetings of stockholders. Also the necessary quorum and voting privileges of the stockholders.
3. Number of directors, their compensation, their term of office, the method of electing them, and the method of creating or filling vacancies in the board of directors.
4. Time and place of the regular and special director's meetings, as well as the notice and quorum requirements.
5. Method of selecting officers, their titles, duties, terms of office, and salaries.
6. Issuance and form of stock certificates, their transfers and their control in the company books.
7. Dividends, when and by whom they may be declared.
8. The fiscal year, the corporate seal, the authority to sign checks, and the preparation of annual statement.
9. Procedure for amending the bylaws.

Special Tax Laws

At the time of the first meeting of the corporate board of directors and prior to issuance of any shares, you might consider adoption of a plan under a section of the Internal Revenue Code (IRC 1244) that grants ordinary rather than capital treatment of losses on certain "small business stock." Among the requirements of qualification as "section 1224 stock" are (1) the stock must be common stock, (2) the stock must be issued by the corporation for money or other property pursuant to a written plan containing several limitations, and (3) the amount of contribution received for the stock and equity capital of the corporation must not exceed maximum dollar limits.

You should be aware, also, of the possibility of electing subchapter S status (IRS 1371-1379). The purpose of subchapter S is to permit a "small business corporation" to elect to have its income taxed to the shareholders as if the corporation were a partnership. One objective is to overcome the double-tax feature of the present system of taxation of corporate income. Another purpose is to permit the shareholders to have the benefit of offsetting business losses by the corporation against the income of the shareholders.

Among the qualifying requirements for electing and maintaining "subchapter S" eligibility are that the corporation has no more than 10 shareholders, all of whom are individuals or estates; that there be no nonresident alien shareholders; that there be only one class of outstanding stock; that all shareholders consent to the election; and that a specified portion of the corporation's receipts be derived from actual business activity rather than passive investments. No limit is placed on the size of the corporation's income and assets.

If you plan to transfer property to a corporation in exchange for stock, you should realize that such a transfer is a taxable transaction unless the transfer complies with the provisions of IRC section 351.

Other Considerations

If your business is at present a sole proprietorship or partnership, you will need to secure a new taxpayer identification number and unemployment insurance account. You should find out in advance whether present licenses and leases will be transferable to the new corporate entity.