BASICS ABOUT CORPORATIONS

You don't need a large business to have a corporation. In fact, most of the new corporations that are formed each month in Illinois are small operations. Even the owners of home-based businesses may find incorporation quite advantageous. This article will discuss the characteristics, advantages, and disadvantages of conducting your business as a corporation.

<u>What is a Corporation?</u> A <u>corporation</u> is a nonhuman entity. No, it is not like ET, the ExtraTerrestrial, and it is not created by God or Mother Nature. Instead, corporations exist because of a statute known as the Business Corporation Act (BCA).

The most important feature of a corporation is that it exists entirely separate and apart from its owners. Virtually all the legal and tax advantages associated with corporations flow from this essential element.

Corporations must have at least one owner, but there is no upper limit. The owners are called <u>shareholders</u> or <u>stockholders</u>. The ownership interests of the shareholders in a corporation are divided into units called <u>stock</u>, <u>shares</u>, or <u>shares of stock</u>. The rules governing corporations along with the advantages and disadvantages apply equally to corporations owned by one or more than one shareholder.

A corporation comes into existence when the prospective shareholders file a paper with the Illinois Secretary of State known as <u>Articles of Incorporation</u>. Among other things, the Articles of Incorporation require the prospective shareholders to determine the number of shares the corporation will be authorized to issue.

The total number of shares a corporation may issue is arbitrary, and there is no upper limit. However, the corporation must issue at least one share of stock for each shareholder. If the corporation will have more than one shareholder, the corporation should issue shares to each stockholder in proportion to their ownership interests. The proportion of the shareholders' ownership interests may vary from a fraction of one percent to a fraction over ninety-nine percent, depending on the deal the shareholders make when they decide to go into business together.

For example, if you are the sole shareholder, it makes no difference whether you own one share or one million shares. In each case, you own one hundred percent of the corporation. Likewise, if two people have decided to go into business on a sixty-forty basis, it makes no difference whether one

owns six shares or six million and the other owns four shares or four million. In each case, their respective interests would be sixty-forty.

<u>How Does a Corporation Conduct Business</u>? A corporation conducts business through a chain of authorized representatives. The shareholders are at the top of the chain. The shareholders, however, do not directly manage the corporation's daily affairs. Instead, the shareholders meet at least once each year to elect a <u>Board of Directors</u>.

Corporations must have at least one director, but there is no upper limit. The directors' job is to make general business decisions for the corporation. Their decisions are then implemented by the corporation's <u>officers</u>, who are appointed by the directors each year at a directors' meeting.

The officers consist of at least the following: president, treasurer, and secretary. The <u>president</u> is responsible for managing the corporation's daily operations. The <u>treasurer</u> manages the corporation's money, while the <u>secretary</u> maintains the corporation's nonfinancial books and records. Corporations may also have one or more vice presidents. A <u>vice</u> <u>president's</u> duties may vary, depending on the corporation's needs. For example, the corporation may have vice presidents for sales, marketing, operations, personnel, and so on.

The shareholders may elect themselves as the directors. In their capacity as directors, they may then appoint themselves as one or more of the officers. If you are a sole shareholder, you may elect yourself as the sole director and, as the sole director, you may appoint yourself as president, treasurer, and secretary. This arrangement is not considered a conflict of interest, and it is permitted by the BCA. Indeed, who else would you want to run your business?

What Are the Advantages of Corporations? You may recall that the essential element of corporations is their existence entirely separate and apart from the shareholders. This feature gives rise to the principal advantage of corporations--limited liability protection.

Because a corporation exists apart from the shareholders, the corporation alone is liable for its debts. Even though they own and manage the corporation, the shareholders are not personally liable for its debts.

For example, let's suppose that I am the sole shareholder of EZ Flush, Inc., a corporation through which I conduct my plumbing business. While attempting to fix a pipe, I accidentally flood my customer's basement with sewage. The corporation alone is liable for the damages caused by the

flooding. I am not personally liable. This means that my customer can only look to my corporation's assets to pay for the damages. All my personal assets, such as my house, my car, and my savings are protected from my customer's claim.

The result might be different if I had intentionally damaged my customer's pipe or if my corporation had no equipment, bank account, receivables, insurance, or any other assets. Then, I might be personally liable. I might also be personally liable if I do not conduct annual shareholder's and director's meetings and if I do not keep my corporation's property, such as its bank account, separate from my own.

In addition to limited liability protection, corporations offer two tax advantages. First, under the present tax code, a corporation may claim a one hundred percent deduction for health insurance the corporation purchases for the shareholders' benefit. Second, a corporation may deduct the cost of life insurance, up to a \$50,000 policy, the corporation purchases for the shareholders.

What Are the Disadvantages of Corporations? Doing business through a corporation carries several tax disadvantages. Because a corporation has its own existence, it pays taxes on its own income. However, if a corporation has losses, only the corporation, and not the shareholders, can claim those losses as a tax deduction.

Most businesses lose money at some time or other. This often occurs during their start-up phase, when cash is tightest. If you are conducting your business through a corporation, you will be unable to deduct business losses until the corporation makes a profit, even if you have personal income from other sources. This delay can be particularly painful for new business owners with limited resources.

After your corporation becomes profitable, you will face another disadvantage, "double tax." Double tax occurs when you and your corporation pay tax twice on the same dollar of income, a terrible fate indeed. Double tax can best be explained by an example.

Let's return to my plumbing corporation, EZ Flush, Inc. EZ Flush and I must both pay taxes based on the income we earn during a calendar year. Because EZ Flush has its own existence separate and apart from mine, all the income the business earns is taxed to EZ Flush, not to me. On December 31, at the close of a calendar year, EZ Flush has a net profit of \$10,000. EZ Flush will pay corporate tax on that \$10,000. On January 1, the start of the next calendar year, EZ Flush still has the \$10,000. I pay myself a \$5,000

bonus out of the \$10,000. As I have now received \$5,000, it is considered my personal income, and I will pay tax on that \$5,000. Although EZ Flush earned only \$10,000, EZ Flush and I must pay tax on income totaling \$15,000. In other words, we are paying tax twice on the same \$5,000!

Double tax can also occur if you decide to sell your business. If the buyer purchases the corporation's assets, the profits from the sale may be subject to double tax. First, your corporation may pay tax on the gain. Next, you may pay tax on the money when you take it out of the corporation. (Strategies for buying and selling corporations and corporate assets will be discussed in this column in the October, 1994 issue of <u>Svoboda's Home and Small Business Reporter</u>.)

Double tax on income can be avoided to some extent through a mechanism known as "zeroing out." In our above example, if I had paid myself the bonus on December 31 rather than on January 1, EZ Flush might have deducted the \$5,000 payment as a business expense. EZ Flush would then have earned and paid tax on only \$5,000, thus avoiding double tax on the \$5,000 paid to me.

Zeroing out has its limits. The Internal Revenue Service may not allow deductions for compensation that it deems to be "excessive." Leaving "excessive" amounts in your corporation can also cause tax problems. These situations generally do not arise unless you are earning well into six figures or unless you have accumulated above six figures in your business. However, they can become real headaches for successful entrepreneurs. Fortunately, the Internal Revenue Code provides some relief in the form of S Corporations.

Another tax disadvantage arises in the form of income taxes. Illinois imposes an income tax on corporations that amounts to 7.3 percent on income above \$1,000.

What Are S Corporations? The specter of delayed deductions for losses, double tax, excess earnings tax, and excess accumulations tax has led many business owners to form "S" corporations. S corporations have the same structure and limited liability protection as regular (also known as "C") corporations. However, due to a section of the Internal Revenue Code known as Subchapter S, the shareholders of corporations that qualify for Subchapter S status are able to deduct losses in proportion with and to the extent of their investment in the business. S corporation shareholders are also free from double tax, excess earnings tax, and excess accumulations tax. Unlike C Corporations, in which income is taxed to the corporation, all

the income of S corporations, whether from earnings or the sale of assets, is taxed directly to the shareholders in proportion to their ownership interest.

Of course, S corporations have some disadvantages, too. Unlike the shareholders of C corporations, shareholders owning more than two percent of an S corporation only receive a partial deduction on health insurance purchased for them by the corporation. Also, as the top tax rates are higher for individuals than for corporations, S corporation shareholders may pay more income tax than C corporation shareholders who leave "nonexcessive" amounts in their corporation. However, the Illinois income tax rate for S corporations is only 1.5 percent on income above \$1,000.

<u>Planning Is the Key</u> Depending on the degree of personal liability that you risk in your business and your need for health or life insurance, a corporation can offer terrific benefits. Proper planning, however is essential to avoiding the pitfalls.