

# The POCKET LAWYER® Self-Help Series

## Understanding California Corporations

*The information in this brochure is for educational purposes only and is intended to assist you in preparing your own California Corporation. It is NOT intended to be legal advice or a substitute for the professional advice of a licensed attorney*

### **What are the main types of business organizations?**

The main types of business organizations are Sole Proprietorships, Partnerships, Corporations and Limited Liability Companies (LLC).

### **What is a Corporation?**

A corporation is a business that is formed and authorized by law to act as a single entity, although it is constituted and owned by one or more persons, known as shareholders. It is legally endowed with rights and responsibilities and has a life of its own, independent of the owners and operators. It has been defined by the United States Supreme Court as “an artificial being, invisible, intangible and existing only in contemplation of the law.” Today, there are more than two million active corporations in North America. According to the Wall Street Journal, in excess of 50,000 new corporations are formed each month.

A Corporation is a legal business entity that is treated separately from its owners. Much like an individual, a corporation can conduct business under its own name, own property, enter into contracts, pay taxes, sue and be sued, etc.

A Corporation protects its owners’ or shareholders’ assets from personal liability. For example, if the corporation gets sued, that liability will be satisfied from the corporate assets. Short of legal wrongdoing or personal guarantees, the owners’ or shareholders’ assets will be protected and their loss will be limited to their investment.

A Corporation pays income taxes as a separate entity. The owners also pay taxes on the dividends they receive from the Corporation. Thus, there is “dual taxation.” With a Corporation, however, many expenses will be tax deductible.

A Corporation comes into existence once the proper documents (Articles of Incorporation, etc.) are filed with the proper state agency (Secretary of State). Thereafter, in order to enjoy the benefits of the “corporate veil,” the owners of the corporation must adhere to corporate formalities, such as holding annual meetings, preparing the minutes for the meetings, filing proper documents in a timely manner, etc. Additionally, it is crucial to treat the corporation as a separate entity. There can be no “commingling” of funds between the corporation and its shareholders. If the distinction between a corporation and its shareholders fades, so does the justification for limited personal liability. That can lead to the loss of the corporate protection.

To ease the burden of the “double taxation”, the IRS allows corporations, (if they meet certain requirements) to become what is known as an “S” Corporation and receive special tax status.

An S Corporation, much like a regular or “C” Corporation, is a separate legal entity. The “corporate shell” still protects its owners’ assets from personal liability. That is, personal assets of shareholders will not be utilized to satisfy a claim brought against the corporation.

An S Corporation is initially a C Corporation. It becomes an S Corporation, or receives the special tax status, once it files the proper documentation with the IRS. An S Corporation may revoke its status and return to C status.

An S Corporation will be taxed like a partnership. There is no “dual taxation” as there is with a C Corporation. The tax treatment is commonly referred to as “pass through” taxation. That is, the S Corporation’s profits and losses pass through its shareholders and are reported on the shareholders’ tax returns, all in proportion to stock ownership. However, many of the S Corporations’ expenses are not tax deductible, as they would have been in a C Corporation.

An S Corporation has certain restrictions. For example, the number of shareholders is limited to 75 US residents. The corporation must be formed in the US and have only one class of stock. The shareholders may not be other business entities, such as another corporation.

Electing the S status attracts many entrepreneurs because they are able to enjoy the corporate protection without the dual taxation.

Non-profit or Non-Stock Corporations or Associations are formed to operate religious, charitable, social, educational, or other similar organizations. Certain states, such as California, have different types of Non-Profit Corporations that are designed for different purposes (e.g., Religious Corporations to operate a particular religion, Public Benefit Corporations for charitable purposes, and Mutual Benefit Corporations to develop a common interest). Non-Profit Corporations or Organizations are subject to the Franchise Tax, unless they apply for an exemption.

### **What is an LLC?**

An LLC, or limited liability company, consists of one or more members, which may be individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, other LLCs, or other business entities. Unlike the restrictions placed in the shareholders of an S Corporation, the LLC members need not be US residents, nor be limited to 75 in number.

The LLC offers limited personal liability for business debts. The members of an LLC are afforded limited personal liability similar to shareholders of a corporation.

The LLC can choose how it will be taxed. The LLC can be taxed like a corporation, or it can choose “pass through” taxation like a partnership or S Corporation.

The LLC is not an incorporated entity. Thus, the LLC is not bound by the myriad of rules that govern corporations. Unlike the S Corporation, the members of an LLC may distribute profits and losses as they agree, without regard to the members’ ownership percentages.

The life of an LLC is for a limited duration. However, filing the proper documents can extend that duration.

### **Advantages of a Corporation include:**

**Limited Liability** - The liability of the owners is limited to the extent of their investment in the corporation (with the exception of unpaid taxes). Creditors cannot attach property of the owners. The corporation can enter into contracts, sue and be sued without involvement of the owners.

**Raising Capital** – Capital can be raised much easier by selling shares of stock in the business.

**Transference of Ownership** – Ownership is more easily transferred since the owners’ interest is represented by shares of stock. Shares can be easily distributed to family members.

**Perpetual Existence** – Because the corporation is an independent legal entity, it does not cease to exist just because one of the owners dies or wishes to retire.

**Centralized Management** – There is a centralized management structure which usually rests in the board of directors and officers of the corporation.

**Retirement Funds** – Retirement funds such as Keogh, 401K’s, defined contribution plans, and other profit sharing, pension and stock option plans offer greater benefits to corporations.

**Tax Options** – There are many more tax options available to corporations than any other form of business operation.

### **Disadvantages of a Corporation include:**

**Governmental Regulation** – It is subject to more governmental regulations than other forms of business operations.

**Organization Cost** – It is somewhat more expensive to organize than other forms of business operation.

**Tax Reporting** – The owners of a corporation may need to file two tax returns, individual and corporate. This may require added time and accounting expense.

**Where to Incorporate:** Having decided to incorporate, the next question to be decided is in which state to form the corporation. You have probably heard of the many advantages of incorporating in the State of Delaware. You may have also heard it is advantageous to incorporate in Nevada, California, and certain other states. The fact is, the best state in which to incorporate is the state in which the corporate headquarters is to be located and business is to be transacted.

**Reserving the Name:** Most states have similar requirements for forming a corporation. Usually, the first step is the selection and reservation of the corporation's name. Most states require the words "incorporated", "inc.", "corporation", "corp.", "limited", or "ltd." to be part of the corporate name. States may also prohibit the use of certain words, such as bank, trust, National, Federal, doctor, etc.

Once the corporation's name has been selected, verification must be made that the name or a similar name is not already being used within the state. If the name is available, it must then be reserved. This is usually done by submitting a letter or form with the required fee, and waiting to receive clearance.

**Registered Agent:** Most states require that a corporation provide the name of a registered agent who maintains an address within the state in order to receive communications and to be available to receive a summons in lawsuits and other services. Normally, the registered agent is an officer of the corporation.

**Directors:** In general, the right and responsibility to determine policy and conduct the business of the corporation rests with the Board of Directors. The number and identities of the persons who make up the board is usually set by the by-laws of the corporation, which are drawn up at the first meeting of the stockholders. The directors, elected by the stockholders, are responsible to the stockholders and may be removed by the stockholders with or without cause.

Directors must act as a body in accordance with the by-laws of the corporation. They can bind the corporation only by actions taken at a board meeting with the necessary quorum. They cannot vote by proxy and their duties may generally not be delegated to others. Directors are generally required by law to meet at least once every year.

**Officers:** The President, Vice President, Secretary and Treasurer (and such other officers as the particular corporation may choose to have), are appointed by the board of directors. The officers run and manage the corporation from day to day. They have only such legitimate responsibilities and authority to act, as are conferred upon them by the board of directors or as specified in the by-laws of the corporation. In general, corporations are required to have a President, Treasurer, and Secretary (or Clerk). Other officers such as Vice President(s), or Assistant Treasurers are optional. If there is only one person in the corporation, that person will be all of the positions mentioned.

**Stocks:** The stockholders of a corporation are the owners of the corporation. When a business incorporates, it issues shares indicating who owns that "share" of the business. Stocks may be paid for with money, property, or services. Thus, if a corporation's net worth is \$50,000, and there are 500 shares issued, then each share would be worth \$100. If there are a total of 4 persons each of whom owns 125 shares of the stock, then each shareholder owns 25% of the corporation. The number of shares to be authorized by the corporation is written into the Articles of Incorporation and filed with the Secretary of State.

Although there is more than one type of stock which a corporation may issue, **common stock** is the most popular. The holders of common stocks are entitled to have the primary voice in selecting directors and are the principal policy-makers of the corporation. They are entitled to share in the profits, and in a final distribution of the corporation assets on dissolution.

Stocks may have either a **par value** (a nominal value stated on the face of the certificate representing the amount contributed by the shareholder to purchase each share) or **no-par value**. A no-par value stock certificate bears no stated or nominal value on the face of the certificate, hence, it does not purport to represent anything more than the given number of stocks or ownership interest in the corporation. (Most small, start-up corporations use no-par value).

**Articles of Incorporation:** the “Articles of Incorporation” is the document that must be filed with the appropriate department of your state. This normally is the Secretary of State of your state. Among the items of information which are required in the articles of incorporation are:

1. Proposed name of the corporation
2. Fiscal year
3. Purpose(s) of the corporation
4. Number of authorized shares of stock and par value
5. Name and address of initial registered agent

**Fiscal Year:** The fiscal year need not begin on January 1 and end on December 31 as with other forms of business operation. The business year may begin and end any time during the year. The fiscal year is usually determined and included in the articles of Incorporation. It is generally advantageous to choose the calendar year as the corporation’s fiscal year because there will be few tax forms to file.

**Employer Identification Number:** Once the Articles of Incorporation have been filed and approved, an employer identification number must be obtained from the Internal Revenue Service.

**Sub-Chapter “S” Corporations:** Under a provision of the Internal Revenue Code, a corporation may elect to have its profits taxed either as a corporation, using the corporate tax rates; or to have it taxed individually to its owners at personal income tax rates. A corporation which meets the requirements, and elects to have its profits taxed individually to its owners, is known as a Sub-Chapter S Corporation. The chief advantage of electing to become a Sub-Chapter “S” Corporation is that the business owner can enjoy all the advantages of doing business as a corporation and still be taxed as an individual.

**Corporate Seal:** Anytime the secretary of the corporation signs a document in the name of the corporation, he must place a corporate seal over his signature. The corporate seal is a piece of equipment that embosses the name of the corporation on legal documents. Its purpose is to verify that the corporation has authorized various actions taken by its directors or officers.

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