ARI
ALEXANDER REMINGTON
INTERNATIONAL ASSOCIATES

PHONE: (864)832-7420
FAX: (864)990-3063
EMAIL: INFO@ARINET.US

ACCURATE, RELEVANT, & IMMEDIATE

Incorporation Guide

Guide to Incorporating and Forming a Limited Liability Company

Our Incorporation Guide is developed with the help of the small business legal experts at Nolo Press.

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Introduction

Congratulations on getting your small business up and running! Now is a great time to consider whether incorporating or forming an LLC makes sense for your business.

Our incorporation guide will help you answer questions like what to expect when incorporating, what entity type is best for your business (C-Corporation, S-Corporation, or LLC), and what state to form in. This guide introduces several of the most important factors to consider, including:

- the potential risks and liabilities of your business
- the formalities and expenses involved in establishing and maintaining the various business structures
- your income tax situation, and
- your investment needs.

And when you're ready to incorporate, ARI is here to help. We'll simplify the incorporation and LLC filing process, helping you easily and affordably get the benefits of incorporating for your business or real estate investment.

Why Consider Incorporating or Forming an LLC?

You don't have to be a large operation with dozens of employees to benefit from incorporating. In fact, quite the opposite is true. Many of ARI's customers are home-based, one-person businesses with less than $50,000 in revenues —or even no revenues and just getting started. Why do businesses and investors consider incorporating?There are several benefits:

Liability Protection

In our increasingly litigious society, it is becoming ever more important to limit your exposure and protect yourself from liability. As a sole proprietor, your liability for business debt is unlimited, meaning personal assets such as your home, personal bank accounts and other valued assets may be at risk. Forming a corporation or LLC draws a firm line between your personal and business assets, helping protect your personal assets from risks or debts associated with running your business.

Tax Savings

As your business income grows, there may be tax advantages to incorporating and paying taxes at corporate rather than personal tax rates. Additionally, if you're paying substantial self-employment taxes today, forming an S-corporation could help you save on income taxes. We'll discuss tax related issues in greater detail in the next section.

Benefits Continued

Reduced Chance of Tax Audit

Sole proprietors tend to be more likely to file incorrect returns (many are self-prepared), and tend to underreport revenue or overreport deductions. For these reasons, the IRS has continually audited a much higher percentage of sole proprietor tax filings than corporate filings. In 2006, 4.31 % of sole proprietors with earnings of >$100K were audited, where only .45 % of S-Corporations were audited. So, you're ten times more likely to be audited if you are a sole proprietor.

Establishing a Professional Identity

Many small businesses choose to incorporate or form an LLC to prove their legitimacy to both customers and suppliers. Including the "Inc." or "LLC" at the end of your business name in all marketing and communications can help to separate you from the competition.

Raising Capital

If you are looking to raise capital, incorporating or forming an LLC also increases the legitimacy of your company from an investor's standpoint. Investors are interested in making sure they are investing in a sound business – one that has adhered to the proper formalities (whether you've formed a corporation or an LLC).

Choosing the Right Entity Type

When you start a business, you must decide whether it will be a sole proprietorship, partnership, corporation, or limited liability company (LLC). Which of these forms is right for your business depends on the type of business you run, how many owners it has, and its financial situation. No one choice suits every business: Business owners have to pick the structure that best meets their needs.

In large part, the best ownership structure for your business depends on the type of services or products it will provide. If your business will engage in risky activities -- for example, trading stocks or repairing roofs -- you'll almost surely want to form a business entity that provides personal liability protection ("limited liability"), which shields your personal assets from business debts and claims. A corporation or a limited liability company (LLC) is probably the best choice for you.

Corporations

What sets the corporation apart from all other types of businesses is that a corporation is an independent legal and tax entity, separate from the people who own, control and manage it. Because of this separate status, the owners of a corporation don't use their personal tax returns to pay tax on corporate profits -- the corporation itself pays these taxes. Owners pay personal income tax only on money they draw from the corporation in the form of salaries, bonuses, and the like.

Limited Personal Liability

One of the main advantages of incorporating is that the owners' personal assets are protected from creditors of the corporation. For instance, if a court judgment is entered against your corporation saying that it owes a creditor $100,000, you can't be forced to use personal assets, such as your house, to pay the debt. Because only corporate assets need be used to pay business debts, you stand to lose only the money that you've invested in the corporation.

Exceptions to Limited Liability

There are some circumstances in which limited liability will not protect an owner's personal assets. An owner of a corporation can be held personally liable if he or she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the corporation defaults
- fails to deposit taxes withheld from employees' wages
- does something intentionally fraudulent or illegal that causes harm to the company or to someone else, or
- treats the corporation as an extension of his or her personal affairs, rather than as a separate legal entity.

Paying Corporate Income Tax

If an owner of a corporation works for the corporation, that owner is paid a salary, and possibly bonuses, like any other employee. The owner pays taxes on this income just like regular employees, reporting and paying the tax on his or her personal tax return.

The corporation pays taxes on whatever profits are left in the businesses after paying out all salaries, bonuses, overhead, and other expenses. To do this, the corporation files its own tax return, Form 1120, with the IRS and pays taxes at a special corporate tax rate.

TAXABLE INCOME:	Tax is:	of the amount over
$0 TO $50,000	15%	$0
$50,001 TO $75,000	$7,500 + 25%	50,000
$75,001 TO $100,000	$13,750 + 34%	75,000
$100,001 TO $335,000	$22,250 + 39%	100,000
$335,001 TO $10,000,000	$113,900 + 34%	335,000
$10,000,001 TO $15,000,000	$3,400,000 + 35%	10,000,000
$15,000,001 TO $18,333,333	$5,150,000 + 38%	15,000,000
OVER $18,333,334	35%	0

What is an S-Corporation?

An S-Corporation is a regular corporation that has elected "S-Corporation" tax status. Forming an S-Corporation lets you enjoy the limited liability of a corporate shareholder but pay income taxes as if you were a sole proprietor or a partner.

In a regular corporation (also known as a C Corporation), the company itself is taxed on business profits. The owners pay individual income tax only on money they receive from the corporation as salary, bonuses, or dividends.

By contrast, in an S-Corporation, all business profits "pass through" to the owners, who report them on their personal tax returns (as in sole proprietorships, partnerships, and LLCs). The S-Corporation itself does not pay any income tax, although an S-Corporation with more than one owner must file an informational tax return like a partnership or LLC, to report each shareholder's portion of the corporate income.

Most states follow the federal pattern when taxing S-Corporations: They don't impose a corporate tax, choosing instead to tax the business's profits on the shareholders' personal tax returns. About half a dozen states, however, tax an S-Corporation like a regular corporation. The tax division of your state treasury department can tell you how S-Corporations are taxed in your state.

Should You Elect S-Corporation Status?

Operating as an S-Corporation may be wise for several reasons:

- Forming an S-Corporation generally allows you to pass business losses through to your personal income tax return, where you can use it to offset any income that you (and your spouse, if you're married) have from other sources.
- When you sell your S-Corporation, your taxable gain on the sale of the business can be less than it would have been had you operated the business as a regular corporation.

continued >>

- S-Corporation shareholders are not subject to self-employment taxes (active LLC owners are). These taxes, which add up to more than 15 % of your income, are used to pay your Social Security and Medicare taxes.

Let's look at a simple illustration.

Maria is a sole proprietor bringing in sales of $90,000. After she pays her costs & expenses, her profit is $60,000.
As a sole proprietor, she is required to pay self employment tax of 15.3 % on this entire $60K of profit, which equates to $9,180.

Now, let's assume Maria formed an S-Corporation for her business, and chooses to pay herself $35K for the year in salary, and take the remaining $25K of profit through a distribution. She still earns the same $60K in profit.
But, let's look at the tax situation. Because corporations only pay Social Security & Medicare taxes on salaries, she's only liable for $5,355, saving over $3,800 in taxes!

	Sole Proprietor (Schedule C)	S-Corporation
Sales	$90,000	$90,000
Costs & Expenses	$30,000	$30,000
Salary		$35,000
Profit	$60,000	$25,000

Self Employment Tax	$9,180	N/A
Social Security & Medicare	N/A	$5,355
		$3,825

You pay yourself a salary

Pay taxes only on your salary - not profit

S-Corporation Requirements

Aside from the benefits, S-Corporations impose strict requirements. Here are the main rules:

- Each S-Corporation shareholder must be a U.S. citizen or resident.
- S-Corporations may not have more than 100 shareholders.
- S-Corporation profits and losses may be allocated only in proportion to each shareholder's interest in the business.
- An S-Corporation shareholder may not deduct corporate losses that exceed his or her "basis" in corporate stock -- which equals the amount of the shareholder's investment in the company plus or minus a few adjustments.
- S-Corporations may not deduct the cost of fringe benefits provided to employee-shareholders who own more than 2% of the corporation.

Fortunately, a decision to elect to be an S-Corporation isn't permanent. If your business later becomes more profitable and you find there are tax advantages to being a regular corporation, you can drop your S-Corporation status.

Retaining Corporate Status

Whether you elect to file taxes as a C-Corporation or S-Corporation, corporations and their owners must observe certain formalities to retain the corporation's status as a separate entity. Specifically, corporations must:

- hold annual shareholders' and directors' meetings
- keep minutes of shareholders' and directors' major decisions
- make sure that corporate officers and directors sign documents in the name of the corporation
- maintain separate bank accounts from their owners
- keep detailed financial records, and file a separate corporate income tax return.

Limited Liability Company (LLC)

Limited liability companies combine aspects of partnerships and corporations.

A limited liability company (LLC) combines the corporation's protection from personal liability for business debts and the pass-through tax structure of a partnership or sole proprietorship. And, while setting up an LLC is more difficult than creating a partnership or sole proprietorship, running one is significantly easier than running a corporation. If you're concerned about being held personally liable for debts of your business, then an LLC may be just the thing for you. Here are the main features of an LLC:

Limited Personal Liability

Like shareholders of a corporation, all LLC owners are protected from personal liability for business debts and claims. This means that if the business itself can't pay a creditor -- such as a supplier, a lender, or a landlord -- the creditor cannot legally come after any LLC member's house, car, or other personal possessions. Because only LLC assets are used to pay off business debts, LLC owners stand to lose only the money that they've invested in the LLC. This feature is often called "limited liability."

Exceptions to Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, this protection is not absolute. This drawback is not unique to LLCs, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he/she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the LLC defaults
- fails to deposit taxes withheld from employees' wages
- intentionally does something fraudulent, illegal, or reckless that causes harm to the company or to someone else, or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

LLC Taxes

Unlike a corporation, an LLC is not considered separate from its owners for tax purposes. Instead, it is what the IRS calls a "pass-through entity," like a partnership or sole proprietorship. This means that business income passes through the business to the LLC members, who report their share of profits -- or losses -- on their individual income tax returns. Each LLC member must make quarterly estimated tax payments to the IRS.

While an LLC itself doesn't pay taxes, co-owned LLCs must file Form 1065, an informational return, with the IRS each year. This form, the same one that a partnership files, sets out each LLC member's share of the LLC's profits (or losses), which the IRS reviews to make sure LLC members are correctly report-ing their income.
LLC owners can elect to have their LLC taxed like a corporation. This may reduce taxes for LLC owners who need to retain a significant amount of profits in the company.

The owners of most small LLCs participate equally in the management of their business. This arrangement is called "member management."

There is an alternative management structure -- somewhat awkwardly called "manager management" in which you designate one or more outsiders, or sometimes specific members, to take responsibility for managing the LLC. The nonmanaging owners (sometimes family members who have invested in the company) simply sit back and share in LLC profits. In a manager-managed LLC, only the named managers get to vote on management decisions and act as agents of the LLC. Choosing manager management sometimes makes sense, but it might require you to deal with state and federal laws regulating the sale of securities.

Comparison Chart

Type of Entity	Main Advantages	Main Drawbacks
Sole Proprietorship	Simple and inexpensive to create and operate Owner reports profit or loss on his or her personal tax return	Owner personally liable for business debts
General Partnership	Simple and inexpensive to create and operate Owners (partners) report their share of profit or loss on their personal tax returns	Owners (partners) personally liable for business debts
Limited Partnership	Limited partners have limited personal liability for business debts as long as they don't participate in management General partners can raise cash without involving outside investors in management of business	General partners personally liable for business debts More expensive to create than general partnership Suitable mainly for companies that invest in real estate
Regular C Corporation	Owners have limited personal liability for business debts Fringe benefits can be deducted as business expense Owners can split corporate profit among owners and corporation, paying lower overall tax rate	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners Separate taxable entity
S-Corporation	Owners have limited personal liability for business debts Owners report their share of corporate profit or loss on their personal tax returns Owners can use corporate loss to offset income from other sources	More expensive to create than partnership or sole proprietorship More paperwork than for a limited liability company which offers similar advantages Income must be allocated to owners according to their ownership interests Fringe benefits limited for owners who own more than 2% of shares
Professional Corporation	Owners have no personal liability for malpractice of other owners	More expensive to create than partnership or sole proprietorship Paperwork can seem burdensome to some owners All owners must belong to the same profession
Nonprofit Corporation	Corporation doesn't pay income taxes Contributions to charitable corporation are tax-deductible Fringe benefits can be deducted as business expense	Full tax advantages available only to groups organized for charitable, scientific, educational, literary or religious purposes Property transferred to corporation stays there; if corporation ends, property must go to another nonprofit
Limited Liability Company	Combines a corporation's protection from personal liability for business debts and pass-through tax structure of a partnership Significantly easier to maintain than a corporation. IRS rules now allow LLCs to choose between being taxed as partnership or corporation	More expensive to create than partnership or sole proprietorship State laws for creating LLCs may not reflect latest federal tax changes
Professional Limited Liability Company	Same advantages as a regular limited liability company Gives state licensed professionals a way to enjoy those advantages	Same as for a regular limited liability company Members must all belong to the same profession
Limited Liability Partnership	Mostly of interest to partners in old line professions such as law, medicine and accounting Owners (partners) aren't personally liable for the malpractice of other partners Owners report their share of profit or loss on their personal tax returns	Unlike a LLC or a professional limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders and landlords Not available in all states Often limited to a short list of professions

Choosing a State

There are no legal requirements to incorporate in the state from which your business is conducted. In fact, a business can incorporate in any state or the District of Columbia, regardless of the principal place of business. But certain states are far more popular for corporations than others. Why? Due in large part to business friendly incorporation laws and favorable tax policies, two of the most "incorporation friendly" states are Delaware and Nevada.

Delaware
Incorporating in Delaware is generally less expensive than most other states. The initial filing fee can be as low as $89, and the annual franchise tax can be as low as $75. In addition, Delaware's corporation laws are some of the most liberal and well established in the United States, making it one of the least complicated states in the country in which to function as a corporate entity.

Nevada
Like Delaware, Nevada has business-friendly tax laws. Actually, Nevada has NO income tax whatsoever, includ-ing corporate income tax -- nor hidden taxes such as franchise taxes, capital stock taxes, or inventory taxes. Sales tax applies only to products sold within the state. Another advantage of Nevada incorporation is privacy of ownership -- investors and owners of Nevada corporations are able to remain completely anonymous.

While incorporating in Delaware or Nevada may make sense for large, publicly held corporations, it's usually not worth the effort for small, privately held corporations that do business only in their home state.

First, you're not likely to save any money in taxes by incorpo-rating in Delaware or Nevada. If your business makes money from operations in your home state, you still must pay your own state's income taxes on this income.

Second, while incorporation fees may be lower in other states than they are in your home state, you will have to qualify to do business in your state in addition to incorporating in a state other than your home state. This process takes as much time and costs as much money as filing incorporation papers in your own state. And you would also need to appoint a
“registered agent” to receive official notices in that state -- another cost you'd have to bear.

The filing process - how we can help.

There are several important steps to incorporating or forming an LLC:

1. Choose an available business name that complies with your state's corporation or LLC rules.

2. File formal paperwork, usually called Articles of Incorporation (or Articles of Organization for LLCs) and pay the filing fee.

3. Create corporate "bylaws" (or an “operating agree-ment” for LLCs) which lay out the operating rules for your entity.

4. For corporations, issue stock certificates to the initial owners, appoint the board of directors, and hold the first meeting.

ARI -- your trusted guide in navigating the filing process.

We hope this incorporation and LLC guide has helped inform your decision on what entity type and state of incorporation present the greatest benefits for your business or real estate investment.

When you're ready to incorporate, our incorporation service can take care of your end-to-end document filing.

- Online order forms guide you step-by-step through the process making it fast and easy (with experts available to answer your questions).
- We check your name for availability, complete all the required paperwork and file the right forms with the right government agencies - assurance it's being done right.
- Enjoy a substantial savings compared to normal lawyer's fees (over $200hr.).

Thank you for considering incorporating your business with us. We wish you the best of luck with your business endeavors!

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