

## **INCORPORATING FAQs**

Q: What is a corporation?

A: A corporation is a legal entity that can exist separately from its owners. Creation of a corporation occurs when properly completed articles of incorporation (called a charter or certificate of incorporation in some states) are filed with the proper state authority, and all fees are paid.

Q: What kind of paperwork is required for incorporation?

A: Articles of incorporation conforming to state law must be prepared and filed with the proper state authorities and filing fees, initial franchise taxes, and other initial fees must be paid.

Q: What should I name my corporation?

A: Choose the name of your corporation carefully. It is very important that you portray the image you want for your new corporation. Legally, the name you select must not be "deceptively similar" to any existing corporation or must be "distinguishable on the record" of your state. For example, if a corporation named New Star Inc. exists in your state, you probably would not be allowed to name your business New Staring, Inc. The state will register a name very similar to an existing corporation; therefore, we suggest you have several names as choices for the incorporation. Additionally, the name you choose must show your business is incorporated. Most states require that the corporate name be followed by some type of indicator, such as Corporation, Incorporated, or an abbreviation.

Q: What are the advantages of incorporation?

A: One of the primary advantages of incorporation is the separation of the personal liability from the corporate entity. Typically, shareholders and directors are not liable for the debts and obligations of the corporation; thus, creditors will not come knocking at the door of a shareholder or director to pay debts of the corporation. In a partnership or sole proprietorship the owner's personal assets may be used to pay debts of the business. Maintaining the limited liability of a corporation requires that the shareholders and directors follow all the rules of governance, including holding annual meetings and maintaining meeting minutes, which my office will direct corporate officers to follow.

Other advantages:

A corporation's life can be perpetual regardless of the owner's age. A corporation possesses the feature of unlimited life. If an owner dies or wishes to sell his or her interest, the corporation will continue to exist to do business.

Retirement funds and qualified retirement plans (like 401k) may be set up more easily with a corporation.

Ownership of a corporation is easily transferable.

Capital can be raised more easily through the sale of stock.

A corporation possesses centralized management.

Q: What are the disadvantages of incorporation?

A: The primary disadvantage to a corporation is double taxation. Profits of a corporation are taxed twice when the profits are distributed to shareholders as dividends. They are taxed first as income to the corporation, then as income to the shareholder. However, all reasonable business expenses such as salaries are deductible against corporate income and can minimize the double tax. Further, the double taxation can be eliminated by making an S corporation election.

Other disadvantages:

There is more complexity and expense with forming a corporation.

There is more extensive record keeping requirements.

Operating a corporation across state lines often requires the corporation to qualify to do business in another state.

Q: What is a federal tax ID number and why do I need it?

A: A federal tax identification number, also known as an employer identification number or EIN, is basically a social security number for businesses. It is the number the IRS uses to identify the business, and it must be included on tax filings the business makes. Businesses apply for an EIN by preparing IRS Form SS-4 and filing it with the IRS. It is the standard practice of my office to obtain the company's tax ID number when we do the incorporation.

If you operate your business as a sole proprietorship or partnership and are now looking to incorporate or form a limited liability company (LLC), you must obtain a new EIN for your business.

Q: What is an S corporation?

A: Standard business corporations or C corporations are required to pay income tax on taxable income generated by the corporation. Making a subchapter S election by completing and filing federal Form 2553 with the IRS is a way to avoid having your corporation treated as a separately taxable entity.

An S corporation is a standard business corporation that has elected a special tax status with the IRS. This tax treatment allows the corporation not to be a separately taxable entity. Instead, the income of the corporation is treated like the income of a partnership or sole proprietorship; the income is "passed-through" to the shareholders. Thus, shareholders' individual tax returns report the income or loss generated by an S corporation.

To be classified as an S corporation, a corporation must make a timely filing of Form 2553 with the IRS. IRS instructions indicate you must complete and file this form:

At any time before the 16th day of the 3rd month of the tax year the election is to take effect, or at any time during the tax year preceding the tax year it is to take effect. An election made no later than 2 months and 15 days after the beginning of a tax year that is less than 2½ months long is treated as timely made for that tax year.

An election made after the 15th day of the 3rd month but before the end of the tax year generally is effective for the next tax year. However, an election made after the 15th day of the 3rd month will be accepted as timely filed if the corporation can show that the failure to file on time was due to reasonable cause.

In order to qualify for S corporation status, the corporation can have no more than 100 shareholders, who must all consent in writing to the election to be an S corporation. The shareholders must be US citizens or permanent residents. Also, an S corporation can have only one class of stock (disregarding voting rights).

Please note: corporations in certain states are required to complete state-specific S corporation election forms for state taxation purposes. Additionally, certain states do not recognize federal S corporation status for state taxation purposes.

Q: What is the organizational structure of a corporation?

A: The organizational structure of a corporation relies on three basic groups: shareholders, directors, and officers.

A corporation is owned by shareholders; however, they do not directly manage the corporation. Instead, they influence corporate decisions through indirect methods such as

electing and removing directors, approving or disapproving amendments to the articles of incorporation and voting on major corporate issues.

The directors, who comprise the "board of directors," are responsible for managing the affairs of the corporation. Usually, directors make only the major business decisions and supervise and appoint the officers who make the day-to-day business decisions of the corporation.

Officers are responsible for the everyday management of the corporation. Typically, officers are appointed directly by the board of directors.

It is important to note that a shareholder may serve on the board of directors and as an officer. In fact, in most states one person is enough to form a corporation.

Q: How many directors do I need to form a corporation?

A: Only one director is required in most states although you can elect to have more. Some states use the number of shareholders in the corporation to determine the minimum number of directors. If the number of shareholders is three or more, then the corporation must have three directors. If the corporation has less than three shareholders, then the number of directors may equal the number of shareholders.

Q: Where should I incorporate my business?

A: One of the first decisions a business must make after deciding to incorporate involves selecting the proper state of incorporation. A corporation is not required to incorporate in the state of its operations, however, often the best decision may be to incorporate in your home state.

Two issues must be weighed to determine the proper state: (1) a dollars and cents analysis comparing the costs of incorporating in the state of operation versus qualifying to do business as a foreign corporation in the state under consideration and (2) determining the advantages and disadvantages of each state's corporate laws and tax structure. The decision usually falls between the state in which the business is located and Delaware.

If the corporation is a closely held corporation and does business primarily within a single state, local incorporation is often preferable. The cost of local incorporation will usually be less than incorporating in another state and qualifying to do business as a foreign corporation in the state. A foreign corporation that qualifies to do business in another state is subject to taxes and annual report fees from both the state of incorporation and the qualifying state. Another disadvantage of incorporating outside of your home state is the possibility of having to defend a lawsuit in another state.

Q: How do I get started with the incorporation process?

A: If you choose to incorporate, articles of incorporation must be filed with that state and initial fees must be paid.

After your articles are filed, your corporation must hold an organizational meeting where bylaws are adopted and the incorporation process is completed. Share certificates should be distributed to shareholders and these transactions should be recorded on the corporation's stock ledger. All of this information should be kept in a corporate record book.

## **LLC FAQs**

Q: What is a limited liability company?

A: The Limited Liability Company or LLC is not a partnership or a corporation. A LLC is a distinct type of business that offers an alternative to partnerships and corporations, by

combining the corporate advantages of limited liability with the partnership advantage of pass-through taxation.

Q: What paperwork is required to form an LLC?

A: Articles of organization must be prepared and filed with the state and filing fees, initial franchise taxes, and other initial fees must be paid.

Q: What should I name my LLC?

A: Choose the name of your LLC carefully. It is very important that your name portray the image you want for your new company. Legally, the name you select must not be "deceptively similar" to any existing company or must be "distinguishable on the record" of your state.

Additionally, most states require that the name you select show your business is a limited liability company, by including the words "Limited Liability Company," or the abbreviation LLC.

Q: How many people are needed to form an LLC?

A: The IRS does allow one member LLCs to qualify for pass-through tax treatment; however, taxation of one person LLCs at the state level may be different.

Q: How is an LLC taxed?

A: A state-registered LLC can be taxed for federal income tax purposes as a partnership. Under the check-the-box rules, an LLC can elect partnership status to avoid taxation at the entity level as an "association taxed as a corporation." If an LLC is not taxed as a partnership, it will be taxed at the entity level similar to a standard or C corporation.

The state income tax treatment of LLC profits and losses may or may not mirror the IRS tax treatment depending on the state. Please note that California LLCs are subject to an annual minimum franchise tax of \$800 per year. The first payment must be made within 3 months of forming your LLC. The state of California does send a bill to help you to remember to make this payment.

Q: what is the organizational structure of an LLC?

A: An LLC is owned by its members. They are analogous to partners in a partnership or shareholders in a corporation, depending on how the LLC is managed. A member will more closely resemble shareholders if the LLC utilizes a manager or managers, because then the members will not participate in management. If the LLC does not utilize managers, then the members will closely resemble partners because they will have a direct say in the decision making of the company.

A member's ownership of an LLC is represented by their "interests," just as partners have "interest" in a partnership and shareholders have stock in a corporation.

Q: How is an LLC managed?

A: An LLC may be managed by its members (owners) or by selected managers.

If the LLC is to be managed by its members, it operates much like a partnership. Each member has an equal say in the decision making process of the company.

If the members choose, they may elect a manager or managers to act in a capacity similar to a corporation's board of directors. These managers are in charge of the affairs of the corporation.

Member management is the normal default rule of state law. This means that if managers are not selected in the articles of organization, the members will direct the affairs of the LLC.

Q: What are the advantages of an LLC?

A: LLCs offer numerous advantages.

#### Pass-Through Taxation

LLCs allow for pass-through taxation. This means that earnings of an LLC are taxed only once. The earnings of an LLC are treated like the earnings from a partnership, sole proprietorships and most S corporations.

#### Limited Liability

The LLC owner's liability is generally limited to the amount of money, which the person has invested in the LLC. Thus, LLC members are offered the same limited liability protection as a corporation's shareholders.

#### Flexible Management Structure and Flexible Ownership is Permitted

Like general partnerships, LLCs are generally free to establish any organizational structure agreed on by the members. Thus, profit interests may be separated from voting interests.

Q: What are the disadvantages of an LLC?

A: The disadvantages of an LLC include:

#### More Paperwork than an Ordinary Partnership

Documents must be filed at the state level to create an LLC, which is not the case with a general partnership.

Q: What is a federal tax ID number and why do I need one?

A: A federal tax identification number, also known as an employer identification number or EIN, is basically a social security number for businesses. It is the number the IRS uses to identify the business, and it must be included on tax filings the business makes. Businesses apply for an EIN by preparing IRS Form SS-4 and filing it with the IRS.

If you operate your business as a sole proprietorship or partnership and are now looking to incorporate or form a limited liability company (LLC), you must obtain a new EIN for your business.

Q: Should I choose an LLC or an S corporation?

A: While the S corporation's special tax status eliminates double taxation, it lacks the flexibility of an LLC in allocating income to the owners.

An LLC may offer several classes of membership interests while an S corporation may only have one class of stock.

Any number of individuals or entities may own interests in an LLC. However, ownership interest in an S corporation is limited to no more than 100 shareholders. Also, S corporations cannot be owned by C corporations, other S corporations, many trusts, LLCs, partnerships, or nonresident aliens. Also, LLCs are allowed to have subsidiaries without restriction.

Q: How do I get started setting up an LLC?

A: After you decide to form an LLC, articles of organization must be filed with that state and initial fees must be paid.

After your articles of organization are filed, your LLC should have an organizational meeting where an operating agreement is adopted, interest certificates are distributed, and other preliminary matters are completed.

## **NONPROFIT FAQs**

Q: What is a nonprofit corporation?

A: A nonprofit corporation is an organization formed as a corporation for purposes other than generating a profit, and in which no part of the organization's income is distributed to its directors or officers. Nonprofits are formed pursuant to state law, often under the Revised Model Non-Profit Corporation Act (1986). A nonprofit can be a church or church association, school, charity, medical provider, legal aid society, volunteer service organization, professional association, research institute, museum, or in some cases a sports association. Being formed with the state as a nonprofit corporation does not automatically provide an organization with tax-exempt status. Nonprofits must apply for tax-exempt status at the federal and sometimes at the state level.

Q: What steps need to be taken to form a nonprofit?

A: The first step is to file nonprofit articles of incorporation with the proper state agency. It is important that the articles contain the required clauses to ensure your nonprofit will qualify for tax-exempt status.

After the nonprofit articles of incorporation are filed, tax-exempt status must be applied for at the federal level and sometimes at the state level. To apply at the federal level, a timely filing of Form 1023 must be made with the Internal Revenue Service (IRS).

Additionally, the nonprofit corporation must comply with corporate formalities and hold annual meetings of directors and members. Bylaws must also be adopted.

Q: What business purposes are valid for a nonprofit?

A: To qualify for federal tax-exempt status under 501(c)(3) of the Internal Revenue Code, the nonprofit must be organized and operate for some religious, educational, charitable, scientific, literary, testing for public safety, fostering of national or international amateur sports, or prevention of cruelty to animals or children purpose permitted under this section of the code. Nonprofits may also be formed for other purposes pursuant to different sections of the Internal Revenue Code. To qualify for federal tax-exempt status as a nonprofit under a different section of the code, your corporation must comply with the requirements of that federal tax code section.

The business purpose of the nonprofit must be listed in the articles of incorporation, and to apply for tax-exempt status, it is very important that the purpose of the organization be well described in the articles.

Additionally, certain states require approvals from state departments prior to approving the formation of a nonprofit corporation. One example of this is New York. New York often requires one or several departmental approvals based on the business purpose of the prospective nonprofit. Please keep in mind that there may be additional time required to obtain these approvals, and additional fees charged. This varies by state.

Q: What are the IRS classifications of nonprofits?

A: Nonprofits formed under 501(c)(3) must be formed for some religious, educational, charitable, scientific, literary, testing for public safety, fostering of national or international amateur sports, or prevention of cruelty to animals or children purpose.

Q: How many directors are nonprofits required to have?

A: Most states require nonprofits to have a minimum of three directors; however, some only require one director, and others allow for less than three directors.

Q: What is a federal tax ID number and why do I need one?

A: A federal tax identification number, also known as an employer identification number or EIN, is basically a social security number for businesses. It is the number the IRS uses to identify the business, and it must be included on tax filings the business makes. Businesses apply for an EIN by preparing IRS Form SS-4 and filing it with the IRS.

Q: What are the advantages of forming a nonprofit?

A: Nonprofits receive the same limited liability protection as do for-profit corporations. This means that directors or trustees, officers, and members are typically not personally responsible for the debts and liabilities of the nonprofit organization.

Other benefits include:

A nonprofit corporation's life is not dependent upon its members. It possesses the feature of unlimited life. If an owner dies or wishes to sell his or her interest, the nonprofit will continue to exist and do business.

Retirement funds and qualified retirement plans (like 401k) may be set up more easily with a nonprofit corporation

Q: What are the disadvantages of forming a nonprofit?

A: The main disadvantage of forming a nonprofit organization is the increased paperwork that is required. Articles of incorporation must be filed with the state, bylaws prepared, and meeting minutes must be kept with your organization's records.

## TAX EXEMPT FAQs

Q: What does being "tax-exempt" mean?

A: The term "tax-exempt," when used in reference to nonprofit organizations, generally refers to the net profits (proceeds over and above expenses) of an organization being exempt from federal and/or state income tax. While a nonprofit organization can be established by incorporating, the entity is not automatically tax-exempt upon creation with the state. Tax-exemption can usually be achieved only through applying for and receiving Internal Revenue Service (IRS) approval.

Q: Is there more than one category of tax-exempt organization?

A: Yes. The one most familiar (and addressed in subsequent questions below) is the Internal Revenue Code (IRC) Section 501(c)(3) public charity or private foundation, which is established for purposes that are religious, educational, charitable, scientific, literary, testing for public safety, fostering of national or international amateur sports, or prevention of cruelty to animals and children. There are also IRC Section 501(c)(4) through 501(c)(27) organizations that are considered tax-exempt, but not charitable. Examples include trade associations, social clubs and certain advocacy organizations involved in substantial political lobbying activity.

Q: What benefit does being tax-exempt offer my nonprofit organization and its contributors?

A: One of the primary benefits of being considered tax-exempt under IRC Section 501(c)(3) is the ability to accept contributions and donations that are tax-deductible to the donor. Additional benefits include, but are not limited to:

Exemption from federal and/or state corporate income taxes.

Possible exemption from state sales and property taxes (varies by state).

Ability to apply for grants and other public or private allocations available only to IRS-recognized, 501(c)(3) organizations.

Potentially higher thresholds before incurring federal and/or state unemployment tax liabilities.

The public legitimacy of IRS recognition.

Discounts on US Postal bulk-mail rates and other services.

Q: How long does it take the IRS to approve tax-exempt status?

A: Typically, IRS 501(c)(3) approval takes between 4 and 6 months, inclusive of likely written follow-up questions. Sometimes it takes a little less; sometimes a little more. Expedited review can be requested if a new organization is being formed to provide immediate disaster relief or if a promised grant is both 1) substantial relative to the organization's budget and 2) the grant has a specifically-defined expiration date. There is no guarantee the IRS will grant expedited review requests.

Q: What happens if the application is rejected?

A: A negative 501(c)(3) determination by the IRS can be appealed. Alternatively, the organization may choose to apply again from scratch. In either case, it is usually an uphill battle to acquire 501(c)(3) recognition once an organization's initial application has been rejected.

Q: What information will be required in the application package?

A: In order for the IRS to make a determination, specific questions must be answered relative to the organization's legal structure, its governing board and potential conflicts of interest. More importantly, pages of detailed questions concerning the organization's activities must be answered. This is in addition to a four-year budget (new organizations) or three years of financial history (existing organizations) and a written narrative essay outlining the organization's programs, both current and planned, that will advance the organization's exempt purpose. Add to that copies of supporting schedules and documentation and you have a basic application package.

Q: Can I file the application before having the articles of incorporation for my nonprofit?

A: Yes, but it is generally not recommended. The IRS will allow unincorporated associations to apply, but these organizations will not have the inherent benefits associated with the corporate structure. In addition, the IRS will still require copies of an organizing document.

Q: Can I start receiving contributions before application is approved?

A: Generally, yes. The IRS 501(c)(3) recognition is usually retroactively effective to the earlier of 1) the organization's legal formation or 2) the commencement of its programs. This means that the organization's activities are retroactively tax-exempt and donations are retroactively tax-deductible to the donor, extending even to prior tax years. Under certain circumstances, IRS tax-exemption may only be retroactive to the date of the filing of the application.

Q: Can I apply for grants before application is approved?

A: Technically, yes, but most foundations, government agencies and other funders, will require an organization to possess an approved IRS 501(c)(3) determination letter.

Q: If my nonprofit is tax-exempt, do I have to pay any type of taxes?

A: Possibly. Private foundations may still be subject to taxes on investment earnings and undistributed minimum grant allocations. All 501(c)(3) organizations may be subject to taxes on "unrelated business income." 501(c)(3) organizations that have employees are generally subject to federal and state employment taxes. Additionally, some states do not exempt 501(c)(3) organizations from sales and/or property taxes. It is important for the organization to know what is required in its state and locality.

- Q: Will my nonprofit be given a tax-exempt number separate from its EIN?  
A: No. Your EIN is the only number federally associated with your organization. If you apply for and receive sales tax-exemption in your state (if available), you may have a number issued by that state agency that is different from your EIN.
- Q: Once my nonprofit has been granted tax-exempt status, what needs to be done maintain that status?  
A: At a minimum, the organization must continue to operate for the purposes for which it received tax exemption. In addition, certain federal and state compliance filings may be required.