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Why Incorporate?

Operating a business without incorporating¹ exposes all of one's personal assets to liability. The primary reason to incorporate a business is to prevent personal liability for business debts and claims. After incorporation, claims against a business may only be paid from the business.² By incorporating, a business publicly declares that the personal assets and funds of owners and investors are off-limits to creditors and anyone else who may have a legal claim against the business. By limiting liability, it is hoped that more people will invest in businesses and own businesses.

Secondary reasons for incorporating are numerous. Often a corporate business structure allows for advantages under the tax system. The public often believes a corporation is a more professional business than a non-incorporated business. Often investors insist on a corporate structure of business. Access to funding sources tends to increase with incorporation, especially after a good track-record is established. Incorporation may enhance tax advantages for employee fringe benefits.

Comparison of For-Profit Corporations

Concern	LLC One Person	LC Multi-party	C Corp	S Corp
Personal liability of owners for business obligations.	None.	None.	None.	None.

¹ A limited liability partnership (LLP) or close corporation may also be used to limit liability. However, these business structures are very complex and are seldom used as a result.

² A corporation is formed to limit liability to only those funds or assets one invests in the business. There are exceptions to this rule. A personal guarantee bypasses the limitation of liability created by the corporate structure. Some abuses of the corporate structure can result in "piercing the veil" and personal liability. Liability insurance is available and recommended to handle these events.

Concern	LLC One Person	LC Multi-party	C Corp	S Corp
General formation requirements.	<p>Flexible and intuitive structure.</p> <p>File articles of incorporation with state and annual reports.</p> <p>Operating agreement used for internal operations and relationships.</p>	<p>Flexible and intuitive structure.</p> <p>File articles of incorporation with state and annual reports.</p> <p>Operating agreement used for internal operations and relationships.</p>	<p>Formal and complex structure.</p> <p>File articles of incorporation with state and annual reports.</p> <p>Must adopt bylaws, record minutes of organizers or directors.</p> <p>Bylaws may be limited by statutes.</p>	<p>Formal and complex structure and must comply with strict IRS rules.</p> <p>File articles of incorporation with state and annual reports.</p> <p>Must adopt bylaws, record minutes of organizers or directors.</p> <p>Bylaws may be limited by statutes and a need to comply with IRS rules.</p> <p>Must elect to be an S Corporation with IRS.</p>
Taxation	<p>Corporation itself is not taxed.</p> <p>Taxed as personal income.</p>	<p>Corporation itself is not taxed.</p> <p>Taxed as partnership income.</p>	<p>Double Taxation Profit is taxed as corporate income and taxed as personal income for shareholders.</p>	<p>Corporation itself is not taxed.</p> <p>Generally taxed as personal income for shareholders.</p>
Management	<p>Managed by owners.</p>	<p>Managed by owners.</p>	<p>Shareholders elect board of directors who then select officers to manage the business.</p>	<p>Shareholders elect board of directors who then select officers to manage the business.</p>

³The operating agreement of an LLC should address issues such as the death of an owner and provide methods for exiting the business.

Concern	LLC One Person	LC Multi-party	C Corp	S Corp
Length of Life ³	Generally, determined by operating agreement.	Generally, determined by operating agreement.	Perpetual.	Perpetual.
Funding	<p>Initial funding is often personal assets or loan-based, which relies heavily upon the personal credit of owner.</p> <p>Business plan and management and experience are critical.</p>	<p>Initial funding is often personal assets or loan-based, which relies heavily upon personal credit of owners.</p> <p>Business plan and management experience are critical.</p>	<p>Maximum funding opportunities.</p> <p>Funding from selling shares to investors.</p> <p>Business plan and management team are critical.</p> <p>Sales of shares must comply with applicable state and federal laws.</p>	<p>Funding from selling shares to investors.</p> <p>Business plan and management team are critical.</p> <p>Sales of shares must comply with applicable state and federal laws.</p> <p>IRS strictly restricts the type of shares.</p>

For-Profit vs. Not-for-Profit

A common misunderstanding is that not-for-profit⁴ companies are not designed to make a profit. Many operate with as much profitability as a for-profit company, plus they have the advantage of being tax-exempt. What is done with that profit is what separates for-profit from not-for-profit companies. For-profit companies are expected to direct profits, or a portion of profits, to the owners/shareholders. In contrast, a not-for-profit company is prohibited from having shareholders who receive the profits. It may, however, reasonably compensate⁵ its employees and officers from its profits via a salary or contract. Also, the purpose of the business must reasonably match one of the accepted IRS purposes for tax-exemption. However, many times a for-profit purpose can be reoriented into a legitimate not-for-profit purpose.

Since a not-for-profit company must qualify for its tax-exempt status and continue to qualify, it must be very careful to avoid violating the IRS rules designed to avoid abuses of tax-exempt status. Tax-exempt status has an obvious economic advantage. However, before pursuing it, one should factor in the cost of complying with the IRS rules. Once the record keeping and red-tape costs are considered, many businesses with smaller profits do just as well from a tax standpoint as a for-profit company. However, if donations and access to grants and other similar funds are important funding sources, not-for-profit status may be critical.

⁴ Sometimes called Non-profit or Non-stock companies.

⁵ "Reasonable compensation" may be high, but it must be supported and justified in case of IRS challenge.

Concern	Profit	Non-Profit ⁶
Personal Liability	None	None
General formation requirements.	Varies by the type of corporation. File articles of incorporation with state and annual reports.	Formal and complex structure and must comply with strict IRS rules in order to take full-advantage of non-profit status. File articles of incorporation with state and annual reports. Must adopt bylaws, record initial minutes of organizers or directors. Bylaws confined by statutes. Must apply and be approved for non-profit status by IRS to take full-advantage of preferred tax status.
Taxation	Varies by the type of corporation.	Once qualified, exempt from income taxes, sales taxes, and others. Some non-profit corporations may also provide donors with a tax-deduction.
Management	Shareholders elect board of directors who then select officers to manage the business.	If a voting membership system is used, members elect a board of directors who then select officers to manage the business. If no voting membership, selected board of directors selects officer to manage the business.
Length of Life	Varies, but can be perpetual.	Perpetual
Funding	Typically, investors and loans.	Donations, loans and grants. Often non-profit status allows access to public funds or private philanthropic funds.

⁶ There are many not-for-profit business types. The qualities listed below are for the “typical” not-for-profit corporation.

Concern	Profit	Non-Profit
Benefit to shareholder, owner, or member	Expected that shareholders and owners will receive some profits of business.	Members and owners may not receive profits from business. However, they may be compensated for services and reasonably salaried.
Special Prohibited Activities	Restrictions on donations to political campaigns.	Varies based on IRS classification. May be prohibited from donations to political campaigns, lobbying activities, and endorsing candidates for political office.

Disclaimer: The above information is general in nature and subject to change over time and from state to state. You should consult a knowledgeable professional about your specific situation. More often than not, there is no "best" form of corporation and you should talk with a knowledgeable professional about the benefits and burdens to determine what best works for your business.