CORPORATE MATTERS:
INCORPORATION BASICS

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Tags
Corporate Law
Incorporation

A foreign entity or individual planning on making an acquisition or conducting some other form of commercial activity in the United States must consider what type of U.S. entity to use in that endeavor. We thought it might be helpful to set out the options and answer an even more basic question for those considering activity in the United States: Why should you incorporate?

There are many advantages to conducting business through a properly formed business entity:

- **Asset Protection.** C corporations and limited liability companies generally allow owners to separate and protect their personal assets in the event of a lawsuit or claims against the business entity.

- **Name Protection**. Most states will not allow another business to form an entity with the same name as an already existing entity. Once you have filed an organizational document with a State's Secretary of State another entity cannot be formed with the same name.

- **Credibility.** In many instances, consumers, vendors and partners may prefer to do business with an incorporated entity.

- **Tax Flexibility.** Assuming you have no plans to go public, you generally will be able to choose whether your entity will be subject to a corporation income tax or whether profits and losses will be "passed through" to the shareholder, partner, or member.

Once the decision has been made to incorporate, consideration must be given to the type of entity to use. There are three main entity types in the U.S.:

- Corporations;

- Limited Liability Companies; and

- Partnerships.

CORPORATIONS

Corporations are a common business entity in the U.S. The benefit of doing business as a corporation is limited liability. There is no limit to the number of shareholders a corporation may have for corporate law purposes. If the entity has been properly formed, capitalized, and maintained (*i.e.*, the corporate formalities

are respected), the owners should have limited liability (limited to the amount of their capital contribution) for the business debts and obligations of the entity. An exception exists for professional services corporations, in which case the shareholder providing the services may be personally liable for the services rendered but not the other liabilities of the corporation.

For U.S. Federal income tax purposes, corporations are subject to double taxation: income is taxed when received by the corporation and then in the hands of shareholders when distributed as dividends. The U.S. Federal corporate income tax statutory rate ranges from 34% to 35% under current law, but the effective tax rate can be substantially lower. Qualifying dividends are taxed at 20% plus a supplemental potential 3.8% net investment income tax for high income U.S. tax residents. Thus doing business in the corporate form is generally disadvantageous from the U.S. Federal income tax perspective, as there is a second layer of corporate income tax. However, if the corporation intends to go public (*i.e.*, raise money from the capital markets, *e.g.*, in an initial public offering) in the reasonably foreseeable future, it may be advantageous to be a corporation, and there will be no U.S. Federal income tax difference as “publicly traded partnerships” are generally treated as corporations for U.S. federal income tax purposes.

Forming an entity in the U.S. can be done relatively quickly and inexpensively.

A corporation can make an S-Corp election. If it does so, profits and losses are generally “passed through” to the corporation’s shareholders. However, there are limitations in an S-Corp ownership, which include:

- No more than 100 shareholders;
- Shareholders must be U.S. citizens or resident individuals; and
- The corporation can only have one class of stock.

Non-U.S. shareholders, in general, do not have to file a U.S. individual income tax return unless the non-U.S. shareholder receives dividends from the U.S. corporation (or otherwise has income from U.S. sources).

LIMITED LIABILITY COMPANIES

A Limited Liability Company (“LLC”) can combine the corporate advantage of limited liability with potential tax advantages of “pass-through” taxation such as partnerships or sole proprietorships. It is a flexible form of entity, particularly for U.S. Federal income tax purposes. LLC’s generally have no restrictions on membership eligibility or numbers. In general, LLC statutes provide default rules which may be overridden by contract (*i.e.*, the operating agreement).

In the case of an LLC, the LLC can be treated as a corporation by making a “check-the-box” election. Otherwise, it is (i) disregarded if it has a single member or (ii) a partnership, if it has more than one member. In the latter cases, profits and losses will be “passed through” to its member(s).

PARTNERSHIPS

Partnerships can be formed as general partnerships or limited liability partnerships ("LLP"). In the former case, the partners will not have limited liability. In the latter case, partners will have limited liability similar to LLC's. The lines between LLC's and LLP's can become murky. However, states may require that at least one partner in a LLP be a general partner unlike the LLC.

In the case of a partnership, like LLC's, there is, in general, no U.S. Federal income tax at the entity level and profits and losses are, in general, "passed through" to its partners. If the partnership is engaged in a trade or business in the U.S., foreign partners must, in general, file an income tax return and are subject to withholding by the partnership. A partnership may also have to withhold tax on a foreign partner's distributive share of passive income (*e.g.*, interest or dividends) not effectively connected with a U.S. trade or business.

ENTITY FORMATION

Forming an entity in the U.S. can be done relatively quickly and inexpensively. Delaware is the preferred jurisdiction for incorporation in the U.S. due to the fact it has been a leader in this front and a comprehensive body of laws has been developed over time. However, a Delaware entity may need to register to do business in another state if it conducts business in that other state. A corporation that does not conduct business in Delaware is not, in general, required to a file a Delaware corporate income tax return even if incorporated under the laws of Delaware, but it may nonetheless be subject to a franchise tax as discussed in more detail below.

STATE LAW TAX CONSIDERATIONS

State law business income tax considerations should not be overlooked in this discussion. An entity conducting business in a particular state may be subject to that state's corporate income tax (which may follow or not follow the U.S. federal income tax rules). The business may also be subject to local income taxes (*e.g.*, New York City) if it does business in that locality. State laws may also have a franchise tax which is generally based on or centered on net-worth rather than income. For example, if you incorporate in Delaware but conduct business outside of that State (and thus are not subject to Delaware corporate income tax), you may nonetheless be subject to a Delaware corporate franchise tax as noted above.