Business Entity Formation: A Primer

Dear business owner:

This primer will walk you through the legal formalities involved in setting up and maintaining a business entity. It is intended for my typical client, which is a small corporation with one or two principals. When the business is this small, these formalities feel silly, but they are still an important requirement. In the eyes of the law, a corporation is generally its own legal entity. Its debts and assets are separate from yours. The only exception to that rule occurs when you treat the corporation like yourself instead of its own legal entity. You must avoid that, because otherwise you might become personally liable for the corporation’s debts. There are three easy steps you can take to show the state that you take the corporation seriously as its own entity:

1. Creating a corporate bank account, which will always contain corporate funds only
2. Investing some of your own money “at risk” into the corporate bank account, so that, if the business failed, you would lose that money forever
3. Following the corporate filing requirements described in this primer

# Type of Business Entity

First, let’s just make sure that an S-corporation is the right choice for you. It is best for most of my clients. If your business is very small, a sole proprietorship might be more appropriate. On the larger end, an LLC might make more sense depending on your financial statements.

## Small business: Sole proprietorship vs. S-corporation

If you do not go through the formality of forming an underlying business entity, then your business is legally identical to you; you are a sole proprietor. There are two factors to consider here: taxes and personal asset protection. If anyone ever sues and recovers damages from your sole proprietorship, then they can reach your personal assets. If you have considerable personal assets that are unrelated to the business and you want to make them unavailable to creditors, then you must either have insurance or operate your business through a business entity.

As far as costs, the main benefit of an S-corporation is that it can greatly reduce your payroll taxes, aka “self-employment tax.” When you operate as a sole proprietor (assuming that you aren’t cheating on your taxes!) then you must pay both the employee’s and the employer’s shares of social security, Medicare, and unemployment insurance tax. Together, they add up to 13.5%. When you add that to your personal income tax, it can easily exceed 30% of your take-home pay! If, instead, you claim most of your pay in the form of corporate profits instead of salary, those profits are not subject to payroll tax. If your company earns $100,000 a year, an S-corp could bring you tax savings of about $10,000 / year!

Of course, there are costs associated with setting up and maintaining an S-corp too. You can expect 6 – 10 billable hours for me to do the setup work (less than $2,000). Then you will have annual costs of about $1,000 for ongoing legal and payroll services. These services will hardly involve any of your time.

Upshot: If your business profits exceed $20,000 / year, then forming an S-corp will save you money overall. Even if you earn less than $20,000, you still might want to consider forming an S-corp sheerly for asset-protection purposes.

## Large business: S-Corp. vs. LLC

Most small business owners have a preconceived notion that they should form an LLC, because of the prevailing notion that it is easier, faster, and / or cheaper than a corporation. I believe that this rumor is based on a half-truth and an oversight. The differences between setting up or maintaining an S-corp and LLC are:

* A few documents at the initial setup.
* Filing a statement of information once a year vs. once every two years
* Annual meetings
* Payroll formalities

These differences, again, are worth about $1,000 / year. So that’s the half-truth. Setting up and maintaining an LLC is a little faster / easier / cheaper than a corporation, but not much.

The major oversight is that most new entrepreneurs are unaware of the tax differences. They don’t know that an S-corp can save them several thousand dollars a year in payroll taxes alone.

There are usually income tax savings for the business enterprise as well. An LLC is taxed based on its net *revenues*, while an S-corp is taxed on its net *profits*. The exact difference will depend on the details of your financial statements. The most important figures to look at are gross receipts, cost of goods sold (COGS), and net profit. Corporations tend to be better for businesses with low COGS, like service providers. An LLC could conceivably offer significant tax savings for a business with high COGS, like a real estate company. I will plug the key figures from your financial statements or projections into a spreadsheet that I prepared for this purpose. So far, all the clients that I have analyzed have come out better as S-corporations.

# Principals

Before we continue, let me explain the three roles that you will be serving for this corporation.

## Shareholder

As shareholders, you will be the corporation’s owners.  Your primary right is to earn profits of the corporation.  Your primary responsibilities are to invest at risk in the corporation, elect the directors, and set the officers’ salaries.

## Director

As the director or board of directors, you will be the corporation’s macro-managers.  Your primary responsibilities are to set the company's long-term vision, to guide its operations, financing, and investing objectives, and to elect the officers. Directors are customarily unpaid.

## Officers

As officers, you will be the corporation’s micro-managers.  Your primary responsibility is day-to-day management according to the directors’ stated vision.  Your benefit is a fixed salary, and your prime directive is to maximize profit for the shareholders. California law requires that the corporation have at least one president (aka CEO), secretary, and treasurer (aka CFO). One person may hold multiple offices, and multiple people may share one office.

# Bylaws

The bylaws are like the corporation’s constitution. I will provide you with a first draft. You should look over the one-page-summary on the first page of the bylaws and give me feedback if necessary. We will then keep the finalized bylaws on file for future reference. It is possible but rare to amend bylaws. There is also ample boilerplate language about shareholder meetings and issuance of stock, most of which is not interesting for a 1 – 2-person corporation.

# Shareholders’ Agreement

If your corporation has two or more shareholders, then I am also providing you with a recommended Shareholders’ Agreement. This document relates to the creation and transfer of stocks. The most important section is the buyout agreement, which describes the procedures to follow when it’s time for someone to leave the corporation. We should look at the buyout agreement together.

# Shareholders’ meeting

You will be required to prepare annual minutes of “meetings” (yes, even if there are only one or two of you). The annual meetings are a two-step process. First is the shareholders’ meeting and then the directors’ organizational meeting. In a small corporation, the shareholders’ meeting usually involves two simple matters:

1. Elect the directors
2. Set the officers’ salaries

In an S-corp where the shareholders and officers are the same people, the tax-savvy strategy is to keep the officer salary as small as reasonably possible. This is because only the officer’s salary, not the shareholder’s leftover profits, is subject to payroll tax. That might sound trifling, but the payroll tax will be almost 15% of your take-home pay! Setting the officer’s salary to $0 is another red flag for tax bureaus, making it appear that you are not treating the corporation as its own entity. However, there is no red-line limit. If you have employees, my advice is to set the officer’s salary equal to that of the highest-paid employee. If you have no employees, then you can get away with a much lower salary. I recommend $7,000 / year. This is a simple amount for tax purposes, as only the first $7,000 of income is subject to some payroll taxes.

# Organizational Meeting

After the directors are elected, they conduct the annual organizational meeting. These are the items I like to include in the agenda of this meeting:

1. For the first meeting only, discuss the circumstances and purpose of the corporation’s founding.
2. For subsequent meetings, provide a summary of the corporation’s important developments in the last year. Include all significant news involving operations, financing, and lending.
3. State the directors’ vision for the company, at least in the upcoming year. Indicate any foreseeable major changes to company structure, operations, financing, lending, lawsuits, regulations, etc.
4. Elect the officers

Your biggest responsibility in this start-up process is to write statements for items 1 and 3 above. I include samples below.

As for electing officers, perhaps the biggest question is how to handle executive decisions when there are more than one of you. Do you want to give one of you the exclusive presidential authority to have the final say in difficult decisions? Or do you want to share that right as equal co-presidents? If there are two of you, you must weigh the possibilities of an unequal relationship vs. grappling with “ties” or deadlock. In my opinion, the only “right” thing to do is to discuss and decide this issue up-front and put it in writing. (Technically, that will be your “organizational meeting”).

# Conclusions and Questions

Today or in the near future, I will provide you with recommended bylaws and a shareholders’ agreement. Although they are terribly boring, you should at least look over the following sections and let me know of any changes that would be more suitable to your corporation:

1. Bylaws “One Page Summary”, especially the definitions of the president, secretary, and treasurer.
2. Shareholders’ Agreement, sections 4 - 5, Buyout Agreement and Purchase Value. No need to pore over this one in legalistic detail. The important upshot is that, if one of you wants to leave for any reason, the corporation **must** buy out your share at a price that is fair to both parties.

I also need the following specific information from you, which I will include in your first annual minutes:

1. If there is more than one of you, which of you will be directors? (It’s OK for all of you to be on the board).
2. If you have or will have any employees, what will be the highest employee salary?
3. If there is more than one of you, who will be president, secretary, and treasurer? (It’s OK for one person to hold multiple offices and / or for more than one person to share an office).
4. Email me a written discussion of the circumstances and purpose of the corporation’s founding. See the samples below for reference.
5. Email me your vision for the company, at least in the upcoming year. Indicate any foreseeable major changes to company structure, operations, investments, financing, lawsuits, regulations, etc. See the samples below for reference.

Sincerely,

Scot S. Fagerland, Esq.

# Samples

## Circumstances and purpose of corporate founding

### Fagerland

This corporation is the successor in interest of myself, Scot Fagerland, sole proprietor. It will continue to conduct the business that I have been doing for years, namely tutoring and the practice of law and patent prosecution. The corporation did not conduct any business in 2015. All business at 2931 S. Sepulveda Blvd. Suite I in 2015 was conducted by Scot Fagerland, sole proprietor. All business at the business address in 2016 has been conducted by the corporation.

The corporation’s legal instruments were filed by Asad Yavari, who listed himself as the corporation’s agent of process. Asad was an incompetent accountant who overcharged the corporation an unconscionable amount. I am still considering legal action against Asad, namely small claims court for fraud. It remains to be determined whether I and / or the corporation would be the proper plaintiff. Today, the corporation authorizes any legal action against Asad Yavari and / or Premier Accounting with the corporation as plaintiff. Action will be taken only if the corporation can afford the filing fees and the action seems profitable on balance. Final decision on that lawsuit is not made today.

On November 19, 2015, I filed an amendment to change the corporation to a professional corporation so that it can practice law. I also amended the name of the corporation to “The Law Office of Scot S. Fagerland” with the same filing. Unfortunately, I was unable to name a new agent of process in this amendment. It is prudent to name a new agent of process, especially if legal action against Asad is taken.

A bank account for the corporation was established in January, 2016. I invested $5,000 owner’s equity into the corporation in the first quarter of 2016. This amount represents a significant portion of my own cash holdings, and it was deposited into the corporation at risk of loss. Other than this amount, I do not keep any personal funds in the corporate account, and do not spend any corporate funds for personal purposes. Likewise, I have a separate personal account, which contains no corporate funds and is never used for corporate purposes. I and my assistant Eva (sometimes with Flat Rate Bookkeeping) have been keeping the corporation’s transaction records in a Quickbooks Online system. I use Quicken at home for my own personal transactions. The Quicken and Quickbooks systems are completely separate, except for the corporation’s monthly payments to me in my capacity as employee and shareholder.

### Stansill

I have been engaging in two primary business activities for the past several years. First, I have been a principal of Pro Audio LA, LLC (PALA). That company is in the business of audio sales and cabling. Second, while working at PALA, I developed a side specialization in acoustics and carpentry. I was the only person in the company with those skills. I increasingly found myself engaging in those services outside of the company. I have been engaged in the carpentry of sound booths and home entertainment systems. I have been making a strong transition from the former to the latter. In order to delineate my personal business activities from those of PALA, I have been performing the carpentry activities as a sole proprietor. I have been designing products, consulting, and managing projects, and becoming a licensed contractor. As all of these skills are distinct from anyone else at PALA, I have informally separated from PALA, and I am considering proceedings to formally sell my share of the company to my co-member. As a sole proprietor, I have been hiring one assistant, Michael Howarth, whom I have characterized as an independent contractor.

This year, I prefer to further formalize and organize the carpentry, acoustic, consulting, and project management activities, and to clearly separate them from PALA, by organizing a corporation to perform these services. In light of California Labor Code Section 2750.3, I also wish to recharacterize Michael as an employee and to place him on a corporate payroll system.

## Vision for the upcoming year

### Fagerland

#### Coronavirus recession and loans

Business started to plummet this March when the city, county, and state issued stay-at-home orders to guard against this year’s coronavirus. I had enough case work to keep revenues at their normal levels until mid-April. Now, business is essentially at a standstill. The corporation will certainly have to take out loans to maintain cash flow while making regular distributions to me. I have already applied for a Paycheck Protection Program loan, which will provide approximately $1,500, mostly for the purpose of covering two months’ worth of my officer salary paychecks. This amount will be forgiven (and will therefore become a subsidy) when I use it for its intended purpose and make such a showing to the bank.

Another QuickBooks Online loan will also most likely be necessary.

#### Relocation decision

I am giving some thought to relocating. I want to find a location that optimizes the corporation’s net profit if it remains in California. That would mean identifying a neighborhood that has the optimal balance of market households and rent. It will take me months to identify the best location. If it ends up being outside California, then this corporation will be dissolved.

### Stansill

Plans for the upcoming year include

* Apply for S-corp status
* Hire another employee to help with daily operations
* Develop a website for my consulting and design portion of the business (preferably [www.StansillDesigns.com](http://www.StansillDesigns.com))
* Set up an independent eCommerce website linked with the main website to sell my custom acoustic treatment and furniture products (preferably [www.JSAcoustics.com](http://www.JSAcoustics.com))