

Basic Legal and Accounting Considerations in Starting a New Business

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If you're considering starting a new business, there are important legal and tax considerations that you should be aware of before starting out. While nothing can take the place of consulting with a business attorney and a qualified accountant to discuss the specifics of your situation, the following will give you a general overview of the concepts that you should be thinking about in starting your new venture.

WHY INCORPORATE?

By far the most compelling reason that almost all entrepreneurs refer to in incorporating their business is the desire to be sure that their personal assets are protected from business losses. When properly done, utilizing a corporate structure to conduct business will allow a business owner to shield their personal assets (home, savings accounts, retirement accounts, etc.) in the event of unanticipated losses. A common fear of most new business owners is that a third party will be injured by a product they sell, slip and fall at their place of business, or perhaps be hit by a vehicle being used in connection with the business. Should the business not be incorporated, the business owner's personal assets may be on the line in the event they are sued and a judgment be entered against them in court. Almost all new business owners are willing to take the risk that their business may rise or fall on its own, but are justifiably concerned that an unanticipated business loss could potentially subject their personal assets to attachment. With very limited exception, a properly formed and maintained corporate entity will shield the business owner's personal assets.

Incorporating your business can protect your personal assets.

In addition to protecting the owner's personal assets, there are often tax advantages to incorporating a new business, especially in connection with deductions for business expenses, salaries paid, fringe benefits, etc.

CHOICE OF ENTITY

Once you've made the decision to incorporate your business, you'll need to speak with both your accountant and your attorney about the choice of corporate entity you'll utilize. For most start up small businesses, the choice typically comes down to a limited liability company (LLC) or a business corporation. There are advantages to both, and from a legal perspective, both will accomplish the main goal of shielding personal assets of the business owner.

The LLC form can be and sometimes is used for the smallest of entities, those owned by a single person who does not expect to be paid through the payroll of the company, but rather take profits when they become available. The LLC form is also often used when the business is created to own real estate. Another advantage of utilizing a limited liability company is its flexibility from a tax perspective. A LLC can choose to be taxed as a corporation, partnership, or an "entity disregarded from its member". No matter how it chooses to be taxed and what number of owners it might have, the LLC is required to file its own tax return with the State of Rhode Island and pay the minimum franchise tax, currently \$400.00. Typically the owner(s) of a LLC are not on the payroll of the entity and pay federal and state income

taxes related to the entity's profit personally in the form of estimated tax payments.

Corporations can, of course, be owned by a single shareholder but the corporate form is more often used when a business is expected to hire employees or if it is likely to be utilizing equipment or buying and selling inventory. There are also decisions to be made as to how the corporate entity elects to be taxed. At time of startup, for taxation purposes, a corporation is considered a "C" corporation, and files its own income tax return and pays its own federal and state corporate taxes. It is possible that the business profits may be taxed twice - once at the corporate level and then again at the shareholder level. This corporate form allows the entity to provide more fringe-benefits to the owners and employees, deductible by the corporation and tax-free to the recipients (including the shareholder-employees).

A "C" Corporation is allowed to elect "S" status (become an "S" corporation) by filing the appropriate form with the Internal Revenue Service. An "S" corporation also files its own income tax return but does not pay its own federal income tax. The owners of an "S" corporation report their share of the entity's income or loss on their personal tax returns. The big advantage of "S" status is that it avoids the potential for double taxation on profits from the business. A disadvantage is that "S" corporations have some restrictions on what fringe benefits can be offered for the owner-employees tax free and deducted as business expenses by the company.

The owners of the corporation (either type) would be employed by the entity and be paid wages, with taxes withheld and paid into the IRS and state taxing authorities on their behalf. Taxes would also be paid into the RI Unemployment & Temporary Disability Insurance programs on these wages which could prove to be beneficial if the owner needs to receive such benefits in the future.

Much like a LLC, no matter whether a corporation chooses "C" or "S" status with the IRS, the entity is required to file its own tax return with the State of Rhode Island and pay the minimum franchise tax, currently \$400.00.

Your choice of entity should be based on the individual situation of the business owner(s), and the nature of the business, and can best be decided after cooperative consultation between the business owners, their business attorney and their accountant.

STEPS IN THE INCORPORATION PROCESS

Filing the formation documents with the Rhode Island Secretary of State

Once a decision has been made as to whether a corporation or a LLC would be the right choice for your new entity, the mechanics of creating a new entity will follow. Typically, the first step will involve checking to see if the name for the business is available with the Rhode Island Secretary of State. Applicable Rhode Island law requires that the name of a new business be "distinguishable on the record" from that of an existing entity. If the name is available, Articles of Incorporation (corporation) or Articles of Organization (LLC) will be filed for approval with the Rhode Island Secretary of State either via their online portal, or by printing out the appropriate forms and filing them in person at the office of the Secretary of State along with the applicable filing fee. Often new business owners believe that once this paperwork has been filed, they now are properly incorporated, when in fact they have only taken the first of several necessary steps.

*If you have
any questions
contact the
Business
Services
Division
Secretary of
State offices at
401-222-3040*

Agent for Service

A corporate entity is required to provide a name and address for its agent for service in its incorporation paperwork. Generally speaking, the agent for service for a company is the person to whom legal notices or paperwork will be sent in the event of a lawsuit or where a regulatory agency will send notices relating to the business of the company. Often business owners list themselves as the agent for service and give their home address as the place where service of process is to be served. A better practice is to list a professional adviser (attorney/accountant) as the agent for service. Almost any document which is forwarded to an agent for service will need a response within a certain number of days, and a business owner may not be aware of the limited time periods involved or may lose track of the deadline in the press of business. Further, while constables and sheriffs are professionals with difficult jobs, they are paid to get the paperwork served, and stories of business owners being served at home in the small hours of the day or night or on holidays are common. Finally, the name and address of a corporate entity's agent for service is available to the general public, and many business owners are not aware that they are publishing their name and home address on the Internet by naming themselves agent for service of their corporate entity.

A better practice is to list a professional adviser (attorney/accountant) as the agent for service.

Preparation of Bylaws/Operating Agreement – Election of Officers

A properly formed corporate entity will have prepared and adopt either Bylaws in the case of a corporation, or an Operating Agreement in the case of a LLC. The purpose of these documents is to outline how the business is to be run, how it will make decisions, the rights and the obligations of its shareholders and what steps will be taken in the event of the death of its shareholders or the dissolution of its business. These documents are a critical part of the formation process, but often are either never completed or are given the briefest of attention. The need for these documents to be clearly drafted and tailored to meet the specific needs of a particular entity rises even higher when there are multiple business owners (who are often friends or relatives) involved so that the rights and obligations of each of them are clearly spelled out right from the beginning of the corporate entity's life. Once the form of Bylaws or Operating Agreement has been agreed upon, a written vote of the owner or owners of the corporate entity is required to adopt them.

During the formation process, the officers of a corporation are also selected and duly elected. In the case of LLCs, a decision will have to be made as to whether the company is to be managed by its members/owners or by a manager selected or hired by the owners of the company to make decisions for the business.

Obtain Employer Identification Number/Corporate Bank Account

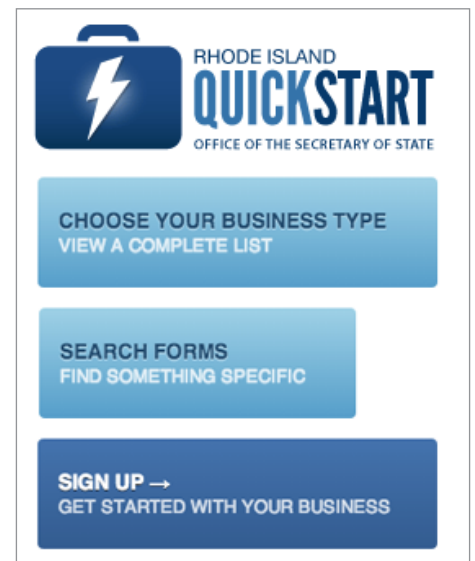
Once a corporate entity's paperwork has been submitted and approved by the Rhode Island Secretary of State, an application is filed either electronically or via fax with the Internal Revenue Service for the issuance of an Employer Identification Number ("E.I.N.") The E.I.N. can be considered the equivalent of a Social Security Number for an individual, and should be used in place of the owner's individual Social Security Number in all documentation relating to the business. Once an E.I.N. has been issued for the new entity, the company's E.I.N. along with a copy of the approved Articles of Organization/Incorporation for the business can be used to open a business bank account. It is highly recommended that all transactions for the business be handled through a corporate bank account rather than through the individual owner(s) personal accounts.

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Registration and Licensing with the appropriate municipal, state and federal agencies

By the time the corporate entity is formed and a business bank account opened, most small business owners are chomping at the bit to start to work. Often they are not aware of the various licensing and registration requirements that are necessary for a new business. The type of business a new entity is pursuing and its location will typically drive the types of licenses necessary. Many Rhode Island cities and towns require certain types of new business to obtain local business licenses, and depending on the type of business may require an inspection by the local or state fire marshal before allowing work to commence. Businesses that make sales at retail will be required to obtain a sales tax permit and perhaps register with the Rhode Island Department of Labor and Training. The types and number of licenses necessary for each new business are as varied as the types of new businesses and should be investigated fully before business commences.

The Rhode Island Secretary of State has compiled a fairly comprehensive guide to the licensing requirements for a new business which can be found at: www.ri.gov/SOS/quickstart, you can access a this tool to help you start a business.



Insurance

Rhode Island businesses that have one employee or more are required by law to obtain Workers Compensation Insurance. There are exceptions for businesses where the owner of the business is the sole employee, or where independent contractors are used by the business. This is yet another important issue that new business owners overlook, and a new business owner should carefully review the requirements with qualified business advisors and their insurance broker. In starting a new business, consultation with an insurance agent is always advisable to determine the types of coverage necessary or advisable depending on the type of new business.

MAINTAINING CORPORATE ENTITY

Once a corporate entity is up and running, there are two important annual requirements necessary to keep the business in good standing with the Rhode Island Secretary of State. Both corporations and limited liability companies are required to file annual reports with the Rhode Island Secretary of State and to pay a filing fee of fifty (\$50.00) dollars to the Secretary of State for the filing of the annual report. Deadlines for filing depend on the type of entity chosen, and late fees are assessed for late filings. A continuing failure to file will result in the Secretary of State revoking the corporate entity's good standing.

As noted above, all businesses are also required to file corporate returns with the Rhode Island Division of Taxation on or before March 1. At present, the minimum tax to be paid by all entities regardless of size or whether or not a profit or loss is reported for the previous year is Four Hundred (\$400.00) Dollars.

The Rhode Island Department of Labor and Training's website provides information on Worker's Compensation Insurance at: www.dlt.ri.gov/wc

COMMON MISTAKES THAT MAY RESULT IN “PIERCING CORPORATE VEIL”

As mentioned above, a properly maintained and operated corporate entity will shield the personal assets of the business owner from attachment in the event of unanticipated business losses. There are several common errors that new business owners make that can result in courts “piercing the corporate veil” between the business itself and its owners and attaching the assets of the owner personally. A savvy business owner who keeps in mind that the purpose of the corporate entity is to hold itself separate and apart from the individual owner will have little trouble avoiding these issues, but experience has shown the following to be some of the most common errors made by business owners in this regard:

a. New business owners sometimes mix personal funds with corporate funds or use personal funds to pay corporate expenses or vice versa. A classic example is using a business account to pay a home mortgage without the proper withholdings, etc. or using a personal account to pay business bills. Should the corporate entity need an infusion of cash, the business owner should deposit the necessary funds in the business’s account and use the corporate entity’s account to pay business expenses. Likewise, besides creating unanticipated taxation issues, writing a check to pay a home mortgage from the business account is almost never advisable. Identifying the proper method to infuse or withdraw funds from the business is something that should be reviewed with a qualified accountant.

b. Often new business owners don’t realize that it is important to let the public know that they are dealing with a corporate entity and not the business owner themselves. All business materials, including websites, marketing materials, checks, stationary, business cards, and invoices should bear the appropriate “Inc.” or “LLC” designation to let the public know that they are dealing with a corporate entity and not the business owner themselves.

c. Failing to act in conformance with the Bylaws or Operating Agreement for a corporate entity, or failing to execute corporate resolutions for larger business decisions is another common error made by small business owners. A corporate entity can only act through the will of its ownership and/or officers, and these decisions must be made via corporate meeting and memorialized by written record of the corporate vote. This is especially important for businesses that have two or more owners.

SUMMARY

The wide scope of corporate law and the applicable provisions of the Internal Revenue Code relating to business ownership are far too broad to be covered in a few short pages. The purpose of this guide is to give a prospective business owner some very basic information that they can review prior to meeting with qualified business advisors to spark a discussion of issues to be addressed as they take the challenging and rewarding leap into the world of small business ownership.

At present, the minimum tax to be paid by all entities regardless of size or whether or not a profit or loss is reported for the previous year is Five Hundred (\$500.00) Dollars.