

## Starting a Business Memorandum

To: Potential Client  
From: The Strategic Counsel, L.C.  
Re: Starting a Business

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Welcome to The Strategic Counsel Law Firm. This memo outlines some critical issues that you want to consider prior to creating your corporation. Please read it carefully. This Memo will cover most of the frequently asked questions as well as provide thought and insight to questions you probably did not know you needed to answer!

### Why should I incorporate?

Using a corporation provides three benefits to a business owner. First, it provides protection from liability. If you are sued in the course of doing business your personal assets are not at risk, just the assets of your corporation. Second, choosing a corporation carefully can provide certain tax benefits to you as the owner of the business. Third, the creation of a corporation provides a certain level of credibility doing business and reflects you are serious about what you do.

### What types of legal entities are there to choose from?

Generally, there are four types of business entities to choose from.

1. **Sole Proprietor:** The first and most simple is the sole proprietorship. In this case you hold your individual self out as a business. The downside to this is there are very few advantages to doing business this way and several big disadvantages. You are 100% personally liable for the debts of the business. Also, some of the tax benefits you are looking for may not be available in this particular way of doing business.
2. **Partnership:** The second type of business is called a General Partnership Agreement. When you have a partnership two people have agreed to work in business together. Although there are certain tax benefits to a partnership, the downside that each partner is liable for the debt of the other partner. So, for example, if your partner gets sued you are automatically responsible for the debt in most general partnerships.
3. **Corporation:** The third type is called a corporation. This type of legal entity is the most popular due to its flexibility. It basically provides the ability to protect your personal assets from claims against the business. You have to pick what type of tax structure you elect for the business (subchapter S or C).
4. **Limited Liability Corporation:** The fourth type of corporation is a limited liability corporation, commonly referred to as an LLC. The limited liability corporation is probably going to be the most popular entity used to do business due to maximum credit protection and maximum tax flexibility. The LLC will provide you the ability, as a business owner, to select how you wish to be taxed while at the same time protecting investors in the business from

any type of liability that they may be exposed to as being an investor. For example, if your limited partner is sued, you are protected from their liability.

### How long does it take to incorporate?

The actual process of incorporation is rather quick. It can take anywhere from 48 hours to 10 days to file the paperwork with the Secretary of State. However, the decisions involved in selecting what type of tax treatment you wish to have for that corporation may take several weeks or months to sort out. It becomes an issue of how much clarity do you have about the entity you want to create and how much clarity you have about how the business will actually operate. Choosing the wrong tax structure, or not choosing one at all, can result in financial consequences at the end of the year.

### What does it cost to keep my corporation in place?

There are several fees you will incur by creating a corporation or an LLC. The first is your annual fees with the Secretary of State to keep your corporation active. The annual filing fee for your business will vary depending on the type of entity. They typically range from \$125 to \$175. You will receive your Uniform Business Report from the Secretary of State in January or February with instructions for filing and payment of the fee. The fees typically have to be paid by May to avoid late fees and/or dissolution of your business.

As a business, you will also have to file taxes. Depending on the type of entity you are, you may have to file additional federal and state forms. This doesn't necessarily mean you owe more taxes. In fact, you may receive tax benefits. However, many people aren't aware that these additional filings are necessary. You should speak with a CPA and anticipate additional professional fees for them to provide this service.

If you are a corporation or an LLC, you also need to file Annual Corporate Minutes to keep your personal creditor protection, or your "corporate shield or veil", in place. Without these, a creditor may possibly pierce your corporate shield and seize your personal assets. Our firm typically charges \$200.00 to prepare these documents each year.

### What exactly is a corporation?

A corporation is a type of entity or business ownership structure. Corporations are created according to state law. Every state provides rules for the formation of corporations. While the rules are not actually the same from state to state, every state recognizes a corporation as an entity that is separate from its owners, provided certain formalities are followed. This means if you create a corporation in Florida and follow the proper formalities and record keeping, California will recognize the corporation and the protection it provides from your personal assets. A corporation conducts business, enters into contracts, incurs liabilities, and acquires assets in its own name, *not* in the name of its owner(s) who are called shareholder(s) or stockholder(s).

While the shareholders can vote on issues that control the corporation, they do not conduct the day-to-day affairs of the business. In exchange for this limited managerial authority, shareholders are insulated from personal liability for the debts and claims for the corporation. The day-to-day management of a corporation is often left to corporation officers, who are responsible to the directors, who in turn are responsible to the shareholders. In many small corporations, the shareholders, officers and directors are the same individuals.

People often refer to several types of corporations. Each type is simply a variation of the same basic structure. The primary difference among the types of corporations relate to who the owners can be (e.g. professional corporations), how the corporations choose to be taxed (“C” versus “S” corporations), or how they sell their stock (public or closely held). They all fall under the large category of a “corporation” under state law; they just have additional special rules that apply to each type of corporation. For example, a professional corporation could be a corporation that is a law firm. There are additional special rules indicating who can own part of a law firm.

#### What are some characteristics of a corporation?

The most important characteristics of a corporation are limited liability, continuity of life, and centralized management.

#### What is a public corporation?

A public, or publicly traded, corporation sells its stock on a stock exchange to individuals or companies. A public corporation may have hundreds of thousands of shareholders all over the world. The shareholders “vote their shares” to elect a Board of Directors that sets company policy and appoints or hires officers who run the company. Only “C” corporations can sell stock to the public on a stock exchange. The SEC (Securities Exchange Commission) imposes many controls upon such corporations.

#### What is a closely held corporation?

Most companies are referred to as a “closely held” corporation. A closely held corporation, like a public corporation, is formed as a regular corporation under state statutes. However, a closely held corporation’s shares are not publicly traded on a stock exchange. They are owned by a small number of shareholders or even one shareholder. Closely held corporations differ from public corporations in several ways. Closely held corporations can choose to be taxed as “C” or “S” corporations. Because there are few shareholders, the owners also function as directors and officers. Thus, they have active control of the corporation. Because the shares of a closely held corporation are not publicly traded, they are difficult to value. Thus, there is a limited market for the selling the shares.

Because the shareholders of a closely held corporation know each other and have chosen to do business together, they usually impose restrictions that limit the transfer or sale of shares to “outside” parties.

### What is a “C” corporation?

A “C” corporation is a corporation that is taxed under Subchapter C of the Internal Revenue Code (IRC). Under Subchapter C, income or losses are determined and income taxes are assessed at the entity level. Basically that means that at the end of the year, the “C” corporation will file a tax return and pay taxes on the money the company has earned. When the shareholders receive distributions or payment from the corporation, they will pay income tax on the money they receive. In essence, this is “double-dipping” or taxed twice. Remember, only a “C” corporation can sell stock on the stock exchange. So as always, there are advantages, disadvantages, and trade offs in every selection. Most small businesses are not “C” corporations because of the taxation. You would use a “C” corporation when you want the ability to create a “war chest” of “retained earnings”.

### What is an “S” corporation?

An S corporation is initially formed under state law as a “C” corporation. After formation, the business elects to be treated as an S corporation for federal income tax purposes. This requires the filing of a special form with the IRS within a certain number of days after creation of the corporation.

As an S corporation, the business is not taxed as a separate taxable entity. Instead, all the S corporation’s income or losses “pass through” to the shareholders on a pro-rata basis in accordance with their percentage ownership of the company. This means the shareholders report the income (or loss) on their own income tax returns. Although, an S corporation must file its own income tax returns, if handled correctly generally no income taxes are assessed against the corporation. This strategy avoids the owner of the corporation from being taxed twice, first on the money the corporation has, then again on the money when he pays him or herself.

A common, costly mistake we see business owners make is not making a tax election. If no election is made, then you are automatically taxed as a “C” corporation. Many business owners try to cut costs by incorporating themselves and are unaware of the significance of tax elections. At the end of the year they are taxed as a “C” corporation and have significant tax liability.

### Are there any special ownership requirements for electing an S corporation status?

To qualify the corporation must be organized under the laws of any state or U.S. territory as a domestic corporation and all shareholders must consent to the election. “S” corporations have the following ownership requirements:

1. The shareholders must be individuals, estates, or certain types of trusts. They cannot be partnerships or corporations.

2. The shareholders must be U.S. citizens or residents.
3. The corporation can have only one class of stock.
4. There can be no more than 75 shareholders. (Note that a husband and wife are counted as one shareholder.)
5. The corporation cannot be a member of an affiliated group, a financial institution, an insurance company, a Section 936 election corporation, or a current or former domestic international sales corporation.

#### How many classes of stock can be issued for an S corporation?

An S corporation can issue only one class of stock and the outstanding shares must confer identical rights to distributions and proceeds of liquidation. An S corporation may issue voting stock and nonvoting stock, which are not deemed to be two classes of stock.

#### How is a partnership taxed?

The taxation of a partnership has the same elements of an S corporation. The tax passes through to the owner(s) and is reported on their individual tax returns. The difference is how the profits are allocated to the owners. In an S Corporation, the profits or losses are allocated to the shareholders on a pro-rata basis, or according to the percentage they own of the company. In a partnership, the profits or losses can be allocated among the shareholders however the owners desire. This can be a powerful tax strategy for some partners. It provides them the flexibility of reallocating profits or losses in a different manner than based on ownership.

#### How is an LLC taxed?

One of the great benefits on an LLC is that they can choose how they wish to be taxed. They can elect to be taxed as an S corporation, a C corporation, or a partnership. If you are starting a company with multiple shareholders and not sure how you will want to be taxed, we usually recommend you choose to be taxed as a partnership. It offers the most flexibility for whatever happens down the road as your business grows.

#### What is a professional association?

Although a few states allow professionals, such as architects, lawyers, and doctors, to incorporate as either a regular corporation or a professional corporation, most states require that they incorporate as a professional association (PA). Professional association statutes include special rules regarding who can be shareholders, officers, and directors. For example, in Florida only a lawyer can own shares in a law firm.

#### Who can own professional association (P.A.)?

Generally, only professionals licensed in the same occupation can be shareholders of a professional association. So architects can own an architectural firm, CPAs can own a CPA firm, and lawyers can own a law firm. Each state has its own list of qualifying professionals. However, as a rule of thumb, if the professionals involved can be sued for

malpractice, they can establish a professional corporation. Examples of qualifying professionals include accountants, architects, chiropractors, dentists, engineers, attorneys, pharmacists, psychiatrists, psychologists, podiatrists, surgeons, and veterinarians.

Can a member of a professional association practice in more than one specialized profession?

No. Professional associations are limited to one profession. An exception is made for professionals in the overlapping areas of architecture, engineering, and surveying but only to the extent allowed by the ethical rules of each profession.

Who are the owners of a corporation?

The owners of a corporation are the shareholders or stockholders. Generally, shareholders invest in the corporation by contributing money or other property in exchange for all or a portion of the corporation's stock. This action, called "buying stock" stock or "capitalizing your corporation", is noted simply by issuing a paper certificate that shows the portion of the corporation, or the number of shares, that a stockholder owns.

Is there a difference in having a *single* shareholder corporation versus *multiple* shareholders?

Shareholders are the owners of the company. There is no substantial legal difference between a single shareholder and a multiple shareholder corporation. When you have multiple shareholders you will create agreements commonly known as "Shareholder Agreements" or "Buy-Sell Agreements" to address what to do in case of disputes, death or disability of shareholders. For example, you will need to decide what happens to a shareholder's stock if they pass away. Can it be sold to a stranger? Or does it have to be sold back to the company to maintain a closely held company?

I'm going to be the only shareholder of my corporation. Why doesn't my attorney issue all the available shares to me?

To answer this question, let's discuss some important terms: *authorized shares* and *issued shares* and *outstanding shares*. State statutes and the Articles of Incorporation govern how many shares of stock corporations are authorized to issue or sell. When you file your Articles of Incorporation and your state accepts them, your company is authorized to issue a specific number of shares or stock. Let's use Florida for example. If you want to pay only the minimum incorporation fee, the state will authorize your corporation to issue 850 shares of stock. If you purchase all 850 shares, you own all the stock your corporation is authorized to sell. You will never be able to sell additional shares to take in a co-owner, reward an employee, and so on, without amending your Articles and paying additional professional fees and state filing costs. Why close off your options? If you issue and purchase just 50 shares, those are the only shares issued and outstanding; you

are still the sole shareholder and 100% owner, but you have 800 authorized shares for future use.

#### What are the differences between preferred stock and common stock?

Preferred stock is said to be preferred over common stock for two reasons: liquidation and dividends. Upon liquidation of the corporation, creditors are in line to be paid from any assets, bondholders are second, and preferred stock holders are third. Last in line are the common stock holders. Dividends are payments, to shareholders, of a portion of the corporation's profits. Holders of common stock receive dividends based on their percentage of ownership of the corporation. If more stock is issued lowering their percentage of ownership, their dividends decrease accordingly. Preferred stock on the other hand is issued with a fixed rate of return on the stockholders investment. For example the owner of 7% of preferred stock receives dividends based on a fixed rate of return of 7% of his or her initial investment to the extent that the corporation has earnings and profits to pay dividends. The preferred dividend can be structured in many ways and there can be various types of investment returns. Preferred shareholders receive their dividends before common shareholders do. In other words the corporation must pay all preferred dividends in full before it pays any common stock dividends for any given year. Moreover, preferred dividends are typically cumulative. If the corporation does not pay all or any portion of the preferred dividends in any year the dividends accumulate and the corporation must pay them in future years before it can declare and pay any common stock dividends. After the corporation pays its creditors and its preferred shareholders it can use the remaining earnings to pay the common stockholders but it doesn't have to. The corporation can either pay the residual earnings to the common stockholders as dividends or decide to keep them in the company as capital for future growth. Keeping the earnings as future growth should benefit the common stockholder. As the company grows the price of the common stock should increase accordingly.

#### Who has the voting rights the common or preferred stockholders?

It is not unusual for the common stock to have all the voting rights and the preferred stock to have no voting rights. However there is no restriction on giving different voting rights to each class as long as the corporate Articles and bylaws address the nature of the voting rights given to each class.

#### Why would a company want to issue two classes of stock of stock with different voting rights?

Corporations create different classes of stock for many different reasons and to accomplish many goals. For example a corporation might create a class of preferred shares in order to raise capital for initial formation or business expansion. Investors may be more inclined to invest in the corporation if they know that they will profit from their investment on a preferred basis over those who use common shares. Alternatively some owners may want to realize a return on their investments before others. Finally, owners may issue voting and nonvoting shares of stock in order to share the business with family

members or valued employees without giving up the control that goes with the right to vote.

What are the legally recognized forms of consideration that can be exchanged for stock?

Consideration can be in the form of money paid, labor performed, services actually rendered to or for the benefit of the corporation during its formation or reorganization, debts or securities cancelled, or tangible or intangible property actually received either by the issuing corporation or by a wholly owned subsidiary. Promissory notes (unless adequately secured by collateral other than the shares acquired or unless permitted by law under an employee stock purchase plan) and future services are not permissible.

Can we restrict the transfer of shares of our closely held corporation?

Yes. Depending on your point of view restrictions on the transferability of shares are either one of the major benefits or one of the major detriments of closely held corporations.

How can the restrictions be a benefit or a detriment?

Because closely held corporations are usually both owned and operated by a close-knit group of individuals, it is essential that the owners be able to work together. Restricting the transfer of stock helps ensure that the shareholders can decide with whom they will work in managing the affairs of their closely held corporation. On the other hand share transfer restrictions can significantly affect the shares' value because they limit the market for the shares. In other words, if only a limited number of people qualify to own shares due to your restrictions, the value of the shares decrease because the market or available people to purchase them is limited. For that reason if statutes or agreements create transfer restrictions owners should establish a specific market for and price of the shares of departing or deceased shareholders. Owners usually do this through Buy-Sell Agreements that both restrict and define the market for closely held shares. Buy-Sell Agreements can take several forms. Stock Redemption Agreements provide that the corporation will purchase the shares of a departing shareholder. Cross Purchase Agreements provide for the purchase of shares by the remaining shareholders. Many Buy-Sell Agreements are combination agreements that allow for either redemption of the stock by the corporation or a cross purchase of the stock by the remaining stockholders. (These are called "Wait and See" Agreements.) In addition to establishing the market for the shares a major purpose of a Buy-Sell Agreement is to establish the value of the shares. If you are a multiple shareholder corporation, you need to consider the creation of a Buy-Sell Agreement.

As one of three shareholders what can I do to prevent a shareholder from selling his or her shares to a stranger thereby forcing me to own a business with someone not of my choosing?

If you want to restrict the ability of a shareholder to sell or otherwise transfer shares you must do so specifically in the Articles of Incorporation, Corporate By Laws, or Separate Shareholder Agreements. For example, the provision can specify that a shareholder be allowed to transfer stock only to the corporation or other shareholders. You must state your restrictions in the corporate documents because standard corporation laws were created primarily for publicly held corporations for which restrictions are the exception rather than the rule.

#### I have close corporation stock. How do I know whether transfer restrictions apply?

Transfer restrictions should be noted on corporation share certificates. For example, a statement similar to the following should appear conspicuously on each share certificate issued by a corporation:

“The rights of shareholders in a statutory close corporation may differ materially from the rights of shareholders in other corporations. Copies of the Articles of Incorporation, By Laws, Shareholders Agreements, and other documents any of which may restrict transfers and affect voting and other rights may be obtained by a shareholder on written request to the corporation.”

#### How do I form a corporation?

Usually, a lawyer will help you think through some of the issues you have just read about. After you make a decision how you wish to proceed, then the lawyer will form a corporation by filing Articles of Incorporation with the Secretary of State. The state of incorporation is often but not always the state in which the corporation will conduct its business activities. If you incorporate in a different state you must qualify the corporation to do business in the state in which it will conduct its principal activities. Forming a corporation can be very complex. We recommend that you work with your business attorney, accountant, and financial advisor to determine which corporate structure is the best for your situation and to form it correctly.

#### Can I pick any name I want for my corporation?

Yes, within certain limits of course. You cannot incorporate under a name that is already in use, that is very similar to another name in use, or that might mislead the public. Also there may be special restrictions on names for certain types of businesses, such as banks and savings and loan institutions. State requirements vary. For example many states require that a corporate name include “INC.”, “Incorporated”, “CO”, “Company”, “Corp.”, or “Corporation” as notice to customers or creditors that they are doing business with a corporation. Your attorney will explain what your state law requires. Common sense, marketing philosophies, and other legal restrictions should also prevail. For instance you would not want to use a name that infringes on a trademark name that is libelous, offensive, or unrelated to your primary product or service or that is hard to spell, difficult to remember or pronounce, or extremely long. Some states set a maximum length for corporate names. Name length is a practical issue as well: being known as

“Bill and Ted’s Most Excellent Travel Agency Services, Real Estate Holdings, Worldwide, Inc.” might make your commercials too long for radio spots!

### What is a Registered Agent?

Florida law requires you name a Registered Agent for your business. This is the person that will receive all official correspondence for your company, including being served in case of a lawsuit. Many people do not want to be served with a lawsuit at their place of business. Obviously, that may not create confidence for your customers! Your Registered Agent must reside in Florida if you are incorporating under Florida Law. You can change your Registered Agent if necessary by filing an Amendment. Our firm can serve as your Registered Agent upon request. The fee for this service is currently \$150 a year, if you are not a member of *Your CorporateCounsel Program*<sup>TM</sup>. If you are a member, it is included in your annual fee.

### Operating Agreement for LLCs

If you have more than one member in an LLC, an Operating Agreement (OA) is critical. The OA covers all the major issues that need to be addressed in the operation of the LLC. Just a few are how to become a member, issuing stock, making distributions, and the issues in a Buy-Sell Agreement like restricting the sale of company stock to outside members.

### Maintaining My Business

Our firm has created a unique process for business owners to not only maintain the legal requirements each year, but to help business owners grow their business. We have included information on this process, *Your CorporateCounsel Advantage Program*<sup>TM</sup>. Members have found it a cost-effective, proactive way to grow their business and delegate the annual legal maintenance to our firm.

### What is my next step?

If after reading this Memo, you can identify which type of entity and which type of taxation structure you wish to use, you are ready to proceed. Complete the enclosed Corporation Quick Start<sup>TM</sup> form and return it to our office. If you need further counselling from an attorney before making a final decision, you can contact our office and schedule a meeting.

### How long will it take?

If you supply us with all the information requested on the Quick Start form, we can draft your Articles within 48 hours. We will need to fax them to you to sign, along with an SS-4 application for your EIN number. After you return them to us, we will file them within 24 hours. The Secretary of State will typically file the Articles within 24 – 48 hours. Once we receive notification that your Articles are filed, we will forward you a

copy. At that point, we will order your corporation minute book and file your SS-4 application with the IRS. The IRS typically takes 3-10 days to assign the EIN number. Once received, we will file your sub-S election (if applicable). We will contact you to schedule your first Corporate Meeting in our office. At this meeting you will sign the Bylaws for your business and issue stock shares.

How much will it cost to Incorporate?

If you use our firm's services, our fees are as follows:

Incorporation or LLC (includes drafting of Articles, filing Articles with Secretary of State, filing for EIN, filing sub-S election if applicable, ordering Corporate Minute Book, drafting of Bylaws, issuance of stock, tracking of stock issuance, review of Corporate Minute Book with client)

for a single shareholder or husband/wife shareholder corporation  
\$1,000 + hard costs\*

for multiple shareholder corporation  
\$1,250 + hard costs\*

Serving as Registered Agent	\$150 a year
Consultation with Attorney	\$500
Buy-Sell Agreement (could be more depending on complexity)	\$3,500
LLC Operating Agreement (could be more depending on complexity)	\$2,500

*\*You are responsible for the hard costs involved with creating your business. These are your filing fees with the Florida Secretary of State and the cost of your Corporate Minute Book. They are as follows:*

<i>Filing Fee for Corporation</i>	<i>\$ 70.00</i>
<i>Filing Fee for LLC</i>	<i>\$125.00</i>
<i>Corporate Minute Book</i>	<i>\$ 57.00</i>

If you are ready to proceed with the creation of your business, complete the enclosed Quick Start Corporation Form™ and return it to our firm. If you need this form, contact Adelina at (813) 286-1700 or [adelina@thestrategiccounsel.net](mailto:adelina@thestrategiccounsel.net).