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Corporations 101—Basics for Businesspeople

Running your own business? Confused about your options when it comes to business structures? There are certainly some features you want. You probably want the ability to share and transfer ownership. And you probably don't want to be personally liable for the company's debts. A corporation may be the answer for you and your business. This article will take a quick look at some of the advantages and disadvantages of the corporate structure; you should talk to your lawyer for advice tailored to your specific needs.

What is a Corporation anyway?

A corporation is simply a business structure you can create by filing articles of incorporation in your state. The equity ownership interest in a corporation is called stock, and the owners of shares of stock are called **shareholders** or **stockholders.**

The most important characteristic of a corporation is that it is a **separate legal entity**. This means the corporation is treated as a legal person in its own right, separate from its directors and shareholders. A corporation can own property and sue or be sued in its own name. Pretty much all of the advantages of incorporating a business—and all the drawbacks too—stem from this characteristic.

Limited Liability

Limited liability is one of the greatest advantages of a corporation. It means shareholders can lose only as much money as they put into the corporation. For example, imagine Alan and Bob are starting a small business, and each put up $5,000 in return for stock in their company, AB, Inc. In theory, the creditors of the company cannot come after them personally for payment because a corporation is a separate legal entity. Even if the business is deader than a three-day-old halibut, Alan and Bob can lose only their investment.

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Of course, limited liability in the real world is a little more complex than that. Banks and others who lend money to small, new corporations know very well that they can't routinely get their money back if their claims are greater than the assets of the corporation, and are unlikely to lend $100,000 to a company whose coffers contain a measly $10,000. Therefore, creditors often require investors to give personal guaranties or to co-sign a note or other obligation in their capacity as individuals.

The Importance of Perpetual Existence

In certain partnerships, if one partner leaves, the remaining partners may have to agree to continue the business, or the partnership will dissolve. In a corporation, on the other hand, shareholders can come and go with impunity. The separate legal entity of the corporation means it can survive even if a shareholder or director leaves. The life of a corporation is indefinite, which means investment in a corporation may be somewhat safer than investments in other, less permanent business organizations.

Transfer of Shares

Being able to transfer shares freely to anyone gives an investor the right to liquidate his or her investment at any time. But this transfer ability can be a disadvantage in a small corporation. Take the example of AB, Inc., a small company where it's essential for the success of the company that the two shareholders get along. If Alan wanted to sell his shares in AB, Inc. to Zoran, but Bob dislikes Zoran intensely, it could be a disaster. In most small corporations, shareholders enter into a share transfer restriction agreement to limit the transferability of shares.

Taxation of Corporations

The fact that a corporation is a legal entity opens up the unwelcome possibility of double taxation: a tax on the earnings of the corporation as an entity, plus the tax paid by the shareholder on dividends paid by the corporation. Small business owners can get around this if they meet the requirements of subchapter S of the Internal Revenue Code. S-corporations do not pay any taxes—the income and deductions are passed through shareholders, who report their share on their individual tax returns. Your lawyer can give you more detailed advice on eligibility requirements.

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Types of Corporations

Besides the distinction between S-corporations and those that file under Subchapter C of the Internal Revenue Code, there are several types of corporations to fit the needs of various enterprises. **General business corporations** are often among the larger enterprises. **Close corporations** are often smaller enterprises in which all or most of the shareholders are actively involved in the management of the business. State law typically allows such corporations more flexibility in management. **Professional corporations** are limited to licensed professionals -- such as physicians or architects -- and professionals licensed in the field are the only shareholders.