



Excerpted from  
FastTrac® TechVenture™



TAKE CHARGE OF YOUR BUSINESS®

A program of the Kauffman Foundation

# Corporations: C Corporation and S Corporation

A *corporation* is a legal entity created under state law. A corporation can manage its own affairs, hold property, borrow money, and legally do nearly anything an individual can do. Stockholders may be, but need not be, employees, officers, or directors of the corporation as well. An advantage of corporations is that they insulate you from liability. If the corporation operates according to laws and regulations, creditors only have access to the corporate assets for business debts. The owners' personal assets are not at risk.

Primarily because of the ability to issue and sell ownership interests, corporations are the entity of choice for high-growth companies.

The law requires corporations to operate separately from the owner and to file all governmentally required reports and taxes. All too often, however, a one- or two-person corporation keeps inadequate records and fails to strictly segregate corporate and personal assets and liabilities. Failing to operate the business as a corporation separate from the owners results in a loss of insulation from liability.

If a creditor can show that your business has not been properly operated as a corporation, the creditor can then reach both your corporate and personal assets. Corporate insulation from liability does not shield you from liability for harm to another caused by your own negligence. You may be liable along with the corporation. Nor does it prevent the corporate owners and officers from being sued. Even if you are not found to be legally liable, defending the action filed against you can cost thousands of dollars. For these reasons, many corporate owners and officers obtain individual liability insurance coverage.

Corporations have a three-tiered control system. Stockholders elect the directors of the corporation. In turn, directors elect the officers. Other than electing directors and expecting dividends, stockholders generally have no other function. The directors make primary decisions for the corporation, and the officers direct day-to-day operations.

Some states permit one person to fill the roles of stockholder, director, and officer. Others permit only one owner but require two officers minimum. All states' requirements are based on the concept that the corporation is a separate legal entity from those individuals who own and operate it.

All corporations start the same. They obtain a charter from the state, generally the one in which they intend to do the most business. Unless the corporation elects to be treated as a partnership for tax purposes (the subchapter S election), it files a corporate

**Tip** If you're doing business as a corporation, follow the rules to maintain your corporate protection.

tax return. After paying taxes, most corporations distribute money to their stockholders in the form of dividends. The stockholders must pay taxes on the income received. This practice results in double taxation.

To avoid double taxation, assuming certain requirements are met (no more than 75 stockholders, all stockholders are U.S. citizens, and all stockholders agree), your corporation may elect to be treated as if it were a partnership at tax time. In that case, the corporation pays no tax and the profits pass through to the stockholders, who pay income tax on what they receive.

- If you make such an election, your corporation is an *S corporation*, or a Subchapter S corporation. The S comes from the subsection of the Internal Revenue Code which permits this election.
- A corporation that has not made the election or is ineligible to make it is known as a *C corporation*. When contemplating an initial public offering, technology-based ventures will almost always be C corporations because of the unlimited number of stockholders permitted and because S corporations generally only allow one class of equity ownership.

Shares of a corporation represent ownership of the corporation. While you may restrict shares through the bylaws of the corporation, you may transfer ownership of all or part of the corporation relatively easily. A corporation can exist forever apart from its founders. When you want to sell your business, the corporation provides a much more salable package than a sole proprietorship or partnership. The corporation is the only entity that can deduct as business expenses many benefits such as health care and retirement plans. These expenses reduce the taxable profits of the corporation and give employees valuable benefits which are not taxed as income.

Incorporating a business carries many advantages. One of the most significant advantages is tremendous financial flexibility in raising capital. A corporation has the ability to provide you the capital structure you need to accomplish your goals.

Once investors, lenders, or stockholders get involved, you need to protect your own interests from those who might seek to take control, ownership, or profits. Even though you start a corporation, nothing guarantees you can continue as a director, officer, employee, stockholder, or even recipient of dividends. Nothing guarantees you will continue to be included in the inner workings of the business. You can be squeezed out in many ways, some direct and others very subtle. To recognize the various squeeze-out methods and protect against them, rely on an experienced business attorney. These professionals make sure your interests are protected before you commit to take on other owners or investors. Continue to consult an attorney as time passes and the venture changes; especially if it becomes more valuable.

**TIP** *Double taxation* occurs when the earnings of a corporation are taxed twice, both as the Net Income of the corporation and again as the dividends distributed to the stockholders. Consult your accountant to advise you on ways to avoid double taxation.

**TIP** Not all companies are eligible to be every type of corporation. Some states require specific businesses such as banks, railroads, public utilities, health care, or law to be specific types of corporations. Consult an attorney and accountant before making a decision about which type of corporation is permitted and right for your business.

**Key Points about Corporations**

- Owned through shares of stock.
- Controlled by directors with officers directing day-to-day operations. Directors are elected by shareholders.
- Income and loss is held by the corporation, and the corporation pays taxes on its profit. Shareholders have no liability for the debts of the corporation. S corporations can be treated as a partnership for tax purposes.
- Legal liability generally remains with the corporation.
- Can be acquired or merged into other corporations, or assets can be sold in part or in whole.
- Shares in the corporation can be transferred or sold, and new shares can be issued.
- Continues until dissolution.
- Unlimited amounts of capital can be raised through sale of stock.

**Corporations**

Software Solutions, Inc. began as an S corporation. Within five years of starting the business, founders Alexei and Nina Vladimir wanted to go public—that is, issue and sell shares of stock to the general public. To do this, they had to give up their S status and become a C corporation. They will have far more than the 75 stockholders permitted by S regulations.

From Real   
Entrepreneurs