

Corporation Basics

Corporations limit personal liability for business debts, but running them takes work.

Most people have heard that forming a corporation provides "limited liability" -- that is, it limits your personal liability for business debts. What you may not know is that there's more to creating and running a corporation than filing a few papers. You'll need to keep good records to handle the more complicated corporate tax return and, in order to retain your limited liability, you must follow corporate formalities involving decision making and record keeping. In short, you've got to be organized.

Limited Personal Liability

One of the main advantages of incorporating is that the owners' personal assets are protected from creditors of the corporation. For instance, if a court judgment is entered against your corporation saying that it owes a creditor \$100,000, you can't be forced to use personal assets, such as your house, to pay the debt. Because only corporate assets need be used to pay business debts, you stand to lose only the money that you've invested in the corporation.

Exceptions to Limited Liability

There are some circumstances in which limited liability will not protect an owner's personal assets. An owner of a corporation can be held personally liable if he or she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the corporation defaults
- fails to deposit taxes withheld from employees' wages
- does something intentionally fraudulent or illegal that causes harm to the company or to someone else, or
- treats the corporation as an extension of his or her personal affairs, rather than as a separate legal entity.

This last exception is the most important. In some circumstances, courts can rule that a corporation doesn't really exist and that its owners should not be shielded from personal liability for their acts. This might happen if you fail to follow routine corporate formalities such as:

- adequately investing money in ("capitalizing") the corporation
- formally issuing stock to the initial shareholders
- regularly holding meetings of directors and shareholders, or
- keeping business records and transactions separate from those of the owners.

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Liability Insurance

Incorporating should never take the place of good business insurance. Even though forming a corporation protects your personal assets, you should use insurance to guard your corporate assets from lawsuits and claims.

A solid liability insurance policy can protect you against many of the risks of doing business. For instance, if you operate a clothing store, good business insurance should adequately cover the bill if someone slips and falls in your store.

Also, insurance can protect you where the limited liability feature will not. For example, if you personally injure someone while doing business for the corporation, say by causing a car accident, liability insurance will usually cover the accident so that you won't have to use either corporate or personal assets to pay the bill. However, insurance won't help if your corporation doesn't pay the bills: commercial insurance usually does not protect personal or corporate assets from unpaid business debts, whether or not they're personally guaranteed.

Paying Corporate Income Tax

If an owner of a corporation works for the corporation, that owner is paid a salary, and possibly bonuses, like any other employee. The owner pays taxes on this income just like regular employees, reporting and paying the tax on his or her personal tax return.

The corporation pays taxes on whatever profits are left in the businesses after paying out all salaries, bonuses, overhead, and other expenses. To do this, the corporation files its own tax return, Form 1120, with the IRS and pays taxes at a special corporate tax rate.

Alternatively, corporate shareholders can elect what's called "S corporation" status by filing Form 2553 with the IRS. This means that the corporation will be treated like a partnership (or LLC) for tax purposes, with business profits and losses "passing through" the corporation to be reported on the owners' individual tax returns.

Forming a Corporation

To form a corporation, you must file "articles of incorporation" with the corporations division (usually part of the secretary of state's office) of your state government. Filing fees are typically \$100 or so.

For most small corporations, articles of incorporation are relatively short and easy to prepare. Most states provide a simple form for you to fill out, which usually asks for little more than the name of your corporation, its address, and the contact information for one person involved with the corporation (often called a "registered agent"). Some states also require you to list the names of the directors of your corporation.

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In addition to filing articles of incorporation, you must create "corporate bylaws." While bylaws do not have to be filed with the state, they are important because they set out the basic rules that govern the ongoing formalities and decisions of corporate life, such as how and when to hold regular and special meetings of directors and shareholders and the number of votes that are necessary to approve corporate decisions.

Finally, you must issue stock certificates to the initial owners (shareholders) of the corporation and record who owns the ownership interests (shares or stock) in the business.

Retaining Corporate Status

Corporations and their owners must observe certain formalities to retain the corporation's status as a separate entity. Specifically, corporations must:

- hold annual shareholders' and directors' meetings
- keep minutes of shareholders' and directors' major decisions
- make sure that corporate officers and directors sign documents in the name of the corporation
- maintain separate bank accounts from their owners
- keep detailed financial records, and
- file a separate corporate income tax return.