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INCORPORATING TIPS – CAPITALIZATION

Capitalizing a new business entity is a critical step of the formation process. Failing to take the step can lead to serious legal problems if the entity is ever sued. So, what is capitalization and what steps must be taken?

Capitalizing Your Corporation

“Capitalization” essentially refers to funding your corporation. In essence, you are providing substance to the entity in the form of money or property. Typically, the funding process works in two ways.

Corporate Stock

You must own stock in a corporation to be considered a shareholder. You are already familiar with this concept if you trade on the stock market. For instance, assume you bought stock in Sirius Radio in anticipation of Howard Stern moving to the station. You purchased stock through a brokerage or retirement vehicle by exchanging money for shares. Technically, you are a shareholder in the corporation. Your own corporation is no different.

The fact that you paid money to have a corporation formed does not make you a shareholder. You must exchange property, cash or services to obtain stock from the entity. Only then are you a shareholder in the entity. This is more easily explained with an example.

Assume I start a corporation for the purpose of providing consulting services to other businesses. The corporation is formed with 10,000 shares and I am going to be the sole shareholder. I have cash and certain assets that I am going to use as part of the business. I decide to exchange $3,000, a copier, fax machine and computer equipment for stock in the entity. This exchange should be reduced to writing, but will constitute the capitalization of the corporation.

Corporate Loan

You can also loan money to a corporate entity for start-up costs. There is no prohibition against a shareholder providing money to a corporation. The loan process should not completely replace the purchase of stock. From a tax perspective, however, dividing your initial capitalization into a partial loan can have distinct advantages.

Inadequate Capitalization

State laws govern the formation of a corporation. Inevitably, these laws set forth amounts or formulas for determining the minimum capitalization amount required for a corporation. You must review the laws in your state to determine the amount and make sure you meet the contribution minimums.

Failure to properly capitalize you corporation can result in disaster if the entity is ever sued. Simply put, the suing party may argue that the lack of capitalization means the corporation was never a viable entity because it had insufficient funds to back debt obligations. The argument gets complicated, but suffice to say you are in serious trouble if a court agrees with the argument. Typically, the court will “set aside” the corporate entity, exposing each shareholder, director and officer to the risk of personal liability. Obviously, such a scenario would be a disaster.

In Closing

If you’ve purchased a corporation from online service, you have work to do. Make sure you determine the minimum capitalization requirements in your state and comply with them.