

15.6: Corporations

Unlike a sole proprietorship or general partnership, a corporation is a legal entity separate and distinct from its owners. It can be created for a limited duration, or it can have a perpetual existence. Since it is a separate legal entity, a corporation has continuity regardless of its owners. Similarly, in a publicly traded company, the identity of shareholders can change, but the corporation continues its business operations without being affected.

Corporations must be formed in compliance with the law of the state law where they are incorporated. Most corporations incorporate where their principal place of business is located, but not all do. Many companies choose to incorporate in Delaware. Delaware chancery courts have developed a reputation for fairly and quickly applying a very well-developed body of corporate law in Delaware. The courts also operate without a jury, meaning that disputes heard in Delaware courts are usually predictable and transparent, with well-written opinions explaining how the judges decided the cases.

To start a corporation, the corporate founders must file **articles of incorporation** with the Secretary of State where they are incorporated. Articles of incorporation typically include:

- The name of the company;
- Whether the company is for-profit or nonprofit;
- The founders' names;
- The company's purpose;
- How many shares the corporation will issue initially; and
- The par value of any shares issued.

Unlike sole proprietorships, corporations can be quite complicated to manage and often require attorneys and accountants to maintain corporate books in good order. In addition to the foundation requirements, corporate law requires ongoing annual maintenance of corporations. In addition to filing fees due at the time of incorporation, there are typically annual license fees, franchise fees and taxes, and fees related to maintaining minute books, corporate seals, stock certificates and registries, as well as out-of-state registration. A domestic corporation is entitled to operate in its state of incorporation but must register as a foreign corporation to do business in other states.

Corporate Legal Structure

Owners of corporations are called **shareholders**. Corporations can have as few as one shareholder or as many as millions of shareholders, and those shareholders can hold as few as one share or as many as millions of shares. In a **closely held corporation**, the number of shareholders tends to be small, while in a **publicly traded corporation**, the body of shareholders tends to be large.

In a publicly traded corporation, the value of a share is determined by the laws of supply and demand, with various markets or exchanges providing trading space for buyers and sellers of certain shares to be traded. Shareholders own shares in the company but have no legal right to the company's assets. As a separate legal entity, the corporation owns any property in its name.

Shareholders of a corporation enjoy limited liability. The most they can lose is the amount of their investment. Shareholders' personal assets are not available to the corporation's creditors.

Shareholders can be individuals or other business entities, such as partnerships or corporations. If one corporation owns all the stock of another corporation, the owner is said to be a **parent company**, while the company being owned is a **wholly owned subsidiary**. Often large corporations form subsidiaries for specific purposes so that the parent company has limited liability or advantageous tax treatment. For example, large companies may form subsidiaries to hold real property so that premises liability is limited to that real estate subsidiary only, shielding the parent company and its assets from lawsuits. Companies that deal in a lot of intellectual property may form subsidiaries to hold their intellectual property, which is then licensed back to the parent company so that the parent company can deduct royalty payments for those licenses from its taxes. This type of sophisticated liability and tax planning makes the corporate form very attractive for larger businesses in the United States.

An exception to the rule of limited liability arises in certain cases involving closely held corporations. Many sole proprietors incorporate their businesses to gain limited liability but fail to realize when they do so that they are creating a separate legal entity that must be respected as such. If sole proprietors fail to respect the legal corporation with an arm's length transaction, then creditors can ask a court to pierce the corporate veil. If a court agrees, then limited liability disappears and those creditors can reach the shareholder's personal assets.

Rights of Shareholders

Not all shareholders in a corporation are necessarily equal. US corporate law allows for the creation of different types, or classes, of shareholders. Shareholders in different classes may be given preferential treatment when it comes to corporate actions such as paying dividends or voting at shareholder meetings.

Shareholder rights are generally outlined in a company's articles of incorporation or bylaws. Some of these rights may include the right to obtain a dividend, but only if the board of directors approves one. They also include the right to attend shareholder meetings, the right to examine the company's financial records, and the right to a portion of liquidated company assets.

Under most state laws, shareholders are also given a unique right to sue a third party on behalf of the corporation. This is called a **shareholder derivative lawsuit**. In essence, a shareholder alleges that the people who are ordinarily charged with acting in the corporation's best interests (the officers and directors) are failing to do so, and therefore the shareholder must step in to protect the corporation.

One of the most important functions for shareholders is to elect the board of directors of a corporation. Only shareholders elect a director. The board is responsible for making major decisions that affect a corporation, such as declaring and paying a corporate dividend to shareholders; authorizing major decisions; appointing and removing corporate officers; determining employee compensation, especially bonus and incentive plans; and issuing new shares and corporate bonds.

One critical function for boards of directors is to appoint corporate officers. These officers often hold titles such as chief executive officer, chief operating officer, chief marketing officer, and so on. Officers are involved in everyday decision making for the company and implement the board's decisions. As officers of the company, they have legal authority to sign contracts on behalf of the corporation, binding the corporation to legal obligations. Officers are employees of the company and work full-time for the company, but can be removed by the board.

Corporate Taxation

Corporations are subject to double taxation. Because corporations are separate legal entities, they must pay federal, state, and local tax on net income. Then, if the board of directors declares a dividend, shareholders are taxed on the dividend that they receive in the form of a dividend tax.

One way for closely held corporations (such as small family-run businesses) to avoid double taxation is to form an S corporation. An S corporation (the name comes from the applicable subsection of the tax law) can choose to be taxed like a partnership or sole proprietorship. In other words, taxes are only collected when a dividend is declared and not on corporate net income. An S corporation is formed and treated just like any other corporation; the only difference is in tax treatment.

S corporations provide the limited liability feature of corporations but the single-level taxation benefits of sole proprietorships. There are some important restrictions on S corporations, however. They cannot have more than one hundred shareholders, all of whom must be US citizens or resident aliens and cannot include partnerships and corporations. S corporations can have only one class of stock and there are restrictions on how shares may be transferred. Finally, all shareholders must agree that the company should be an S corporation. These restrictions ensure that "S" tax treatment is reserved only for small businesses.

Advantages of Corporations	Disadvantages of Corporations
<ul style="list-style-type: none">• Separate legal entity from owners• Corporation unaffected by change of ownership/shareholders• Limited liability for shareholders• Not subject to some laws• Considered as an "individual" with Constitutional rights	<ul style="list-style-type: none">• Formal documents required to be filed in state of incorporation• Can be complicated to manage• High formation and maintenance costs• Subject to double taxation• Heavily regulated by government

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