URI MARINE ADVISORY SERVICE
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INCORPORATION OF RHODE ISLAND FISHING VESSELS-- PROCEDURE, COST AND MERIT

by

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Marine Memorandum #43

I. Introduction

The business structure under which commercial fishing vessels operate can take one of three distinct forms: sole ownership, partnership, or corporation. The purpose of this paper is to outline the procedure, the costs, and some of the advantages and disadvantages of incorporation. Since laws pertaining to incorporation vary widely from state to state, the content of this discussion refers to Rhode Island.

The general corporate business form contains four principal characteristics:

1) A corporation has all the legal powers of a person.

2) A corporation's liability is its debts and not those of officers or shareholders.

3) Assets and properties of the corporation belong to the corporation and not its members.

4) Corporate life is either for a specified period of time, or it may be perpetual.

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[1]The authors thank Prof. R. Sisco for helpful comments on a draft of this paper.

There are various types of corporations. One of these is the closed corporation or the family corporation. For a fishing vessel owner the closed, corporation is the type considered most appropriate. It is designed specifically to benefit small business, and is, in effect, a "streamlined" form of incorporation, which allows small business to acquire the advantage of the corporate structure without incurring the high costs and administrative complexity of the ordinary corporate structure. More specifically, the primary features of the closed corporation are the following:

1) Number of shareholders cannot exceed 30 (minimum one).

2) There need be no directors or boards.

3) There may be only one class of stock and there is no general market for the stock.

4) Unlike in large corporations owners and managers are the same individuals.

5) Reporting consists of one annual report of income.

6) No meetings are required.

7) Stock in the closed corporation may not be held by other corporations or partnerships.

8) A single shareholder may be granted the right to dissolve the corporation via notification to the Secretary of State (R.I.).

<u>Procedure and cost of incorporation</u>

Prospective incorporators file "articles of incorporation" with the Secretary of State (R.I.), who issues a certificate of incorporation. At that time, or no later than 30 days thereafter (as specified in the articles) the corporation comes into existence. For vessel owners there is no delay involved in incorporating a vessel other than the time used in making arrangements with a lawyer and accountant. Such consultations are advised unless the vessel owner is unusually proficient in such administrative or legal matters.

The articles of incorporation are:

1) The name of the corporation.

2) The period of duration; may be perpetual.

3) The purpose of the corporation; that is, the business to be undertaken.

4) The amount of stock to be issued and the face value.

5) The rights of shareholders.

6) Provisions for internal regulations.

7) Address of corporation office; may be lawyer's or accountant's office address.

8) The number of and names and addresses of directors (closed corporation require none).

The initial legal and professional fees for incorporation a fishing vessel are about $500. In addition there is an $80 fee for filing and a $30 minimum franchise fee based on the number of shares. These are state fees; there are no Federal incorporation fees.

Advantages and disadvantages of incorporation

a) Liability and bankruptcy

One of the disadvantages of incorporation has already been mentioned. To incorporate will cost possibly somewhere between $600-700, and since a corporation is a separate business entity some additional bookkeeping is necessary.

Incorporation is undertaken, however, for a number of reasons, such as liability, taxes, family security, etc. The corporate structure protects the vessel owner from personal liability. Most vessels are covered by hull and P.I. insurance, but if a jury award exceeds the amount of coverage, or if some stipulation in the insurance policy has been broken, so the owner is not covered, then it is only the assets of the corporation that can be touched. The vessel owner by incorporating has separated his business from his home or other assets he might have. Similarly if a vessel corporation goes bankrupt, only the assets of the corporation can be touched and not those of the shareholders (except if these have been put up as security for a loan by the corporation).

b) Payroll taxes

By incorporating the vessel owner has become an employee of the corporation. As an employee he is subject to tax withholding (state and federal), withholding of social security tax matched by the corporation, and withholding of Rhode Island temporary disability tax. Further, the corporation will have to pay State and Federal unemployment taxes for the vessel owner, who now has become an employee of the corporation.

Some of these changes have little affect. There might be some minor interest loss due to tax withholding, and the combined rate of employer and employee in social security taxes is higher than the rate for a self employed individual. However, the employer's (corporations) contribution is tax deductible. Whether or not it is a disadvantage to pay for and have unemployment insurance depends upon the individual case.

c) Income taxes

A major advantage of incorporation is in regard to income taxes. Many vessel owners have a marginal federal income tax rate of 30% (tax on the last dollars earned). The federal corporate income tax is 22% on taxable income below $25,000 and 48% on taxable income above $25,000. A vessel owner would be in a position to determine how much income to leave in the corporation to minimize his income taxes (personal and corporate combined). This can be done by charging the corporation a fee as a director. While the state personel income tax in Rhode Island currently is 17% of the federal personal income tax, the Rhode Island Corporate income tax is the higher of the following three:

1) 8% of taxable net income

2) .7% of net worth

3) $50, flat fee

Therefore, state corporate income tax can be slightly higher than the state personal income tax, but this in most cases is more than offset by reduced federal tax.

d) Other advantages

A corporation offers a great flexibility with opportunities for tax savings not easily derived under personal ownership. For instance, a corporation can pay life insurance, retirement, and other benefits for its directors or employees, the cost of which is tax-deductible; for an owner of a non-incorporated vessel, these are not tax deductible. Charges for office space, utilities, transportation, etc. are also more easily defined for a corporation. Further, a corporation has the opportunity to carry back or carry forward tax-losses, an opportunity not enjoyed under sole ownership.

Another major advantage of incorporation is that there is no probate. If husband and wife or other members of the family are the stockholders in a vessel corporation, the corporation continues even if the husband should pass away, and inheritance taxes to be paid would be relatively small compared to a non-incorporated property.

Some final remarks

If a fisherman buys a vessel, and expects that, due to investment credits, depreciation, and/or initial high cost of operation, the books will be in the red, then he should initially incorporate the vessel under Sub-chapter S. Then the corporation will be treated as a partnership for tax purposes, but still enjoy the other advantages of incorporation. Therefore, a tax loss on the vessel can be used against the vessel owner's labor income or other income. Then later when the book figures are in the black, the corporation can change away from Sub-chapter S.

If a vessel owner has two vessels, the question might arise whether to form two different corporations or to have both vessels in the same corporation. This will depend on the purposes of incorporation. From a liability standpoint it would be advantageous to form two corporations; but both from a cost and tax viewpoint, it would be advantageous to have the vessels in the same corporation. Two corporations would require much more accounting including the problem of allocating fixed assets. Further, if an individual controls two corporations then the $25,000 net income taxed at the lower corporate tax rate have to be split between the two corporations.

By incorporating a vessel, ownership has changed hands. Therefore, if the vessel owner has monies deposited in the Capital Construction Fund he must notify the Secretary of Commerce (NMFS) about this change. If the vessel owner has at least 80% of the stock in the new corporation, the monies in the Fund will not have to be withdrawn; but if he controls a smaller share of the corporation, then he should determine whether transfer of the funds into the corporation can take place according to Internal Revenue Service Code Article 351.

While this paper has attempted to point out some of the costs, procedures, pros and cons of incorporation, the authors strongly recommend that if a vessel owner seriously considers incorporating his vessel, he contact a lawyer and an accountant.