Small Business Incorporation Guide

Should My Business Incorporate or Form an LLC?

Corporations and LLCs are both separate legal entities (business structures) that enjoy certain protections under the law and important benefits. Most people form a legal business structure to safeguard their personal assets.

Incorporating, or forming a Limited Liability Company (LLC), allows you to conduct your business without worrying that you might lose your home, car, or personal savings because of a business liability.

How You Can Benefit from a Corporation or LLC

Regardless of their size, all businesses can benefit from incorporating. Advantages of forming a corporation or Limited Liability Company (LLC) include:

- **Personal asset protection.** Both corporations and LLCs allow owners to separate and protect their personal assets. In a properly structured and managed company, owners should have *limited liability* for business debts and obligations.

- **Additional credibility.** Adding "Inc." or "LLC" after your business name can add instant authority. Consumers, vendors, and partners may prefer to do business with an incorporated company.

- **Name protection.** In most states, other businesses may not file your exact corporate or LLC name in the same state.

- **Perpetual existence.** Corporations and LLCs continue to exist, even if ownership or management changes. Sole proprietorships and partnerships just end if an owner dies or leaves the business.

- **Tax flexibility.** Though profit and loss typically *pass through* an LLC and get reported on the personal income tax returns of owners, an LLC can also elect to be taxed as a corporation. Likewise, a corporation can avoid *double taxation* of corporate profits and dividends by electing Subchapter S tax status.

- **Deductible expenses.** Both corporations and LLCs may deduct normal business expenses, like salaries, before they allocate income to owners.

The Facts About an LLC

A Limited Liability Company (LLC) combines the **tax flexibility of a partnership with the personal liability protection of a corporation**. LLC owners report their share of business profit and loss on their personal tax returns, similar to tax reporting for a general partnership. **Forming an LLC can help you separate yourself from your business**, protecting your personal assets in the event of a judgment against the company. All 50 states and the District of Columbia now recognize this popular business type.

Limited Liability Companies (LLCs)

- Independent legal structures separate from their owners
- Help separate your personal assets from your business debts
- Taxed similarly to a sole proprietorship (if one owner) or a partnership (if multiple owners)
- No limit to the number of owners
- Not required to hold annual meetings or record minutes
- Governed by operating agreements

The Facts about S Corporations

S Corporations get their name from a unique section of the Internal Revenue Service (IRS) code. A corporation can eliminate the disadvantage of *double taxation* of corporate income and shareholder dividends by applying for S Corporation status. Owners report profit and loss on their individual tax returns. They still have the opportunity to separate and protect their personal assets from judgments against the business.

Benefits of an S Corporation

Business owners typically choose S corporation status for a couple of reasons:

Avoiding double taxation on corporation profits:

Reason one for electing Subchapter S status is to avoid the doubling effect of paying both corporate and individual income tax.

As noted above, by avoiding federal and state corporate income taxes, the shareholders do end up paying more in personal income taxes than they would otherwise.

However, when you “do the math” and consider the total taxes paid on the business profits at both the corporate and individual level, an S corporation commonly (but not always) saves income taxes.

Saving on employment taxes:

A second popular reason to operate an active trade or business as an S corporation comes from employment tax rules.

To understand this reason, you need to understand that with small C corporations, shareholder employees commonly attempt to extract (and are often successful in extracting) all of the corporation’s profits in the form of salary paid to shareholder employees. Thus additional payroll taxes

The S Corporation allows for paying out say (made up number) $ 200,000. profit by means of dividend, instead of payroll. Thus reducing payroll taxes paid by $ 30,000, and eliminates the corporate tax. Because amounts the S corporation pays out of profits to shareholders as distributions of profit are not subject to employment taxes.

The Facts about C Corporations

The Internal Revenue Service (IRS) refers to general corporations as "C" Corporations. Forming a C Corporation allows a business owner to create a separate legal structure that can shield their personal assets from judgments against the business. Unless a corporation applies for S Corporation status, the IRS taxes corporate profits as well as dividends paid to shareholders. Many tax professionals refer to this scenario as "*double taxation*."

Benefits of a C Corporation

While you might think, based on the preceding discussion that an S corporation automatically and always beats a C corporation, choosing the better corporate tax treatment is trickier than that.

Experienced business owners and entrepreneurs may choose the C corporation tax treatment for the following reasons.

Growing through reinvested corporate earnings:

As the preceding discussion of C corporation tax treatment indicates, the dividend tax paid by the owners of the corporation is only levied at the point that dividends are actually paid out to the shareholders.

If a corporate plans to retain earnings to fund growth, a C corporation may not cost that much more in taxes on a current basis than an S corporation does. And do note that if a corporation

earns and reinvests modest amounts of profit in the business, the tax rates may be lower than what I used in the example above. The first $50,000 in profit that a C corporation earns may be subject to a low 15% federal corporate income tax.

Tax-free fringe benefits for shareholder-employees:

Small corporations often employ their owners--which raises an interesting tax planning opportunity. A C corporation can provide tax-free fringe benefits to employees, including shareholder-employees.

In other words, the corporation can make pension fund contributions or buy health insurance for employees. These expenditures are tax deductions for the corporation. But the benefits aren't taxed to employees.

For many of these fringe benefits, by the way, the corporation needs to be non-discriminatory in the way it treats employees. With a pension plan, for example, the corporation needs to treat shareholder-employees and non-owner employees consistently.

With some fringe benefits, however--such as accident and health insurance--the C corporation may be able to discriminate, thereby providing shareholder-employees with generous tax-free income in the form of fringe benefits.

Comparing an LLC vs. a Corporation

Advantages of an LLC	**Advantages of a Corporation**
• Has no limit to the number of owners • Owners can report profit and loss on their individual tax returns • Not required to hold annual meetings or record minutes	• May issue shares of stock to attract investors • Corporate income splitting may help lower overall tax liability • Limiting Employment Taxes
Disadvantages of an LLC	**Disadvantages of a Corporation**
• Cannot engage in corporate income splitting to lower tax liability • Cannot issue stock	• Double taxation of corporate profits and shareholder dividends • Must hold annual meetings and record minutes

	• S Corporations have restrictions on number of owners

Finally - Sole Proprietorships

- Owner remains personally liable for lawsuits filed against the business
- No state filing required to form a sole proprietorship
- Easy to form and operate
- Owner reports business profit and loss on their personal tax return