Which business structure is best for my business?

The most popular business structures are the: Sole proprietorship, Partnership, Limited liability company (LLC), S corporation (S corp) and C corporation (C corp). In this guide we're going to look at the benefits and drawbacks of these business structures.

Sole proprietorships and partnerships are pretty much identical. If you go into business on your own you have a sole proprietorship, if you go into business with someone else you have a partnership. Both are simple and cheap to set up but suffer from one major drawback:

Your personal assets are not safe if the business gets sued.

That's why many small business owners decide to use a different business structure, usually either a: Limited liability company (LLC), S corporation (S), or C corporation (C).

Generally speaking all three offer much the same protection for your personal assets if the business is sued.

Many attorneys recommend going for an LLC if legal protection is all you're looking for. That's because LLCs are easy to operate and extremely flexible. They're also cheaper to set up in many states.

The other reason people set up an LLC or corporation is to save tax. In particular S owners often pay less self-employment tax, and C owners who keep money in the business can pay tax at the 15% or 25% corporate tax rates. C owners can also enjoy more tax-free fringe benefits.

About LLCs? It's important to remember that LLCs don't have their own set of tax rules. You, the owner, can choose to be taxed any way you like. By default LLCs are taxed like:

- Sole proprietors (if there's only one person)

- Partnerships (if there are two or more people)

But by filling in a form you can elect to be taxed as either an S corp, or C corp. That's why LLCs are often called the chameleons of the tax world. It's also why they're so popular.

Which is best for my business?

We'll start by taking a very quick look at the benefits and drawbacks of each type of structure, starting with sole proprietorships and ending with C corps. After that, we'll summarize the key points. We won't have time to cover every single fact about every type of entity. The idea is to cut the fluff and focus on the really important stuff.

Remember, however, that this guide is not meant to replace proper advice from a tax pro or attorney. The idea is to arm you with enough facts so that you can have a sensible discussion and get good value for money from your adviser.

The Sole Proprietorship

Tax Treatment

Sole proprietorships are called 'pass-through' entities because the profits pass through the business and onto the owner's personal tax return. The business is not taxed separately. It doesn't matter whether you keep the profits in the business checking account or withdraw them. Personal income tax is payable on all the profits of the business, no matter what you do with them.

All of the income and expenses of the business are listed on Schedule C. Your net profit is then entered on line 12 of your 1040 and taxed at regular individual tax rates.

If the business makes a loss this also passes through to your personal tax return and can usually offset other income, for example your salary if you also have a job. This is attractive in the start-up phase when losses are quite common.

Self-Employment Tax

Sole proprietors pay Social Security and Medicare but it's called self-employment tax. The tax rate is 15.3% which is twice what employees pay because as a self-employed person you end up paying both ends – the employer and employee's contributions.

Because sole proprietors pay more than ordinary employees, they're entitled to claim a tax deduction for half their self-employment taxes. Once your profits exceed $102,000, you only pay the Medicare portion which is 2.9% on the rest of your earnings.

Audit Risk

The IRS probably wouldn't admit it but conventional wisdom in the tax community is that filing a Schedule C increases your risk of being audited.

An audit will cost you time and probably money. Between 80% and 90% of sole proprietors who get audited end up paying more tax. The extra tax usually runs to thousands of dollars.

The following table shows the extra tax on average from audits carried out by correspondence:

Under $25,000	$11,048
$25,000 - $100,000	$11793
$100,000 - $ 200,000	$32640
$200,000 or more	$70017

Source: IRS Data Book 2007

So just how likely are you to get audited? Usually about 1% of individual tax returns are examined. The most heavily audited returns of all are those claiming the earned income credit.

For Schedule C filers who do NOT claim the earned income credit the percentages are as follows:

Under $25,000	1.3 %
$25,000 - $100,000	2.0 %
$100,000 - $200,000	6.2 %
$200,000 or more	1.9 %

LLCs are not included in this list because they do not have their own unique tax status. On the face of it, sole proprietors with turnover of more than $25,000 are at least four times more likely to be audited than other business entities, such as S corps and partnerships.

However, it's important to remember that incorporating your business will not shield you from audit risk. The IRS uses a complex but secret point scoring system to decide which tax returns are audited.

Your audit risk will increase:

1. If you claim a lot more expenses than similar businesses in your area.
2. If there is discrepancies between gross income reported in tax returns and the amount reported by others entities as paid to your business.
3. If there is discrepancies between wages expenses reported in tax returns and wages payments reported in forms 941/944 and 940.
4. If there is tax return inconsistencies from one year to another.
5. If your tax return was filed improperly or using a wrong form.
6. If you pay your taxes late.

The following table shows the percent audit for other entities:

C corporations	0.9 %
S corporations	0.5 %
Partnerships	0.4 %

Source: IRS Data Book 2007

However, it probably takes more than one thing to get you audited.

Liability Protection.

LLCs and corporation enjoy limited liability. This is the main reason people set them up: to protect their personal assets from claims against the business.

What type of business needs legal protection?

Any business with employees needs limited liability because employees are "walking lawsuits". Also any business with premises open to the public needs liability protection in case by accident a customer is injured on your premises and you could be sued for thousands of dollars.

Also businesses that sign contracts with other businesses should consider liability protection because disputes often end up in court.

It is true that some businesses are much more vulnerable to lawsuits and legal action than others but many attorneys argue that all businesses should incorporate because it doesn't cost very much but could save you thousands if not millions of dollars.

The sad truth is that lawsuits can come out of nowhere when you least expect them. It's impossible to say that some businesses are safe because it's impossible to predict every possible risk your business faces. For this reason every business should consider **limiting** its liability.

Summary – Sole Proprietorships

• A sole proprietorship is the easiest and cheapest way to run a business. But don't forget the various licenses and permits required in your state or local area.

• The business does not pay any tax itself.

• Sole proprietorships are pass-through entities which means profits or losses flow through to your personal tax return and are taxed at individual income tax rates.

• Sole proprietors also pay 15.3% self-employment tax on income up to $102,000 and 2.9% on the rest. They're entitled to a 50% tax deduction.

• Statistics reveal that sole proprietors have the highest audit risk.

• Sole proprietors have absolutely no built-in liability protection, which means creditors of the business can come after your personal assets.

Partnerships

If you go to business with someone else you have a partnership. Like sole proprietorship's these are easy to set up.

Partnership Agreement

This is probably the most complicated part of setting up a partnership. Although not compulsory, you'd be crazy not to get one drafted up. The partnership agreement acts as a kind of "rule book" for the partnership and will prove invaluable if you have a dispute with the other partners.

A good attorney will make sure the agreement covers every important issue, including:

- How profits and losses are shared?
- Who has the decision-making power?
- How much each partner can borrow without approval?
- Ways to resolve conflicts and disputes.
- The work duties of the various partners.
- A clause for valuing the business if anyone wants to sell out.
- What happens if the partnership is dissolved?

Tax Treatment

Partnerships are pass-through entities, like sole proprietorships – the profits pass through the business onto the partner's personal tax returns. Partners therefore pay exactly the same tax as sole proprietors.

The filling requirement are different, instead of complete Schedule C, the form sole proprietors use to report their income and expenses, the overall partnership tax return has to be completed (Form 1065). This lists all the income and expenses of the business. A form K-1 is then completed for each partner, which list each person's share of the different types of income. The information on the K-1 is then copied onto the partner's personal tax return.

Like sole proprietorships, losses flow through to the individual partner's personal tax returns and can usually offset other income, for example any salary you earn.

This could give you a welcome cash boost in the form of a refund check from the IRS! There is, however, one important restriction when it comes to partnership losses – they're limited to your partnership basis.

Calculating basis can get quite complicated. Some things make it go up and other things make it go down: For example, money you put in the business generally increases your basis, as do profits you leave in the business. Money you take out usually decreases your basis.

Self-Employment Tax

Like sole proprietors partners pay 15.3% self-employment tax and can claim half as a tax deduction.

Audit Risk

Many tax pros argue that partnerships are much less likely to be audited than sole proprietors. For example, figures from the IRS show that only 0.4% of partnership tax returns were audited in
2007, compared with approximately 3% of sole proprietors with revenues of more than $25,000. So on paper it seems that partnerships face a much lower audit risk. But remember the IRS looks at lots of different factors, such as tax return inconsistencies, to decide who gets audited.

Limited Liability

Like sole proprietors, partnerships also suffer from lack of legal protection. Most have unlimited liability which means business creditors can come after each partner's personal assets.

In fact it gets much worse than this. You are usually personally liable for your own actions and the actions of the other partners. It's not uncommon for 'innocent' partners to end up paying debts incurred by 'guilty' partners.

Limited Partnerships

Most partnerships are general partnerships which means all the partners are personally liable when the business is sued. With limited partnerships it's different.

Limited partners, who are typically outside investors not active in day to day management of the business, can usually only lose the money they invest in the business – their personal assets cannot be touched.

A limited partnership must, however, always have at least one general partner who is personally liable.

Limited partnerships are complicated to set up and are not suitable for most small businesses.

Summary – Partnerships

• Partnerships are easy and cheap to form. But don't forget the various licenses and permits required in your state or local area.

One thing you may have to spend a bit of money on is getting your partnership agreement drafted by an attorney. This acts as the rule book for the business and will prove invaluable if you fall out with the other partners.

• The partnership does not pay any tax itself. Partnerships are pass-through entities which means your share of the profits or losses flows through to your personal tax return and is taxed at individual income tax rates.

• Partners also pay 15.3% self-employment tax on income up to $102,000 and 2.9% on the rest. They're entitled to a 50% tax deduction.

• Statistics reveal partnerships have less audit risk than sole proprietors.

• There's no limit to a partner's liability, which means business creditors can come after your personal assets. You're also liable for the actions of your partners.

Limited Liability Companies (LLC)

LLC stands for Limited Liability Company and the owners are called members.

The LLC is a relative new type of business structure. It was only in 1996 that most states had recognized them.

LLCs have become extremely popular because they offer three major benefits:

- They're simple to run and very versatile.
- They offer extremely flexible tax treatment.
- They provide the maximum liability protection.

For these reasons the LLC is the entity of choice of many tax professionals and attorneys, especially those advising small business owners.

The Operating Agreement

• Every LLC should have an operating agreement. Like a partnership agreement the operating agreement sets out the LLC's internal rules and the rights and duties of the managers and members.

• It's not a requirement in most states but is highly recommended. Even single member LLCs should have an operating agreement.
This may seem strange because why, after all, would you need rules to tell yourself how to act?

The reason is an operating agreement shows the outside world that you take the management of your business seriously and makes it look less like a sole proprietorship. This might help you if someone tries to argue that you and your LLC are actually one and the same. A creditor might do this to try and "pierce the veil" of limited liability and come after your personal assets.

There are lots of clever provisions a good attorney can include in the operating agreement to protect you against almost every eventuality. Operating agreements can also be used to override certain state laws.

Tax Treatment

LLCs enjoy very favorable tax treatment. They don't have their own set of tax rules and there's no such thing as an LLC tax return. What makes them special is that members can choose how the business is taxed.

A single member LLC can choose to be taxed as a:

- Sole proprietor
- S corporation, or
- C corporation

A multiple-member LLC can choose to be taxed as a:

- Partnership
- S corporation, or
- C corporation

By default an LLC is a pass-through entity and taxed like a sole proprietor or partnership. In other words, the profits or losses of the business flow through to the member's individual tax returns.

A single-member LLC must complete Schedule C, just like any other sole proprietor, and multiple member LLCs must complete form 1065, just like a partnership.

Alternatively, you can complete form 2553 and elect for your LLC to be taxed as an S corporation. The business still remains an LLC, all that change is the tax treatment.

Many tax professionals say it's best to have LLC taxed as a sole proprietorship or partnership in the early years when profits are small or there is losses. Losses flow straight trough to your individual tax return and can offset other income.

Later on, when the business is more profitable, it may be a good idea to elect for corporate tax treatment so that some surplus profits kept in the business can be taxed at the 15% corporate tax rate. This is known as income splitting.

LLCs that can benefit from corporate tax treatment often go the whole nine yards and switch to a corporation so as to enjoy other benefits unique to corporations, such as access to outside investors and employee stock options.

Converting an LLC to a corporation is a nontaxable event.

State Tax Treatment

The tax treatment of LLCs (and corporations, for that matter) varies considerably from state to state. Some have much lower taxes than others. You can set up your LLC in any state you like.

Is a good idea to pick a state with very low taxes?

The answer is NO because if a business owns property, employs people or makes sales in any state it generally owes taxes in that state. So if you form an LLC in Florida but do all your business in California, you will still have to pay California state income tax.

You could face heavy penalties if you fail to register in your home state. For example, in Indiana an LLC formed in another state faces a penalty of up to $10,000 if it does business in
Indiana without a certificate of authority.

So why is Nevada so popular with people setting up LLCs and corporations? The main legitimate reason is for the extra liability protection available in that state.

The important point is this: Do not form your LLC or corporation in another state just to save tax.

State Taxation – LLC vs. Corporation

In some state LLCs and corporations pay tax at very different rates and this may influence your choice of entity or how you choose your LLC to be taxed.

The classic example of this is California. S corporations doing business in California pay a 1.5% tax on their **profits.** By contrast an LLC taxed as a partnership is subject to an $800 annual tax plus a fee which is based on **gross receipts**.

If you have big sales but small profits you may be better off being taxed as an S corporation. But if you have big profits coming off relatively low sales you may be better with an LLC.

The important point is this:

Do not base your choice of business structure on Federal tax alone. You must also find out about taxes in the states you do business.

Limited Liability Protection

This is the number one reason for setting up an LLC or corporation for that matter. If someone attacks your business with a lawsuit, or if you cannot afford to pay your creditors, your personal assets will usually be safe.

Your business may lose everything but at least the buck stops there – your creditors will not be able to get their hands on your personal assets: your home, your mutual funds or other personal assets.

It's critical to stress that limited liability protection is extremely valuable but does not protect you from every eventuality.

For example, you're personally responsible for any personal injury or damage to property committed by you personally.

You may even be personally responsible for torts committed by your employees if you are negligent in supervising them.

This is not just an LLC thing but applies to corporations as well.
We'll look at examples of when the LLC or corporation will fail to protect you later on.

Flexibility

One of the best things about LLCs is their flexibility, especially when it comes to sharing the profits of the business. Members can choose to split profits and losses in any way they like.

For example, if you put up most of the money, the operating agreement can specify that you get most of the profits to start with. Later on you may decide to split them equally with the other members.

However, not all businesses can form LLCs. In some states LLCs cannot be used by professionals such as doctors, lawyers or accountants. Professional firms often use an LLC variation, known as the Limited Liability Partnership (LLP).

The drawback of using an LLC is that you may find it more difficult to raise capital because many venture capitalists are more comfortable investing in a corporation.

Paperwork

LLCs are easy to maintain – they don't have the same record keeping requirements as corporations. There is no need to have annual meetings or keep minutes. Corporations have to keep formal minutes, have meetings and record key decisions.

If they don't do this properly they lose their limited liability status.

Most states require you to submit an annual report. This is often just a one page form containing the names and addresses of the LLC members and managers and the registered agent of the LLC and the cost is usually very low.

In terms of tax, if you go for the default pass through taxation, you can expect the same amount of tax complexity, paperwork and accounting costs as a sole proprietor or partnership.

Although they don't have the same recordkeeping requirements as corporations, many experts advise keeping formal records for your LLC to show you take the management of your business seriously.

This will help keep your limited liability status watertight.

It's also critical to comply with all state laws so that you don't lose the benefit of limited liability protection.

For these reasons it is recommended that you:

- Hold regular meetings with the other members and managers.
- Draft resolutions which document your major decisions.
- File your annual reports.
- Obtain all the necessary licenses and permits.
- Make sure everyone you do business with knows you are an LLC. Always sign documents as a representative of the company.

Summary – LLCs

• **Setting up**. Forming an LLC is easy and cheap in most states.

• **Operating agreement**. Every LLC should have a well-drafted operating agreement. A good one will protect you against almost every eventuality.

• **Tax treatment**. LLCs enjoy extremely flexible tax treatment and can elect to be taxed as a:

- Sole proprietorship
- Partnership
- S corporation
- C corporation

• **State tax**. Some states have lower taxes than others but you won't save money by forming your LLC or corporation there.

• **More on state tax**. In some states LLCs and corporations pay tax at different rates. Find out before you take the plunge.

• **Limited Liability.** An LLC will protect your personal assets from most claims against the business.

• **Flexibility.** An LLC allows you to divide the profits of the business any way you like.

• **Paperwork.** LLCs have fewer recordkeeping requirements than corporations. There's no need to have annual meetings or keep minutes and record key decisions

S Corporations

There is two types of corporations.

- S corporation.
- C corporation.

S corps offer limited liability and simple tax treatment. The business does not pay tax itself, the profits pass through the business to the owner's tax return.

S corps were the main way of business before the advent of LLCs, Many tax pros and attorneys argue that LLCs have largely replaced S corps because they offer the same liability protection and tax treatment but are easier to run.

Tax Treatment

S corporations are 'pass-through' entities because the profits pass through the business and onto the owner's personal tax return. The business is not taxed separately. This means Federal income tax is the same as sole proprietorships and partnerships.

In fact C corporations are the only businesses that are taxed separately. As we'll see shortly, C corps profits are taxed at corporate income tax rates.

Remember LLCs don't have their own set of tax rules. You can decide for yourself if you want your LLC be taxed like a sole proprietor/partnership, S corporation or C corporation.

Even that S corps are pass-through entities they do have to file a special tax return (Form 1120S) to report the profits or loss of business. Then the form K-1 is given to each shareholder who report their share of the income on the individual tax returns.

Many business star as S corps because any losses can flow through the individual tax return and offset other incomes. Later on when they become more profitable, sometimes they convert to C corporations to enjoy the 15% corporate income tax rate and fringe benefits.

Self-Employment Taxes

One of the main reasons people set up an S corporation or make the S corps tax election for their LLC is because S corps can help you save self-employment taxes.

Remember sole proprietors, partners and LLC members who go for default tax treatment pay self-employment tax on all of their income. The tax rate is 15.3% up to $102,000 and 2.9% on the rest. This can result in a big tax bill.

Owners of S corporations are taxed much more generously. Salaries and bonuses are still subject to income tax and self-employment tax but profit distributions (sometimes referred to as dividends) are only subject to income tax – there is no self-employment tax.

S corps owners can potentially save thousands in self-employment tax by taking the smallest salary possible and the rest of their income as distributions.

Why not pay yourself no salary and just take distributions?

That's a no-no because the IRS insists that your salary is 'reasonable' – if it isn't they will tax your distributions as salary.

To find reasonable salaries many tax pros use independent websites such as Salary.com or Payscale.com

Example

Let's say Julissa has net income from her S corporation of $90,000. If she receives all of the money as salary she will have to pay self-employment tax on the whole amount and her tax bill will be $13,770:

$90,000 x 15.3% = $13,770

But if she pays herself a reasonable salary of $50,000 her self-employment tax is $7,650:

$50,000 x 15.3% = $7,650

And she can pay the remaining $40,000 as a distribution, free from self-employment tax. Her SE tax saving is $6,120.

This strategy is not without drawbacks, however. Maximizing distributions may, for example, reduce what you are allowed to contribute to a retirement plan.

Finally, this loophole may disappear eventually and all entities may end up paying uniform self-employment taxes.

State Taxation of S Corporations

Most states recognize that S corporations are pass-through entities and the owners pay state income taxes on their share of the profits.

Please note that some states do, however, require you to make an extra state-level S corporation election.

Other states such as Florida recognizes the federal S corporation election and does not require a state-level S corporation election, but in order to qualify for S corporation status in Florida, S corps must have no more than 100 shareholders, the shareholders must agree in writing to be an S corporation, and the S corporation can have only one class of stock (disregarding voting rights).

Some states do not recognize S corporations and tax them like C corporations. Your corporation will still be an S corps for Federal tax purposes but not for state tax purposes.

Some states such as California, New York and New Jersey tax both the S corporation and the shareholders – a form of double taxation.

Before you set up an S corporation or have your LLC taxed like one, contact your state income tax office and ask them:

• Is a separate state S corps election is required?
• How will your S corp be taxed?

So how does this affect your choice of entity?

Remember that in some states S corps and LLCs pay different amounts of tax.

The extra tax may be significant or it may be small. Find out before you take the plunge!

S Corporation Losses

Like sole proprietorships and partnerships, S corporation losses flow through to the individual shareholders and can offset other income. However, similar to partnerships, you cannot deduct a loss unless it is smaller than your stock basis.

Your stock basis is generally the total money and property you put into the business. It also includes any income you've paid tax on but the business hasn't paid out yet.

Example

Giselle invests $3,000 into his S corporation when he incorporates. In the first year the corporation's loss is $5,000. Giselle can only offset a loss of $3,000 because his basis is $3,000.

Unlike partnerships, an S corps owner's basis does not increase when the business itself borrows money (unless the shareholders personally loan the money to the corporation). This could severely limit your ability to offset losses.

This is one of the big differences between partnerships and S corporations.

Fringe Benefits

S corporation owners enjoy fewer tax-free fringe benefits than owners of C corporations. For example, the owners cannot benefit from setting up a medical reimbursement plan.

Flexibility

S corporations have various restrictions, although most of them will not be of concern to the average small business owner:

• No more than 100 shareholders are allowed. This could be a problem if you are looking for outside investors or ultimately want to go public.

• Only US citizens are allowed to own stock in an S corp.

• S corporations cannot be owned by other corporations, LLCs and partnerships which again may make it hard to find investors.

• S corporations can only have one class of stock – common stock.

How much of the corporation you own determines your income. With LLCs the income you receive is not tied to your ownership.

For example, if one person contributes most of the money to get the business going an LLC structure would allow him or her to receive most of the profits for the first couple of years, after which they could be split equally.

S corporation rules do not allow profit to be allocated in a way that does not match ownership shares.

S corporations do, however, have their benefits:

• Your interest is freely transferable, which means you can sell your stock without the approval of other shareholders. LLC members need approval from the other members.

• Your stock is easy to sell or transfer to family members. This can be time consuming and costly for a sole proprietor or partnership.

With corporations your ownership of all the business assets is wrapped up in the stock you hold and all you have to do is sign over your stock.

• The corporate structure allows you to easily sell shares in the company through stock offerings. This is useful for attracting investors and employees.

Liability Protection

S corps, C corps and LLCs offer the same protection for your personal assets from claims against your business.

But if the only reason you want to incorporate is to obtain limited liability protection, an LLC may be a better choice.

As we'll see shortly, LLCs often provide the best protection, especially when it comes to protecting your business from personal claims.

Corporations also have to jump through a lot more hoops to preserve their limited liability status.

If you don't a court can pierce the corporate veil and hold you personally liable for the debts of the business.

They must hold directors and shareholders meetings, keep minutes and let shareholders vote on big decisions. These requirements are the same for S corporations and C corporations.

Summary – S Corporations

• **Setting up.** State filing fees for S corps, C corps and LLCs are similar in most states.

• **The S corp election.** An S corp is just a corporation that completes IRS Form 2553 electing pass-through tax treatment.

• **Tax treatment.** S corps therefore pay the same Federal income tax as sole proprietorships and partnerships.

• **Self-employment tax.** S corps salaries are subject to 15.3% self-employment tax but S corps distributions (dividends) are not.

Paying a low but reasonable salary and the rest as distributions could save you thousands in tax.

• **LLCs.** Remember LLCs can elect S corps tax treatment. Some do this for the self-employment tax savings.

• **State tax.** In some states LLCs and S corps pay different amounts of tax. Find out before you take the plunge.

• **Losses.** Like sole proprietorships and partnerships losses can offset other income but you cannot deduct a loss greater than your stock basis. Unlike partnerships, your basis does not go up when the business borrows money.

• **Fringe benefits.** S corps owners enjoy fewer fringe benefits than C corps owners.

• **Liability protection.** S corps, C corps and LLCs offer the same protection for your personal assets from business claims but:

- LLCs provide more protection for your business against personal claims.
- Corporations have more paper work and formalities to comply with to preserve their limited liability.

• **Flexibility.** S corps can only have one class of stock and other corporations, LLCs and partnerships cannot be shareholders.

C corporations

Tax Treatment

The difference between C corporations and all the other entities is that C corps pay their own tax, therefore they are not pass-through entities.

The corporation pays corporate income tax on its profits at the following rates:

Taxable Income	%
$ 0 - 50,000	15
50,000 - 75,000	25
75,000 - 100,000	34
100,000 - 335,000	39
335,000 - 10 million	34

If the owners then want to get their hands on the profits they have to pay themselves a dividend. Dividends are currently taxed at a maximum rate of 15%.

So C corporations are potentially taxed twice: Once at the corporate level, and again by shareholders when dividends are paid. Clearly this is unattractive and undesirable for most small business owners.

How to Avoid Double Taxation

Many small C corporations avoid this double tax problem by having all profits paid out as salaries and bonuses. These amounts are tax deductible so the corporation ends up with no profits and doesn't have to pay any corporate income tax.

The owners then have to pay income tax at individual rates on their salaries, much like any other business owners.

To avoid paying dividends which are subject to double taxation, another strategy is to pay shareholders consulting fees. Of course you have to make sure there is some genuine consulting. This consulting fees will, however, be subject to social security and Medicare taxes.

Using a C corporation you will pay less tax on income kept in the business to help it grow, for example if you need money to buy inventory or fun a marketing campaign.

This is called income splitting because you can keep some of the income in the corporation and pay out the rest as salaries.

Money kept in the business will be taxed at rates as low as 15%, instead of having all the income taxed in your hands at rates of up to 35%.

The first $50,000 of profits you keep in the corporation will be taxed at just 15% and the next $25,000 will be taxed at just 25%.

For this strategy to work your corporation must, of course, be earning surplus profits that you can afford to keep in the business instead of paying out for your personal living expenses.

LLCs electing C Corporation Tax Treatment

It's not just C corporations that can benefit from income splitting.
Remember an LLC can opt to be taxed like a C corporation.

Not all tax advisors approve of this strategy it should be noted. Some refer to it as "checking the stupid box." This is because they are concerned about potential problems resulting from two conflicting sets of laws: being treated as an LLC for legal purposes but a corporation for tax purposes. However, that's just one view. Other advisers recommend using an LLC.

Fringe Benefits

The other tax benefit of using a C corporation is that they enjoy the most fringe benefits. The idea behind fringe benefits is you get to receive something tax free and the corporation still gets a tax deduction.

One of the best fringe benefits is a medical reimbursement plan which allows the C corporation to pay all medical expenses not covered by medical insurance. The costs are tax deductible for the corporation and tax free for you.

Other fringe benefits C corps can offer include:

• 100% deduction for disability insurance premiums.
• Tax-free life insurance up to $50,000.

Fringe benefits are probably not a good enough reason by themselves for most businesses to incorporate. However, they can result in significant extra tax savings.

Remember an LLC can elect to be taxed as a C corporation and will then enjoy the same fringe benefits.

Tax Treatment of Losses

Using a C corporation is not a great strategy if you expect losses in the short term because these do not flow through to your personal tax return and cannot offset other income.

Losses have to remain inside the corporation and can only produce tax savings when the corporation starts making profits.

Personal Service Corporations

It's a bad idea to use a C corporation if it's classified as a Personal Service Corporation. You will probably end up paying more tax because all the income of a personal service corporation is taxed at 35%. A corporation is classified as a personal service corporation if it provides personal services and those services are mainly performed by the corporation's owner/employees.

The IRS defines the following services performed in the following fields as personal services:

• Consulting
• Accounting
• Actuarial science
• Architecture
• Engineering
• Health (including veterinary services)
• Law, and
• Performing arts

So if you plan to provide services in any of these field fields you may be better off going for an S corp or LLC because they are pass-through entities and avoid this tax classification.

Other Taxes C Corps Face

Unique to C corps are three additional penalty taxes:

• **Accumulated earnings tax**. If your C corporation holds onto too much of its profits it incurs an accumulated earnings tax of 15%. This doesn't kick in until accumulated earnings exceed $250,000. The corporation can, however, accumulate earnings above this limit, provided it has a valid reason, for example to pay future expenses.

• **Personal holding company tax**. This tax targets C corps that earn most of their money from investments such as dividends.
You don't have to worry about this tax if you have a regular business selling goods.

• **Corporate alternative minimum tax**. Very few small businesses have to worry about this.

State Tax Treatment of C Corps

State corporate tax rates range from 0% to 10%. Some of the most high-tax states for C corporations are:

• Massachusetts 9.5%
• Minnesota 9.8%
• Pennsylvania 9.9%

Some of the low-tax states include:

• Kansas 4%
• Colorado 4.5%
• Florida 5%

So how does this affect your choice of an LLC or corporation? Before you take the plunge compare how different entities are taxed in your state. Make sure any Federal tax savings will not be offset by higher state taxes.

Limited Liability

C corps provide pretty much the same asset protection as S corps.
They have to jump through the same hoops to preserve their limited liability status: they must hold directors and shareholders meetings, keep minutes and let shareholders vote on big decisions.

The simple truth is that most corporations probably do not keep up with all these duties.

C Corp Flexibility

All publicly traded companies are C corporations. This is probably the best entity if you want to take your business public or attract venture capital.

C corporations can structure ownership in ways S corps cannot. You can have different classes of shares which have different voting rights, rights to receive dividends and payouts on liquidation.

One option is to start out with an S corporation and later convert it into a C corporation. All you have to do is complete a form. Once revoked you cannot have S corp status again for another five years.

There's also nothing to stop you converting your LLC into a C corporation. This is generally a nontaxable event although it may be a lot more time consuming and expensive than converting an S
corp into a C corp.

Some states do however provide a one-step procedure for LLCs wishing to convert.

Summary C Corporations

• **Setting Up.** Setting up a C corps is similar to forming an S corp. You just don't complete the extra form electing pass-through tax treatment.

• **Liability protection.** C corps also offer the same legal protection as S corps and have the same corporate formalities.

• **Tax treatment.** C corps pay their own tax – corporate income tax. Shareholders also pay tax on any dividends they receive. This problem can be avoided by paying out all profits as salaries.

• **Income splitting.** C corps can keep up to $75,000 in the business and pay tax at just 15-25%. This is only worth doing if the business needs the money.

• **Fringe benefits.** C corporations enjoy more tax-free fringe benefits than any other entity, in particular medical reimbursement plans.

• **LLCs.** LLCs can elect C corp tax treatment if they want to benefit from income splitting and fringe benefits.

• **Losses.** Losses do not pass through to shareholders to offset other income so a C corp may not be a good idea if you expect losses in the early years.

• **Personal service corporations.** It's a bad idea to use a C corporation if it's classified as a personal service corporation – tax is a flat 35%.

• **Other taxes.** C corps sometimes have to pay penalty taxes such as accumulated earning tax, personal holding company tax, and corporate alternative minimum tax. These are not a problem for most small corporations.

• **State tax**. Some states have high corporate tax rates. Make sure any Federal tax savings are not offset by higher state taxes.

• **Flexibility**. Probably the best entity if you want to go public or attract venture capital.

LLC vs. Corporations

Liability Protection When the Business Gets Sued

LLCs and corporations offer similar protection for claims against the business. However corporations have to work a lot harder to preserve their limited liability status. A court may allow the corporate veil to be pierce if the corporation has disregarded corporate formalities.

To avoid this the corporation must:

• Hold shareholder and director meetings and prepare minutes
• Formally approve and document key decisions.

LLCs do not require the same level of formalities but should still keep detailed financial records and record key decisions.

When You Get Sued

As we've seen both corporations and LLCs protect your personal assets from claims against your **business**. This is known as inside-out liability protection.

But what happens to your business if you get sued personally. Will your business be protected? This is known as outside in liability protection.

That depends on whether you have an LLC or corporation. LLCs generally offer more protection than corporations against personal claims. If you own stock in a corporation, a personal creditor can often take control of the business and force it to sell assets and distribute cash.
But if you have an LLC, in many states a personal creditor can only obtain what's known as a charging order. This gives the creditor the right to receive any distributions by the LLC but nothing else.

Because the LLC's managers decide if profits are distributed they can stop making distributions so that the creditor gets nothing.
Worse still, the creditor will still have to pay federal taxes on these earnings, even though he hasn't received one penny!

This is often enough to make attorneys settle or not sue in the first place. However some states DO allow LLCs to be liquidated so that creditors can get their hands on your business assets.

Finally, it should be pointed out that many attorneys advise against single-member LLCs. A single member LLC may not be granted a charging order and a creditor may be allowed to foreclose on your membership. So speak to an attorney if this type of protection is important to you.

In summary, a corporation only protects your personal assets from business creditors. An LLC does this but can also protect your business assets from personal creditors.

Tax Treatment

• **LLCs**. Most LLCs go for default tax treatment and pay the same tax as sole proprietorships or partnerships. However, there's nothing to stop you electing S corp or C corp tax treatment.

Your business is still an LLC – all that changes is the tax treatment.

• **S corporations**. S corps are pass-through entities which means they pay the same Federal income tax as sole proprietorships or partnerships.

The thing tax advisers like most is that your income can be split into salary and distributions. There is no self-employment tax on distributions. Your salary has to be reasonable, however.

• **C corporations**. A C corporation allows you to keep some surplus profits in the business and pay tax at just 15% or 25%. C corps owners also enjoy more tax-free fringe benefits than other entities.

• **Look at ALL savings and costs**. Make sure you look at the overall financial picture before you form an LLC, S corps or C corps.

• For example, will any Federal tax savings be offset by higher state taxes and accounting fees.

• **Get advice**. Finally, make sure you speak to a qualified tax pro or attorney before taking the plunge.

End

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