A Guide to Incorporating Your Business

Forming a C or S Corporation

- Advantages of Incorporating
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- Comparing C Corps., S Corps. and LLCs

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Introduction

You may have heard that incorporating your business can help you save on taxes. Even if your corporation has just one employee (yourself), you can still enjoy significant tax savings. Just as important, you will have peace of mind knowing that your personal assets are protected from business liabilities.

Sole Proprietorships and General Partnerships

A sole proprietorship and general partnership are two of the simplest and least expensive forms of business to start. If you currently operate a small business by yourself, then you operate a sole proprietorship. A general partnership is created when two or more people go into business together. Because of this simplicity, many small businesses are sole proprietorships or general partnerships.

> A sole proprietorship and general partnership can become the most expensive type of business in the long run.

However, even with low start-up costs and simple operation, other factors can make these the most expensive business structures in the long run. First, your liability for business debts is unlimited. These business structures cannot shield you, as the owner, from liabilities that could literally cost you and your family everything. For instance, if you have significant business losses or an adverse legal judgment, creditors can force you to sell your home and personal property to cover the claim.

Second, you may not be taking advantage of a variety of tax savings, such as the ability to reduce self-employment taxes. Finally, when it comes time to selling or passing on your sole proprietorship, it can't be done. Sole proprietorships can't continue beyond the life of the owner.

Corporations

The primary advantage of a corporation is that its owners, known as stockholders (or shareholders), are not personally liable for the debts and liabilities of the corporation.

Once brought to life by filing articles of incorporation with the state, a corporation can act much like a person. It can own and operate a business, hire employees, buy and sell goods and services, enter into contracts, lease or buy real estate, maintain its own checking and savings accounts, and sue and be sued. A corporation is not affected by the death or bankruptcy of any shareholder, officer or director. Instead, it continues to exist as long as it complies with the state requirements and corporate formalities.

You may have heard the terms S corporation and C corporation. They are actually both the same type of business entity, but an S corporation has simply made a special IRS election to be treated as a pass-through entity for tax purposes, much like a sole proprietorship or partnership. In other words, corporate income "passes through" to the owners, who pay taxes on the profits at their individual tax rates.

C corporations, on the other hand, are corporations with two potential levels of tax. A C corporation pays tax on its corporate income (the first tax). Then, if a C corporation distributes profits to its shareholders, the shareholders pay personal income tax on those dividends (the second tax). Although this may seem like a significant disadvantage, C corporations have tax flexibility and can minimize any double taxation problems.

Advantages of Incorporating Your Business

Liability and Asset Protection

Sole proprietors and partners of a general partnership risk everything they personally own when they operate a business. If a judgement is awarded against the business, the owner's personal assets can be used to satisfy payment. Your home, car, savings and investments could all be taken from you should your business be sued or go into debt.

With a general partnership, each partner can solely make decisions that have joint consequences for the partnership. If one partner makes a bad decision, both partners are liable for the entire amount of any damages.

Unlike a sole proprietorship or general partnership, a corporation is a legal entity separate from the individuals who own or operate it. Because of this, the personal assets of the shareholders, directors and officers of a corporation are generally not at risk when the corporation is sued or goes bankrupt. If you own property or other significant assets, forming a corporation is one of the easiest ways to protect them. If you plan to hire employees, a corporate entity will protect you personally from employee lawsuits.

With a corporation, your personal assets are generally not at risk.

Unless you personally guarantee the debts of the corporation, the only way an individual can be liable for corporate debts is through a legal action commonly referred to as "piercing the corporate veil." This occurs when a court looks at the corporation not as a separate entity, but as an extension of the individual. Generally, it occurs through fraud or failure to treat the corporation as a separate entity, such as not having a separate corporate bank account. Properly maintaining your corporation can prevent a piercing of the corporate veil.

Tax Savings

A sole proprietorship or general partnership will also miss out on some important tax advantages available to corporations.

- **Reduction in self-employment tax.** When you operate as a sole proprietorship, your first $113,100 of earnings for tax year 2013 is subject to self-employment taxes (Social Security and Medicare), which is currently a combined 15.3%. With a corporation, only salaries are subject to such taxes. By allocating a corporation's earnings between a reasonable salary and profit, you can generate significant tax savings.

  The following chart illustrates some of the tax benefits that can be achieved by incorporating:

EXAMPLE: John, who is married, operates a sole proprietorship that earns $80,000 per year. If he incorporated, assume that John would take an annual salary of $35,000. For this illustration, assume no state income tax and 2013 tax rates.

	Sole Proprietorship		S Corporation	
INCOME				
Salary	$	0	$	35,000
Profits	$	80,000	$	45,000
GROSS INCOME	$	80,000	$	80,000
DEDUCTIONS				
½ of Self-Employment Tax	$	5,652		N/A
½ of Social Security & Medicare	$	N/A	$	2,678
TOTAL DEDUCTIONS	$	5,652	$	2,678
ADJUSTED GROSS INCOME (AGI)	$	74,348	$	77,323
Less Personal Exemptions	$	(7,800)		(7,800)
Less Standard Deduction		(12,200)		(12,200)
TAXABLE INCOME	$	54,348	$	57,323
TAXES PAID (Excluding State Unemployment Tax)				
Self-Employment Tax	$	11,304		N/A
Social Security & Medicare	$	N/A	$	5,355
Federal Unemployment Tax		N/A		42.00
Income Tax	$	7,260	$	7,706
TOTAL TAXES PAID	$	18,563	$	13,103
TOTAL TAX SAVINGS			**$**	**5,460**

- **Medical expenses.** C corporations can offer a medical reimbursement plan for their officers, employees and owners, which allows you to deduct medical costs not covered by insurance. With a sole proprietorship, medical reimbursement plans may cover employees, but not the owner. Therefore, unreimbursed medical expenses are deductible only if they exceed 10% of adjusted gross income (AGI).
- **Retirement plans and fringe benefits.** There are a number of fringe tax benefits which favor corporations over sole proprietorships. For example, corporate tax-deferred retirement plans, such as defined contribution and defined benefit plans, can be more flexible and can have higher contribution limits. Corporations are also allowed to pay for (and deduct) certain childcare expenses, term group life insurance premiums, group disability insurance premiums and certain travel expenses associated with directors' and shareholders' meetings.

Ease of Transfer

Corporate ownership interests can generally be sold to third parties without disturbing daily operations. A sole proprietorship, on the other hand, cannot be sold as a whole. Instead, each of its assets, licenses and permits must be individually transferred.

Other Benefits

On top of the numerous benefits listed above, the corporate form has other distinct advantages. Typically, it's easier to raise money if your business is incorporated. A corporation also gives your business legitimacy when dealing with other companies, banks and potential partners.

Operating and Maintaining a Corporation

In order to properly maintain your corporation and ensure personal liability protection, you will have to comply with certain corporate formalities. Some of the most important ones are described below.

Director and Shareholder Meetings

Corporate shareholders must typically meet annually to elect corporate directors. It's the job of the directors to meet at least annually to elect corporate officers. You may also need to hold special meetings to approve special actions like purchasing another company, amending charter documents, adding a new shareholder and approving actions that fall outside of the normal course of business. Written minutes should be kept which record the actions taken at the meeting.

Corporate Formalities

I. Director and Shareholder Meetings
II. Separate Personal and Business Finances
III. Annual Reports
IV. Tax Returns

Separate Personal and Business Finances

Since a corporation is a separate legal entity, corporate finances must be kept separate from your own personal finances. It's essential to have a corporate bank account, and you will need a separate Federal Tax ID Number (EIN).

Annual Reports

After the initial government filings, most states require an annual report that lists the corporation's business address and the names of the directors and officers. Typically, the state requires a filing fee with the annual report.

Tax Returns

Corporations must file a federal corporate tax return, either on Form 1120S for S corporations or Form 1120 for C corporations.

Comparing C Corporations and S Corporations

A corporation that elects to be treated as a pass-through entity for tax purposes is known as an S corporation. In an S corporation, income passes through to the shareholders who then report the income on their individual tax returns. In addition, it allows you to write off any losses against ordinary income. An S corporation makes sense for a small business owner who wants the protection and tax advantages of a corporation, but who has no intent of raising significant capital or going public in the near future.

S Corporation Eligibility

To become an S corporation, you need to file Form 2553 with the IRS, and most small businesses can qualify. Generally, you are limited to 100 shareholders and all of them must be citizens or residents of the United States. Furthermore, the corporation may issue only one class of stock, and not more than 25% of the income can be passive income over three continuous years. An S corporation may switch and become a C corporation in the future.

C Corporations – Tax Flexibility

If you do not make the special IRS election, then the corporation is a C corporation by default. In a C corporation, income is taxed at the corporate rate. If the corporation pays shareholder dividends, the individual shareholders will be responsible for this income on their individual tax returns at the capital tax gains rate if the dividend is a Qualified Dividend.

Although C corporations are subject to double taxation, proper financial management can mitigate this problem. Most importantly, any corporate profit can be reduced by paying a bonus to corporate officers (including yourself).

In addition, this two-part tax mechanism actually creates an opportunity for tax flexibility. With a C corporation, you can use income shifting to take advantage of lower tax brackets.

> **EXAMPLE:** A business earns $100,000 gross per year. With a sole proprietorship, an owner who is married (filing jointly) would be in the 25% income tax bracket. If the business owner had a C corporation, he or she could take $50,000 in salary and leave $50,000 in the corporation as profit. The federal tax rate on the $50,000 corporate profit is 15%. Furthermore, the business owner is now in a lower tax bracket for his or her personal income tax. This can reduce your overall tax liability.

Limited Liability Companies (LLCs)

Like a corporation, a limited liability company is a separate business entity. It combines the personal liability protection of a corporation with the tax simplicity of a sole proprietorship or a partnership. In other words, the owners (or "members") of an LLC are not personally liable for its debts and liabilities, and there is only one level of taxation. Moreover, an LLC is more flexible and requires less ongoing paperwork than an S corporation.

An LLC combines personal liability protection with tax simplicity.

LLCs Compared to S Corporations

- **Fewer corporate formalities.** Corporations must hold regular meetings of the board of directors and shareholders and keep written corporate minutes. On the other hand, the members and managers of an LLC need not hold regular meetings, which reduces complications and paperwork, unless they choose to do so.
- **Real estate and passive income.** A pass-through tax structure should be used to preserve the benefits of capital gains tax treatment for asset distributions. LLCs have become the business entity of choice for real estate investments and other passive income–generating activities.
- **Simpler management structure.** LLCs are not required to have a formal board of directors (known as managers in an LLC). The owners and officers of an LLC can make all important company decisions directly.
- **No ownership restrictions.** S corporations cannot have more than 100 shareholders, and each shareholder must be a resident or citizen of the United States. There are no such restrictions placed on an LLC.
- **Potential tax disadvantage.** By default, an LLC is generally treated as a pass-through entity for tax purposes, like a sole proprietorship or partnership. Unfortunately, an LLC does not enjoy the same self-employment tax savings as an S corporation. Instead, a single-member LLC must pay self-employment tax on both salary and profit. An LLC can, however, make an election with the IRS to be treated like a corporation for tax purposes, whether as a C corporation or an S corporation.
- **Greater acceptance of corporations.** Since limited liability companies are still relatively new, not everyone is familiar with them. In some cases, banks or vendors may be reluctant to extend credit to an LLC. In addition, some states restrict the types of business an LLC may conduct.

Where to Form a Corporation

Most people choose to form their corporation in their state because it’s often the most cost-effective option. If you incorporate in a different state, you often need to register as a foreign corporation in your state, which requires a separate filing fee and subjects you to your state’s taxes.

Business Entity Comparison Chart

	Limited Liability Company	Sole Proprietorship/ General Partnership	S Corporation	C Corporation
Formation	State filing required.	No filing required, unless doing business under an assumed name.	State filing required; Subchapter S election typically must be made within 60 days of formation.	State filing required.
Personal Liability	The owners (called members) are generally not liable for the company's debts.	The owner is liable for all the debts of the business.	The owners (called "shareholders") are generally not liable for the company's debts.	The owners (called "shareholders") are generally not liable for the company's debts.
Formalities and Record-keeping	Formal meetings and minutes are not required; however, annual state reports are required.	No formalities.	Formal board and shareholder meetings and minutes are required, and annual state reports required.	Formal board and shareholder meetings and minutes are required, and annual state reports required.
Management and Operation	Management is flexible, like a partnership; typically, an operating agreement outlines management duties. A board of managers is optional.	Sole proprietor has full control. Partnerships have a flexible management and operational structure.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operation.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operations.
Taxation	An LLC is pass-through by default, but members may elect to be taxed as a C corporation or S corporation instead.	The company does not pay tax on its profits, but instead, income and loses are "passed through" to the owners, who must pay taxes on their proportionate share of the company's income.	The company does not pay tax on its profits, but instead, income and loses are "passed through" to the owners, who must pay taxes on their proportionate share of the company's income.	Taxed at the entity level. If dividends are distributed to shareholders, dividend income is taxed at the individual level.
Tax Reporting	See Sole Proprietorship/ General Partnership; LLCs may also elect to be taxed as a C or S corporation.	All income for sole proprietorships is reported on Form 1040, Schedule C. Partnerships report income on Form 1065, with profit distributions on Schedule K-1.	S corporations report income on Form 1120S, with salaries reported on Form W-2 and profit distributions on Schedule K-1.	C corporations report income on Form 1120, with salaries reported on Form W-2 and any profit distributions on Form 1099-DIV.
Ideal For	Owners wanting the liability protection of a corporation with less corporate formalities, and the simplicity of pass-through taxation of income.	Owners wanting minimal formalities, maximum flexibility, and not worried about personal liability.	Owners wanting the liability protection of a corporation, with the simplicity of pass-through taxation of income.	Owners needing maximum tax and ownership flexibility combined with liability protection.

LegalZoom's Incorporation Service

If you're a business owner, you need to protect your personal assets. Incorporating your business is one of the ways to do just that. The corporate business structure can save you money in taxes, give you greater business flexibility, and make it easier for you to raise capital.

LegalZoom makes forming a corporation simple and affordable. With our easy three-step process, you can incorporate your business from your home or office for as little as **$99 plus state fees.**

1. Complete an Online Questionnaire

Fill out our easy-to-understand questionnaire. Most people complete it in 15 minutes or less.

2. We File the Incorporation Papers

We complete the required documents and file them with the proper government agency.

3. Your Corporation is Complete

We deliver the filed articles of incorporation to you along with personalized corporate bylaws. We can even obtain your Federal Tax ID Number (EIN).

Questions?

To learn more about LegalZoom's Incorporation service or to get started, call us at (888) 381-8758 Monday–Friday from 6 a.m.–7 p.m. and Saturday from 10 a.m.–2 p.m. PT.