

## To Incorporate or Not, That Is The Question - 4/17/2001

by [Sanford Botkin](#)

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Perhaps the single biggest question that I get as a tax lawyer is: "Should I start off as a corporation?" The answer is clear cut....It depends!" The answer varies on a number of factors. Accordingly, this article will serve as a short summary of you choices.

### Sole Proprietorships:

Without question, this is the simplest form of entity around; boy is it simple. There are no federal or state unemployment taxes, there are no double tax problems, there are no meetings, such as stockholder meetings, that need to be held, there is no employment number required from the IRS unless you have employees, and the only form that IRS requires is form Schedule C with your Form 1040 that you are filing anyway.

Sole proprietorships also have the advantage of being the best entity to use any losses incurred. If you have losses in your business, which is usually the case in the first year or two, these losses can be used against any form of income on your tax return such as wages, interest, dividends, pensions, rents, etc. If the loss exceeds your income, you can carry back all business losses two years or carry forward business losses twenty years and offset the next twenty years of income.

Moreover, sole proprietorships allow some fringe benefits such as 60% to 100% deduction for medical insurance that the owner pays for. This can be increased to 100% by hiring a spouse as noted in my Tax Strategy System.

With all these advantages, you would think that this should be the entity of choice; however, there are some drawbacks and some of these drawbacks are very substantial.

Probably the major drawback is liability. Sole proprietors have unlimited liability in their business. Although much of the liability can be mitigated with insurance, I believe that any business that has any substantial potential liability should not be a sole proprietor.

**Big Tip:** If you have any employees, you have substantial liability because all employers are liable for acts of their employees. Thus, if you have any employees, you should NOT be a sole proprietor.

If however, you don't have employees and have little liability such as that found with most multi level businesses, this might well be the entity of choice. By the way, did I say that this entity is simple?

Partnerships: The next level in complexity is a partnership. This involves two or more people who are sharing profits in a venture. Here you are required to file a partnership tax return. Moreover, since most partnerships pay salaries to either the partners or staff, you will need a federal ID number and be subject to federal and state employment tax on salaries. Partnerships, however, are pass through entities as sole proprietors. Thus, there is no separate tax at the partnership level and all income and losses pass through to the partners as if they earned them individually.

Unlike sole proprietors, however, losses are limited to the basis in the partnership. Basis is what cash or property you contributed and all loans that you guaranteed or made to the partnership.

The big, big disadvantage is that you are unlimitedly liable for partnership debts and for the acts of your partner. This is a major disadvantage. In fact, it is such a problem that I do not recommend that most people ever become partners.

Regular C Corporation: Corporations are separate entities that require their own tax return to be filed (IRS form 1120). They are taxed separately on all monies that are not paid out in expenses or bonuses or salaries. If the funds are paid out again in dividends, you could be taxed again. Thus, there is a potential of double taxation. Moreover, corporations are very formal beasts. In fact, based on complexity and formalities involved, they are the biggest headache of all. You must have yearly stockholder meetings even if you are the only stockholder, (author's note: if you are the only stockholder, the meeting would probably be short) and yearly Board of Director meetings. You must have separate bank accounts, and must get an employer ID number from both the IRS and the state. In addition, some states impose some strict taxes on corporations. For example, in California, you pay what their normal tax rate would be or \$800 whichever is higher. Thus, if you have a loss, you end up paying California \$800. How's that for an anti-business state!

Corporations also have the disadvantage of being subject to same potentially nasty surprises if not planning correctly such as accumulated earnings tax etc.

Corporations, however, do have some advantages. You can deduct 100% of your health insurance premiums and 100% of any disability insurance premiums, which are tax-free benefits to the employees. They also can accumulate (with planning) \$50,000 per year for future business needs and have this amount taxed at the 15% rate. If you are in the 40% tax bracket, this is a substantial savings. Probably the main advantage, however, is limited liability. If you maintain the formalities, your liabilities are generally limited to the assets of the corporation with the exception of malpractice suits. In malpractice, the owners may be unconditionally liable regardless of the entity. Corporation also can have many different classes of stock, which is great for estate planning and for raising capital.

TIP: Because liability protection is so important in the decision whether to incorporate, I almost always recommend some form of corporation or LLC if there are employees in the business. As noted above, employers are liable for the acts of their employees: thus, employees are walking liability machines. If you have any employees, you must limit your liability.

### S Corporations:

These are hybrids of sole-proprietorships and corporations. The main advantage is that they generally are not subject to double taxation. All income and losses flow through to the owners; thus, eliminating most of the double taxation problem. S corporations also limit liability just like regular corporations and are subject to the same formality requirements. They also have two other major advantages:

First, the stockholders are taxed on the earnings based on their ownership. Thus, you can have your 17 year old son or daughter taxed on their share of the dividends.

Second: how would you like to eliminate some of your social security taxes? You can with an S corporation. Lets use the following example to illustrate what to do:

Sam earns \$70,000 as a sole proprietor, net of his expenses. He pays income tax on the \$70,000 and pays 15.3% social security on the \$70,000, which is about \$10,600 alone! However, if he forms an S corporation and pays himself a reasonable salary of \$35,000 and pays the rest in a form of a dividend, he only pays social security on the salary and not the dividend. Dividends are not subject to social security. He saving 15.3 % on \$35,000, which is a \$5,355 yearly saving! This technique can not be accomplished with any other entity.

With all these advantages, one would think that S Corporation would be the ideal entity. However, there are some limitations and disadvantages. There can be no more than 75 stockholders who, for the most part, must be individuals. Moreover, S corporations can't have several classes of stock; thus, limiting estate planning and reduces the chances of raising capital. S Corporations have the same formalities as regular Corporations and the same paper work and meeting hassle. Certain fringe benefits are not available to S corporation as they are to regular corporations and even sole proprietorships with some planning such as a self-insured medical plan. You can deduct any health insurance premiums with an S corporation. Regular corporations can deduct 100% of the premium, and sole proprietors can also deduct 100% if they hire their spouse in their business. Regular corporations can deduct all of their disability insurance premiums; S corporations can not.

One final item to note is that with both S corporations and partnerships, you can deduct any losses up to your basis in the stock or partnership. However, with partnerships, any debt that you guarantee is added to your basis. This is NOT true with S corporations. You must contribute property, money or load the money to the corporation, not guarantee a debt.

Limited Liability Companies (LLC): This is the newest addition to the business party, being a fairly recent innovation. This is like a sole proprietor or partnership, however, there is limited liability like that of a corporation. You can even elect to be treated as a corporation. If there is only one owner, you would file and be taxed as a sole proprietorship. If there are two or more owners, you are taxed as a partnership. LLC work well to both limit liability and not have the formalities of corporation ownership.

One final point is where to incorporate. If you ask five accountants, you will get five different answers. I personally like incorporating in Nevada. Contrary to what most people will tell you, this will not save you taxes. However, Nevada has some strong laws against piercing the corporation for liability protection. In addition, there are some extra privacy considerations available in Nevada that most other states don't have. If you are interested in finding out more, contact Alan Wilson or Scott Letourneau at Nevada Corporate Planners 888-627-7007 for a free analysis as to whether being a Nevada corporation is right for you.

BIG TIP: One big issue involves multiple owners of corporations or LLCs. What happens if you and one other own your corporation, and you don't get along? The result has been some of the most expensive and protracted legal battles around. It is worse than a divorce. Thus, a big, big tip is that if you are incorporated or have an LLC and have co-owners, always set up a buy-sell agreement at the start. This will eliminate a lot of problems, and you will bless yourself for listening to me.

In short, the way you start up your business can protect you from liabilities and make your life a lot less taxing!

Sandy Botkin is a CPA, attorney and former trainer of IRS attorneys nationwide. He lectures all over the nation on tax planning for self-employed and corporate taxpayers and can be seen in the big events with Donald Trump, Anthony Robbins and many others. He has been written up in Newsweek and in many other magazines. He is also a syndicated writer and noted author of this famed tape series "Tax Strategies for Business Professionals" and "Tax and Financial Strategies for Residential Real Estate." To find out more about Sandy and his products, check out his terrific small business web site at: [www.taxreductioninstitute.com](http://www.taxreductioninstitute.com) or by calling his office at 301-972-3600 in Maryland.