Why Consider Incorporation?

A common question that gets asked oftentimes is when and how people should incorporate their business. Or perhaps you're not sure if it would be beneficial from a tax standpoint. This is why we look at the advantages and disadvantages of some of the more common business entity types.

Sole Proprietorships

A sole proprietorship is the simplest and most common business structure. This is an unincorporated business with one owner, usually a married couple. There is no legal distinction between the business and the owner(s).

Advantages	Disadvantages
Formation **No formal action is required to create a sole proprietorship.** **Consider that as the business owner, you will still need to obtain any necessary licenses, permits and a Doing Business As (DBA) permit.**	**Personal liability** **Since there is no legal separation between the owner and the business, the owner's personal assets are at risk for all of the business' debts and obligations, including any legal judgments.** **This risk extends to any liabilities incurred as a result of the actions of employees also, regardless of the possession of insurance.**
Control over the business **The owner makes all of the business decisions, including strategy, concept, operations and what expenses are incurred.** **The owner is entitled to all of the business' profits.**	**Raising capital funds** **Sole proprietorships cannot sell stock.** **Banks and loan funds are sometimes hesitant to lend to sole proprietorships because of a perceived lack of credibility if the business fails or has no obtainable assets.**
Tax filing is simpler **A Schedule C usually takes less time to prepare than other entity's return, and also it takes into account whatever business profit or loss impact has on your Form 1040.** **Self-employment tax and estimated tax payment requirements should also be considered to help avoid interest and penalties.**	**Burden of responsibility** **The flip side of having complete control over the business is the burden and pressure that comes with it – the owner is the one ultimately responsible for all successes and failures of the business.**

IRS Tax Resources:

- IRS Schedule C Profit or Loss From Business
- (Instructions) IRS Publication 334 Guide for Small Businesses

Partnership

A partnership is the agreement of two or more people to go into business together, whether it's two friends, two colleagues, husband and wife, or family members. At the federal level, a partnership is not taxed, but instead serves as a distribution of income and expenses to the partners involved in the partnership demonstrated on their Form 1040.

Types of partnerships:

- General
- Partnerships

  Limited

  Partnerships
- Limited Liability Partnerships
- Limited Liability Limited Partnerships (not always recognized)
- Joint Ventures

Advantages	Disadvantages
Easy and inexpensive to form **Most of the time spent in creating a partnership is in developing the Partnership Agreement, usually from an attorney.**	**Joint and individual liability** **Depending on the type of partnership chosen, partners could be subject to liability for their own actions, the actions of their fellow partners and the actions of the partnership itself.** **The liability can extend to the personal assets of the partners.**
Shared commitment **Since there is more than one owner, there are more people invested in ensuring the success of the business.** **Pooling of financial resources usually yields benefits as well.**	**Disagreements among partners** **There are bound to be disagreements among the partners. The Partnership Agreement should explicitly dictate which decisions require all partners to agree, which requires a majority and which are within a partners' discretionary power.**
Complementary skills **Ideally a partnership will leverage the strengths and expertise of each partner.**	**Shared profits** **While the profits of a partnership are shared based on their investment, each partner may have contributed time, effort or resources to the business disproportionate to their shares of the profits. This could generate discord among partners.**

Resources

- IRS Form 1065 Return of Partnership Income
- Instructions IRS Publication 541 Partnerships

S Corporation

An S Corporation is a legal entity separate from its owner or owners. While it has similar requirements to a C Corporation, it also has a pass-through feature like a partnership. Of course, there are specific requirements for making the S election, so become familiar with those before advising your client of this option. Here are some advantages and disadvantages of an S Corporation:

Advantages	Disadvantages
Possible tax savings **An S corporation shareholder can take a wage and also receive his or her share of the business's income as a distribution. At the federal level, the distribution is oftentimes taxed without self-employment tax.** **An S corporation's profit is disbursed onto a personal Form 1040 and taxed at a personal rate than a corporate tax rate.**	**Stricter operational processes** **Both S and C Corporations require stricter operational processes, including scheduling director and shareholder meetings, and maintaining minutes of those meetings.** **The requirements for stock ownership limitations, consent, notification and filings must be followed precisely, or else the S corporation risks losing its S election status.**
Limited liability **The shareholders' personal assets are protected from liability incurred by the business or other shareholders.**	**Shareholder compensation requirements** **Each shareholder must receive reasonable compensation. A combination of a low salary with a high distribution could raise a red flag for the IRS.**
Independent life **If a shareholder leaves the business, the S corporation can continue to do business as usual.** **Shares in the company can be transferred without compromising the entity, even if the shares transferred represent a majority interest.**	**One class of stock** **S Corporations can only issue one class of stock.** **This can make it more difficult to specially allocate income or losses to specific shareholders.** **This can also make it more difficult to get venture capital.**
Credibility **Potential creditors, employees and customers may view an incorporated entity as more credible because the shareholders have made a commitment to formalize the business.**	**Filing timely returns** **Currently S Corporation returns are due on March 15th of each year, therefore pushing tax preparation earlier than the normal personal return deadline.**

Resources

- IRS Form 2253 Election by a Small Business Corporation (Instructions)

C Corporation

A C Corporation is also an incorporated entity that is separate from its owners. Most larger corporations, including publicly traded companies, are C Corporations.

Advantages	Disadvantages
Limited Liability **The shareholders' personal assets are protected from liability incurred by the business or other shareholders.**	**Double Taxation** **C corporation dividends are taxed both at the corporate and shareholder levels.**
Ability to sell stock **Like an S corporation, a C corporation can sell stock. Unlike an S corporation, a C corporation can sell different classes of stock. This attracts venture capital.**	**Complexity** **Corporations are complex entities that usually require more time to start and operate.** **They also have more recordkeeping and compliance requirements, allowing for higher administration costs.**
Corporate tax treatment **Shareholders of a C corporation only pay taxes on the salary, bonuses and dividends paid to them.** **The remaining business profit is taxable to the corporation at the corporate tax rate, which can be lower than the personal income tax rate.**	**Corporate tax losses** **Shareholders may not be able to receive any tax benefit of the C Corporation because it pays its own taxes.**
Healthcare benefits **A C corporation can create a medical reimbursement plan that allows the corporation to deduct medical payments.** **The shareholders can then use this plan and enjoy the benefits tax-free.**	**Dividend Distribution** **A corporation's profits are divided on the basis of stockholdings.**

Resources

- IRS Publication 542 Corporations
- IRS Form 1120 U.S. Corporation Income Tax Return (Instructions)

Limited Liability Company

A Limited Liability Company has a hybrid legal structure. For federal tax purposes, an LLC is not a separate entity, but for some states it is. When your client chooses to form an LLC, you should also discuss what type of tax entity the business will have for federal filing purposes. An LLC can be a sole proprietorship (Single-Member LLC or SMLLC), a partnership or a corporation.

Limited liability **The members' personal assets are generally protected from liability incurred by the business or other members.**	**Limited life** **Several states mandate when an LLC has a majority change in ownership, in which case the entity is dissolved. This could occur when a member unexpectedly dies or when a member decides to leave the business.** **Typically, all members of an LLC must approve the addition of new members or altering the ownership percentages of existing owners.**
Less recordkeeping **Generally, an LLC requires less additional recordkeeping than its underlying federal tax entity. In some states, the LLC reporting requirements are lighter than corporate filing requirements.**	**Administration costs** **Many states impose franchise tax or other fees on LLCs and require annual report filings.** **Creating an LLC is oftentimes more expensive than creating a sole proprietorship or general partnership.**
Sharing of profits **LLCs can be structured in various ways to suit the needs of its members or to manage the risk within the business.** **This results in fewer restrictions on how profits are allocated.**	**Less legal precedent** **While corporations have been in existence for hundreds of years, LLCs are a fairly new entity type. Thus, there is less case law for deciding legal issues that are unique to LLCs**.

Resources

- IRS Publication 334: Tax Guide for Small Businesses
- IRS Publication 3402: Taxation of Limited Liability Companies

This e-book is for informational purposes only. If you should have further questions, please feel free to contact myself or your tax advisor.

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