



SHOULD YOU INCORPORATE YOUR BUSINESS?



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As a business owner, you have dozens of decisions to make at any one time. One of the most important decisions to make is choosing what type of entity your business will be. While you already made this decision when you started your business, your situation could change at any time. Currently, your business may not be in the best structure for your current tax and liability situation.

Many business owners start out as sole proprietors, which is the simplest business structure, or entity, to have. With a sole proprietorship as your business entity type, you don't have to register your business within your state, you can simply start operating your business. You might have local licenses you need to abide by, but you don't need to register like a corporation does. So, by default, every business owner starts out as a sole proprietor if nothing else is done.

The question that many business owners have is whether they should incorporate their business to benefit from the many advantages of incorporation. If they should incorporate, when is the best time to do it? We'll explore the advantages and disadvantages of these two types of entities, as well as answer these questions, in this report.

As always, you should work one-on-one with an attorney and a tax accountant to determine the best options for your specific situation.

There are four major differences between a sole proprietor and a corporation:

1. Getting paid
2. Tax treatments
3. Liability
4. Filing requirements

Let's take a detailed look at each one.



Getting Paid

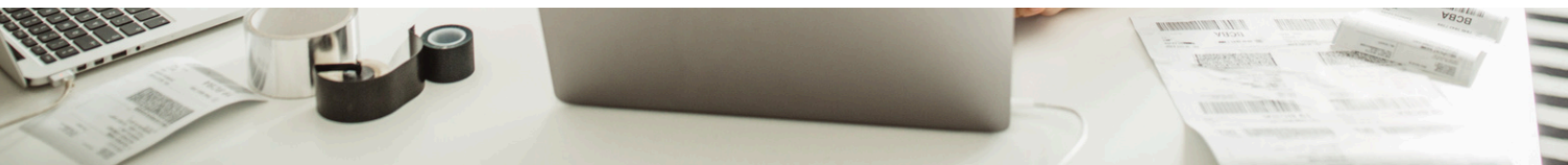
A big difference between corporations and sole proprietorships is how owners get paid. With a sole proprietorship, there is no paycheck in the traditional sense of getting a W-2 at the end of the year. Instead, owners take draws, which is a fancy term for taking money out of your business. You simply write a check or make a bank transfer from your business account to your personal account. You can do this whenever you want; however, you do still need to have enough cash on hand to run your business operations.

What if you are a contractor getting paid by corporations? You are still a sole proprietor (as long as you haven't incorporated), and the total of all of the 1099s the corporations have issued to you will be your revenue, to be reported on Schedule C of the IRS Form 1040.

With corporations, getting paid is a bit more structured. Owners of corporations earn a salary, which is paid like a traditional paycheck with a W-2 at year's end. The salary cannot be just any number; it needs to reflect the market value of the services rendered by the owner to the business. In tax practice, the term for this is "reasonable compensation," and there are rules (and many court cases) around determining this number.

Corporate owners can also be paid dividends in addition to their salary. Dividends are taxable to the owner or shareholder who receives them. If the corporation has elected S Corporation status, which is a tax election granted by the IRS, owners can take tax-free money out of the business in the form of distributions (within limitations).

To summarize, sole proprietors take draws and S Corporation owners take a salary and can take dividends and distributions





Payroll Taxes vs. Self-Employment Taxes

In a sole proprietorship, self-employment (SE) taxes are paid on the entire net income of the business (with some limits and exceptions). The self-employment taxes are calculated on the Schedule SE of the Form 1040. Let's say you have \$100,000 in net profits before SE taxes for the year. Your total SE tax would be \$14,129.55, using 2021 numbers and greatly simplified conditions.

For Social Security taxes, 12.4 percent is taken on 92.35 percent of \$100,000, and 2.9 percent is taken the same way for Medicare taxes. Half of that amount is then deducted in another place on your tax return. Depending on your state SE tax rules, you may also need to pay state self-employment taxes.

Here are the calculation details:

$\$92,350 \times 12.4 \text{ percent} = \$11,451.40 = \text{Social Security taxes}$

$\$92,350 \times 2.9 \text{ percent} = \$2,678.15 = \text{Medicare taxes}$

Total SE taxes: \$14,129.55

Amount that is deducted from income: $\frac{1}{2}$ SE taxes = \$7,064.78

For corporate owners, the story is quite different. In a corporation, if you have \$100,000 in net profits before payroll taxes, you will likely pay yourself part of that money in salary. Let's say you pay yourself \$75,000, and that is considered reasonable compensation, which is a specialized tax term beyond the scope of this document. Your payroll taxes will be computed on your paycheck and W-2. You don't have to pay self-employment taxes at all, but you do need to file and pay payroll taxes.



On a \$75,000 annual salary, the employee's portion of social security taxes is \$4,650 at 6.2 percent and Medicare taxes are 1.45 percent: \$1,087.50. The employer's portion is identical.

Total payroll tax paid by the corporation is: \$11,475. The same is true with state payroll taxes, if any.

$\$75,000 * 6.2 \text{ percent} = \$4,650 = \text{Social Security taxes}$

$\$75,000 * 1.45 \text{ percent} = \$1,087.50 = \text{Medicare taxes}$

Total payroll taxes: \$11,475

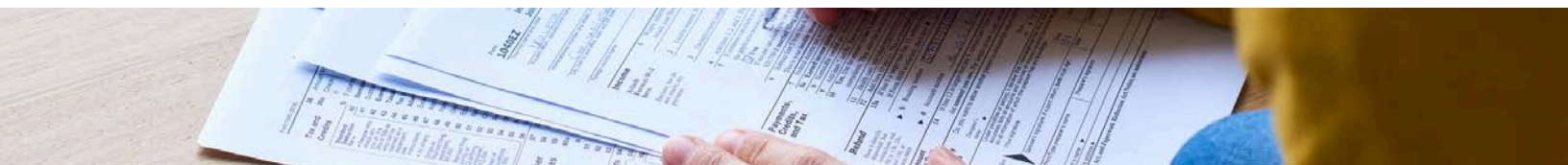
Total payroll tax paid on the \$25,000: \$0

The S Corporation will pay slightly less in payroll taxes because only the \$75,000 salary is involved and not the entire \$100,000 in profits. The bigger the difference is between the profits and the salary, the bigger the tax savings.

However, that's just the effect of payroll taxes and self-employment taxes. Let's take a look at income taxes next.

Taxes Treatments

The good news for a sole proprietor is that they only have their individual tax return – the 1040 – to complete for federal tax requirements. For a corporation, the Form 1120 is due, and the owner still needs to file their 1040 individually as well. However, the corporate owner won't have to complete Schedule C; instead, they will have Schedule K-1 to apply to their 1040 return. The effect is mirrored at the state level for states that have corporate filing requirements.





For a sole proprietor, income taxes and self-employment taxes are paid on the entire net profits, calculated on Schedule C of the IRS Form 1040. The tax calculation is as follows:

Total net income: SE tax adjustment: Standard deduction (assuming single filing status):

Total net income:	\$100,000
SE tax adjustment:	(7,065)
Standard deduction (assuming single filing status):	(12,550)
Taxable income:	\$80,385
Tax per tax tables:	\$13,431
SE tax:	\$14,129
Total tax due:	\$27,560

For an S Corporation, the income would be split into two calculations: the \$75,000 in wages, and the \$25,000 profit. The \$25,000 profit would be reduced by the employer's portion of payroll taxes, \$5,737.50. The 1040 would look like this:

Wages:	\$75,000
K-1 income:	\$19,266
Standard deduction:	(12,550)
Taxable income:	\$81,716
Tax per tax tables:	\$13,728
Total tax due: (remember this does not include payroll taxes)	\$13,728



Your Cash Flow

Let's look at the big picture with this simplified example.

Net income:	\$100,000
Income tax:	(13,431)
Self -employment tax:	(14,129)
Take home cash:	\$72,440

The sole proprietor has \$72,440 left after subtracting taxes from the \$100,000 net income.

The S Corp looks like this:

Net income:	\$100,000
Income tax:	(13,728)
Self -employment tax:	(11,475)
Take home cash:	\$74,797

The S Corp has \$74,797 left after subtracting taxes from the \$100,000 net income. Another way to look at the S Corp's cash flow is:

Net Pay from paycheck, where \$5,738 in payroll taxes have been deducted:	\$69,262
Net income per K-1, where \$5,738 (employer's portion of payroll taxes) has been deducted:	\$19,263
Income tax:	(13,728)
Take-home cash:	\$74,797





The S Corp owner also has the following expenses:

- Initial legal expense of incorporating and filing with the state (this cost is one-time and the benefits will be felt all of the years you are in business)
- A payroll system • Payroll tax return filings quarterly and annually
- Unemployment taxes • Workers' compensation
- The cost of preparing the federal 1120 tax return annually
- The cost of preparing the state corporate tax returns annually
- State corporate taxes, depending on the state
- Some minor administrative expenses each year

It bears repeating: The bigger the difference is between the profits and the salary, the bigger the tax savings is for S Corporations, and the more reason to convert from a sole proprietor.

Don't forget how simplified this example is. The effect of state taxes must also be considered when deciding on your type of entity or whether to switch. In California, for example, the minimum corporate tax payment is \$800, excluding the first year.

Retirement plan options vary for the type of entity you choose, and this can have an impact on your tax savings as well.

Through 2025, the 20 percent Qualified Business Income Deduction, passed by Congress with the Tax Cuts and Jobs Act, will also affect these numbers. Both sole proprietors and S Corporations qualify for this tax deduction.

Your salary needs to be reasonable for what you contribute to the corporation. You can't take a tiny salary with huge profits to avoid payroll costs; the IRS will most certainly red-flag your return.



There may also be switching costs to convert from one entity to another, not just legal, but tax penalties. This is true in the case of switching from a C Corporation to another type of entity when passive income is involved.

The best approach to determining exactly how your situation stacks up is to consult with your tax accountant and have them do a workup using your specific numbers.

Liability

As a sole proprietor, any liability you incur while in business directly impacts you as an individual. When your business is incorporated, you personally have limited liability, since the corporation is a separate entity. For example, if you have employees and they decide to sue you for any reason, they would sue your corporation instead of you directly. Your personal assets may be protected, while your business assets would be at risk.

In small businesses, you may have to personally guarantee any business loans. If that's the case, the limited liability that a corporate structure would offer is not helpful related to that specific debt.

Protecting your personal assets is an excellent reason to incorporate. While it's not foolproof in every situation, it can help to protect your personal wealth from claims against your business.

Another type of entity that can protect your personal assets is an LLC, limited liability company. This form of business can limit an owner's liability, can be taxed like an S Corporation as a passthrough entity, and does not require the extreme administration that the corporation does.



Filing Requirements

For sole proprietorships, there are no filing requirements. One tax return, the 1040, is due each year (notwithstanding requirements like sales tax). There are no payroll requirements, unless you have employees (you cannot be an employee yourself). It's pretty simple.

When incorporating, there is a good amount of paperwork. Here are the things you only need to do once if you incorporate your business:

- Articles of Incorporation need to be drafted and filed with the state. By-Laws need to be drafted.
- An EIN needs to be acquired from the IRS, which is separate from your social security number.
- S Corporation election should be applied for via the IRS. This is simply a form (Form 2553).
- If you do business in multiple states, you will need to register as a foreign corporation in each state.
- Payroll setup.

Here are the items you need to do at least annually:

- An annual shareholders meeting needs to be held and minutes recorded. You don't need to file these anywhere.
- Annual statements of information need to be filed with each state you do business in.
- The Form 1120 needs to be filed annually, along with state returns in each state you have nexus, or a business presence, in. Nexus is a legal term with a very specific definition that is beyond the scope of this document.
- Payroll tax return filing.



With a S Corporation, you don't need to have more than one owner. You can be one person, a 100% owner, and incorporate your business. However, you do need to be a US citizen or resident alien. If not, you have the option to form an LLC or remain as a sole proprietor.

Should You Incorporate?

The answer depends on you and your goals. One reason to incorporate could be for the limited liability benefit alone, especially if you have employees.

Another reason is if the tax savings is greater than the costs of being a corporation. For this, a detailed analysis can be performed by most tax accountants so you can see the numbers as they apply to your specific set of circumstances. The biggest gain in taxes is when your profits far exceed any reasonable salary that you would have to pay yourself in the corporation. However, that's not the only benefit.

There are many more minor benefits to incorporating that your tax advisor can review with you during your detailed comparative analysis.

We hope this report helped you become more informed about the decision to incorporate. Feel free to reach out for any questions you may have. We can also provide a full comparison analysis for you.



**Give us a call, email us, or schedule
a time on our calendar so we can talk.**