Making The Right Choices When Incorporating A New Venture

by *Jennifer Friedman*

(NAPSA)—If you're passionate about starting a new business, you may have the urge to jump right in without considering several key factors. One of the most critical is selecting a type of business structure and the tax implications that result from that choice.

While there is no business structure that is right for every legal entity, there are potential benefits (and drawbacks) associated with each option. Before reviewing some of these, here is a basic explanation of three common business formations:

Limited Liability

Limited Liability Corporation (LLC): Incorporating as an LLC provides the flexibility and control of a partnership, and the credibility and asset protection enjoyed by a corporation. The operating agreement determines how the business is managed and how profit and loss are allocated among owners.

Corporate Credibility

S Corp: This is considered a business corporation under state law, and is formed by filing incorporation documents and appointing a registered agent. S corporations offer the credibility and structure of a corporation but allow for profits and losses to be passed through its shareholders and reported through individual income tax returns. The business itself is not taxed.

Tax-Related Benefits

C Corp: Owned by its shareholders, a C corporation is a legal business entity under state law formed by filing incorporation documents and appointing a registered agent. Operating as a C corporation positions the business for tax-advantaged expansion while offering unique tax-planning strategies.

Given a basic understanding of the different business structure options available, small-business owners should be sure to take into consideration two primary tax implications before making the decision as to which business structure is right for them: income tax liability and employment taxes.

Income Tax Liability

Income tax liability relates to how businesses are taxed as a result of a taxable event, or any transaction that has tax consequences, while employment taxes are what a small-business owner must pay to fund Medicare and Social Security.

Jennifer Friedman of CT Small Business believes assessing the total tax impact of a business structure is a key factor for an entrepreneur starting a business.

In the case of LLCs, the company is not a separate taxpayer: Income simply flows to the owners. As a result, the business owner cannot be taxed twice on the same income. Because, in most cases, a business that operates as an LLC is not a taxpaying entity, it will not pay employment taxes on the income of the owners. The owners will pay self-employment tax on their individual income tax return for all the income that is passed through to them.

A Variety Of Options

An LLC can also elect to be taxed as a corporation. However, it's important to be mindful of a strong caveat in this case. If an LLC elects S Corp taxation, it still has to satisfy all the S Corp tax rules and states differ in how they treat this IRS election. But if all requirements are met, LLC owners can enjoy the best of both worlds, so to speak, by electing S corporation federal taxation. While this is not a common strategy, it's important to talk through the potential implications for your business with a tax advisor.

Many small businesses opt for S corporation status, which means that the corporation itself does not pay income taxes, and double taxation of dividends will not apply. S corporations also provide flexibility in structuring owner compensation, as owners can lower overall tax liability by receiving both salaries and dividends.

C corporations are separate taxpayers: they file their own tax returns and pay corporate income tax on their taxable income. C corporations tend to have more complex tax and legal requirements than an LLC or an S corporation, but they also have more flexibility in restructuring and in increasing ownership in the business.

S and C corporation owners do not pay self-employment taxes. If they receive income as a salary, then payroll and income taxes must be paid. In these situations, business owners pay only the employee share of Social Security and Medicare taxes on their wages. The corporation pays the employer's share of these taxes and reduces its income accordingly. This can result in a substantial total tax savings for the owner-employee.

Assessing the total tax impact of the business structure is an important factor for any entrepreneur starting a business, and understanding the variations between the different options is crucial in making the right decision.

There are many business formation and legal compliance services available to entrepreneurs and small-business owners; for example, working with an accountant can be helpful in determining the best formation option.

Once entrepreneurs decide on the structure that is right for their business, they should look for an online service provider that has the right tools, forms and expertise to understand the specific requirements of each state to ensure a seamless incorporation process.

To learn more about incorporation, visit ct.wolterskluwer.com.

Jennifer Friedman oversees marketing activities for the Small Business segment of CT, a Wolters Kluwer Company providing legal compliance solutions to the small-business community. As the Chief Marketing Officer (CMO) of CT Small Business, she directs all activities related to digital marketing and advertising to help build the brand through innovation, partnerships and enhancing the customer experience.