



The Pros and Cons of the Corporation ***A compilation of factors as researched by Creative Finesse***

Important Note: Creative Finesse is not a taxation expert and therefore cannot advise you in matters related to your taxes, the filing of, or the status or benefit of a particular business structure. We recommend that you seek out the assistance of a professional tax advisor, CPA or other qualified individual when making your decision on the type of business that is best for you. Creative Finesse can be reached on the web at www.creativefinesse.com. August 2006

Before making your decision on the business structure that is best for you, you should take into consideration various factors, including taxation issues, that accompany the different business structures and corporation options that exist. Many complex tax rules must be followed and there are legal and accounting costs associated with the operation of a corporation.

Of the different ways of doing business that are in existence, a corporation is the most expensive and you must factor in the initial corporation charges (filing fees, professional advice, etc.) and annual fees to the state that are required in order to maintain a corporation, as well as added professional assistance that may more than likely be required for federal and state tax reporting.

The tax consideration is one factor, but the personal liability shield provided is sometimes a more important factor when deciding on whether or not to incorporate and which business structure is best for you and your business.

All corporations begin as C Corporations but may elect S status with the IRS.

C Corporation:

Owners are completely separate and treated as employees of the corporation for tax purposes – with the corporation as a completely separate tax entity from its owners.

C Corporations are subject to corporate income taxes but most small business C corporations legally avoid paying corporation income taxes by paying profits to the owners in the form of tax deductible salaries, bonuses and fringe benefits.

This is the more formal business entity and has greater tax reporting responsibilities than other entities.

A Corporation allows profits to be kept in the business for expansion or inventory buildup with retained profits taxed. The initial corporation tax rates are lower than the tax rates applicable to most individuals (up to \$75,000 in income).

A Corporation is legally termed an artificial person. It may own property, enter into contracts, borrow money, and sue and be sued, just like an individual. For tax purposes, it is an entity distinct from its owners, who are called stockholders or shareholders. A corporation may have one stockholder who can also be a director and this person will likely name himself as the president as well as take on other corporate titles, like secretary and treasurer.

A Closely Held Corporation is the category that most small business corporations fall into. This is a corporation that sells stock privately and has 75 or fewer shareholders, and has shareholders who all work in the business, or are closely related to people who do, or are experienced investors.

If a corporation offers shares to the public or has more than 75 investors, it is not closely-held and more complicated stated and federal tax and securities come into play. A shareholder who works in the corporation is an employee and is not considered self-employed in the eyes of the tax law.

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Double Taxation of Profits:

A C Corporation follows federal and state corporation income tax rules that are different from those for sole proprietorships, limited liability companies or partnerships. You might say that before any profits are paid to shareholders, a C Corporation must pay income tax on the profits at the corporate rate. Any profits that are distributed to shareholders via dividends are then subject to the shareholder's individual income tax. This amounts to "double taxation" with business profits taxed at both the corporate and personal levels. To best deal with this double taxation: All or most all of a small C corporation's earnings are typically paid out to employees as wages, bonuses or fringe benefits (not taxed to the corporation as profits since they are deductible employee expenses). After all employees are paid for labor, there usually is no income for small business corporations to owe tax on unless the shareholders want there to be taxable profits left in the corporation. If any income is left in the business, it is usually tied up in inventory or retained to fund future growth. It is taxed, but at corporate tax rates that are lower than the personal income tax rates that apply for most small business individuals.

If you pay dividends, then the double taxation of C corporations that is usually avoidable is not then so. Dividends are not deductible corporate expenses like wages. They are distributed only after the corporate income taxes are calculated (taxed once) and then dividends are taxed (once again) to the shareholders (employees usually) who receive them. The second tax is on the individual tax returns of shareholders.

Corporate Losses:

Just as a C Corporation profits belong to the business and not the shareholders, so do losses. The corporation is a separate tax entity from shareholders and individual shareholders cannot claim operating losses of a C corporation business. Instead, the losses of a C Corporation in one year can be offset against future or past corporate year's profits. Sole proprietors, partners and limited liability company owners are subject to restrictive rules for claiming tax benefits from business losses.

Tax Reporting:

C Corporations must file annual tax returns whether they have any corporate income to report or not. The due date is the 15th day of the third month after the close of the corporation's tax year. If on a calendar year, this is due on March 15th yearly. States require annual corporate tax filings as well and most require that a minimum amount of corporate tax be paid annually to maintain the corporate status (usually a few hundred dollars).

Fringe Benefits:

C Corporations enjoy the greatest variety of tax favored fringe benefits of all business entities. Newer businesses typically cannot afford these but once income exceeds \$100,000, a C Corporation is a good consideration. The fringe benefits are any tax-advantaged thing of value like health insurance (for business owner or employee) and are usually partially or totally tax-free to recipient and deductible for the business.

Charitable Contributions:

C Corporations can directly claim charitable contributions. Sole proprietors, S corporations, LLCs and partnerships cannot.

Incorporating Your Business:

Forming a C Corporation can complicate your life and add extra expenses. It is wise to make an informed decision. Typically the business owners put money into a newly created corporate bank account in return for shares of the stock. This is known as capitalizing the business. The taxation of this investment does not come until later when you sell or dispose of your stock. There is no minimum investment required for

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federal tax purposes, but there might be within the laws of the state. Most states require that corporations have sufficient cash or other assets to show that they are not empty shells, called adequate capitalization. You should always adequately fund your corporation to make sure there is a reasonable amount of money to meet expenses and pay debts. Otherwise the IRS or a court or creditor may deem your corporation as a sham because it is undercapitalized and then hold you personally liable for corporate debts.

You should exercise caution and pay attention to corporate formalities because the IRS does. Always prepare corporate minutes or resolutions of any significant corporate financial transactions, compensation of officers and etc. Auditors often inspect corporate records and if you haven't kept up your corporate paperwork, they can disregard your business' corporate status. Tax benefits can be disallowed because corporate record books are not up to date or state filings for the corporation were not made.

S Corporation:

S Corporations pass income through to their shareholders who pay tax on it according to their individual income tax rates. Electing S corporation status eliminates the possibility of double taxation on business profits. Because S Corporations are pass-through entities, their profits are taxed directly to the shareholders, the business owners. S corporations pay no federal corporate income tax but must file annual tax returns.

Losses pass through too. S Corporation shareholders take most business operating losses on their individual returns, with limits on the losses taken by shareholders who are not active in the business. These losses are claimed on the individual shareholder's individual income tax returns. Although an S corporation business is not a tax-paying entity, it is most definitely a tax-reporting entity. An annual corporation tax return showing income and expenses and the resulting profit or losses must be filed.

All corporations begin as C Corporations but may elect S status with the IRS. S corporations are treated like partnerships or limited liability companies for tax purposes. S Corporations don't pay taxes but instead shareholders pay taxes on business income at their individual tax rates. Electing S corporation status means forgoing some of the tax benefits available to a C Corporation. Because business start-ups typically lose money in their early years, electing S corporation status is advantageous. S Corporation shareholders can claim business losses directly on their personal tax returns.

Should You Choose S Corporation Status?

Most individuals incorporate for non-tax reasons. They usually seek to shield their personal assets from business obligations and lawsuits. Corporate shareholders, unlike partners and sole proprietors, aren't personally liable for business debts.

The S Corporation combines this limited liability with pass-through tax treatment, allowing business income and deductions to flow directly through to shareholders. This is the same tax result as with a sole proprietorship, partnership or LLC. Also S corporations offer tax benefits from operating losses that are common in a business start up phase. S Corporation allows shareholders active in the business to take operating losses against their other income but those who do not work cannot take this benefit. You can elect an S Corporation status in the early years and then when profitable, convert to a C corporation. The switch will produce fringe benefit tax savings.

S Corporation Disadvantages:

The S corporation cannot retain earnings without the shareholders having to pay tax on them. S Corporation profits pass through to the shareholder even if funds are retained. S Corporations cannot provide the full range of fringe benefits that C corporations can. Smaller businesses cannot afford the

