

## **Should I Incorporate?**

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In his book “the E-Myth”, author Michael Gerber talks about working on your business instead of in your business. In the book “The 7 Habits of Highly Effective People”, author Steven Covey discusses “being with the end in mind”. Setting up your business as an entity is one way to satisfy both of these elements.

The purpose of this article is to outline the most common forms of entity and to give a cursory overview of the advantages and disadvantages of each. Setting up your entity is a long term decision that carries certain advantages and disadvantages with it that can be long term. Before making your entity selection, you should seek the advice of a competent professional to advise on your own personal situation.

### **The 5 Different Entities**

In terms of legal and tax structure, there are 5 different choices of entity: Sole Proprietorship, S Corporation, C Corporation, Limited Liability Company, Partnership and Personal Services Corporation (or LLC). There are different reasons (and rules) to use each.

#### **1. Sole Proprietorship**

If you haven't set up another form or entity, this is most likely how you are classified. A sole proprietor is the easiest way to get into business. You operate it on a calendar year and a “cash basis”. The sole proprietor is the easiest way to start a business.

##### **Advantages**

Easy to set up, lowest cost of tax preparation, least amount of administration.

##### **Disadvantages**

No continuity if the owner leaves, dies,...., potential higher chance of tax audit, more difficult to transfer the business. No liability protection, no tax advantage.

#### **2. S Corporation**

For most small business activities, this is the entity of choice.

##### **Advantages**

All gains and losses flow directly to the shareholders, there are certain tax advantages with FICA tax, you can sell shares, you can acquire investors. Liability protection. Potential lower chance of tax audit.

##### **Disadvantages**

Limited number of shareholders, only trusts and people can be shareholders, no medical reimbursement plans (like C corporations), transfer of property is at the Fair Market Value (FMV) between shareholders, limited ability to defer gain through a 1031 exchange if selling real property. More costly to maintain, renew, and do tax preparation than a sole proprietorship.

#### **3. C Corporation**

When you file your articles of incorporation with the state of domain, you will by default be a C corporation unless you petition the IRS to reclassify your entity as an S corporation.

##### **Advantages**

Earnings are taxed at a lower rate and then can remain in the corporation. All dividends are taxed at a maximum rate of 15% (currently). Ability to set up a qualified “medical reimbursement plan” that will allow the corporation to expense non-insurance reimbursed expenses. Liability protection. Potential lower chance of tax audit.

#### Disadvantages

"Double taxation" of earnings; first at the corporate level then at the shareholder level. More costly to maintain, renew, and do tax preparation than a sole proprietorship.

### 3. Limited Liability Company (LLC)

For owning real property and in certain cases for the operation of a business, this could be your entity of choice.

#### Advantages

Distributions don't have to be in proportion to contributions as is the case in corporations. No annual meeting minute requirement. Ability to trade out of real property as separate members and into replacement real property in a 1031 exchange. Potential lower chance of tax audit.

#### Disadvantages

Depending on the activity, state statute or federal tax law might prohibit being an LLC. Check with your professional advisor.

### 4. Partnership

When two or more people combine resources (money, property,...) with the intention of making a profit, a partnership is formed.

#### Advantages

Can set up a limited partnership. Limited partner's exposure is limited to their initial investment in the company. Can be a good entity for an activity that has a beginning and an end (like a development project).

#### Disadvantages

Many partnerships are started with no partnership agreement. If there are problems in the future, there is no governing document. General partners and managing general partners have no liability protection. Recommended: set up an LLC instead.

### 5. Professional Services Corporation (or LLC)

Depending on your activity, your state statutes, the level of employee ownership of your entity, and the amount of time each employee spends doing certain activities, you may, by default have to set up your entity as a Personal Services Corporation (PSC) or a Professional Limited Liability Company (PLLC).

#### Advantages

See above.

#### Disadvantages

A PSC is taxed at the corporate level at a flat rate of 35% (currently). More costly to maintain and do tax preparation than a sole proprietor.

#### **Which should you choose?**

Which entity you choose really depends on what you are doing and what your goals are. The ONLY way you should select the entity that is best for you is by setting aside the time and paying a professional (CPA or lawyer) to walk you through your specific situation and assist you in selecting which is best for what you want to do.

#### **Become the Expert**

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