

The Line Between Business And Personal Finance Is Often Blurred. When Should You Graduate From One-Man Show To A LLC Or S-Corp (Or Other Entity)?

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There is really not a specific rule as to when a self-employed individual should consider incorporating or forming a limited liability company (LLC). However, if the work is expected to continue for more than just a brief period of time, it is worthwhile to consider the factors weighing in favor of forming a legal entity. Among the factors weighing in favor of forming a new entity, and which type of entity to form, are the following:

- **Personal asset protection** – both a corporation (whether an S-corp or a C-corp) and an LLC provide protection of personal assets from liabilities related to the operations of the business. This means that if the business signs a contract that it then fails to perform upon, the assets of the entity are subject to the liability, but the owners personally owned assets are not. This is probably the single most important factor in establishing a separate legal entity.
- **Tax Audit Issues** – When you operate as a sole-proprietor, all of your income and expenses are reflected on Schedule C of your personal 1040. When you file as an S-corporation or an LLC, all of the income and expenses are reflected on the entity's separate tax return. While the IRS does not publish a list of items that are likely to increase the chance of an audit, conventional wisdom is that Schedule C sole proprietor businesses face a greater likelihood of the expenses claimed being questioned.
- **Costs** – While forming an S-Corporation or an LLC are typically not significant, if the business is intended to last for a brief period of time, the benefits may not justify the expense. For example, if an individual is otherwise gainfully employed but is doing some consulting work on the side for a limited duration, and the expenses that will be incurred as a consultant will be small or nonexistent, then the costs to set up an entity, file the necessary tax returns and pay any fees required to the state to form and maintain an LLC or S-corporation may not justify the cost.
- **Taxes** – Both an S-corporation and an LLC are commonly referred to as pass-through entities. This means that they do not generally pay taxes at the entity level. Rather, all of the income and expenses of the entity are reflected on the owners' individual tax return (Form 1040). Thus, the tax treatment of sole proprietorships, S-corporations and LLCs are generally very similar. Keep in mind that President Trump has proposed some changes in the tax laws that might change this result.

- **Self-employment/Medicare Taxes** - One significant benefit that S-corporations have over LLCs and sole proprietorships is in the area of self-employment and Medicare taxes. Generally, all income earned from a sole-proprietorship and an LLC is subject to both self-employment and Medicare taxes. That is not always the case with an S-corporation. With an S-corporation, some of the distributions that the owner receives can be characterized as dividends as opposed to a salary. While a reasonable portion of the distribution to an owner who devotes personal services to the business will be treated as salary, any excess would arguably be treated as a dividend, exempt from these taxes.
- **Formalities** – When the owner of an LLC or an S-corporation is one single individual, the manner in which the entities operate is very similar. However, if there will be more than one owner, the LLC form of ownership provides much greater flexibility in customizing the rights which each owner has with respect to the income and control of the entity. S-corporations are corporations and must follow the very strict law of corporations in the state in which they are formed. LLCs, on the other hand, are designed to be much more flexible – in fact, they are really thought of as “creatures of contract.” This means that the owners are provided much greater flexibility to design the operations of the entity between the owners to suit their particular purpose. They might divide control up in a way that is inconsistent with proportionate ownership interests, and the rights to distributions from the entity may differ from owner to owner.
- **Ownership** – There are significant differences between an S-corporation and an LLC as to who can be an owner. Specifically, the provisions of the Internal Revenue Code provide very strict limitations as to who can be an owner of an S-corporation. While an LLC can have an unlimited number of owners, an S-corporation cannot have more than 100 owners. S-corporations cannot be owned in any manner by any individual who is not a US citizen or permanent resident; LLCs can. S-corporations cannot be owned by another corporate entity, meaning another corporation, an LLC and except in limited circumstances, a trust or an estate; LLCs can.

The decision as to whether or not to take the step from being a sole-proprietor and becoming either an S-corporation or an LLC is not an easy one. Once that decision is made, considering whether to form an S-corporation or an LLC also requires consideration of many factors. However, it is a decision that many new ventures and entrepreneurs must make. It is always wise to sit down with an attorney and/or tax advisor to consider options so that a decision can be made that suits the owner's particular business purpose.