

BEST TAX PRACTICE -

Creating an Entity Is A LEGAL Decision – NOT A Tax Decision

The creation of an (any) entity is a decision that is based in the law - making it a legal decision usually decided upon so to limit risk and liability. Though such a decision can have tax implications - great and small, please understand that it is *first and primarily* a Legal decision.

- Unless the tax preparer is an attorney, the tax preparer is just that - a tax preparer and not an attorney. This author is not an attorney; I am a tax preparer and as such can speak to tax matters. For legal advice you should seek the counsel of an attorney.

Now that these points are clarified, let's talk about how an entity may help or hinder one's tax scenario.

The default entity any individual has is the Sole-Proprietor. No decision is needed to create this entity and all income is reported on one's personal tax return and taxes paid are as Ordinary income - determined by one's overall tax return and subsequent tax bracket. Typically there are no "additional" costs incurred in having a Sole-Proprietor business and if so, they would typically be significantly lower than any costs incurred for any other entity. There is no legal separation or protection between personal and business (assets).

There is more than one type of entity one can create - an LLC, a Partnership, a Corporation or a Sub S-Corporation ("S-corp"). Each of these entities has different tax implications and ramifications. From a tax perspective, not all entities are created equal.

A created entity costs money.

CREATING THE ENTITY

There is a financial cost to creating the entity; it cannot be created for free. The cost of creating the entity can run as much as a few hundred dollars to a few thousand dollars depending on many different elements.

MAINTAINING THE ENTITY

There are costs for maintaining the entity; it cannot be maintained for free. The conservative estimates start at approximately \$3,400 for the year and can go higher. For conservative budgeting, the following figures are provided - your experience may vary.

\$ 800+ A basic and simple corporate tax return

\$1,800+ Bookkeeping and payroll

\$ 800 MINIMUM "franchise" fee due California (if incorporated in or conduct business in California); other states may have their own 'minimum' fee

NOTE: These fees do NOT include any *Income Taxes* the entity may owe to the feds and any states. Income taxes due the IRS and any state vary.

There are many different elements that are considered in examining one's potential tax savings of creating an entity.

A recent look at a person who had \$100,000.00 of income with conservative business expenses taken against the income run through a (full) corporation was determined that the potential tax savings to the client was approximately 4 to 5% - *before* the costs of maintaining the corporation was taken into consideration. In this scenario, the bottom line of savings was

approximately \$1,000.00 when allowing for the costs of maintaining the corp. At the end of the day, was the \$1,000 savings worth all of necessary machinations of having a corporation? Some would say the savings is not enough and others would say it is worth it.

It is common that emotions are a significant reason someone begins to consider and then creates an entity initiated by either an infomercial or a belief that “incorporating” is a magic bullet, which saves the individual from the ravages of the big bogey taxman. Many a person has created an entity to only find afterwards that the tax savings did not materialize and worse, their entity actually cost them money and more than any tax savings they thought they were to get.

Purchasing a gym membership does not improve one’s cardiovascular condition, create 6-pack abs, nor improve stamina. Actual use of the gym is required to get results.

Proper use of the created entity rules is an integral part to maintaining the necessary distinction between personal and “corporate,” to maintain the integrity and sanctity between the two, as well as any tax savings.

From a tax perspective, if after reading through this, you think that creating an entity (“incorporating”) could save you more than the presumed minimal costs used in this example for maintaining your corporation, or you want to explore tax savings that you may or may not experience, you should have the *next* conversation with your tax preparer.

If you have any *LEGAL* questions regarding “incorporating,” you are advised to seek the advice of an attorney.