EPISODE 004

Tax Talk: The Truth About Business Entities

Show Notes Located At: www.SenicaEvans.com/4

Senica Evans: “I'm starting a new business. What's the best way to set it up? Should I set it up as an S-Corp or an LLC elected to be treated as an S-Corp?” Ladies. It's time for us to talk about business entities.

Welcome to Her Chic Business. The podcast helping women business owners build bigger bottom lines, reclaim their time, and end entrepreneurial burnout. I'm your lovely Tax Accountant, Enrolled Agent, and hostess with the mostess, Senica Evans. Ladies. It's time for us to talk. Let's get into it.

On today's episode, number four, of Her Chic Business podcast, I'm spilling the beans and telling the truth about business entities.

But first, this episode is brought to you by Innovative Tax Planning, my service that ensures business owners pay the least amount of taxes legally, ethically, and morally possible. It's time to be proactive, be tax ready and beat Uncle Sam especially since this is the greatest tax overhaul in 31 years. Visit betaxready.com for more info and to get started.

Last week, I did an ask me anything post on my personal Facebook page and this was one of the questions… "*What's better S-Corp or LLC with an S-Corp election*?"

Before I get into the nitty gritty (I think you'll be surprised by my answer by the way) let's look at the basic entity structures. The IRS classifies businesses into three main categories… corporations, partnerships, and sole proprietors. Anything else you've heard of is some derivative of one of those three. Yep… even nonprofits.

So you're probably thinking hold on Senica. *You forgot about LLCs.* Nope. Didn't forget. LLCs are not recognized as an entity type by the IRS. It's actually a state level designation but I'll talk more on that later. Back to the three main types… we have corporations, partnerships, and sole proprietors.

First, we're going to talk about Sole Proprietors or as I like to call them Sole Props. A Sole Prop is the easiest type of business to set up. Depending on the state you're in, you'd file an assumed name certificate or a fictitious name or a DBA, which is doing business as. This allows you to operate as your chosen business name.

Now, sole props do not create a separate business entity. Let me say that again. Sole props do not create a separate business entity. You are your business and your business is you!

<disclaimer> I'm not a lawyer and I don't play one on TV so this is for informational purposes only it cannot be deemed as legal advice </disclaimer>

If someone were to sue your business and you operate as a sole prop your personal assets are open to be included. So if you have a major snafu… let's say… someone sues you, your house is on the line. This is what a sole prop does but when it comes to taxes, my

zone of genius, the income and expenses from your business are included and filed with your personal 1040 return via a Schedule C.
You're going to pay self-employment tax on any profits from the business. The self-employment tax rate is 15.3% and it's made up of Social Security and Medicare. So you'll need to factor that into your budget. The caveat here is, not to confuse you, is that you receive an adjustment for half of the calculated self employment tax on your personal or 1040 return.

Now think about when you where an employee, you paid FICA or Social Security and Medicare or however they listed it on your paycheck stub. Your employer matched what you paid. Now, as a self-employed person you are responsible for both parts -- the employer and employee. It's all on you. But the government was nice enough to give you an adjustment of half of the calculated self employment tax but it looks real funky on your return because you're probably like *I've never seen that*.

The first page of your 1040 shows it being subtracted from your income as an adjustment. The second page shows a total amount of the tax that's due. The first page gives you the adjustment. The second page gives you that total tax. So enough about sole props let's go on to partnerships.

Partnerships come in a few different varieties. There is a general partnership, limited partnership, and limited liability partnership. Now I'm keeping it basic on this episode so I won't take you down the whole partnership rabbit hole. Not today. So what you need to know here is that when two or more people come together with the intent to make money... to have a business... a partnership is formed... which is basically what a general partnership is. Now of course, with a limited partnership and a limited liability partnership you have to file paperwork with your secretary of state.

Again, I'm not going to get all into this on this episode. Warning! I have to give you a warning for the vocabulary lesson ahead. When it comes to taxes, partnerships are what's called a disregarded entity and that basically means the business is separate from the person. Except for when it comes to taxes. So the taxation of the business profits takes place on the owner's personal return. This is commonly referred to as a pass through entity. I'm sure we've all heard that term before.

The profits and losses of the partnership show up on a schedule E on your personnel return as a partner. You receive a schedule K1 from the partnership to file with your personal taxes. A schedule K 1 is what a W2 is to an employee that shows your portion of the profits or losses in the business. Okay and as a partnership or a partner in the partnership you're still going to pay self employment tax. The amount the taxes are based on, so your tax base, it all depends on the type of partner you are... if you get guaranteed payments... the share of the profit... It all depends on the type of partner that you are. Again, we're not getting into partnerships today. So now let's get into corporations.

So like partnerships, corporations have options and can be classified as either a C Corp or as an S Corp. There are different flavors, right! So we just learned what a pass through entity was with partnerships. So an S corp is another type of pass through entity.

I like to explain S Corps as an entity that pulls characteristics from partnerships and from corporations, like a hybrid.

Forming an S Corp requires you to file Articles of Incorporation with your secretary of state. So you're going to start off as a C Corp. So when you go to Secretary of State and file your Article of Incorporation, you are a corporation at that point. What you have to do next is... you need to tell the IRS you want your business to be treated as an S Corp. You have to file [Form 2553](), sign, and send into the IRS. You'll get a letter back. Now this is making your election to be treated as an S Corp.

So the allure of the S Corp is having the separation of business and personal with none of the double taxation with the C Corp. So just be sure not to commingle funds.

Commingling funds is bad. No mixing business and personal... no dipping into the business account to pay personal bills... like that's all a no-no. We want to keep it separate. Why it's such a big no-no... not to dive off the deep end... but there's a such thing as a corporate veil and if you commingle your personal and business, everything, together where there's no true separation... we can't identify that there's two separate entities there.

You can do what's called "piercing the corporate veil" that's bad because that just means you filing all this paperwork and doing all these things was for naught because there was no true separation that was maintained. So now they're one and the same. You might as well be a sole prop at that point. But I digress. Don't commingle OK.

Now that we talked about commingling, S Corps have a lot more compliance issues to be aware of and reasonable compensation is a huge one. So you must reasonably compensate yourself as you would if you hired someone to do the same work that you do. Now this is the part that trips people up. I see it all the time.

S Corps are seen as a great way to save on the self employment tax. Let me give you a quick example. Let's say as a sole proprietor you have a profit of $100,000 in your business. That $100,000 is going to yield $15,300 self employment tax. And then you still get to pay your ordinary income tax. Now, if you had an S Corp and, just to keep apples to apples, you had the same $100,000 profit. The profit is not going to be subject to self employment tax because you are an S Corp and because we have this pass through entity.

So it sounds like a great plan. Right? Like everybody needs to go and hop on the S Corp bandwagon. You better believe that if we realize that, the IRS is aware of that and has realized that too. So the IRS is a big stickler for making sure S Corp owners take a reasonable compensation. Huge. Big word. So in my scenario above, it's unrealistic that the owner had a $100,000 in profits and doesn't take a salary... like nothing at all. Or they only take a real small salary... Let's say $10,000... that's still considered or can be looked at from a high level as trying to circumvent the self employment tax. Because even if they had $10,000 in salary, they're going to pay their taxes as an employee and employer would on that $10,000. But they're still saving money because they have $90,000 that's not subject to the self employment tax. So it's still a way to kind of circumvent the system, right? The IRS is like, *nope you can't do that*. *So we're going to combat that by doing reasonable compensation audits.* That's a big deal. So you want to make sure that you are reasonably compensating yourself. Otherwise you risk the red flag going off.

Okay so let's get into C Corps real quick. C Corps have a really bad rep because of the double taxation. That's the first thing I hear whenever I mention corps or corporations. It's always *Oh I don't want to be double tax* but an S Corp is different from a C corp.

There is no double taxation with the S Corp. It's only with the C Corp and C Corps are completely separate entities and they actually have a life of their own. There are, of course, a lot more compliance measures that must be met with a C corp. C Corps are your Nike, Facebook, and Amazon type companies. . Those are all your C Corps just to give you an example. It makes more sense for those bigger corporations to take advantage of the things that are there for C Corps. So C corp owners are either on payroll and or they receive dividends. So there's no self employment tax on the return because it's being taken care of through payroll.

OK… now LLCs… the good part. So LLCs. are also known as a limited liability company which is a state level designation. So you get this LLC designation by filing Articles of Organization with your secretary of state. Each state has their own application, their own forms, and their own fees. So you look at your secretary of state for your specific state requirements.

The number of members in the LLC determines how the business is taxed. So a single member LLC has just one member and is considered a disregarded entity.

We talked about that earlier. So the IRS doesn't recognize LLC. Therefore a single member LLC is taxed as a sole proprietor. A single member LLC is taxed and treated the same as a sole prop.

If there are two or more members in an LLC it's now taxed as a partnership but those are the defaults. When you let the IRS know you are a multi member LLC, they expect to receive a partnership return Form 1065 If you let the IRS know that you have an LLC and you are the only member, the IRS is looking to see a Schedule C on your personal returns.

Those are the defaults. When I say default that automatically makes you (or should make you) think that there must be other options. So as an LLC, you have the option to be taxed as a corporation. You would just fill out the Form 2553 and send it in to the IRS to make that election. And this is where I see lots of confusion. Like a ton of confusion.

When I first met one of my clients she stressed the point that she was tired of feeling like she had to go get a masters degree in accounting just to run her business. She was like this is too much for me. It was a total stressor. Of course, me being me, I reassured her that no master's degree was needed because I can make everything super simple.

One of the issues she had, that was stressing her out, was understanding LLCs. So I said it again and I'm gonna say it now... there's a lot of confusion among business owners and understanding that while the LLC offers limited liability... that's limited liability protection... the business taxes are not separate from the personal.
So you have an LLC, let's say a single member LLC. The business taxes are not separate from the personal. They're together... no different than a sole prop. Unless of course you make the election to be treated otherwise.

So the question at the top of the show... “What's better S Corp or LLC with an S Corp election?”

In relation to taxes, it's the same thing. They are both being taxed as an S Corp and on the state side you may benefit from reduced fees as an LLC and there may be less formalities when compared to a corp. But again that depends on the state. So with all things taxes... I always say, “it depends” because it does.

But the question that was asked was “what's better?” It's the same thing. It's like saying what's better, this red apple or that right Apple. They're still red apples. Pick one. But when we dive into it further then you have to look at what benefits are there on the state level that would make an LLC work for you as the business owner.

There is no one size fits all solution. I am totally against that thought process that everybody needs to be an S Corp. Everybody needs to be an LLC. No everybody does not need to do the same thing. There is not a cookie cutter solution because we're all individuals. We're all different. We all have different goals and objectives and the same thing with our businesses. Our businesses are not all equal. There are a lot of things that make sense on the surface that are similar but our ultimate end goals, objectives, etc. are different and that needs to be addressed.

~~So with that being said is better talk with an accountant or an attorney.~~ Scratch that is best talk with an accountant AND attorney. You've got to get the tax from the accountant and you've got to get the legal from the attorney. You need both. So with that being said. Head on over to senicaevans.com/4 to read the show notes from today's episode, check out my resources, and get more info about my service, Innovative Tax Planning which helps business owners, like you, pay the least amount of taxes legally, ethically, and morally possible. Shoot me an email at info@simplifiedaccount.com if you need any help.

Now go knock this week out the park!

Thanks for tuning into Her Chic Business with me, Senica Evans. If you enjoyed the episode and want to find out more please visit senicaevans.com Don't forget to like love, applaud, share and leave a review. It will help me help you. Join us next week for another new episode of Her Chic Business Talk to you soon.