



Introduction

Choosing to incorporate your business is an important decision that can provide major benefits to your tax situation – benefits that proprietorships and general partnerships don't get. As your business moves forward into incorporation, this overview will provide you with helpful information on tax savings, ease of transfer and more.

Tax Savings

- **Reduction in Self-Employment Tax.** When you operate as a sole proprietorship, your first \$102,000 of earnings for tax year 2008 is subject to self-employment taxes (Social Security and Medicare), which is currently a combined 15.3%. With a corporation, only salaries are subject to such taxes. By allocating a corporation's earnings between a reasonable salary and profit, you can generate significant tax savings. For example, if you earn \$80,000 as a sole proprietor, you would pay self-employment on all \$80,000. However, if you are incorporated and took \$35,000 in salary, the remaining \$45,000 in profit would NOT be subject to the self-employment tax. With an S-corporation, this saves you over \$5,000.
- **Medical Expenses.** C-corporations can offer a medical reimbursement plan for their officers, employees and owners, which allows you to deduct medical costs not covered by insurance. With a sole proprietorship, medical reimbursement plans may cover employees, but not the owner. Therefore, unreimbursed medical expenses are deductible only if they exceed 7.5% of Adjusted Gross Income.
- **Retirement Plans and Fringe Benefits.** There are a number of fringe tax benefits which favor corporations over sole proprietorships. For example, corporate tax-deferred retirement plans, such as defined contribution and defined benefit plans can be more flexible and can have higher contribution limits. Corporations are also allowed to pay for (and deduct) certain childcare expenses, term group life insurance premiums, group disability insurance premiums and certain travel expenses associated with directors' and shareholders' meetings.

Ease of Transfer

Corporate ownership interests can generally be sold to third parties without disturbing daily operations. The business of a sole proprietorship, on the other hand, cannot be sold as a whole. Instead, each of its assets, licenses and permits must be individually transferred. A new bank account and tax identification number would be required.

Other Benefits

On top of the numerous benefits listed above, the corporate form has other distinct advantages. Typically, it's easier to raise money if your business is incorporated. A corporation also gives your business legitimacy when dealing with other companies, banks and potential partners.



Example of Tax Savings

The following chart illustrates some of the tax benefits that can be achieved by incorporating:

John, who is married, operates a sole proprietorship that earns \$80,000 per year. If he incorporated, assume that John would take an annual salary of \$35,000. For this illustration, assume no state income tax and 2008 tax rates.

	Sole Proprietorship	S-corporation
<u>Income:</u>		
Salary	\$ 0	\$ 35,000
Profits	\$ 80,000	\$ 45,000
GROSS INCOME	\$ 80,000	\$ 80,000
<u>Deductions:</u>		
½ of Self-Employment Tax	\$ 6,120	\$ N/A
½ Social Sec. & Medicare	\$ N/A	\$ 2,678
TOTAL DEDUCTIONS	\$ 6,120	\$ 2,678
ADJUSTED GROSS INCOME	\$ 73,880	\$ 77,322
<u>Taxes Paid:</u>		
Self-Employment Tax	\$ 12,240	\$ N/A
Social Security & Medicare	\$ N/A	\$ 5,355
Income Tax	\$ 11,945	\$ 12,805
TOTAL TAXES PAID	\$ 24,185	\$ 18,160
TOTAL TAX SAVINGS		\$ 6,025

The decision to incorporate your business should not be solely based upon this article or other information found on this website. There are many factors to consider regarding what entity structure you should operate your business under as each situation is unique. You should engage all of your trusted business advisors – legal, accounting or others, to determine the best structure for your situation.