



PDHonline Course G469 (2 PDH)

Owning and Operating a Small Engineering Company

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ATTACHMENT A

Incorporating Your Business

Tax Factors to Consider

By [William Perez](#), About.com Guide

Sole proprietors are unincorporated businesses. They are also called independent contractors, consultants, or freelancers. There are no forms you need to fill out to start this type of business. The only thing you need to do is report your business income and expenses on your Form 1040 Schedule C. This is the easiest form of business to set up, and the easiest to dissolve. (An LLC with only a single shareholder, a so-called single-member LLC, is taxed as a sole proprietor on a Schedule C.)

Corporations are incorporated businesses. Every form of business besides the sole proprietor is considered a separate entity, and this often provides a measure of legal and financial protection for the shareholders. The shareholders of corporations have limited liability protection, and corporations have full discretion over the amount of profits they can distribute or retain. Corporations are presumed to be for-profit entities, and as such they can have an unlimited number of years with losses. Corporations must have at least one shareholder.

Partnerships are unincorporated businesses. Like corporations, partnerships are separate entities from the shareholders. Unlike corporations, partnerships must have at least one General Partner who assumes unlimited liability for the business. Partnerships must have at least two shareholders. Partnerships distribute all profits and losses to their shareholders without regard for any profits retained by the business for cash flow purposes. (LLCs are taxed as partnerships, unless they choose to be taxed as corporations.)

S-Corporations have features similar to a partnership. An S-corporation must have at least one shareholder, and cannot have more than 100 shareholders. If any shareholder provides services to the business, the S-Corp must pay that shareholder a reasonable salary. This salary is a separate payment from distributions of profits or losses.

As mentioned above, sole proprietors, S-corporations, and partnerships are taxed at the shareholder level. Corporations, however, are taxed at the corporate level.

S-Corporations can be owned by a single person, and so the IRS expects S-Corps to pay a reasonable salary to the managing shareholder in addition to a profit distribution. Naturally, I am inclined to pay myself more as profits and less as salary in order to minimize the payroll taxes (Social Security and Medicare taxes) that are due on salary. The IRS is aware of this situation and is on the lookout for it. The IRS expects S-Corps to pay reasonable compensation for the services of the officers. "Reasonable compensation" can be interpreted in different ways. But it means what you would expect to be paid if you were hired by someone else.

Partnerships and Limited Liability Companies are taxed at the shareholder level, much like an S-Corp. The IRS, however, has not demanded that partnerships pay a reasonable salary to managing shareholders. General partners in a partnership are considered self-employed, and their share of profits are subject to the self-employment tax. Limited partners, however, pay self-employment tax only on "guaranteed payments" for services rendered to the partnership. Every partnership must have at least one General Partner. LLCs, however, can be composed of shareholders who designate all management responsibility to salaried employees. Thus on an LLC, shareholders would not be subject to self-employment tax unless they receive a "guaranteed payment" for services rendered to the LLC. (See IRS Publication 541, Partnerships, Partner's Income or Loss.)

Schedule C Sole Proprietors are taxed on their 1040. The entire business profit is considered self-employment income, and is reported on a Schedule C. As a Schedule C business, you do not pay yourself a salary. Only salaries and payroll taxes paid for other employees are allowable business expenses.

C-Corporations are taxed separately from their shareholders. Any salary paid to yourself is deductible as a business expense to the C-Corporation. Also, if the C-Corp distributes dividends to the shareholders, the dividends are taxed at a special "qualified dividends" tax rate of 15%. Dividends from a corporation are taxed twice, once at the corporate level and again at the shareholder level. Since the corporation has already paid tax on its earnings, this distribution qualifies as a "qualified dividend" at the lower 15% tax rate. On my 1040, I pay only 15% tax on these dividends.

C-Corporations are the *only* business that can split profits between retained earnings and dividends. S-Corps and Partnerships must report all profits as a distribution, even if the business has retained some of the cash for next year's operating expenses. The ability to choose when and how much you are taxed by controlling when and how much money is distributed is a crucial tax advantage for C-Corporations. This means that there is more flexibility with a C-Corporation to pick your tax rate than there is with the other options. However, S-Corps, partnerships, and Schedule C businesses are easier to set up and operate.