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4545 Mount Vernon Street, Houston, Texas 77006

713-461-9699 • Toll-free Fax: 1-866-274-8369

www.WealthKeepers.net

Should My Business Be an S Corporation?

James C. Mulder
jcmulder@wealthkeepers.net

As I have stated on many occasions, my preferred entity to operate a business is an LLC. The primary reason is that it will protect an owner's creditors from actually getting control of the business and perhaps liquidating it to satisfy the owner's creditors. Another reason is the simplicity with which it can be operated. No annual minutes requirement, for instance. Another reason is that under federal tax law, the owners of an LLC can make an election to have it taxed as a corporation for federal income tax purposes.

There are two tax types of corporations, C and S. A C corporation has its own tax bracket. Depending on whether the business is a personal service business or otherwise, the tax brackets can be a flat 35% or range from 15% on taxable income from \$0-50,000; 25% on taxable income from \$50,000 - \$75,000; 34% on taxable income from \$75,000 - \$100,000; and 39% on taxable income from \$100,000 - \$335,000. An S corporation does not pay tax at the entity level. All taxable income is passed through to the owners in proportion to their ownership.

An LLC that makes an election to be taxed as a corporation and then makes an election to be taxed as an S corporation can allow for some tax planning. An LLC that does not make such an election will be taxed as a sole proprietorship if there is only one owner (including a husband and wife in a community property state like Texas) or it will be taxed as a partnership if there are more than one owners. This means that all of the net profits of the business will be earned income and all will be subject to the 15.3% self employment tax up to \$102,000 for 2008 and 2.9% on anything above \$102,000. This is the owner's version of social security or FICA taxes. To an employee his or her "self employment" taxes are withheld in the form of FICA and the employer pays ½ and the employee pays ½. A business owner that is taxed as a sole proprietor or partner is not an employee and is taxed on the profits of the business with the same total percentage. And I don't need to add that this is in addition to the income tax on the profits.

There is an opportunity to reduce the amount of self-employment taxes paid, but it can only come if the owner is an employee. In order for an owner to become an employee, the business must be taxed as a corporation. If it is a C corporation, and you limit the compensation of the owner-employee to say 75% of what he or she was getting as earned income in the past, the corporation will pay corporate tax on the 25%, or if it is distributed to the owner-employee, the corporation will pay tax on the 25% anyway and the owner will pay a dividend tax on the distribution. This is what is commonly referred to as double taxation. On the other hand, if the business makes an election to be taxed as an S corporation, the 25% not paid to the owner employee will be taxed to the owner(s) based upon their ownership. This 25% will not be subject to self-employment taxes and is considered unearned income.

Depending on the amount of earnings in the past, much in the way of self-employment taxes can be saved. For instance, if a sole proprietor who had earned \$100,000 in 2007 formed an LLC and made an election to have it taxed as a corporation and then made the S election and decided in 2008 to pay himself a salary of \$75,000. If he earned the same \$100,000, his tax would be \$3,825.00 less in 2008. This is because \$25,000 would not be subject to the 15.3% self employment or FICA taxes.

So, you say, how about just paying myself \$10,000 as a salary and save \$13,770? Well as my first law partner always said, "Pigs get fat, Hogs get slaughtered". You must pay yourself a reasonable wage. How much that is is in the eye of you, your accountant and the IRS.

Other considerations are the extra reporting requirements, 941, 940 and Texas Workforce Commission. You also have to provide a W-2 and file it for the owner. The accountant will probably have more costs, since there will be a corporate tax return also.

So, should you make your business an S corporation? I don't know. I like to educate my clients well enough so that they make the decision. We offer a 1-hour initial conference at no charge to discuss your asset protection issues, which includes the topic of this article. At the end of that conference we can usually quote you a fixed fee to prepare your asset protection plan and can offer you common fees of attorneys experienced in the preparation of the legal structures needed to implement your plan.

James C. Mulder is an attorney with over thirty years of experience in Wealth Transfer, Tax and Asset Protection Planning. He is Board Certified in Estate Planning and Probate Law and in Tax Law by the Texas Board of Legal Specialization. He is one of only fifteen attorneys in the Houston area that are Board certified in both Estate Planning and Probate Law and Tax Law. Mr. Mulder concentrates his practice in Wealth transfer, tax, and asset protection planning. The implementation of such planning includes the preparation of very comprehensive wills, trusts, business organizations and family partnerships. Mr. Mulder has prepared over 1,000 asset protection plans.