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Some Federal, State & Employment Tax Considerations When Deciding on A Business Entity (LLC, Corporation or Sole Proprietorship)

The amount of taxes that you have to pay is one of the key reasons that individuals select one business entity type over another. The term “tax” though is a bit too general for a business as “tax” could refer to federal tax, state tax, city tax, social security tax, health care tax or sales tax. These taxes are confusing to even the very well informed but we will attempt to simplify them by examining why some people opt for an LLC when deciding on a business entity. Before you continue, you should refresh your memory of the different types of business entity options for an individual who wants to start his/her own business and you can see this article here. Now that your memory has been refreshed, we will use the LLC business entity to better explain some of the tax impacts of the different entities.

What Is A Limited Liability Company?

A LLC is a relatively new business entity that was established to offer the business owner limited liability protection while addressing the problems of corporate formalities. Instead of holding meetings and creating bylaws, an LLC owner or owners can create a flexible operating agreement. This agreement simply explains how the LLC will operate and describes the various roles and responsibilities of the members.

How Is A LLC Taxed?

Federal Taxes

If you are a LLC with one member, although the LLC is a separate legal entity you do not have to file a completely separate federal tax return for it. In this case, the business owner can complete Schedule C and attach it to his/her personal tax return Form 1040. When the LLC has more than one member, the LLC must be treated as either a corporation or, the more common option, a partnership.

If you set up a Corporation, you are required to file a separate corporate tax return which you will pay tax on and then deal with any dividend distributions and/or salary in your own personal tax return. In terms of complexity and cost, completing tax forms for a LLC is far simpler than completing a corporate tax return. Also, for a simple personal tax return that includes the LLC aspects, accountants will charge approximately \$200 as compared to around \$700 for a corporate tax return and a separate personal return. As the cost of tax preparation is an ongoing cost, it is something that you should consider when deciding on a legal entity.

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Another reason some opt for a LLC is to avoid double taxation. A LLC addresses the problem of double federal taxation as a LLC is a “pass through entity.” This means that all of the earnings in the LLC are taxed as if you earned them personally. This treatment is similar to a corporation that elects “S” Corporation status but electing S status restricts who can own stock and how profits are distributed. Moreover, S status is something that you must file a form with the government for and this again is something that you may seek the help of an accountant or lawyer to do.

State & City Taxes

The tax treatment and what you will have to file for the various business entities differs by State but generally the same advantages that exist for a LLC exist at the State level. One key thing to remember here is that if you file a Federal “S” election (either for the LLC or a Corporation) you often must file BOTH a federal election and a separate State election. For example, in New York, you must file separate forms for a S election (a federal form and a State form) and if you only file one form then your election will only apply to the government branch that accepted your election. If your election is not accepted or you forget to file it, your corporation will be taxed by the State and then you will be taxed again personally once money is distributed from the company.

Another key thing to note when thinking about a LLC v. a Corporation is that some local branches of government may not accept the S election and as a result you will be subject to double taxation. For example, in New York, while you may file a federal and State S election, you may NOT however file a S election for the city as the City of New York does not recognize S status. This means that if you select a corporation over an LLC, your corporation will be required to pay over 9% New York City tax on your earnings before any money is distributed to you. As like anything, it is not quite that simple as New York imposes a “non incorporation” tax that unincorporated entities must pay that somewhat evens this out. You should speak to a qualified accountant or lawyer to see exactly how your State and City handle taxation as it relates to a business entity as the practices are vast and confusing.

You should also ensure that you are complying with annual and quarterly filings as interest and penalties can really start to add up if you miss deadlines.

Payroll Employment Taxes

There can be a downside related to payroll taxes if you set up a LLC. One disadvantage is that a LLC is subject to self-employment taxes on all of the income earned.

Payroll taxes (over 15% for social security and Medicare) make up a big part of taxes that both a Corporation and a LLC have to pay. (As an employee, you are only required to pay half of the 15% and the employer pays the other half). As a business owner though, you pay the full amount and the amount you pay will be different depending on whether you are a LLC or a Corporation. Here is a brief and simple example. An entity (LLC or Corporation that elects S status) makes \$100,000 and the owner assigns themselves a salary of \$60,000 (salary must be reasonable in order not to be subject to tax). When this occurs, let us say that the business owner picked a Corporation and S status was elected. In

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this case, the owner will only have to pay self-employment tax on the \$60,000 rather than the full \$100,000. Do not confuse self-employment tax with income tax as income tax is paid on the full \$100,000 and this cannot be avoided. If the owner selected LLC as a business entity, the owner would have to pay the 15% tax on the full \$100,000. Again though, this is not as clear cut as it appears because the LLC can also file and S election and receive the same benefit that the corporation receives. This will limit some of the benefits associated with the LLC as they will be subject to the stringent S status tax rules. Very confusing indeed.

Sole Proprietorship

For simplicity, some still opt to set up a sole proprietorship. This business entity does not provide the owner with limited liability protection but it does avoid double taxation issues. For the purposes of the federal, State and payroll tax matters discussed above, a sole proprietorship is taxed in a manner very similar to an LLC.

Do I Need A Lawyer To Set Up My Business And Guide Me?

Yes and in most cases and Accountant too. Well guess what, at Scott Legal Services, P.C. you have both as our founder Ian E. Scott is a qualified C.P.A and a Lawyer! While you do not have to hire a lawyer to set up a business, the choice of business form has significant tax, financial and liability implications that you should carefully consider so that you set up your business the right way. Let **Scott Legal Services, P.C.** be your guide. Also, if you require further assistance, please contact Scott Legal Services, P.C. at 1-212-223-2964 or email us at iscott@legalservicesincorporated.com.

Get Your Free Chart That Summarizes What To Consider When Forming A Business

Confused? No problem, click [here](#) to obtain a **free chart** that summarizes everything listed above in an easy to read and understandable format. There is no obligation and the chart will help you understand this complicated area.