

# Building The Corporate Fortress

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Whether you're a one-person business or have several employees, incorporating can greatly enhance your liability protection and financial situation. This article provides an overview of the benefits to incorporating a business.

The corporation has been referred to as the Ultimate Tax Shelter. When you incorporate, you are able to get all the great money-saving tax advantages that benefit and protect billion-dollar giants like GM, IBM and GE. The corporation can protect you while saving you money and it can help speed the growth of your business.

Using your own corporation to do business, you open up a whole new world of opportunities for increasing your net profit through proper tax planning. Your corporation can also protect you personally from liability for problems involving corporate assets or employees.

Let's look at why you should incorporate. Risk is what business is all about. From the beginning, corporations were chartered by states to provide business owners with protection from liability. The states recognized that by eliminating some of the risk of personal loss, more people would be willing to create and grow businesses. So, personal liability can be avoided for business activities conducted in our corporation.

The owners of a corporation are referred to as shareholders. When the corporation is properly run, shareholders are not liable for corporate actions, even if they own 100% of the stock. Only the assets in the corporation are at risk if the corporation is sued. The shareholders' personal assets remain safe behind the corporate shield.

The victim of an accident caused by a corporate employee can obtain a judgment against the corporation and the employee personally. But the victim cannot get a judgment against a corporate shareholder personally, unless the shareholder was also the employee who caused the accident. If an employee feels the employer has wronged him, he may obtain a judgment against the corporation, but not against the shareholders. This is also true for someone is injured on property owned by the corporation, they can only get a judgment against the corporation, not the shareholders.

Run properly, the corporation protects the shareholders personally in each of these situations. Only the shareholder's investment in the corporation is at risk.

Though the regular (also referred to as the C corporation for the section of the Internal Revenue Code that describes it) has been around for over 100 years, the S corporation was first

recognized in the 1950's. The S status exists only for tax purposes; otherwise, the S and C corporations are identical. The liability shield for both the S and C corporation provide exactly the same protection, but their tax treatment is significantly different.

A C corporation can provide significant benefits, such as medical insurance and medical reimbursement plans for all employees, including employees who are also shareholders. These expenses are 100% deductible to the corporation and not included in employee's income. The C corporation is a separate taxpayer and pays tax on its net income. The tax rate starts out at 15% on the first \$50,000 of profit, which can be an advantage. Unfortunately, any dividends paid out of a C corporation are not deductible to the corporation, meaning that the corporation pays taxes on them. Then the shareholders must pay tax again on these dividends on their personal returns. If you need the benefits of a C corporation, limit the corporate earnings to just what is need to provide the benefits with very little left over. Thus there is little left in the corporation to tax.

If you don't need the benefits of the C corporation, the S corporation is for you. An S corporation files a tax return, but does not pay taxes. Each shareholder pays tax individually on the net profits proportional to their ownership, even if those profits are not distributed.

Keep in mind that the corporation should be used for business activities, not for long-term hold property. There is almost never a good reason to hold investment property in a C corporation. The reason is that the maximum long-term capital gains rate for the C corporation is 35%. This tax must be paid on the retained earnings of the corporation before these earnings can be distributed to the shareholders as dividends. Once distributed to each shareholder, these earnings (dividends) are taxed again on the shareholder's return.

An S corporation solves this problem by allowing the sale of assets to be taxed only once on the shareholder's personal return, but losses are limited by the shareholder's basis in the S corporation. Since this problem is essentially solved by the limited liability company (LLC), the LLC is typically the best way to hold long-term investment property.

But, if you buy real estate as a sole proprietor with the intent to re-sell (property you flip or quick turn), the property is considered dealer property for tax purposes. This is also true for builders and developers. Since the IRS considers these activities as business activities, a sole proprietor will pay self-employment tax of approximately 15% on the net profit. So, if the net profit from business is \$60,000 and you are reporting on your personal tax return as a sole proprietor, you will owe \$9,000 in self-employment taxes in addition to regular income tax.

If these same transactions were done inside an S corporation, you may only pay yourself

a \$20,000 salary. Between you and your S corporation, you would pay only \$3,000 in employment taxes, **saving \$6,000!** The remaining \$40,000 earned in the corporation is distributed to you without any corporate level tax, just your personal income tax and free of any employment taxes.

Keeping your dealer properties separated from your investment properties will also help prevent the IRS from trying to reclassify any investment property as dealer property. Such a reclassification can cause a significant loss of tax benefits, such as: no depreciation deductions, 1031 exchanges not allowed, no installment method of taxation, and rental income subject to self-employment taxes.

The next question many real estate entrepreneurs ask is where they should incorporate. The first corporation you form should be in the state where you are doing business. You may also be wondering if you should file for the corporation yourself or hire an attorney. An attorney will charge anywhere from \$500 to \$800 plus the cost of the state filing fees. With the right information, you can file the correct paperwork with the state and complete all the corporate documents yourself.

One area that even many attorneys neglect is the initial corporate meetings and formalities. These are extremely important, since without them you do not have a valid corporation. There is a continuity that must be maintained from the forming of the corporation through the appointment and functioning of the Board of Directors and Officers.

Once properly incorporated, you are required to hold annual meetings of the shareholders and directors and to record the minutes of those meetings. An attorney will charge from \$150 to \$300 to conduct and complete the minutes of these meetings. Once again, with the proper instruction, you can hold these meetings and complete the minutes or resolutions yourself.

Forming and running your own corporation is actually quite simple. Certainly, you can handle all the required tasks yourself. Doing it yourself provides you not only with a significant cost savings, but assures you that everything is done just the way you want it.

Whether you're in a one-person business or have several employees, incorporating can tremendously enhance your financial position—both in asset protection and the minimizing of taxation. Because of the significant tax benefits of a corporation, even long-term hold investors should consider having a corporation for managing their properties.