

INC. VS LLC

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So you have a brilliant idea for a business. Every detail has been carefully planned from marketing to financing. Your lifelong dream of being your own boss will soon be realized. There is, however, one very important decision that must be made before your business can come to life. It is the choice of entity decision.

Most of us are familiar with corporations, but you may wonder if your business is suitable for corporation status. In recent years, we have heard more about LLCs (Limited Liability Companies), but what is an LLC? More importantly, what are the differences between corporations and LLCs, and why might you choose one over the other?

Background on These Business Entities

Corporation

A corporation is an entity separate from its owners formed through compliance with state incorporation statutes. A corporation can be closely held with only a few shareholders or publicly held with shares sold on the open market. The shareholders elect directors, and the directors elect officers. The officers and directors, who need not be shareholders, manage the corporation.

A corporation is taxed separately from its owners on income. When accumulated profits are distributed to shareholders as dividends, the shareholders are further taxed on the dividends. Hence, earnings distributed to shareholders are taxed once at the corporate level and a second time at the shareholder level. This is what is commonly referred to as the double-taxation of corporate earnings.

S Corporation

An S corporation is a special type of corporation for federal income tax purposes. All shareholders must consent to the S corporation election. The election results in corporate level income being treated as received directly by the shareholders regardless of whether a dividend is actually paid. Therefore, the corporation has no income tax consequences and no double-taxation occurs.

Not every corporation is eligible for the election. Some of the most noteworthy limitations are that an S corporation cannot have more than 75 shareholders and it may have only one class of stock.

LLC

Like corporations, LLCs are formed and operated pursuant to state statute. LLC members can participate directly in management or designate certain members or nonmembers as managers. LLCs are hybrid entities providing protection for members from personal liability for the entity's obligations while traditionally, and still commonly, they are taxed as partnerships. This means that, like the S corporation, LLC members are taxed on the LLC's earnings regardless of whether they are distributed.

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S Corporation vs LLC

While the S corporation and LLC have similarities, they also have distinct differences. An LLC is not limited to 75 shareholders as the S corporation is. Also, certain taxpayers are prohibited from holding stock in an S corporation, but no such limitation exists for an LLC. In addition, an LLC may have more than one class of stock.

Contributions and distributions of property are also treated differently for S corporations and LLCs. Generally, a member has no gain or loss on the contribution of property to the LLC. In contrast, a contribution of property to a corporation (including the S corporation) is a taxable event for the shareholder unless the shareholder is in control (80% total combined voting power) immediately after the contribution. Distributions of appreciated assets are treated similarly. Such a distribution to a shareholder of a corporation will trigger gain recognition at the corporate-level. However, an identical distribution will trigger no gain to an LLC.

Classification as an S corporation is preferable if the entity contemplates going public and desires to avoid the intermediate step of converting from an LLC to a corporation. In addition, S corporation status increases the potential for engaging in nontaxable corporate reorganizations.

An S corporation is more attractive than an LLC when a corporate charter is a prerequisite imposed by the regulators of some trades or businesses if LLCs do not meet the requirements. Another disadvantage of LLCs is the lack of ease in issuing LLC interests in capital markets as compared to traditional stock.

Limited Liability

A corporation is liable for its debts out of its own assets. Shareholders are not personally liable for corporate debts beyond their investment in and financial commitment to the corporation.

Members of LLCs enjoy the same protection from personal liability. This applies even to members who participate in management. Protection from liabilities while participating in management is one of the most attractive features of LLCs.

Expense and Complexity in Forming and Operating

Corporations are the most expensive entity to organize and operate. A corporation must prepare and file a certificate of incorporation, prepare articles of incorporation and bylaws, pay filing fees, and comply with statutory procedures such as an organizational meeting of incorporators or directors. If a corporation does business in more than one state, it must obtain a certificate of authority from and maintain a resident agent in those states. Formation and operation of an S corporation is no less complicated.

An LLC is organized by filing articles of organization with the state. Additionally, an LLC normally has an operating agreement, although not required to be in writing in all states, specifying how the organization will be managed.

Flexibility in Management

The members of an LLC have flexibility in management. Most states permit members to choose between management by the members or management by one or more managers who are appointed by the members. Typically, management by the members is the default provision unless stated differently in the articles of organization or operating agreement.

A corporation's management structure is rigid. The shareholders elect the directors, and the directors elect the officers. The directors and officers manage the corporation, and they need not be shareholders.

Taxation of Income

Consideration of how the business income will be taxed is important. Regular corporations are taxed at the entity level whereas S corporations and LLCs are taxed at the shareholder or member level. Therefore, one must consider the differences between the corporate income tax rates and the individual income tax rates. There are also variations in the filing requirements of the entities. All corporations must file a tax return without regard to the corporation's gross income. Returns are generally due on March 15.

An LLC with a single member is disregarded as a separate entity for federal tax purposes unless it is classified as a corporation. This means that the member will include the LLC income on her Form 1040 Schedule C. Under the "check the box" regulations, an LLC with two or more members is classified as a partnership for federal tax purposes unless the LLC elects to be treated as a corporation. If taxed as a partnership, an LLC does not file a federal income tax return. Rather, the income flows through the LLC directly to the members. The members then include their proportionate share on their individual return. Individual income tax returns are generally due April 15.

Distributions of Cash

Distributions from regular corporations are considered dividends if they are from the corporation's earnings and profits of either the current year or a prior year. Distributions not treated as dividends are considered a return of investment and are not taxable but reduce the shareholder's basis in her stock. After the shareholder has fully recovered her basis in her stock, distributions are treated as capital gains.

S corporation shareholders and LLC members are currently taxed on the income of the entity, and as a result, their basis in the stock or membership increases. Cash distributed from previously taxed income is not taxable to the shareholders or members. Rather, the basis in the stock or membership is reduced by the cash distribution. Once the basis is used up, cash distributions are taxable as capital gains.

Transferability of Interests

Most state statutes provide that a member of an LLC may assign her interest to a nonmember, but the assignee does not become a member and has no right to participate in management unless the other members unanimously consent to the transfer. Without consent, the assignee is only entitled to receive the member's share of the profits.

A corporation, on the other hand, has free transferability of interests. A shareholder is free to sell, gift, or pledge her stock. Transferability may be limited by contractual restrictions (e.g., pursuant to a buy-sell agreement) or by applicable state or federal securities laws.

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