

# THE LLC VERSUS THE S CORP

*Criteria you can use to determine which is better for your new venture.*

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Limited liability companies (LLC) and Subchapter S corporations (S Corp) are at the forefront of the dizzying array of entities in which new ventures are structured. However, it may be a surprise to learn that organizational flexibility, tax planning and exit strategy drive the choice of entity for a new venture far more than incorporating simply to limit personal liability. By understanding how LLCs and S Corps work and the organizational flexibility, tax planning and exit strategy issues involved, owners can determine which entity is a better choice for a particular venture.

An LLC is a hybrid between a corporation and a partnership. The LLC owners are usually called members and they enjoy limited liability like shareholders in a corporation. Unlike a corporation, however, an LLC with one member is completely disregarded for tax purposes and an LLC with two or more members is usually treated as a partnership for tax purposes. This means that the LLC itself pays no taxes, the taxes are shown only on the tax returns of the LLC's individual members. LLCs may be operated by members themselves or managers who are comparable to a board of directors.

An S Corp is a corporation that makes an election under subchapter S of the Internal Revenue Code such that the profits, losses and other tax attributes of the corporation are passed through directly to the shareholders on their tax

returns. Although the taxation of LLCs and their members may seem similar to the treatment of S Corps and their shareholders, there are important differences that affect the choice of entity in a specific case. For instance, S Corps may only have up to 100 shareholders, and may only be owned by U.S. citizens or certain trusts. Thus, corporations and partnerships cannot be S Corp shareholders. S Corps, furthermore, may only have one class of stock (although there can be differences in voting rights). Other than the differing tax treatment, the S Corp functions just like a corporation with shareholders, directors, officers and corporate minutes.

The LLC's organizational structure is far more flexible than the S Corp. An LLC may contain several different classes of stock while an S Corp may have only one class. More importantly, an LLC is not required to distribute profits and losses to its members on the basis of their ownership percentages so long as they can justify a different economic arrangement to the IRS. For example, one owner may contribute start up capital and the other possesses the management skill to run the business. They may decide that each of them own half the business but they intend to distribute profits such that one owner receives 70 percent of the profit until his initial start up capital is repaid to him and thereafter the parties split profits equally. An S Corp would require that profits in this

example be split equally since both parties own half the shares. In short, the LLC is better able to satisfy the needs of parties who wish to tailor their economic arrangements as opposed to basing profits and losses using the conventional stock ownership approach.

For example, in a real estate development joint venture, the parties may prefer the flexibility of allocating profits and losses that the LLC affords. On the other hand, a real estate management company might favor the S Corp approach because they do not require flexibility in allocating profits and losses and value more highly the S Corp tax savings discussed in the following paragraph.

Tax planning is another key in choosing the proper entity for the transaction. In real estate transactions where the entity's job is to simply hold real estate, the LLC is usually the best entity choice because the tax treatment of the appreciating real estate assets when you liquidate the LLC may outweigh all other considerations. In a management company situation, however, the choice is not as clear cut. An S Corp can save its owners thousands of dollars in self-employment taxes that the LLC cannot. The LLC owner who is an active employee is taxed on 100 percent of the revenues generated from the business. The S Corp owner/employee, however, can receive the profits from the S Corp in the form of a salary and a dividend. Under the tax laws, only the salary is subject to the self-employment tax while any dividends are not. For example, if the business generated \$100,000 in profit during a tax year and the owner/employee receives \$50,000 in salary and a \$50,000 dividend, the LLC owner would pay the 15.3 percent self-employment tax on all \$100,000 while the S Corp owner/employee would only pay the self-employment tax on the \$50,000 in salary. The S Corp owner/employee would not pay the 15.3 percent tax on the \$50,000 dividend and save \$7,650 in taxes. Before you think you can avoid the tax altogether by just receiving a dividend and no salary, the IRS will recharacterize dividends as salary if it believes the salary is too low. A good rule of thumb for owners to use on this issue is to set a salary for himself comparable to what he would pay to hire someone else to perform the job. Before choosing the S Corp, however, an owner must consider if this tax benefit outweighs the LLC's benefits in terms of its organizational flexibility and its prof-

it and loss distribution.

Some accountants recommend that treating an LLC as an S Corp for tax purposes gives the client the best of all worlds regarding LLC flexibility and S Corp self-employment tax savings. This strategy, however, often fails to consider how easily the LLC operating agreement may contain provisions that result in the termination of the LLC's S Corp election. For example, an LLC treated as an S Corp for tax purposes with an operating agreement that allocated profits and losses on some basis other than straight stock ownership, or which permitted ownership by a non-qualifying S Corp shareholder, would likely result in the inadvertent termination of the S election. The consequences of that S Corp termination are additional tax liability, a potential IRS audit and associated fines.

The final issue an owner must consider is their exit strategy is for their business. For example, if an owner's goal is to obtain venture capital financing you usually want to start out as an S Corp or a regular corporation. The reason for this is that venture funds rarely invest in LLCs treated as partnerships because such an investment requires that the venture fund report income on its K-1 partnership tax return and also entails reporting obligations to its investors. On the other hand, if an owner is buying real estate and developing it to sell to someone, the LLC's organizational flexibility and ability to distribute profit and losses without entity level tax generally makes it the best vehicle for such a project.

At the end of the day, choosing the right entity requires a high wire act of balancing the conflicting interests of organizational flexibility, tax efficiency and your exit strategy. While this article gives you general guidelines, each entity choice must be tailored to each situation and the parties must pick and choose how they value organizational flexibility versus tax efficiency while keeping an eye on the not to distant exit strategy. Consider these issues very carefully at the outset because turning a blind eye to them can cause organizational problems or the loss of hundreds of thousands of dollars in lost profit to the tax man later.

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