

## Should I form an S-Corporation or an LLC?

When looking for a company form where all the investors enjoy limited liability an entrepreneur has three obvious options, a C Corporation, an S Corporation or a Limited Liability Company (LLC). Oftentimes the entrepreneur opts not to form a C Corporation due to the fact that earnings are taxed at the corporate level and distributions to the shareholders are taxed at the individual level, resulting in the 'double taxation' of C Corporation earnings. Once an entrepreneur determines that the C Corporation is out of the question the next dilemma is whether the business is best suited to be an S Corporation or an LLC.

There are a number of similarities between an S Corporation and an LLC. These similarities are listed below:

- Limited liability for shareholders/members
- Must file with the state and pay a filing fee
- The entities exist perpetually unless otherwise provided in the articles of organization or operating agreement
- The income and losses from the entity flow through onto the shareholders'/members' tax return and are taxed at an individual level

Because of the many significant similarities, the two forms are often confused with each-other and the more subtle differences are ignored during the decision making process. However, it is critically important to consider the differences before formation to avoid costly mistakes down the road.

### **Administrative Requirements:**

An S Corporation often has more administrative requirements than an LLC. The S corporation is required to elect a board of directors and/or officers and file annual reports. Also required, are board meetings and minutes for those meetings. An LLC may be more loosely organized and run by the members.

While an LLC is allowed to be more loosely organized and run by the members, it may be in the investor's best interest to clearly define the roles of each member in an operating agreement, especially for the non-managing members. If the members' roles are clearly defined, non-participating members in an LLC will not have to pay self employment tax on distributions; this topic will be discussed in greater detail below. The extra development of member roles required in the LLC

operating agreement may result in just as much administrative effort for an LLC as there is for an S Corporation.

All things considered, even with the added verbiage in the LLC operating agreement, there is a slight advantage administratively to setting up an LLC verses an S Corporation.

## **Self Employment Tax:**

A disadvantage of an LLC is that all earnings are subject to Self Employment tax for participating members. Self Employment tax is basically the same as Social Security and Medicare taxes on salary in how it is calculated. Social security is paid at 12.4% of net income up to the Social Security limit. Medicare is charged at 2.9% of net income of the LLC with no limit. This basically means that there is a 15.3% tax on the first \$107,000 of income and a 2.9% tax after that on all income.

The other disadvantage is that the entire amount of Self Employment tax is paid on the Members tax return. With payroll taxes on salary, half is taken from the paycheck and the employer pays half.

The only exception is for non-participating members which are not subject to Self Employment Tax. For example, an individual that simply holds rental real estate in an LLC would not pay Self Employment Tax on the earnings of the LLC while a business owner actively involved in the operation of their LLC would.

In an S Corporation no shareholder distributions are subject to self employment tax. Therefore, for distributions from an S corporation, a shareholder can save substantial tax on any payments that can be classified as distributions rather than salary. As the IRS realizes that this tax strategy exists, there is a minimum salary requirement for an S corporation that a shareholder must comply with. This is discussed further below.

## **Salary Requirement:**

In an S Corporation the IRS requires participating officers to take a reasonable salary. By taking this salary, the shareholder and the corporation are paying payroll taxes (Social Security and Medicare) basically in place of Self Employment taxes. Careful consideration should be given as to the amount anticipated to be paid to shareholders and the roles of these shareholders in managing the company.

In order to determine the amount of salary that must be taken by a shareholder in an S Corporation, the shareholder must determine an amount that is both



reasonable and economically feasible. Also, the shareholder must be careful to ensure that if distributions are taken after the salary, that the salary is reasonable in respect to the distributions. For example, a doctor operating as an S corporation that has net income before their salary of \$500,000 could not opt to take a \$20,000 salary and take \$400,000 in distributions. The salary in this case must be reasonable and in accord with market value of salaries for similar professionals. On the other hand, a contractor that lost \$100,000 last year and was not able to take any distributions would not be required to take a salary because it would not be deemed to be economically feasible under the circumstances. If the contractor were profitable in future periods, the shareholder should begin taking a salary prior to or at the same time as the shareholder begins taking distributions so as to avoid having the IRS reclassify a portion of the distributions to salary.

The advantage here for the S corporation is that any amounts taken in distributions are not subject to Self Employment Tax. Therefore, if the net income for the entity will greatly exceed that which would be a reasonable salary, the shareholder should consider an S corporation and take distributions after taking a reasonable salary.

## **Members/Shareholders Allowed:**

An LLC is allowed an unlimited number of members and may sell different classes of membership. Furthermore, an corporation may be a member of an LLC. Unlike the LLC, an S Corporation may have no more than 100 shareholders of the same class of ownership and a corporation may not be a shareholder in an S Corporation.

The LLC clearly offers an advantage in this case in the form of more flexibility as to allowed owners.

## **Tax Forms:**

A multi-member LLC will file a form 1065 and each member will receive a K-1 indicating their share of the income or loss. Each member will report the appropriate amount of income and loss from their K-1 on their personal returns (form 1040). If the LLC is a single member LLC the sole member foregoes preparation of the form 1065 and simply reports the income or loss from the LLC on their personal return (form 1040) on schedule C. This creates an advantage for the LLC as there is not the additional cost and administration of a tax return.

All S Corporations file a form 1120S and each shareholder will receive a K-1 indicating their share of the income or loss. Each member will report the

appropriate amount of income and loss from their K-1 on their personal returns (form 1040).

## **Profit and Loss Allocation:**

LLC income and loss is allocated to members based on their percent of capital contributed or their ownership percentage unless otherwise indicated in the operating agreement. When drafting the operating agreement LLC members are allowed to indicate a different ratio of profit and loss allocation, other than the default ownership percentage. This allows members and managers of LLC's a lot of flexibility when planning for allocations of profit or loss when there are different levels of involvement and/or capital investment among the members.

Unlike the LLC, an S Corporation's profits and losses are always allocated to members based on the shareholder's ownership percentage, or number of shares held out of the total shares. Also, distributions from corporations must be made in proportion to ownership of the entity.

## **Summary:**

As described above, there are a number of differences to consider when deciding between an S Corp and LLC. The differences are summarized in the table below.

	S Corporation	LLC
Administrative Burden	Annual report required. Must elect board of directors. Must hold board meetings and maintain meeting minutes.	Fewer requirements; however clear definition of member roles required to avoid SE Tax on distributions to non participating members.
Self Employment Tax	Only salary subject to SE tax for all shareholders. Distributions not subject to SE tax.	Salary subject to SE tax. Distributions to participating members also subject to SE tax.
Salary Requirement	Reasonable salary required. Salary subject to payroll and SE tax.	No salary required.
Members/Shareholders Allowed	Maximum 100 shareholders. Only one class of ownership allowed. Corporations may not be shareholders.	No limit to number of members. Different classes of ownership allowed. Corporations allowed to be members.
Tax Forms	Form 1120 S with K-1 provided to shareholders	Single-member: income or loss reported on member's 1040 Multiple-member: Form 1065 with K-1 provided to members
Profit and Loss Allocation	Profits and losses allocated based on ownership percentage	Profits and losses allocated based on percent of capital contributed unless otherwise



		stated in the operating agreement.
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The decision on whether to select an S Corporation or an LLC when forming a business is a dynamic one with a number of factors to consider. If you have any questions or would like our assistance in navigating these options or any other tax issues that you face, please contact us at [tanya@thecfogroup.com](mailto:tanya@thecfogroup.com) or 775-359-7600. Also, please visit our website for other tax tips and information about our firm at [www.thecfogroup.com](http://www.thecfogroup.com).