



Guiding You Through the Legal Maze.SM

**SHOULD MY BUSINESS BE
AN S CORPORATION
OR A LIMITED LIABILITY COMPANY?**

**© 2015 Keith J. Kanouse
One Boca Place, Suite 324 Atrium
2255 Glades Road
Boca Raton, Florida 33431
Telephone: (561) 451-8090
Fax: (561) 451-8089
E-mail: Keith@Kanouse.com**

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SHOULD MY BUSINESS BE AN S CORPORATION OR A LIMITED LIABILITY COMPANY?

As a business lawyer representing clients starting new businesses or buying businesses including franchised businesses, my client and I will discuss what type of business entity should be formed to own and operate the business. While there are several types of business entities permitted under state law, for the vast majority of my clients, the answer comes down to 2 types of business entities: (i) an S corporation ("S Corp."); or (ii) a limited liability company ("LLC").

An S Corp and a LLC have two major positive advantages in common: (1) each limit your personal liability for the business entity's debts and other obligations to the amount invested by the shareholders/members; and (2) each avoids the double-taxation of U.S. income taxes at the business entity level and at the shareholder/member level. There are no U.S. income taxes paid on the income earned by the business at the business entity level. All income of the S Corp or LLC is deemed to be distributed to the shareholders or members and reported on their personal income tax returns.

However, there are differences and restrictions, and advantages and disadvantages of S Corps and LLCs, which must be analyzed on a case-by-case basis based several factors including: (i) the type of business to be operated; (ii) the laws of state where the business entity will be formed; (iii) the number, state of residency and sophistication of the investors; and (iv) the investors' investment, operating and exit strategies. The following is only a brief summary of the similarities and differences of an S Corp and a LLC and is not to be relied on as legal advice. An accountant should also be involved with the various complex tax issues to minimize your tax obligation.

S CORPORATION

The formation of an S Corp is identical to a regular corporation ("C Corp"), except that an S Corp elects to be taxed under Subchapter S of the Internal Revenue Code by completing and filing IRS Form 2553 with the IRS. There are certain restrictions and requirements imposed on S Corps that do not apply to C Corps that are discussed more in detail below.

If you make the decision to create (incorporate) an S Corp, you will follow the corporation law of the applicable state, usually the state in which the business is or will be located. In Florida, the corporation law is the Florida Business Corporation Act, Chapter 607 of the Florida Statutes. Your attorney files Articles of Incorporation with the appropriate state agency and pays a filing fee. In Florida, the state agency is the Florida Secretary of State's Office, Division of Corporations. There may be other documents that you must file along with the Articles of Incorporation. The law defines the owners of the S Corp as "shareholders."

Once incorporated, the shareholders contribute money or other consideration (capital contributions) to the S Corp in exchange for shares of common stock, usually evidenced by stock certificates. The shareholders elect directors who are primarily responsible for the over-all running of the S Corp. The board of directors appoints officers (President, Secretary, Treasurer, etc.) responsible for the day-to-day operations of the business. As part of the incorporation process, the S Corp's initial directors and shareholders consent to the adoption of bylaws that provide for the management of the S Corp and the regulation of its affairs.

An S Corp can have a sole shareholder that can serve in all capacities as the sole shareholder, director and officer. If there are 2 or more shareholders, the shareholders should consider entering into an agreement among themselves and the S Corp ("Shareholders' Agreement") addressing in writing a number of issues including: (i) the shareholders' respective capital contributions; (ii) personal loans to the S Corp (iii) personal guarantees of the S Corp's obligations to certain third parties such as lenders, landlords and/or franchisors; (iv) what services each shareholder will be providing to the S Corp and the terms of compensation, if any, (v) restrictions on the transfer of shares, (vi) post-death or disability provisions; and (vii) key man life insurance and other matters.

While an S Corp does not pay U.S. income tax, as further discussed below, the S Corp must maintain separate records and file tax returns for informational purposes.

LIMITED LIABILITY COMPANY

A LLC is a relatively new type of entity that is becoming increasingly popular. This is particularly so if you would not qualify as an S Corp because you have an investor that is “ineligible” to be a shareholder in an S Corp or if you contemplate 2 or more classes of investment (for example, preferred stock and common stock), or a different allocation of income, losses, credits and allowances among the shareholders other than proportional allocation.

After you make the decision to create (organize) a LLC, you will follow the limited liability company law of the applicable state, usually the state in which the business is or will be located. In Florida, the limited liability company law is the new Florida Revised Limited Liability Company Act, Chapter 605 of the Florida Statutes. Your attorney files the Articles of Organization with the appropriate state agency and you pay a filing fee. There may be other documents to file along with the filing of the Articles of Organization. In Florida, the state agency is the Florida Secretary of State’s Office, Division of Corporations. The law defines the owners of the LLC as “members.”

Once organized, the members contribute money or other consideration (capital contributions) to the LLC in exchange for membership interests (units), usually evidenced by certificates of membership interests. The members and the LLC adopt an operating agreement (similar to an S Corp’s bylaws and shareholders’ agreement combined) that addresses such issues as: (i) the members’ respective capital contributions to the LLC; (ii) their ownership interests in the LLC and the allocation of profits, credits, losses, and deductions; (iii) personal loans to the LLC; (iv) personal guarantees of the LLC’s obligations to certain third parties such as to a lender, landlord and/or franchisor; (v) creation of a management committee and managing members; (vi) what services a member will be providing to the LLC and the terms of compensation, if any, (vii) restrictions on the transfer of membership interests, (v) post-death or disability provisions: and (viii) key man life insurance and other matters.

DIFFERENCES, RESTRICTIONS, ADVANTAGES AND DISADVANTAGES

The answers to the following issues, along with the input from your accountant, will assist you in making the final decision to be either an S Corp or a LLC.

Limited Liability of Owners of Business Entity. The shareholders of an S Corp have limited liability because their personal liability for the debts and other obligations of the S Corp is limited to the amount they have contributed to the capital of the S Corp in exchange for shares. Likewise, the members of a LLC have limited liability because their personal liability for the debts and other obligations of the LLC is limited to the amount they have contributed to the capital of the LLC in exchange for membership interests. There are exceptions to these rules, such as personally guaranteeing an obligation of the S Corp or LLC like a loan, lease or franchise agreement. The amount contributed to the capital of either business entity affords the shareholders/members a tax basis in their equity interest. In a LLC, any debts of the LLC also increases the basis of some or all of the members and may be advantageous in deducting losses. The same does not hold true for an S Corp.

U.S. Income Taxes on the Business Entity and Its Owners. A C Corp must pay federal income taxes on its net taxable income (currently, 15% of the first \$50,000; 25% between \$50,000 and \$75,000 and 34% up to \$10 million) and state income taxes (5½% in Florida). Then the shareholders must also pay federal income taxes on the corporation's net taxable income, which the C Corp does not retain for working capital, reserves and other business purposes, that is distributed to the shareholders in the form of dividends (maximum 15% rate).

An S Corp does not pay taxes at the corporate level. All of the net taxable income is deemed to be distributed to the shareholders in proportion to each shareholder's proportionate ownership interest in the S Corp even if the S Corp retains some or all of the income for business purposes. Any distributions of income that has been previously taxed to the shareholders can later be distributed by the S Corp to the shareholders free of additional taxation. The losses incurred by an S Corp, which are

common for most businesses during the start-up phase, can also be passed through to the shareholders and used to offset other income, thereby reducing the shareholder's overall tax liability.

The principal advantage of a LLC is that it may be taxable as a partnership for U.S. income tax purposes under the default rules, if properly structured, thereby avoiding double taxation. The Internal Revenue Service has ruled that a Florida LLC is taxable as a partnership. However, state income tax laws vary. A LLC with 2 or more members is classified as a partnership under the default rules but may elect to be treated as a C Corp or S Corp by filing IRS Form 8832 along with IRS Form 2553. Whether the LLC has elected to be taxed as a partnership or as an S Corp, the LLC is not taxed at the business entity level. The terms of the operating agreement govern any distributions to the members. All of the net taxable income or net losses are deemed to be distributed to the members as provided in the operating agreement even if the LLC retains some or all of the income for business purposes. Unlike an S Corp, these distributions do not have to be in proportion to a member's proportionate ownership interest in the LLC. Any distributions of income that has been previously taxed to the members can later be distributed by the LLC to the members free of additional taxation. The losses incurred by a LLC, which are common for most businesses during the start-up phase, can also be passed through to the members and used to offset other income, thereby reducing the member's overall tax liability.

Florida Income Tax on Business Entity – An S Corp usually does not have to file a Florida corporate income tax return unless it pays federal income tax on Line 22c of IRS Form 1120S. A LLC, classified as a partnership for Florida and federal income tax purposes, must file Form F-1065, if one or more of its owners is a corporation. In addition, the corporate owner of an LLC classified as a partnership for Florida and federal income tax purposes must file a Florida corporate income tax return. A single member LLC is disregarded for Florida and federal income tax purposes, so it does not have to file a separate Florida corporate income tax return. However, the income of the LLC is not exempt from tax if a corporation owns the LLC, whether directly or indirectly. In this

case, the corporation must file Form F-1120 reporting its own income and the income of the single member LLC.

Owners of Business Entity - An S Corp cannot have more than 100 shareholders. The shareholders can be individuals (U.S. citizens or resident aliens), estates, charitable organizations and certain trusts. You cannot have corporations, partnerships or foreigners as shareholders. An S Corp may have a wholly owned subsidiary and may elect to treat the subsidiary as a qualifying S Corp subsidiary or QSub. For a LLC, there are no limitations on the number of members. There are no limitations on the types of members. They can be individuals (both U.S. citizens and foreigners), corporations, partnerships, other LLCs, etc. An LLC can be owned by or own another LLC.

Management - An S Corp normally provides for centralized management of S Corp by a board of directors, unless the bylaws otherwise provide for management by the shareholders. A LLC can provide for centralized management by a management committee (managers and/or managing members) or the operating agreement provide for management by the members.

Distributions of Income, Credits, Losses and Deductions - An S Corp can only have one class of stock ("common stock"). However, an S Corp can have voting and non-voting common stock but not preferred stock. Each of the shareholders must report their proportionate share of profits or losses on his or her individual tax returns based on his or her stock ownership interest in the corporation. A LLC may have different classes of membership interest giving priority in distributions to one class before another class. A LLC may specially allocate income, credits, losses and deductions on a disproportionate basis favoring certain members over other members.

Transferability on Interest - The shares of an S Corp are freely transferable, subject to federal and state securities laws and any restrictions contained in a shareholders' agreement or other agreement. The transferee has the same rights as the transferring shareholder. Membership interests in a LLC are generally not freely transferable, as most operating agreements require the consent of the other members to the transfer. A permitted transfer may be subject to the requirements of federal and

state securities laws. Unless otherwise provided in the articles of organization or operating agreement: (a) an assignment of a membership interest does not entitle the assignee to become or to exercise any rights or powers of a member; and (b) an assignment of a membership interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned.

Self-employment Tax –S Corp shareholders/employees attempt to minimize the amount of self-employment taxes by paying themselves “reasonable” salaries for services rendered on behalf of the S Corp. subject to FICA (Social Security and Medicare taxes) on both the employee and employer. The employer’s share is deductible. Any excess profits of the S Corp paid as dividend distributions to the shareholders are not subject to self-employment taxes.

The owners of LLCs (single and multi-member) are treated differently than S Corp shareholders in the payment of employment taxes. If you are a member of a LLC, you are not considered an employee of the LLC. You are considered to be “self-employed.” You do not receive an IRS Form W-2 and there is no withholding from your pay for FICA taxes or Medicare taxes. All income to members is treated as “earned income” and subject to self-employment tax. In 2012, employees pay 10.4% Social Security tax on self-employment income up to \$110,100. The amount will increase to 12.4% on January 1, 2013, if there is no change in the current law. The Medicare rate is 2.9% on all amount earned. Fifty percent of the SECA tax is deductible by the member. Members in manager-managed LLCs may not have to pay self-employment taxes if they are not active in the business.

Creditor Protection – Both a shareholder of an S Corp and a member of a LLC generally have limited liability to creditors of the business entity equal to the amount of capital contributed to the business entity in exchange for the shares or membership interests. However, there is a difference in treatment with respect to a judgment creditor of a shareholder or member that seeks to levy against

the shares or membership interests. A shareholder's shares evidenced by stock certificates are subject to levy by a judgment creditor of a shareholder. The judgment debtor then becomes entitled to all the rights as a shareholder. If you are the sole shareholder of the S Corp, the judgment debtor can take over the business or sell its assets to satisfy its judgment.

A member's interest in an LLC is generally not subject to levy but is subject to a charging order obtained against the member by a judgment creditor. This limits the judgment creditor to being an assignee of the member's LLC profit distributions, if any. This is the judgment creditor's sole remedy in a multi-member LLC. The judgment creditor has no other rights. This makes a multi-member LLC a good "asset-protection" tool. However, in Florida, the membership interests in a single-member LLC may also be subject to levy by a judgment creditor of the member, if the judgment creditor establishes to the satisfaction of a court that distributions under a charging order will not satisfy the judgment within a reasonable time, and upon such showing, the court may order the sale of that membership interest pursuant to a foreclosure sale.

CONCLUSION

Due to the long-established statutory and case law involving corporations giving greater certainty, the inconsistent treatment of LLCs as sometimes treated like a partnership and sometimes treated like a corporation, and the complexity of LLC taxation, an S Corp seems the preferable business entity assuming there are eligible shareholders and no need for special allocations. However, LLCs are becoming increasingly the business entity of choice where circumstances require more flexibility in ownership and/or profit and loss distributions.

Keith J. Kanouse, Esq.