


A COMPARISON OF AN “S” CORPORATION AND A LIMITED LIABILITY COMPANY

Originally published in the Fall 2008 e-mail newsletter of  **NJEntrepreneur.com**
THE BUSINESS BUILDING RESOURCE OF NEW JERSEY

When choosing a business entity to start a business there are many factors to consider when determining which entity is the best fit for your company and its goals. Some factors to consider are the ease of formation, taxation, need to raise future capital and limited liability. For small businesses, the two main choices are the S-corporation and limited liability company (LLC). The LLC has become the entity of choice recently among business owners and attorneys, but that does not necessarily mean it is the right choice for your business. You need to determine your business needs and goals before choosing the type of entity to form. Before comparing the two entities, a basic understanding of each business entity is important.

The “S” Corporation

An S-corporation is formed as a standard corporation however after it is formed, an election is filed with the Internal Revenue Service electing to be taxed under Subchapter S of the Internal Revenue Code. The S-corp. status allows the corporation to avoid the double taxation imposed on a standard C-corporation, and instead allows it to be taxed as a partnership. Under the partnership taxation rules all income or losses derived from the entity pass through to the owners personal tax returns, which should generate a lower tax rate than the corporate income tax rate.

Another benefit of an S-corporation is that the owners are protected by limited liability of the corporate entity. For example, if the corporation is sued or goes bankrupt, the only liability an owner will have for such debt is the amount of money invested in the corporation; unlike a partnership or sole proprietorship where a owner would have unlimited personal liability for the debts of the entity and could lose a lot more than just their investment. Owners of a corporation are called shareholders.

However, along with the benefits of an S-corporation election comes some strict rules:

- 1) An S-corporation can only have a shareholder that is a U.S. citizen or resident;
- 2) An S-corporation cannot have more than 100 shareholders;
- 3) Profits and losses are allocated based on proportion of ownership;
- 4) Corporations or other business entities cannot be shareholders; and
- 5) An S-corporation can only have one class of stock.

The Limited Liability Company

The limited liability company is a hybrid entity that combines the limited liability of a corporation with the pass through taxation of a partnership. An LLC may have various forms of management, from a member-managed, where the members manage the business of the LLC, to a manager-managed, where an outside manager would manage the business affairs of the LLC. Furthermore, profits and losses may be allocated any way that the members desire, it does not have to be based on the amount of capital contributions contributed by each member. An LLC may also have multiple classes of membership interests. Each class of membership interests may have different rights. For example, a common interest may have full rights as a member, while a class A interest may have limited voting rights and preferential distribution rights. Also, an LLC may not be subject to the strict recordkeeping rules of a corporation depending upon what is agreed to in the operating agreement among the members. Owners in an LLC are called members.

Comparison between an “S” Corporation and an LLC

An LLC and an S-corp. may sound very similar; however, there are a number of significant issues that differentiate the two entities from one another. They both provide limited liability to their owners; and they both have a pass through method of taxation.

But that is where the similarities end. Each entity has a tradeoff that a business owner will need to decide which is more important. This is where a good corporate attorney can help an owner decide which is the better entity for his or her business. Below is a chart outlining the differences between the two entities:

Topic	"S" Corporation	LLC
Owners	Shareholders	Members
Number of Owners	100 Maximum	Unlimited
Classes of Equity	One Class	Multiple Classes
Types of Owners	US Citizens and Residents	Anyone or any Entity
Equity	Stock	Membership Interests
P/L Distribution	According to Ownership	Anyway Members Decide
Management	Officers & Directors	Officers, Directors, Managers, Members, or as decided by Members
Controlling Documents	By-Laws & Certificate of Incorporation	Operating Agreement and Articles of Formation
Employment Tax	Payroll Deductions	Liable for self-employment tax

The LLC is a more flexible entity with many more options. It does not have to comply with the formalities of a corporation, such as board meetings, shareholder meetings and the election of directors, which are just a few of the formalities a corporation must follow. Below are specific aspects on certain topics affecting the two entities.

Operations/Management

An S-corporation is a corporation for all purposes other than taxation and, therefore, it must comply with a state's general corporate laws which impose certain formalities for a corporation, such as recordkeeping procedures, voting and meetings. A corporation is managed by its directors and officers, with no ability to alter the management structure. Profits and losses are split based on the number of shares of stock owned by each shareholder compared to the total number of shares outstanding.

On the other hand, the LLC members have greater choice in the management of the LLC; they can use a member-managed style, which is similar to partnership, or a manager-managed style, which is similar to a corporate structure. They are not bound by the same formalities as the corporation. Furthermore, the Operating Agreement provides members with the ability to designate how profits and losses will be distributed among the members. Allocations of profits and losses do not have to be based on capital contributions, but can be agreed to by the members.

Taxes

One significant advantage of an S-corporation over an LLC relates to employment taxes. A member of an LLC is considered to be self-employed by the government; therefore, he/she must pay a self-employment tax, which includes Social Security and Medicare payments. Members generally make quarterly estimated tax payments if they expect a gain during the year.

However, if a corporation pays a salary to a shareholder, they are subject to standard employment taxes, just as if they were a regular employee. This requires the corporation to file employment forms with the state and federal government, which may amount to a lot of paperwork throughout the year. But, by filing periodic payroll taxes, the S-corporation may save some money on employment taxes, but as the owner you have to offset the time consumed in making the periodic reports with the money saved from paying the employment taxes. At this point, you should consult your accountant to determine the amount of savings to the corporation compared to the reporting requirements. This factor should be reviewed with your accountant before making a final determination.

Conclusion

The LLC is a relatively new entity but is also a very hot entity that people are using more frequently as it becomes more understood. It offers the limited liability of a corporation, pass-through taxation of a partnership and the flexibility to mold it to your particular situation. The S-corporation is still a viable business entity, but is used less often since the advent of the LLC. The major attraction to an S-corporation is the potential savings for employment taxes, but in the long run, the savings may not be so significant based on the paperwork. Either way, for a small business both entities are a good choice to start your business. A good corporate attorney should be able to help you navigate through the pitfalls that are associated with each entity, because every situation is different and requires a thoughtful consideration before choosing an entity.

Louis Zambrio is an attorney at OlenderFeldman LLP, based in Union, N.J. A full service law firm, it provides customized business, financial, technology, intellectual property and litigation services to clients of all sizes. Essentially serving as "general counsel" for many of its clients, they assist clients in all aspects of their businesses, including corporate formation, employment-related issues, stock option and other equity compensation plans, contract drafting and review, and providing advice on structuring business relationships with third parties. Louis Zambrio may be contacted at lzambrio@olenderfeldman.com or 908-964-2432. Please visit www.olenderfeldman.com.