About the Authors/BART BASI, CPA & MARCUS S. RENWICK

Dr. Bart A. Basi is an expert on closely-held enterprises. He is an attorney, a Certified Public Accountant, and President of The Center for Financial, Legal & Tax Planning, Inc. He is a member of the American Bar Association's Tax Committee on Closely-Held Businesses.

Marcus Renwick is an attorney and the Director of Research and Publications with the firm.

With four specific services, The Center provides complete unbiased planning. The Center does not sell any products; its main purpose is to provide advice. Local experts are retained to implement the plans developed by the Center. The Center for Financial, Legal & Tax Planning is located at 4501 W. DeYoung Street, Suite 200, Marion, Illinois 62959. Phone 618-997-3436; Fax 618-997-8370.

Dr. Bart Basi

Limited Liability Companies, S Corporations and C Corporations: What's the Difference?

In the past, choosing a business entity under which to operate was easy. Either you operated as a sole proprietorship, a partnership, or you incorporated as a C Corporation. There were clear advantages and disadvantages to each one.

Today the choice is not so simple. Business people have an alphabet soup of business types to choose from. Though many of the new forms offer limited liability and single layer taxation, the tax and legal differences are not nearly as clear as they used to be in the past. This article will discuss three types of business entities and point out some very subtle and not widely known differences between the chosen entities. All three entities are excellent for any small business person to operate a business.

When deciding which entity to operate under, the business owner must take into consideration legal liability, tax circumstances while operating and dissolution, the person's goals, and the size of the operation, among other factors. Tax circumstances are of utmost importance when choosing an entity. However, ease of transferability, legal protection, and other factors are affected under each entity type. The advantages of having a Limited Liability Company (LLC), S Corporation, and C Corporation are discussed below.

Limited Liability Company (LLC)

In an LLC, there are no restrictions on ownership. An S Corporation, on the other hand, does have restrictions on ownership. To hold an S Corporation status, one must be a resident and citizen of this country. No more than 100 people are allowed to own stock. If the ownership requirements are violated, the company loses its S Corporation status and it cannot attain S Corporation status for a number of years.

With an LLC, these restrictions do not exist and its status is not jeopardized. While most LLCs will maintain membership of well under 100 members, the option or ability to expand the number of investors rapidly does exist. Many immigrants just starting business can benefit from this form of business as well without suffering from double taxation.

There are fewer formalities in maintaining an LLC. This is a major convenience and aids in limiting liability. The types of businesses identified here are all subject to being disregarded as an entity if the owner does not obey formalities. This is what is known as "veil piercing" and it happens when company owners do not observe formalities in paperwork, meetings, and otherwise use the business as an "alter ego."

While the owner of the business cannot use the company as an alter ego to defraud people out of money, the LLC does not require the formalities that corporations do. Hence the LLC can be a better insulator against liability if maintenance of meetings and documents is going to be an issue.

Shares of an LLC are easier to put into a trust than an S Corporation. To put shares of an S Corporation into a trust, special trusts must be used. It can be somewhat complicated and LLCs tend to work very well instead of S Corporations if you want to transfer ownership through a trust.

No unemployment taxes are due on income, unlike both the C Corporation and S Corporation. While this is not a huge tax savings, it is a significant savings. If your business is going to make less than $10,000 per year, LLC's may be the way to go. If you're an at-home business, this is particularly important.

During operation of an LLC, profits are taxed only at the shareholder level as opposed to C Corporations, which are taxed twice. However, profits from the operation of the business "flow through" to the income statement of the owner. This does not mean distributions are taxed immediately; the income of the LLC is taxed to the owner within the current quarterly period. This can be a significant disadvantage if the LLC does not pay out much in distributions. Owners can find themselves facing large tax bills without the cash to cover it if regular distributions are not made.

When winding up the affairs of the entity and dissolving, profits are taxed once. Nearly all, if not all, businesses will eventually close their doors. Both the LLC and the S Corporation offer the owners the chance to close the doors and be taxed only once on the sale of the assets. This is in contrast to C Corporations, which can be hit very hard with taxes upon dissolution of the corporation.

LLCs are becoming more popular. This is because most business owners want a limit on liability, single layer taxation, want to limit the formalities and still enjoy the protections. Few attorneys know the advantages of the LLC, but with time, it will be more known.

S Corporations

Profit is not subject to self employment taxes. The self employment tax is 15.3% for those who are self employed and encompasses both Medicare and Social Security taxes. Normally when a person is employed by an employer, their employer pays half of the tax, subjecting the employee to only paying half of the full tax. When one is self employed, they must pay the full tax by themselves. Under the use of a Subchapter S Corporation, salary (not profit) is subject to self employment tax. However, if the salary is insufficient, the IRS can reclassify the profits as a salary, subjecting them to self employment taxes.

This is in contrast to LLCs. While operating under an LLC, both salary and profits are subject to self employment taxes. For people with incomes below the social security threshold amount, this can result in a significant amount of money being put into self employment taxes. Of course this can be good or bad depending on your retirement planning needs and expectations.

Since S Corporations are flow-through entities, losses can be deducted. This also holds true for the LLC. However, this is in contrast to C Corporations in which shareholders cannot deduct losses. If an S Corporation is experiencing losses, it can deduct the losses and the owner will recognize the loss on his or her income statement leading to a lower tax liability. However, there is a limit. You cannot deduct amounts that exceed your investment and loans to the company.

During operation of an S Corporation, profits are taxed only at the shareholder level as opposed to C Corporations, which are taxed twice. Just like with the LLC, the profit, not the distributions, are taxed. This can be good or bad depending on the situation.

When winding up the affairs of the entity and dissolving the business, profits are taxed once. This is in contrast to C Corporations, which can be hit very hard with taxes upon dissolution of the corporation. As stated above, all businesses close their doors and their assets are sold at one point or another. With an S Corporation this transfer is only taxed at the shareholder level.

C Corporations

Even though C Corporations are taxed once at the corporate level and then at the shareholder level, certain tax advantages can come into play due to new tax legislation.

Profits from a C Corporation to a shareholder are what is known as dividends, and not distributions. Dividends from C Corporations enjoy a special rate of tax at 15%. This means that money received from a C Corporation, no matter if it is $1 or $1 million, every dollar is taxed at 15% and it is not subject to ordinary income tax rates.

At the corporate level, C Corporations enjoy lower tax rates than most people do at nearly any income level. If your income is low enough, you may be able to use this to your tax advantage. Generally if the corporation's income is below $75,000, it can be to the advantage of the corporate holder to use a C Corporation.

Fringe benefits are nontaxable to shareholders of C Corporations. This is in contrast to LLCs and S Corporations where the owners are taxed on the value of the benefits. The fringe benefits are fully deductible at the corporate level, in a C Corporation.

There are no ownership restrictions when owning a C Corporation. Unlike the S Corporation, there are no ownership restrictions for a C Corporation. Nearly any person in the entire world, United States citizen or not, can own the stock. There is also no restriction on the number of shareholders. This works out well for publicly traded companies such as GE, Ford, and GM. Had there been a restriction on ownership in these situations, they would have lost their status long ago.

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Shareholders do not pay self employment taxes on C Corporation dividends. When dividends are distributed, they get taxed at the federal 15% rate and the state tax rates. Medicare and Social Security taxes are not paid on dividends. However, the IRS is fast to reclassify dividends as salary subjecting them to self employment taxes if the salaries are not reasonable.

Shareholders of C Corporations do not immediately recognize income. If you plan on starting a company and not distributing profits, C Corporations are good for this. Otherwise, the shareholder would have a lot of income on their income statement and no dividends or cash to pay the tax bill with. Having a C Corporation allows the business person to accumulate a large amount of profits, reinvest them, etc., and not have to pay taxes at a personal level.

Conclusion

There is no one "be all, do all" separate entity for the business man or woman. Each entity has subtle differences which can make a substantial difference to the business owner. When deciding which entity type to go with, consider tax and legal aspects to the full extent necessary. The Center is well adept at providing, setting up, and maintaining entities such as those discussed above. Call The Center for these and all of your financial, legal, and tax planning needs.

Reprinted from Distributor's Link Magazine, Fall 2005