

S-CORP VS. LLC:



WHICH STRUCTURE IS RIGHT FOR YOUR BUSINESS?

Corporations and limited liability companies ("LLCs") are preferred business structures because, unlike sole proprietorships and partnerships, both offer liability protection. This means that the owner of a company cannot be held personally responsible for the company's debts. The personal assets of an owner are shielded from company liabilities.

In recent times, with lawsuits at a rampant high, the U.S. courts have attacked and awarded the personal assets of corporate owners because certain corporations have operated closely to sole proprietorships. LLC's are more protected when it comes to lawsuits; corporations have greater tax benefits and write-offs. It has been estimated that 50,000 lawsuits are filed in this country every day of the week.

S corps and LLCs are similar in that they are both "pass-through" entities for tax purposes; the income of these companies are passed through to their owners and reported on the owners' personal income tax returns, thereby eliminating the double taxation incurred by owners of a standard corporation, or C corporation. (With a C corporation, the net business income is subject to corporate income tax, and the monies remaining after the corporate income tax are taxed a second time when they are distributed as dividends to its owners who must then pay personal income tax.)

The comparison chart below sums up the similarities and differences between the two business structures:

Features	S Corporation	Limited Liability Company
Liability Protection	Yes	Yes
Operational Control	Board of Directors/Officers	May be member-managed or manager-managed
Federal Income Tax	Pass-through	Pass-through
Flexibility/Ease of Operation	No; subject to same formalities and record keeping rules as traditional C corps	Yes
Ownership Restrictions	Yes	No
Flexibility in Profit-Sharing	No	Yes
Employment Tax	Employment/payroll tax on salary; no employment tax on dividends paid to shareholders	Self-employment tax on total net income

Employment Tax: Savings vs. Paperwork

A major factor that differentiates an S corp from an LLC is the employment tax that is paid on earnings. The owner of an LLC is considered to be self-employed and, as such, must pay a "self-employment tax" which goes toward Social Security and Medicare. The entire net income of the business is subject to this tax at a rate of 15.3%.

In an S corp, only the salary paid to the employee-owner is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules. Therefore, there is the potential to realize substantial employment tax savings.

One might assume that these savings could be further manipulated by reducing the salary to an extremely low amount and attributing the rest of one's earnings to distributions—but this would be an incorrect assumption. In practice, the IRS is careful to notice whether a salary is reasonable by industry standards. If it determines a salary to be unreasonable, the IRS will not hesitate to reclassify distributions as salary.

Still, while the potential employment tax savings may make the S corp an attractive structure for your business, bear in mind that you would then have to deal with all the paperwork associated with payroll tax. The payroll tax is a pay-as-you-go tax that must be paid to the IRS regularly throughout the year--on time, or you will incur interest and penalties. The paperwork alone can be an overwhelming task for someone who is not familiar with this; and if you expect to incur losses or otherwise experience a cash flow crunch during the year that would hinder you from paying the payroll tax when due, this could present a problem.

Owners of LLCs pay their self-employment tax once a year on April 15 when income taxes are normally due (or make quarterly estimated tax payments, if they expect to owe total taxes of \$1,000 or more). Income tax filings are also relatively easy for the owners of an LLC: A single-member LLC files the same 1040 tax return and Schedule C as a sole proprietor; partners in an LLC file the same 1065 and Schedule C as do owners of traditional partnerships.