Form of Entity: S Corporations v. Limited Liability Companies
by Brogan Duffy, CPA

Questions often arise regarding the differences in tax treatment between two popular forms of business organization: S corporations and limited liability companies (LLCs). Both of these are considered flow-through entities for federal income tax purposes and as such are generally not taxed as separate entities. Instead, the income, deductions and tax credits of these flow-through entities pass through to the owners, and distributions or dividends paid by the entity are distributed tax free to the owners. Both S corporations and LLCs provide limited liability to their owners under state law and both entity types avoid double taxation inherent in C corporations when earnings are distributed to shareholders.

This paper explores some of the key advantages and disadvantages of S corporations vs. LLCs.

S Corporations

S corporations are treated as corporations under state law. They are recognized as separate legal entities and provide shareholders with the same liability protection afforded by C corporations. For federal income tax purposes, however, taxation of S corporations resembles that of partnerships. As with partnerships, the income, deductions and tax credits of an S corporation flow through to shareholders annually, regardless of whether dividends are paid. Thus, income is taxed at the shareholder level and not at the corporate level. Dividends paid by the corporation are distributed tax free to shareholders to the extent that the distributed earnings were previously taxed to the shareholders.

S corporations registered and qualified to do business in California are also treated as flow-through entities, whereby the income, deductions and tax credits of an S corporation flow through to shareholders, and dividends paid by the corporation are distributed tax free to shareholders. However, S corporations in California must pay the greater of tax on net taxable income (currently 1.5%) or the minimum franchise tax (currently $800) each year, whether or not it actually does business, until it is formerly dissolved.

To achieve S corporation status, a corporation must qualify as a small business corporation. Characteristics of a small business corporation include:

- A “domestic” corporation (incorporated and organized in the United States)
- Only one class of stock
- Limited to a maximum of 75 shareholders
- Has only individuals, estates and certain trusts as shareholders
- Has no nonresident alien shareholder

No maximum or minimum dollar sales or capitalization restrictions apply to small business corporations.

To become an S corporation, a small business corporation must file a valid election with the IRS. For S corporation status to apply in the current tax year, the election must be filed either in the previous year or on or before the fifteenth day of the third month of the current year (generally March 15). Even if the 2½-month deadline is met, a current election is not valid unless the corporation qualifies as a small business corporation for the entire tax year.

Limited Liability Companies

The limited liability company (LLC), a statutory creation with its own separate legal identity, is a hybrid business entity providing its owners, called "members", with both the limited liability characteristic of a corporation and the operational flexibility and pass-through tax treatment of the partnership. An LLC is free from the ownership restrictions faced by a corporation desiring S corporation status. For an LLC, there is no limit on the number of owners, or on the persons permitted to be owners, or on the permissible types of ownership interests.

For federal income tax purposes, under the pass-through default rule for "domestic" entities, a newly formed eligible LLC will be classified as a partnership if it has a least two members, or it will be disregarded as an entity separate from its owner if it has a single owner. Accordingly, a single-member LLC would be treated as a sole proprietorship, if it is owned by an individual, or as a branch or division, if it is owned by a corporation.

All LLCs doing business in California must be registered with the Office of the Secretary of State. An LLC classified as a partnership or disregarded entity generally will determine its California income, deductions and credits under California's Personal Income Tax Law. California law also imposes both an $800 annual tax and an annual fee based on gross receipts on all LLCs treated as partnerships or disregarded entities. The annual gross receipts fee starts at $900 for gross receipts of at least $250,000 going up to a maximum of $11,790 for gross receipts of at least $5,000,000.

Major Federal Taxation Differences

There are many differences in federal tax treatment between S corporations and LLCs. Below are two of the most noteworthy differences.

First, an S corporation recognizes a gain on any distribution of appreciated property in the same manner as if it had been sold to the shareholder at its fair market value. The amount of the recognized gain is passed through to the shareholders. For an LLC, there is no recognized gain to the LLC or member from a distribution of appreciated property at the time of the distribution.

Furthermore, if an S corporation fails to qualify as a small business corporation at any time after the election has become effective, its status as an S corporation ends. With termination of S corporation status, a corporation reverts to C corporation status. And capital gains associated with appreciated real estate do not receive favorable tax treatment in a C corporation. Thus, it is generally advisable that corporations (either S corporations or C corporations) not hold real estate that may appreciate in value.

The second federal tax treatment difference deals with self-employment taxes. For an S corporation, the Internal Revenue Code imposes self-employment tax (15.3%) on reasonable compensation to shareholder-employees for the services that they perform for the corporation. However, the IRS has ruled that S corporation distributions are not subject to self-employment tax.

For LLCs, the basic rule (with some exceptions) is that all income a member of an LLC receives is subject to self-employment tax. The most recent federal tax regulations on this point require LLC members to pay self-employment taxes on their entire share of LLC profits if any one of the following four conditions apply:

- They participate in the trade or business for more than 500 hours during the LLCs tax year.
- If they work in their LLC (even if they work less than 501 hours) and it renders professional services in the fields of health, law, engineering, architecture, accounting, actuarial science or consulting.
- If they have personal liability for the debts of or claims against the LLC by reason of being a member.
- They have the authority to execute contracts on behalf of their LLC. Under the law of most states, all members of a member-managed LLC have this type of "agency" authority, but non-managing members in a manager-managed LLC do not.

Therefore, an S corporation is generally favorable to an LLC as a from of organization for small businesses that do not have appreciated property and that can meet the requirements of a small business corporation.