

LLC or S Corporation: Which Business Structure is Best for Your Business? This is one of the first things business owners must decide - the type of legal structure under which their business will operate. Corporations and limited liability companies (LLCs) are the preferred choices because under these structures, the business is protected by limited liability, meaning business owners will not be held responsible for the company's debts and liabilities. Limited liability covers some or all debts and acts of liability as provided by the shield laws of the state and businesses operating under a partnership and sole proprietorship do not qualify for limited liability coverage.

About LLCs

Some states charge LLCs a franchise or capital values tax which is the fee charged to the company for the privilege of receiving limited liability from that state. This fee is determined either by a single factor or a combination of factors: revenue received; profits received, number of members in the company. In most states, the fee charged is minimal.

Owners of LLCs are called members. There are no restrictions on ownership and members can include individuals, corporations, foreign entities and other LLCs, with no maximum on the number of members allowed.

A single-member LLC (SMLLC) that doesn't file Form 8832 Entity Classification Election to choose to be taxed as a corporation will be automatically classified as a "disregarded entity" under federal law, meaning the SMLLC will pay taxes under the guidelines of a sole proprietorship. A multi-member LLC can be either a corporation (includes an S Corp) or a partnership. If the multi-member LLC doesn't file Form 8832 Entity Classification Election to choose to be taxed as a corporation, they'll automatically be classified as a partnership under federal tax laws.

About S Corporations

When setting up an S Corporation, owners will find there's a mountain of administrative paperwork that must be filed and maintained and detailed record keeping is necessary. For instance, owners must file specific articles (information, incorporation, organization) with the state before the company is considered to be legitimate. Quarterly and annual payroll tax returns must be filed. Additionally, because of the complexity of the returns prepared for an S Corporation, the costs can be significant.

There are more restrictions with an S Corp, such as there's a limit of 75 owners (called "shareholders") and none of the owners can be non-residents. A number of states charge more fees for S Corporations than is charged for LLCs and in some states, taxes may be charged when the company reaches a specific size. Also, when considering liquidation or closing down the business, there are usually federal and state income taxes that must be paid.

LLC or S Corporation?

Knowing whether to choose to become an LLC or S Corporation will depend on the size and complexity of the business. The more people involved and the more money generated will affect this decision. An important fact to keep in mind is for tax purposes, LLCs and S Corporations are considered to be “pass-through entities”. This means that income received from the business is only taxed when it has “passed through” to the owner and/or members, at which time it will be reported when personal income tax returns are filed. Thus, there’s no double taxation on income received.

Also, consider the payroll or employee tax that’s paid to cover contributions to social security and Medicare. An LLC’s entire net profits will be taxed while only the amount designated as salary will be taxed under an S Corporation. This means that if an LLC has a total net income of \$100,000, that entire amount will be taxed but an S Corp with the same net income that declares \$50,000 as salary payments will only be taxed on \$50,000. Therefore, a significant difference in the amount paid in employment taxes could be realized under an S Corporation.

There is no easy formula for choosing between these entities. Because there are details and distinctions involved that owners should be familiar with to avoid serious tax consequences and unlawful infringement, the best advice is anyone who’s new to starting a business should fully research the subject and then consult experts (i.e., CPAs) to assist with the set up.