Which to choose: LLC or S Corp?

TAX: Help guide your clients to the best choice.

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Once you and your client have agreed that operating as a sole proprietorship is not the best answer, the choice depends on what your client wants to accomplish. Here are some things to consider.

Note: This discussion does not include partnerships because the partnership does not provide the liability protection that the LLC and corporation offer. When discussing the LLC, we are assuming the LLC is being taxed as a partnership and has not elected to be taxed as a corporation.

Running a service business

The LLC can be a good choice to maintain a service business. (Caveat: Be sure the entity can operate as an LLC if it is located in California.) This is especially true if the owners are the only individuals performing services. There is no payroll reporting. If there are multiple owners, the LLC allows them to:

- Share in operating expenses;
- Divide profits according to services performed;
- Avoid payroll tax filings (assuming there are no workers other than owners);
- Get larger discounts on volume purchases;
- Reduce costs of accounting and tax filings;
- Make an IRC §754 election on the death of the member (if operating as a partnership); and
- Easily terminate to go separate ways.

The LLC allows multiple service providers to share expenses and divide profits disproportionately, where an S Corp requires payroll for the owners, and distributions of profits must be done proportionately. An LLC may have an unequal division of profits or use guaranteed payments to make profit payments.

However, an S Corp may be a good alternative if:

- The business is generating large gross receipts and could be subject to the California annual fee on LLCs;
- There are investors who want to be paid off; and
- Members want to avoid self-employment tax on the profits of the business — after reasonable compensation is paid.

Manufacturing, restaurant, retail

The biggest disadvantage for these businesses operating as an LLC is California's annual fee, which will apply even if the business is not generating a profit.

However, when operating a business where family estate planning, family wealth planning, and succession planning are involved, the LLC fee may be a small price to pay for the flexibility offered by the LLC.

The S Corp allows:

- Pension benefits to be subtracted before income is taxable to the owner;
- Unlike a corporation, no double taxation at liquidation;
- Ability to pay profits without paying self-employment tax — assuming reasonable compensation is paid;
- Wages paid to owners may increase the federal manufacturer's deduction, while guaranteed payments and net income to the LLC members do not count;[1] and
- An ordinary loss under IRC §1244 is allowed up to $50,000 ($100,000 MFJ), which is not available to the LLC.

Holding investments

The LLC is a very popular vehicle to hold investments. The income and loss from the investment flows directly through to the investor, and there is no maximum tax on net passive investment income applicable to an S Corp.

Holding investments may be the best reason to form an LLC because:

- There is no problem with passive activity income;
- The LLC is easily dissolved, split off, or reformed;
- There are no shareholder restrictions, and an S Corp can inadvertently — or on purpose — lose the S election;
- Real property may generally be distributed to members without tax consequences; and
- The LLC is a good vehicle for estate planning.

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[i] One paragraph, pertaining to C Corps, has been removed from Lynn's original article.