BUSINESS LAW REPORT

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CORPORATION or LIMITED LIABILITY COMPANY

Selecting the "Right" Business Entity

By Jay D. Fullman, Esq.

Available forms for conducting business include: general partnership, sole proprietorship, regular "C" corporation, Subchapter "S" corporation, statutory close corporation, limited partnership, and limited liability company (LLC) (or limited liability partnership (LLP) for attorney and accountancy firms). Each has advantages and disadvantages. The specific entity to be selected depends on the needs and objectives of the business to be conducted and the desires of the owners. This article will focus on comparing and contrasting corporations and LLCs.

SIMILARITIES

In a number of ways, corporations and LLCs are similar. Both are entities separate and distinct from their owners. Corporations and LLCs each have the key, important characteristic of protecting the owners from personal liability for the debts and liabilities of the business. The owners can usually sell their ownership interest in the entity to other people or entities. The ownership interest in each is granted in the form of a certificate: a stock certificate for a corporation, and a membership certificate for an LLC. Both entities can offer tax-deductible benefits to employees.

TAXATION

All corporations and LLCs pay an annual minimum tax for operating in California. The profit of a regular "C" corporation is taxed at the entity level. That is, if the corporation has net profit at the end of the year, the corporation pays tax on the net profit, at tax rates applicable to corporations. If a "C" corporation then pays dividends to its shareholders, the shareholders may also pay tax on the dividends received as income. Thus, the profits of "C" corporations may be subject to taxation twice, or double taxation. Corporate losses can be carried back to prior years, or carried forward.

Profits of Subchapter "S" corporations are not taxed at the entity level. Rather, all corporate profits "pass through" to the shareholders. Thus, "S" corporation profits are taxed like partnerships: the shareholders are taxed on their percentage of corporate profits, based on the percentage of corporate stock held. The tax rates are determined by the individual's tax rate. And corporate losses pass through to the shareholders' tax returns.

LLCs are also taxed like partnerships: The entity's profits pass through to the LLC members, and are taxed through the members' individual income tax returns. Members' taxes are usually based on their percentage of ownership in the LLC. However, the LLC members can allow for profit distributions that are based on some method other than the proportion of capital contributed by each member. The tax rate is the members' individual tax rate. In addition to profits being taxed at the individual level, California imposes a tax on the LLC's gross revenue.

Since LLCs and "S" corporations are taxed like partnerships, not all employee benefits are fully tax deductible like they are for "C" corporations.

"S" CORPORATION VS. LLC

Neither the "S" corporation nor the LLC can be used for all types of businesses. California law does not allow businesses that must be licensed to operate as LLCs. Doctors, accountants, construction contractors, and service businesses that must be licensed under the Business and Professions Code cannot form LLCs. Depending on the nature of the business, licensed persons can form either "S" corporations or limited liability partnerships to obtain "pass through" taxation instead of paying taxes on profits at the entity level.

Certain types of businesses cannot form as an "S" corporation, including banks and insurance companies. "S" corporations also cannot hold stock in a regular "C" corporation, unless the "C" corporation is a wholly owned subsidiary.

Another difference between "S" corporations and LLCs is the number of authorized owners. A California "S" corporation cannot have more than 35 shareholders. An LLC can have an unlimited number of members. LLCs and "S" corporations (as well as "C" corporations) can have as few as one (1) owner.

OTHER ISSUES

When deciding whether to form a "C" corporation, "S" corporation, or LLC, other factors that enter into the decision may include what happens to the business if the owner dies or departs, management flexibility, and that annual Meeting Minutes are usually not required for LLCs.

This summary by no means compares and contrasts all the similarities and differences between corporations and LLCs. For advice relating to your specific business, or proposed business, contact Jay D. Fullman at the numbers and addresses above.