EVERGREEN™
WEALTH SOLUTIONS
PLAN. GROW. PROSPER.™

S CORPORATIONS VS. LLCS:

Which Entity Is Right For You?

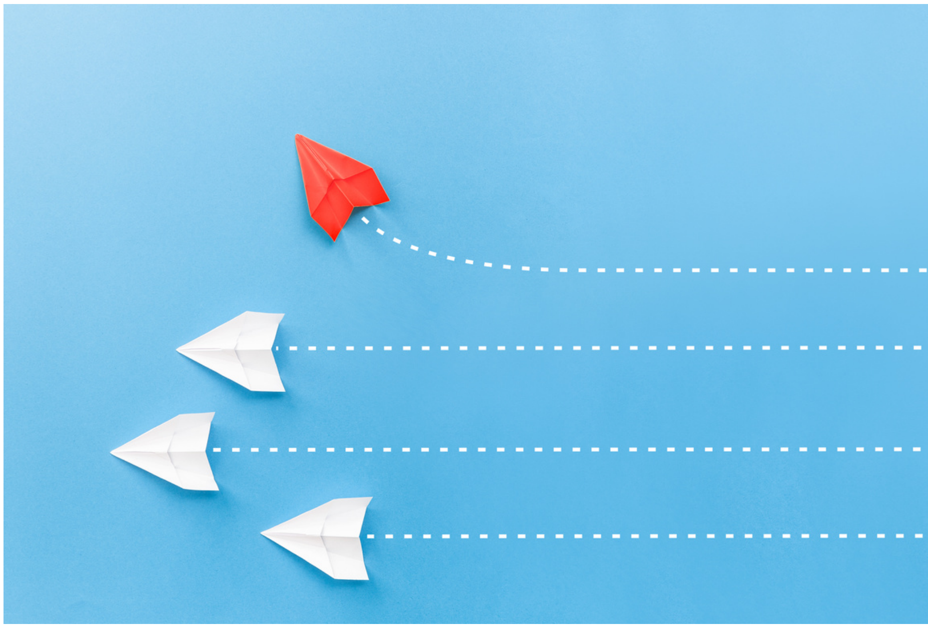
The LLC is quickly becoming the entity -type of choice among many small and medium-sized businesses.
However, some business owners are still more comfortable with the more traditional S corporation, which provides many of the same benefits as an LLC.

Similarities Abound

There are many similarities between S corporations and LLCs, and either may be preferable to operating as a regular C corporation or a partnership. The most important traits they share are limited liability and flow-through taxation.

Similar to a regular corporation, both entities limit the owner's liability to his investment in the entity as opposed to a general partnership in which a partner's liability is unlimited. As with a general partnership, the income and losses of LLCs and S corporations are taxed at the shareholder (member) level versus the corporate level with a regular corporation. This allows the owners to take tax-free distributions of their earnings. Shareholders in regular corporations are taxed when earnings are distributed.

Regular corporations do hold a couple of advantages over LLCs and S corporations. The income in a C corporation will often be taxed at a lower rate than the flow-through income taxed at the individual level. Also, fringe benefits paid by a flow-through entity are generally taxed to the recipient, whereas such benefits are usually tax-free in a C corporation.
In cases where there may not be much retained value or earnings in the entity, such as a medical practice, a C corporation may still be the way to go. But, if you want the benefits of limited liability and flow-through taxation, which entity should you choose?



Flexibility is Key

LLCs offer far greater flexibility than S corporations. S corporations are limited in the number and types of shareholders they can have. Plus, income and losses and earnings are distributed to shareholders strictly on a pro-rata basis.

LLCs can generally have any type, number, or classification of owners if provided for in the membership agreement. Also, LLCs can specially allocate income and deductions, provided the allocation has substantial economic effect.

However, flexibility does have its price. Since you can make the structure and operations of an LLC as complex as you want, you may incur higher professional fees to carry out your wishes.

Basis Matters Too

S corporation shareholders and LLC members can take tax-free distributions from their respective entities to the extent that they have basis. Losses from the flow-through entity can be deducted on their personal tax returns to the extent that they have basis and a risk of economic loss.

Curious what your basis is?
Generally, basis is calculated as follows:

Capital contributions + Loans to the entity + Flow-through income - flow-through losses - distributions - loan repayments

There is a major difference between S corporations and LLCs as to what types of loans increase basis. S corporation shareholders only receive basis for loans made directly to the entity. Conversely, LLC members also receive basis for loans from a third party that are guaranteed by the member and for certain other loans. This additional basis can be critical in the early years of an entity when it may be spinning off significant losses.

Self-Employment Tax...Ouch!

One potential disadvantage of an LLC relates to self-employment tax. Assuming that the LLC member participates in the business, the member must generally pay self-employment tax on all flow-through income. There is usually no way to limit the self-employment liability to a set “compensation,” or earned income amount. So, LLC members can end up paying a lot of self-employment tax.

On the other hand, the flow-through income from an S corporation isn’t subject to self- employment tax. Shareholders only pay their portion of FICA and Medicare taxes on wages paid to them by the corporation.

What Else?

There are other matters you must consider. For starters, there are state income and franchise tax implications, characterization of gain on the sale of entity assets (e.g. “hot” assets), the impact on your ability to merge with another entity, interplay with related entities, and the ability of LLCs to make optional basis adjustments (e.g. step-up).

It should also be noted there is generally no tax-free way to convert from a regular corporation or from an S corporation to an LLC. You can change your business structure at any time, but there are many variables to consider. Consult with your tax professional, who can help you evaluate which type best suits your needs.

EVERGREEN™
WEALTH SOLUTIONS

www.evergreenwealthsolutions.com

info@egwealth.com

1000 Commerce Park Drive, Suite 407
Williamsport, PA 17701

Phone: 570.601.6960 | Fax: 570.651.9032