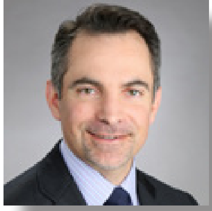

To LLC or Not to LLC: That is the Question!

by Jordan N. Uditsky

Limited Liability Companies, or "LLC" as they are more commonly known, have been the "entity du jour" over the past decade, and I've been asked by many a client what the real reasons are to choose an LLC over, for example, an S-Corporation, a Partnership or a traditional C-Corporation. Choosing the most appropriate structure for your business can be confusing even for the most learned legal practitioner, and I find that most attorneys know which entity they should recommend but don't necessarily know why. In this article we'll explore the differences between two of the most popular business structures, the LLC and the Subchapter S Corporation, or "S-Corp".

The LLC and S-Corp are popular business structures for a variety of reasons, some of which the two have in common. Both the LLC and the S-Corp are creatures of statute, meaning they are separate legal entities created by a state filing and subject to state-mandated formalities, such as filing annual reports and paying periodic filing fees. Both entities are taxed like sole proprietorships (in the case of a single owner or shareholder) and partnerships (in the case of multiple owners or shareholders), meaning the company itself doesn't pay federal taxes, but rather all company profits and losses are "passed through" to the individual owners, who report these tax attributes on their individual federal tax returns. These two business structures also share another key feature in that they have the ability to separate the liabilities of the business from the personal assets of the owners, thereby shielding those assets from business obligations. Despite the similarities, LLCs and S-Corps do differ in several ways, including their operational flexibility, administrative requirements, profit-sharing and employment tax implications, all of which we will explore in this article.

What is an LLC Anyway?

According to the Internal Revenue Service, an LLC is an entity "designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership". Although many times you will hear practitioners refer to an LLC as a "limited liabilitycorporation", you should note that an LLC is not actually a corporation. While both corporations and LLCs are created as a matter of state law, they are separate entities with entirely different governing rules and regulations. Nevertheless, the LLC is a flexible form of business enterprise that combines elements of both the corporate and partnership structures. As a pass-through entity, all profits and losses generated in an LLC are reported by the individual owners, or "members" as they are called, on their individual federal tax returns. What differentiates the LLC from a partnership, however, is the limit of the liability for which a member is responsible, which in most cases will be limited to such member's investment in the company.

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How About an S-Corp?

Like a C corporation, an S-Corp is a corporation organized pursuant to the laws of the state in which it is formed. As in the case of an LLC, however, S-Corps resemble partnerships in the manner in which they are taxed, meaning all aspects of income, deductions and tax credits flow through to the shareholders, regardless of whether cash distributions or contributions are made. S-Corps must make an affirmative election under Subchapter S of Chapter 1 of the Internal Revenue Code to be taxed as a partnership and the following requirements must be met in order to do so:

- The entity making the election must be a domestic corporation;
- The entity making the election may only have one class of stock;
- The entity making the election may not have more than 100 shareholders;
- Shareholders of the entity making the election must, subject to certain limited exceptions, be U.S. citizens and natural persons; and
- Profits and losses allocated to the entity's shareholders must be in proportion to each shareholder's interest in the business.

So Which is Right for My Business

As indicated above, LLCs and S-Corps differ in several ways, including but not necessarily limited to their operational flexibility, administrative requirements, profit-sharing and employment tax implications. Understanding the differences will dictate which of these two popular entities are right for your business. One of the primary differences between an LLC and an S-Corp is the amount of administrative formality that is required to maintain an S-Corp. Remember, an S-Corp is in fact a corporation and therefore requires compliance with certain administrative formalities such as formation of a board of directors, annual reporting and other mandatory business filings, adopting by-laws, issuing stock, annual shareholder and director meetings with mandatory record keeping and other administrative requirements that a typical small business may not be prepared to deal with, particularly one with a single owner. An LLC on the other hand requires far fewer forms for registration and generally lower start-up costs. Limited Liability Company's are not generally required to have formal meetings nor maintain minutes of meetings, though record keeping is still highly recommended. With fewer administrative formalities to maintain, LLCs may be more difficult to penetrate by those seeking to challenge its shield of liability protection. Generally, as long as the members of the LLC do not "co-mingle" funds, imposing liability beyond the LLC itself may be very difficult.

Another distinguishing feature between the LLC and the S-Corp is the operational and management flexibility inherent in an LLC versus the rigid structure of an S-Corp. Most matters relating to governance of an LLC can be handled in one document, typically termed an "Operating Agreement" or "Limited Liability Company

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Agreement", which is the governing document of the company. Most state codes in fact allow members of an LLC to essentially override the LLC statute by otherwise agreeing in the operating agreement how the LLC will be governed. The owners of an LLC can decide to be self-managed (or, "member-managed" as it is otherwise known) or manager-managed. When member-managed, the LLC is run in the same manner as a partnership where the partners handle the day-to-day operations of the company. When manager-managed, the LLC is run similar to a corporation, where the members may elect one or more people to handle the day-to-day decisions of the company. S-Corps on the other hand, have directors and officers, where the board of directors makes major decisions and officers are elected to manage the company's daily business. Of course, an LLC also has the flexibility to "elect" officers if they so choose, but many business owners appreciate the simplicity of their businesses being managed by a manager they have the authority to appoint or remove in their sole discretion.

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When organizing a new company involving more than one owner, particular attention should be paid to the allocation of the company'sprofits and losses as well as the distribution of available capital. S-Corporations, which are restricted to one class of stock, must allocate profits and losses pro-rata to its shareholders based on their relative share of ownership. Thus, a shareholder who owns 25% of the company's stock reports a distribution of 25% of the company's year-end taxable profit or loss, as the case may be, on the shareholder's individual federal tax return. The one class of stock restriction governing S-Corps does not apply to LLCs, thereby allowing flexibility in planning distributions and allocations of profits and losses. A business organized as an LLC may allocate profits and losses disproportionately among its members, taking

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into account factors such as sweat equity, preferred returns for members contributing more capital and other arrangements forming the basis for so-called "special allocations". The IRS may scrutinize such special allocations to ensure members are not attempting to evade taxation by allocating larger losses to members in higher income tax brackets, thus it is important to structure the allocations so that they have what the IRS terms "substantial economic effect". Consider the case of four members who form an LLC where three members put up an equal amount of cash while the fourth member signs a note to contribute his or her share in installments over the first five years of the business. The operating agreement may provide that the first three members receive a larger distributive share of profits and losses for those five years during which the fourth member's note is outstanding, even though all four members may each have an equal 25% ownership interest in the company. The IRS should respect this arrangement given there is a legitimate financial basis for the special allocation (i.e., it has "substantial economic effect"). It should be noted that an LLC's structural flexibility would allow an operating agreement governing the foregoing company to provide for other restrictions, such as a limit on the fourth member's ability to vote on certain issues affecting the company until the note is paid in full. It is this structural flexibility that motivates many entrepreneurs to choose the LLC for their new businesses.

While not generally a significant consideration for most new small business owners, it is important to note that owners of LLCs are considered to be self-employed and must therefore pay the 15.3% self-employment tax contributions towards Medicare and Social Security (note that the rate was effectively reduced in 2012 to 13.3% but is slated to return to 15.3% in 2013). Thus, all the income of an LLC is subject to self-employment tax whereas a corporation may retain some of that income after payment of the owner's salary and treat it as unearned income not subject to self-employment. Of course, nothing is free in the eyes of the IRS as any such unearned income will be taxed at some point when it is distributed to the company's shareholders as taxable dividend income. While LLCs have been the entity of choice in recent years, the flexibility associated with its ownership and management structure in multi-member businesses comes with a price. That price is reflected in what can be complex operating agreements reflecting the practical realities of an agreement among the owners. In such situations it is important to remember that an operating agreement is not an "off-the-shelf" document that a practitioner or formation service can quickly plug names into and deliver without a thorough understanding of the member's relative expectations. LLC operating agreements may need to combine complex provisions usually found in shareholder agreements, separate buy-sell agreements, partnership agreements and even employment agreements. Such provisions may affect issues such as capital contributions to the business, allocation and distribution of profits and losses as described above, members' voting rights, admitting new members or removing existing ones, restrictions on transfer of membership interests and many others. Each member should retain their own counsel experienced in business organizations to advise them of their relative rights and obligations before entering into any such agreement.

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