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FORMALIZING YOUR FIRM: LLC VERSUS S CORPORATION VERSUS C CORPORATION

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As we work with entrepreneurs in setting up the structures for their new ventures, one of the first questions we are asked is what is the right entity to use. For most entrepreneurs, we find that the most frequently used entities are limited liability companies (“LLCs”), traditional corporations (“C Corps”) and

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S corporations (“S Corps”). Each of these entities are similar in many areas and generally provide limited liability protection to their owners from the entities' creditors, including those that make claims in disputes with the entity. However, because these entities also differ in many ways, one entity is often a better choice for your business. The following is a discussion of the differences that most typically impact our clients.

INITIAL CONTRIBUTIONS BY OWNERS ON FORMATION

LLC. Members generally may contribute assets in exchange for capital interests without incurring tax. However, a member may incur tax if (a) the member contributes encumbered assets (to the extent the member's contributed liabilities allocated to the other members exceed such member's tax basis in its contributed assets and its share, of the LLC's liabilities), (b) the LLC is an investment company, or (c) the contribution is a disguised sale. A member may also receive a profits interest in the LLC in exchange for services in a tax-free manner.

S Corps and C Corps. Shareholders generally may contribute assets in exchange for stock in a controlled corporation without incurring tax. However, a shareholder may incur tax if (a) the shareholder contributes encumbered assets (to the extent the shareholder's contributed liabilities exceed the shareholder's tax basis in its contributed assets), or (b) the corporation is an investment corporation. Unlike an LLC, a shareholder may not receive

additional stock in exchange for services in a tax-free manner.

Resulting Comparison: In general, with proper planning, owners may form each entity without triggering tax. In addition, with proper planning, each entity may receive publicly-traded securities and cash without triggering tax. When encumbered assets are contributed that trigger tax, an owner may incur less tax on formation with an LLC. Owners who will provide services and want a greater share of the profits (in excess of what their capital contributions justify), may prefer using the LLC since the profits interest may be received without immediate tax.

DIFFERENT TYPES OF OWNERSHIP INTERESTS

LLC. An LLC has no restrictions on the number or type of owners. Various classes of ownership interests with different voting, distribution and liquidation rights are permitted.

C Corp. A C Corp has no restrictions on the number or type of owners. Various classes of ownership interests with different voting, distribution and liquidation rights are permitted.

S Corp. Owners generally may not include corporations, partnerships, LLCs

and some trusts, but may include individuals and revocable trusts (as used for estate planning). An S Corp may only have 100 owners. Voting and nonvoting common stock is permitted, but all common stock must otherwise have the same distribution, liquidation and other economic rights. Preferred stock is not permissible.

Resulting Comparison: LLCs and C Corps provide more flexibility in terms of permitted owners and types of ownership interests.

However, if individuals and revocable trusts will be the only owners and there is no desire for different classes of ownership with different rights to share in profits (or only voting and nonvoting interests/stock), either entity generally should suffice.

HOW MANY TIMES WILL THE SAME DOLLAR BE TAXED

LLC. Unless a special election is made, an LLC should be taxed as a flow-through partnership. Accordingly, while an LLC (with more than one owner) will file an annual partnership federal income tax return (Form 1065), the LLC itself will not pay income tax. Instead, the LLC's

SPECIAL SITUATIONS

- ✓ If you plan to start a rental real estate business and want a step-up in basis in your LLC interest (and the related real estate) at death, an LLC is usually the best choice. Generally, an S Corp should not hold real estate or highly appreciating investments.
- ✓ If you are forming a service business and want to minimize your employment taxes, an S Corp may be the better choice.
- ✓ If you anticipate losses in the first years of your business and want to deduct the maximum amount of losses, or if you want to use special allocations of tax items, an LLC may be a good choice. As your business later becomes profitable, an LLC may generally be converted to an S Corp on a tax-free basis (unless the LLC's debt exceeds its tax basis in its assets), whereas the conversion of an S Corp to an LLC is a taxable event.

items of income, gain, loss and deduction generally will flow through to its members in proportion to their respective interests and will be taxed on the members' respective income tax returns.

With proper planning, the members may make special allocations of various items of profit and loss to the members in different percentages and do not need to share proportionately in each item.

S Corp. The S Corp is also generally a flow-through entity that files an annual federal income tax return (Form 1120S); however, if the S Corp was previously a C Corp, there may be an additional tax on built-in gains existing at the time of the conversion. The shareholders pay tax on their proportionate share of the net pass-through items allocated to them from the S Corp. The shareholders must share proportionately in each pass-through item and no special allocations may be made.

C Corp. The C Corp is not a flow-through entity. It must file its own tax return and then each of its shareholders must pay the income tax applicable to any dividends that are distributed to the shareholders. If a profitable company is growing, this may be beneficial if the corporation has a lower tax rate than its shareholders. The funds may be retained by the corporation and no distribution is necessary for the shareholders in relation to their tax obligations.

Resulting Comparison: LLCs and S Corps generally offer one level of tax to their owners, but only the LLC allows special allocations of income, gain, loss or deduction among the owners. C Corps are taxed and then their shareholders are

taxed to the extent dividends are distributed out of the corporation's profits.

DISTRIBUTING THE SPOILS

LLC. When the LLC distributes assets to its members, the members generally will not be taxed on the distributions. However, a member may incur tax if (a) the member receives cash or marketable securities and the value of such assets exceeds the member's tax basis in its LLC interest, or (b) the member is relieved of debt in an amount that exceeds the member's tax basis in its LLC interest. If a member receives a distribution of assets (other than cash or marketable securities), the distribution generally will not trigger tax.

S Corp. An S Corp's distributions to its shareholders are generally nontaxable to the extent of the respective shareholders' tax basis in their stock. However, if the S Corp distributes an asset to a shareholder, the distribution will trigger taxable gain to the extent the fair market value of the asset exceeds its tax basis.

C Corp. A C Corp's distributions of cash or assets to its shareholders are generally taxable.

Resulting Comparison: When distributing assets to owners, the LLC may result in less taxes. However, most ordinary distributions of cash from either an LLC or an S Corp to their owners will be tax-free since the owners already paid tax on their share, of the flow-through items. Distributions from a C Corp are generally taxable to the recipient.

EMPLOYMENT TAXES

LLC. Generally, members who actively perform services are subject to employment tax on their entire share of the LLC's net income. However, if an LLC is engaged in a rental business, a member's share of the net rental income generally is not subject to employment tax. For example, if an LLC (a service business) allocated net income of \$110,000 to a member, the member would incur the following federal taxes: (a) income tax of \$27,500 (assuming a 25% rate), (b) social security tax of \$12,648 (12.4% on income up to \$102,000 wage base in 2008, and (c) Medicare tax of \$3,190 (2.9% on all income). The member would be left with \$66,662.

S Corp and C Corp.

Shareholders are only subject to employment tax on their compensation but not on distributions.

However, a shareholder's compensation must not be unreasonably low; otherwise, some of the shareholder's distributions may be recharacterized as disguised compensation. To demonstrate, if an S Corp (a service business) paid \$50,000 to a shareholder as compensation and \$60,000 as a distribution (\$110,000 total), the following federal taxes would be imposed: (a) income tax of \$12,500 (assuming a 25% rate) on the compensation and \$15,000 on the

distribution; (b) social security tax of \$6,200 (12.4% on the compensation), and (c) Medicare tax of \$1,450 (2.9% on the compensation). The shareholder would be left with \$74,850.

One additional item of note, S Corps allows the owner-employee (so long as required levels of ownership are met) to take an above-the-line deduction for health insurance premiums paid for by the employee for the employee or such employee's family members, as long as those premiums are reimbursed by the S Corp.

Resulting Comparison: An S Corp or C Corp may be a good choice when the owners are concerned about employment

taxes. However, if an owner's compensation is already above the wage base from other sources, the main difference between the LLC and an S Corp or C Corp (on income taxed as compensation) will be the Medicare tax (2.9%). In addition, more complex tax planning may be done

with multiple entities (LLCs, S Corps, C Corps or limited partnerships) to help minimize employment tax issues while utilizing the benefits of LLCs/limited partnerships.

LOSSES & TAX BASIS

LLC. A member may deduct its share of the losses up to the member's tax basis in its LLC interest, subject to at-risk and

SPECIAL SITUATIONS (CONT.)

- ✓ If you own agricultural properties (such as farm land) and want to operate your business out of an entity for liability protection and business reasons, and want to start making gifts to your descendants while still maintaining control over most business decisions, an LLC is the better choice.
- ✓ If your business operates in several states, a more complex business structure utilizing multiple types of entities (LLC, S Corp and/or limited partnership) may produce the best income tax result.

passive activity loss limitations. The member's tax basis in its LLC interest generally equals (a) the member's tax basis in its contributed assets, less (b) the member's contributed liabilities assumed by the LLC, plus (c) the Member's share of the LLC's liabilities, plus (d) the member's allocations of income, less (e) the member's allocations of losses, and less (f) the fair market value of assets and cash distributed to the member.

S Corp. A shareholder may deduct its share of the losses up to the shareholder's tax basis in his or her stock, subject to at-risk and passive activity loss limitations. The shareholder's tax basis in its stock generally equals (a) the shareholder's tax basis in its contributed assets, less (b) the shareholder's contributed liabilities assumed by the S Corp, plus (c) debt that the S Corp owes to the shareholder, plus (d) the shareholder's distributive share of income, less (e) the shareholder's distributive share of losses, and less (f) the fair market value of assets and cash distributed to the shareholder. A shareholder's basis does not include any part of debt that the S Corp owes to third parties or other shareholders.

C Corp. Losses accumulate within the corporation and may only be used to offset future profits of the C Corp subject to certain restrictions. A shareholder may not deduct its share of the losses.

Resulting Comparison: If the owners anticipate initial losses and the entity will have third party debt, the owners may be able to deduct some losses with the LLC; however, if minimal losses are expected or the owners have a high tax basis in their

interests/stock, either an LLC or an S Corp may work. If the owners of the entity do not have offsetting income where they could use the losses, a C Corp may be better to retain the losses to offset future corporate profits.

DEATH OF OWNER

LLC. Upon the death of an individual member, the deceased member's interest takes a step-up in basis equal to fair market value. As a result, the LLC may make an election (the 754 election) in which the LLC's assets related to the deceased member's interest may also receive a step-up in basis to the extent of the fair market value of the decedent's interest. A 754 election may also be made when a member sells or transfers its LLC interest during life.

S Corp or C Corp. Upon the death of an individual shareholder, although the deceased shareholders stock takes a step-up in basis to fair market value, the successor shareholder will not receive a step-up in basis in any of its share of the S Corp's or C Corp's assets.

Resulting Comparison: With the 754 election, a successor owner in an LLC will likely have less capital gains tax on the sale of the LLC's assets as a result of the step-up.

Entrepreneurs must also be aware of the tax liability to the State of Texas. As opposed to an income tax, entities with operations in Texas must pay the margin tax. Generally, the tax obligation for an LLC, S Corp or C Corp will be the same.

From a legal drafting standpoint, for most practical purposes an S Corp and a C Corp will require the same documentation. A C Corp becomes an S Corp solely by filing an election with the Internal Revenue Service. A C Corp may require additional documentation to designate the rights of its different classes of stock often referred to as a Certificate of Designations or these differences can be set forth in its Certificate of Incorporation or Certificate of Formation.

Many other factors may impact the choice of which entity best fits an entrepreneurs business plan. Successful entrepreneurs typically begin develop a close relationship with good advisors, including both accountants and legal counsel. These professionals can

assist with determining how best to address issues such as the relationship among owners, the management structure of the entity and the desirability for future investors.

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