

## LLCs vs. S Corporations: The Battle Rages On

By Dennis F. Gorman, Esq., CPA

The LLC, or limited liability company, became popular in the U.S. about 20 years ago after the IRS decided to characterize an LLC as a “partnership” for tax purposes. Prior to that time, a great deal of uncertainty existed regarding the classification of entities. With the “check the box” entity-classification regulations, however, the IRS has become much more user friendly. While both an LLC and an S corporation are “flow-through” entities, there are material differences.

In this article, we explore the several ways in which an LLC is superior to an S corporation.

### AN LLC IS SUPERIOR IN SEVERAL WAYS

1. LLCs come in two varieties: a regular LLC; and a Series LLC, which is permitted to have multiple divisions which are protected from one another regarding liabilities. Divisions within S corporations have cross liability for each other. (The Delaware Series LLC is named after the first state to approve such an LLC.)
2. An LLC provides better protection from creditors. The LLC statute states clearly that both the “members,” who are essentially the stockholders and the “managers” of an LLC shall have no personal liability with respect to any activities stemming from the LLC. If you, as an LLC member or manager, perpetrate a wrongful act, you would be liable for the act. However, if others within the LLC do likewise, you would not be liable. This same liability protection exists generally for the shareholders and directors of an S corporation. However, if you as an S corporation shareholder are sued personally and a judgment enters against you, the plaintiff could seize your shares in the S corporation. On the other hand, when you are an LLC member, the law prevents the plaintiff from seizing your shares in the LLC. Rather, the plaintiff may only obtain a “charging order” from the judge, stating that whenever the LLC makes a monetary distribution to you, the charging order could intercept and award it to the plaintiff.
3. Special allocations and loan basis. The Internal Revenue Code requires an S corporation’s profits or losses to be allocated pro rata at the end of each year to each of the owners, who must report them on their personal income-tax returns. With an LLC, on the other hand, you can provide special allocations of net income or net losses as well as specific items such as depreciation and tax credits to one member or another, as long as you meet the requirements of the Internal Revenue Code. This protection gives you great flexibility when you assemble, for example, a large building-renovation project involving historic tax credits by providing flexibility in allocating, e.g., the tax credits. Furthermore, net losses that flow through from LLCs and S corporations may only be used to reduce other income on the owner’s tax return to

the extent of the owner’s “basis” in the entity shares. LLC members receive basis credit for loan guarantees in addition to capital contributions and loans to the entity. S corporation shareholders receive no basis credit for loan guarantees.

4. An LLC generally avoids a capital-gains tax on a member’s contribution of appreciated assets to the company. With an S corporation, owners who contribute appreciated assets in one transaction must receive 80 percent or more of the stock concurrent with the transfer. Otherwise, the appreciated assets are treated as sale to the corporation, which requires the owner to pay a capital-gains tax on his or her personal return. Transfers of appreciated assets to an LLC are not subject to the 80-percent stock requirement for tax-free treatment.
5. An LLC generally avoids a capital-gains tax on the LLC’s transfer of appreciated assets to the members. This is useful when, for instance, the LLC members no longer need a company car and want to give it to a member’s son or daughter. With an S corporation, a transfer of appreciated assets outside the corporation triggers a taxable gain.
6. Estate and gift planning. An LLC may be used to attain discounts for gifting shares to your heirs for estate-planning purposes. The discount will generally be greater than those available for S-corporation stock.
7. An LLC is permitted to have a foreign investor as an owner. However, an S corporation is not.

### ADVANTAGES OF AN S CORPORATION

There are two issues that often cause advisors to lean towards forming an S corporation instead of an LLC. One, is that the LLC is the new kid on the block. As a result, people have been using S corporations much longer than LLCs and are, therefore, more comfortable in general with S corporations. The other, has to do with payroll taxes.

The question that arises is: Does the flow-through amount from the LLC or S-corporation constitute taxable self-employment income? In general, the income that flows from an S corporation is not subject to self-employment tax. With an LLC, however, the flow-through amount may or may not be subject to such a tax, depending on the type of business the LLC is in. When the LLC is in a strictly capital-intensive business -- i.e. the ownership of real estate -- the flow-through amount is generally not subject to self-employment tax. If, however, the LLC runs a barber shop, the members would have a hard time making the case that the income was used to pay for much more than their own labor.

## TAKE A REASONABLE SALARY

All things considered, keep in mind that the IRS is targeting S corporations for potential tax evasion. The IRS is on the lookout for owners who do not take reasonable salaries from their S corporation in order to try to beat the system by not withholding payroll taxes. The way to avoid IRS penalties for such conduct is to take a reasonable salary by the end of the year – and “reasonable” means much more than \$1 a year!

Whether you are an owner of an S corporation or a member of an LLC, you should take a reasonable salary from your business and pay the applicable payroll taxes on that money.

Keep in mind that the Social Security wage base is \$118,500 for 2015. Therefore, once you exceed the base, the Medicare tax is all that applies.

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