

From the 'Lectric Law Library's stacks Pros & Cons of C-Corporations, S-Corps, Ltd Liability Companies, Etc.



Excerpted from '95 *misc.business.consulting* newsgroup thread on the relative advantages of
C-Corps, S-Corps, LLCs, etc. - 'LLL Staff

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From: xxx@AZStarNet.com (John P)

Date: 21 Oct 1995 11:33:11 -0400

xxx@vnet.ibm.com wrote:

>Two small questions,

>**What is a [Limited Liability Corporation](#) ?**

>**How does it differ from a S-Corp ?**

Actually, in most states, you have three choices -- C, S, or LLC (Limited Liability Company).

C corporations get taxed on profits at corporate rates, and dividends are taxed to the shareholders. S corporations and LLCs (when approved by IRS, which approval is generally not hard to get) are taxed at personal rates, form 1040, Schedule C.

C corporations are subject to formal requirements, e.g., annual reports, board of director meetings, etc. S corporations also, possibly to a lesser extent. LLCs are exempt from these requirements, at least in many states.

S corporations are limited to 35 shareholders, and to domestic capitalization. LLCs are not so limited, at least in many states.

LLCs generally provide more accounting flexibility than either C or S corporations.

Bottom line, check your accountant, preferably a CPA, and your attorney for advice in your particular situation.

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From: xxx@well.sf.ca.us (Robert M)
Date: 21 Oct 1995 18:39:20 -0400

John Pederson wrote:

>C corporations get taxed on profits at corporate rates, and dividends
>are taxed to the shareholders. S corporations and LLCs (when >approved
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personal rates, form 1040, Schedule C.

S-Corp and Partnership income are not reported on Schedule C. That applies only to [sole proprietorships](#). S-Corp profits and depreciation are reported to shareholders on Schedule K-1, and reported on a 1040 through Schedule E. Also, cash dividends paid out to shareholders are reported on 1099-DIV, and claimed on the 1040 as is other dividend income.

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>reports, board of director meetings, etc. S corporations also,
>possibly to a lesser extent. LLCs are exempt from these requirements,
>at least in many states.

S-corps fall under the same reporting requirements as C corps. Annual reporting and BofD meeting requirements vary from state to state.

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From: xxx@AZStarNet.com (John P)
Date: 19 Nov 1995 09:07:32 -0500

Carol S wrote:

**>Would someone who has done a company fromation recently plese explain
>the pro's and con's of each type?**

Corporations generally provide protection against personal liability of individual shareholders with respect to claims against the business. Sole proprietorships and partnerships do not.

Corporations generally provide continuity beyond that available to sole proprietorships and partnerships.

C-Corporations are taxed as separate entities, at corporate rates, and then shareholders are taxed, at their individual rates, on dividends.

S-Corporations are generally like C Corporations, except that they are limited to 35 shareholders, can only use domestic capitalization, and are taxed only to the shareholders at their individual rates -- Form 1040, Schedule C. They must close their books at the end of each year, and shareholders pay taxes on all profits in the year earned, whether or not they are distributed. They are subject to IRS approval, in order to receive the individual tax treatment.

LLCs are new in the last 4 or 5 years. They are available in most but not all states. They are generally like S-Corporations, except that there are fewer formalities (e.g., no annual reports, no limitation to 35 shareholders, no limitation to domestic capital). They also are taxed to individual shareholders, provided IRS approval has been

obtained. There may be more accounting flexibility -- see your accountant, preferably a CPA.

These are the highlights. Best advice is still see a qualified attorney, preferably with LLC experience.

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From: xxx@well.sf.ca.us (Robert M)
Date: 20 Nov 1995 20:51:36 -0500

John P wrote:

>S-Corporations are generally like C Corporations, except that they are
>limited to 35 shareholders, can only use domestic capitalization, and
>are taxed only to the shareholders at their individual rates -- Form
>1040, Schedule C.

Again, the above paragraph is incorrect. Sole props. declare business income and expenses on Schedule C. Schedule C is not used to declare S-Corp. profits at all.

For an S-Corp., profits earned and depreciation taken is reported to shareholders via Schedule K-1 (which is not filed with the IRS). From Schedule K-1, the shareholder declares S-Corp. profits and takes depreciation credits on Schedule E.

Other features concerning S-Corps: Corp. cannot deduct benefits, such as [health insurance](#), for shareholders owning 2% or greater shares of the company. Corp. cannot own subsidiaries. Corp. cannot retain earnings, all earnings are taxed to shareholders regardless of distribution.

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From: xxx@airmail.net (J.M M)
Date: 21 Nov 1995 18:27:47 -0500

PRO'S OF INCORPORATION:

1. limited liability for shareholders; i.e. the shareholders are not individually liable for [debts](#) of the corporation, such as a lease obligation or loan payback.
2. a corporation may exist perpetually; unfortunately, all persons eventually die.
3. multiple classes of ownership; by using common stock and preferred stock with different rights, terms and conditions, a person forming a corporation has great latitude in providing its shareholders a return on their investment.
4. eliminate self-employment tax, which is payable by individuals engaged in business and by active members in a limited liability company.
5. some people think a corporation provides a much better image for conducting business operations, more sophistication, etc.
6. operating a corporation is relatively easy to understand; most of us are familiar with concepts of a board of directors, officers, and such.
7. incorporating a corporation can be done quickly if needed. I have done one in less than 24 hours.
8. in most states the corporation can take formal corporate action by written consent instead of holding a meeting of the board or the shareholders, which simplifies and makes more inexpensive its operation.

9. the laws are mostly settled concerning corporations, both from a tax status and for the duties and liabilities of the officers and directors. Most of the issues you would face in operating a corporation have already been dealt with and there will be a statute, case or administrative ruling concerning it.

CON'S

1. Tax. The corporation's income is taxed at the corporate level. Then when you distribute earnings to the shareholders via dividend, the shareholders include the dividend in their taxable income and are all taxed on that income again. This is commonly referred to as double taxation.
2. Added administrative costs. You will now have a new set of accounting books to keep, bank accounts to balance, etc. However, the fees paid to a CPA and/or bookkeeper may be deductible from income.

Congress responded many years ago to the double taxation issue by authorizing a "subchapter s" corporation. Subchapter s is a subchapter of the Internal Revenue Code which basically eliminates tax at the corporate level. A corporation figures up its income and expenses and passes both of those items through to its shareholders in proportion to their stock ownership. For example, a shareholder who owns 40% of the outstanding shares of stock would report, on his or her personal income tax return, 40% of the income and expenses of the corporation. The tax is levied only on the shareholders.

However, Congress also put some rather severe limitations on Subchapter S corporations. It is very difficult to use a fiscal year other than a [calendar](#) year. It can only have 35 total shareholders (husband and wife count as one shareholder). It can only have one class of stock. The shareholders can only be individuals or a qualified trust.

In response to these restrictions, in 1977 Wyoming became the first state to enact legislation recognizing the LLC business entity. The LLC is a hybrid of sorts. It has most of the same pros and cons as a regular corporation, except that it is taxed as the Subchapter S corporation, but adds an additional level of complexity in operation because it is very tax-sensitive. I cannot briefly explain why it is so tax sensitive, but suffice it to say that the tax treatment of an LLC is not guaranteed. It has to be properly designed and operated.

However, the IRS has now ruled that members active in management are subject to self-employment tax. And there is an open issue of whether there can even be, for tax purposes, a single-member LLC. Most commentators argue that a single member LLC should be taxed just like a sole proprietor. (A corporation can have just one shareholder without affecting its tax status.) This shows that the corporation's advantage of knowing the issues and answers does not apply to an LLC yet.

One can get around the self-employment tax issue by creating another entity to be the member and having the individual actively manage the entity. This works very well if the entity that is a member is a family limited partnership.

I most commonly advise [small businesses](#) to use the Subchapter S form so long as they can live with the restrictions. However in second place is the LLC.

Another issue you should consider is how many entities do you need. As a matter of basic asset protection in this litigious society, I generally advise my clients to set up a separate entity for each income stream. If there is a lawsuit, only one income stream is generally put in

jeopardy.

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