2013 Payroll Fact Sheet

Should Your Business Be an LLC or an S Corp?

You've finally decided to start a business of your own. Or maybe you have been running one as a sole proprietor, even moonlighting on the side, and have decided you need to protect your personal assets from those involved with your growing business. You might even decide there could be a tax break in it for you. Whatever your reasoning, you're likely contemplating a choice that many entrepreneurs face: should your enterprise be structured as a limited liability corporation, often called an LLC, or an S corporation, known commonly as an S corp, which is named after subsection S of Chapter 1 of the Internal Revenue Code? These two organizational forms have similarities and differences—which can make choosing between them and others, like a C corporation (which includes publicly-held companies), confusing at best. Each state might also have different rules that come into play. That's why you'll want to get some input from a respected accountant and/or attorney to help you decide what might be the best fit for your business.

Defining the Benefits

A major advantage of organizing your business as an LLC or an S corp is that you can protect your personal assets from the creditors of your business. "Limited liability means you can't be financially responsible for more than your investment in the company," writes Greg McFarlane in his book, *Control Your Cash: Making Money Make Sense*. "If you put in $10,000, and incur $11,000 in debt, you're only potentially liable for $10,000. Your creditors (check that, your LLC's creditors) can't 'pierce the corporate veil,' as the phrase goes."

Another common aspect of LLCs and S corps is that they help you avoid paying both personal and corporate taxes. The difference is that in an S corp, owners pay themselves salaries plus receive dividends from any additional profits the corporation may earn, while an LLC is a "pass-through entity," which means that all the income and expenses from the business get reported on the LLC operator's personal income tax return, says Ebong Eka, a CPA who also pens his own blog about the world of entrepreneurship at MoneyMentoringMinutes.com.

Both LLCs and S corps can also deduct pre-tax expenses, such as travel, uniforms, computers, phone bills, advertising, promotion, gifts, car expenses, and health car premiums, McFarlane writes.

Note the Differences

Once you understand the benefits that come from LLCs and S corps, it's time to explore some of the pros and cons of each approach. Here are some of the key differences, according to Eka:

LLC Pros:

1. The owner of a single member LLC doesn't have to file a tax return for the LLC, as they only report the activity on their personal tax return.
2. Ease of Set up: Most LLC forms are only a single page for single member LLCs.
3. Inexpensive to Start: The cost of setting up an LLC is also inexpensive, usually just a couple hundred dollars.
4. Guidelines: The red tape involved in forming an LLC isn't as stringent as that involved with S corps, which also leads to savings on accountant and attorney fees, among others.

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LLC Cons:

1. Self-employment Tax: Single Member LLC owners are required to pay self-employment tax on income generated in the LLC, which means making quarterly estimated payments to the IRS.
2. Owners of LLCs must make sure they don't pierce the "corporate veil," meaning they have to operate the LLC separately from their personal affairs. "The LLC must not be a shell but an operating entity," says Eka. "There have been cases where a business owner lost their protection because there was no distinct difference between the LLC and its owner."

S Corp Pros:

1. The key advantage of an S corp is that it offers tax benefits when it comes to excess profits, known as distributions. The S corp pays its employees a "reasonable" salary, which means it should be tied to industry norms, while also deducting payroll expenses like federal taxes and FICA. Then, any remaining profits from the company can be distributed to the owners as dividends, which are taxed at a lower rate than income.

S Corp Cons:

1. S corps have more strict guidelines than LLCs. Per the tax code, Eka says, you must meet the following standards to create an S corp:
   - Must be a U.S. citizen or resident
   - Cannot have more than 100 shareholders (a spouse is considered a separate shareholder for the purpose of this rule).
   - Corporation can only have one class of stock
   - Profits and losses must be distributed to the shareholders in proportion to the shareholder's interest. For example, you can't have disproportionate distributions of dividends or losses. If a shareholder owns 10 percent of the S corp, he or she must receive 10 percent of the profits or losses.
2. It costs more to form an S corp.
3. Shareholders must adhere to the requirements at all times. If they don't, they risk disallowing the S corp election and the corporation would be treated as a C corp and its corresponding restrictions.
4. Passive income limitation: You can't have more than 25 percent of gross receipts from passive activities, such as real estate investment.
5. There can be additional state taxes for S corps.
6. Shareholders should pay attention to paying themselves a "reasonable" salary for the work they perform for the S corp since the IRS is increasingly scrutinizing S corps for this.

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Case Study: Why an LLC Might Be Best for Your Business

Given that it takes far less red tape to organize and is generally cheaper to administer, the LLC might be your best choice if you're a new business owner, or operate an Internet business, says Eka.

There is also another key benefit of LLCs: you can elect to be taxed as an S corp while retaining the structure of an LLC. Consider the case of Mike Turner, founder of Front Street Brokers, a real estate agency in Boise, Idaho. When he started his business, which sells high-end homes and properties, he was advised to form it as an LLC, which he did. However, a couple years later, as the business began to earn more revenue, Turner was shocked by the amount of taxes he was paying the IRS. It was then that his accountant told him how he could elect to be taxed like an S corp while keeping his LLC intact. He decided to make the switch. He began paying himself and his wife a modest salary, which he also pays fees on like FICA and unemployment insurance, and then paying himself a monthly dividend from the extra profits his company was earning. "The rules are I must pay myself a realistic salary," says Turner. "I can't pay myself minimum wage, and do the rest in dividends. But in my industry, the average salary is not that high, so I can still take a hefty amount via the dividends. The difference has been a savings in between $6,000 and $8,000 a year that Turner saves in federal taxes. "I feel I get the best of both worlds," he says. "For my small business I get all the legal benefits of running my small business through an LLC, but I can be taxed as an S corp, which saves me money at tax time."

Case Study: Why an S Corp Might Be the Better Choice

While Turner's story is a compelling one for a smaller, lifestyle business, the truth is that fast-growing businesses who plan to bring on investors or share the ownership of the company with employees may need to consider making the switch to an S corp sooner rather than later.

Consider the case of Vicky Phillips, the founder of GetEducated.com, which provides guides and ratings for college courses and programs offered online. Phillips originally started her business, which is based in Burlington, Vermont, as an LLC and has kept it that way for 10 years. But now that her business is established—it now earns $1 million in annual revenue—she's ready to bring on investors to expand even faster. And, in talking to her advisers, she came to realize that it was in her best interest to convert her company into an S corp, despite some of the disadvantages of doing so. "There's much more paperwork required to substantiate everything," she says, since running an S corp requires you to hold meetings, keep minutes, make resolutions, elect officers, and produce formal financial statements. "But the S corp structure creates more separation between me and the company, which is something that investors and bankers are more comfortable with." Phillips says that she spent about $6,000 on attorney and accountant fees making the switch over from an LLC, whose assets were essentially bought by the new S corp, though she admits she could have spent less if she had been willing to do more of the paperwork herself. "I'm not a huge fan of more paperwork, which is one of the key reasons we held off on making the switch for as long as we did," she says.