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LLC or Corporation? What's Best For You?

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LLC or Corporation: What business form is right for you new enterprise?

By Mark B. Goddard

For most entrepreneurs, the choice of business entity comes down to an LLC or corporation, since both insulate personal assets from liability claims. LLCs, S corporations and C corporations all have advantages, depending on your business goals.

LLCs – flexibility and less hassle

One advantage of the LLC is the ability to choose how the company's income will be taxed. The members have the right to be taxed as either a partnership or as an S corporation. While both of these decisions offer "pass-through" taxation, this decision impacts other taxable issues like self-employment taxes.

Another advantage of an LLC is the ability to decide how profits are to be distributed. If your company's business plan is to reinvest all profits back into the company rather than make distributions to your members, then the pass through taxation does not offer much benefit. However, if distributions are planned to be made, then the pass-through taxation avoids paying both the corporate tax and then personal income tax on the income distribution.

While each state's laws for LLCs differ, generally, organizers are allowed to draft an operating agreement that covers almost all aspect of how the company will operate. This customization may be the primary reason to choose an LLC. Additionally, a big draw of the LLC is that it's easier to run and there are fewer record-keeping requirements. Corporations require many formalities that are not required of an LLC.

LLC members – equivalent to shareholders in a corporation – are all treated equally. There is only one class of ownership interest, unlike a C corporation, which can have preferred shares that receive preference in dividends.

One significant caveat on LLCs: some courts have ignored the corporate form for single-member LLCs for non-operating companies used simply to shield assets from creditors.

S corporation – a hybrid option

Like an LLC, an S corporation has pass-through taxation, and it has an additional advantage: a manager-shareholder can take a salary, plus additional income in dividends. Unlike the salary, the dividends won't be subject to Social Security and Medicare taxes, and that may create an overall tax savings. As is discussed above, an LLC can choose to be taxed as an S corporation.

An S corporation has only one class of stock, and it must adhere to all the formalities of a traditional corporation.

The "corporate-lite" nature of an S corporation is balanced by several restrictions that don't apply to either LLCs or C corporations. An S corporation is limited to 100 individual shareholders that must be U.S. citizens. Other companies and corporations cannot own S corporation stock.

C corporation – if you're thinking "big"

The C corporation is the "traditional" incorporated business, and it has the strictest formalities. There is no pass-through taxation. Thus, manager-owners will see profit taxed first at the corporate level, and a second time when it is distributed to them as dividends or salaries.

One big advantage of a C corporation is that it doesn't have to distribute profit at the end of the year. The C corporation can retain earnings, investing them in the business, paying debt or holding them for future distribution to shareholders. While an LLC and S Corp also do not have to distribute profit, due to the pass through taxation, the members or shareholders in these situations would face "phantom income" from the profit of the company with no distributions to cover the taxable liability.

As mentioned earlier, a C corporation can issue preferred stock, which may encourage investment, and there are no restrictions on who can own stock.

If you see a public offering in your future, a C corporation will place you in a better position to satisfy the reporting requirements of the Securities and Exchange Commission. An acquirer that is a public company also will find it easier to integrate a target company that already is maintaining corporate formalities.

We recommend that the starting point for selecting the right entity is to talk to your attorney about your long-range plans and goals for the business. While you can be successful with any business entity formation, the right choice will maximize tax savings, accommodate the inevitable changes that will come to your business, and save you aggravation and money.

About the Author

Mark Goddard is a shareholder in Turner Padget's Columbia office where he has an active litigation practice specializing in business and corporate litigation, complex insurance defense matters and probate litigation. He has extensive trial and arbitration experience and has taken over 25 cases to verdict in venues throughout South Carolina. He may be reached at (803) 227-4334 or by email at mgoddard@turnerpadget.com.

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