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## S Corp. vs. LLC: Which Structure is Right for Your Business

Determining the type of legal structure for a new business can be daunting for entrepreneurs and small business owners. Learn more about S Corporations and [Limited Liability Companies \(LLC\)](#), and decide if one of these business structures is right for you.

by Chrissie Mould  
Contributing Author

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across the S corporation. S corps and LLCs are similar in that they are both "pass-through" entities for tax purposes; the income of these companies are passed through to their owners and reported on the owners' personal [income tax returns](#), thereby eliminating the double taxation incurred by owners of a standard corporation, or C corporation. (With a C corporation, the net business income is subject to corporate income tax, and the monies remaining after the corporate income tax are taxed a second time when they are distributed as dividends to its owners who must then pay personal income tax.)

abSo what is the difference between an S corporation and an LLC? And which structure is right for you?

The answer depends on your own unique situation. If operational ease and flexibility are important to you, an LLC is a good choice. If you are looking to save on [employment tax](#) and your situation warrants it, an S corporation could work for you.

## Business Ownership & Operation



There are restrictions on who can be owners (called "shareholders") of an S corporation. An S corporation can have no more than 75 shareholders. None of the shareholders can be nonresident aliens. And shareholders cannot be other corporations or LLCs.

An S corporation is operated in the same way as a traditional C corp. An S corp. must follow the same formalities and record keeping procedures. The directors or officers of an S corp. manage the company. And an S corp has no flexibility in how profits are split up amongst its owners. The profits must be distributed according to the ratio of stock ownership, even if the owners may otherwise feel it is more equitable to distribute the profits differently.

LLCs offer greater flexibility in ownership and ease of operation. There are no restrictions on the ownership of an LLC. An LLC is simpler to operate because it is not subject to the formalities by which S corps must abide. An LLC can be member-managed, meaning that the owners run the company; or it can be manager-managed, with responsibility delegated to managers who may or may not be owners in the LLC.

And the owners of an LLC can distribute profits in the manner they see fit.

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Let's say, for example, you and a partner own an LLC. Your partner contributed \$40,000 for capital. You only contributed \$10,000 but you perform 90% of the work. The two of you decide that, in the interest of fairness, you will each share the profits 50/50. As an LLC you could do that; with an S corporation, however, you could only take 20% of the profits while your partner would take the other 80%.

### Employment Tax: Savings vs. Paperwork

A major factor that differentiates an S corporation from an LLC is the employment tax that is paid on earnings. The owner of an LLC is considered to be self-employed and, as such, must pay a "self-employment tax" of 15.3% which goes toward social security and Medicare. The entire net income of the business is subject to self-employment tax.\*

In an S corporation, only the salary paid to the employee-owner is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules.

Therefore, there is the potential to realize substantial employment tax savings. Case in point:

Mary owns a print shop. In keeping with the industry standard, Mary decides that a reasonable salary for a print shop manager is \$35,000 and pays herself accordingly. Mary's total earnings for the year are \$60,000: \$35,000 paid in salary and the remaining \$25,000 paid as a distribution from the S corp. Mary's total employment tax is \$5,355 (15.3% of \$35,000).

If Mary were the owner of an LLC, she would have to pay employment tax on the entire \$60,000, equaling \$9,180. But as an S corporation, she realizes savings of \$3,825 in employment tax.

One might assume that these savings could be further manipulated by reducing the salary to an extremely low amount and attributing the rest of one's earnings to distributions—but this would be an incorrect assumption. In practice, the IRS is careful to notice whether a salary is reasonable by industry standards. If it determines a salary to be unreasonable, the IRS will not hesitate to reclassify distributions as salary.

Still, while the potential employment tax savings may make the S corporation an attractive structure for your business, bear in mind that you would then have to deal with all the paperwork associated with payroll tax. The payroll tax is a pay-as-you-go tax that must be paid to the IRS regularly throughout the year—on time, or you will incur interest and penalties. The paperwork alone can be an overwhelming task for someone who is not familiar with this; and if you expect to incur losses or otherwise experience a cash flow crunch during the year that would hinder you from paying the payroll tax when due, this could present a problem.

Owners of LLCs pay their self-employment tax once a year on April 15 when income taxes are normally due. Income [tax filings](#) are also relatively easy for the owners of an LLC: A single-member LLC files the same 1040 tax return and Schedule C as a sole proprietor; partners in an LLC file the same 1065 partnership tax return as do owners of traditional partnerships.

The comparison chart below sums up the similarities and differences between the two business structures:

	S Corporation	Limited Liability Company
Liability Protection	Yes	Yes
Operational Control	Board of Directors/Officers	May be member-managed or manager-managed
<a href="#">Federal Income Tax</a>	Pass-through	Pass-through
Flexibility/Ease of Operation	No; subject to some formalities and record keeping rules as traditional C corps	Yes
Ownership Restrictions	Yes	No
Flexibility in Profit-Sharing	No	Yes
Employment Tax	Employment/payroll tax on salary; no employment tax on dividends paid to shareholders	Self-employment tax on total net income *

There is no one, magical entity that works for everyone. A CPA or a specialized tax attorney can assist you in choosing the right structure for your business. The important thing is to consider the operational, legal and tax aspects of each structure as they apply to your unique situation.

\* The self-employment tax rate for 2011 is 13.3% (10.4% for social security and 2.9% for Medicare). For self-employment income earned in 2010, the self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

For both 2010 and 2011, only the first \$106,800 of total net income is subject to the social

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security portion of the tax. All of the the total net income is subject to the Medicare portion of the tax. (Source: IRS <http://www.irs.gov/businesses/small/article/0,,id=98846,00.html>)

•For those who prefer the tax treatment of an S corp but like the simplicity of an LLC, there is an alternative worth considering: Forming an LLC that is taxed as an S corp. An LLC may make a special election with the IRS to be taxed as an S corp. This election is made on IRS Form 2553 and must be filed with the IRS before the 16th day of the third month of the tax year in which the election is to take effect.

An LLC that is taxed as an S corp is still a limited liability company from a legal standpoint (subject to the laws governing limited liability companies in the state of formation); however, for tax purposes it is treated as an S corp.

**A word of caution:** Certain nuances of S corp taxation can be confusing to some LLC owners, especially do-it-yourselfers and/or those who prepare their own tax returns; for example, an LLC owner might easily make the mistake of referring to an IRS publication that addresses LLCs when, in fact, such a publication would not apply to an LLC that is taxed as an S corp--and such an error could lead to negative tax consequences. It is therefore highly recommended that you consult a CPA or other qualified tax professional for advice and/or assistance.

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Chrissie Mould has over a decade of experience in corporate and small business administration and [startup business](#) consulting. She is an incorporation specialist and CEO of New Ventures, LLC. The company provides low-cost incorporation services to entrepreneurs and small businesses.

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