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Choice of Entity: Corporation or Limited Liability Company?

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There are many different types of business entities, including corporations, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, and even sole proprietorships. Historically, the most popular type of entity was the corporation, but in the last ten years, the limited liability company (LLC) has become the entity of choice. The reasons for this shift are that an LLC provides its owners with limited liability protection (like a corporation) and more favorable tax treatment (like a partnership). Also, since the rights and obligations of owners are largely contractual, an LLC provides its owners with greater flexibility in structuring management, voting and economic terms.

The corporation, however, remains an important entity, especially since it may provide its owners with favorable tax treatment by electing to be treated as an S corporation. As a result, this paper summarizes some of the general advantages and disadvantages of corporations, S corporations and LLCs, and then reviews the more important characteristics of these three types of business entities.

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SUMMARY OF GENERAL ADVANTAGES AND DISADVANTAGES

C CORPORATION	
ADVANTAGES	DISADVANTAGES
Owners have limited liability	Double taxation
Multiple classes of stock permitted with different economic interests (e.g., common and preferred stock)	Must observe corporate formalities such as annual meetings and written minutes
No restrictions on number, type or citizenship of owners	
Owners may freely transfer shares of stock (unless otherwise restricted in writing)	
Incentive stock options for employees are permitted	
Corporate law is well settled	

S CORPORATION	
ADVANTAGES	DISADVANTAGES
Owners have limited liability	Maximum of 100 shareholders
Owners may freely transfer stock to permissible types of owners (unless otherwise restricted in writing)	Must observe corporate formalities such as annual meetings and written minutes
Incentive stock options for employees permitted	One class of stock only, although there may be voting and non-voting shares
One level of taxation, shared pro rata among owners	Only U.S. citizens and resident aliens may be owners; no entities (except single-members LLCs) may be owners
Corporate law is well settled	Owners pay income taxes on corporation’s income, even if they do not receive cash (“phantom” income)

LIMITED LIABILITY COMPANIES	
ADVANTAGES	DISADVANTAGES
Owners have limited liability	Person may become member only with consent of all members (unless otherwise agreed in writing)
Multiple classes of membership interests permitted	LLC case law and some tax issues still developing
No restrictions on number, type or citizenship of owners	Offering incentive equity to employees is more complex and not well understood by employees
Flexible management (management structure can mimic corporation, partnership, or hybrid)	Self-employment taxes for owners who are active in LLC
One level of taxation, shared based on owners’ agreement	Owners pay income taxes on LLC’s income, even if they do not receive cash (“phantom” income)
No “corporate” formalities	

	C corporation	S corporation	LLC

CHARACTERISTICS

FORMATION			
Method of formation	File certificate of incorporation with state.	File certificate of incorporation with state.	File certificate of formation with state.
Governing documents	Certificate of incorporation, bylaws and, if desired, shareholders agreement.	Certificate of incorporation, bylaws and, if desired, shareholders agreement.	Certificate of formation and operating agreement.
Designation of owners	Shareholders	Shareholders	Members
Number of owners	One or more shareholders.	One to 100 shareholders, with spouses counted as one shareholder.	One or more members.
Eligible types of owners	No restrictions.	Individual U.S. citizens and resident aliens only; estates and certain trusts; no corporations, LLCs or other business entities.	No restrictions.
Capital structure	No restrictions on number or types of classes of stock (e.g., common stock and preferred stock).	One class of stock only, but there may voting and non-voting shares.	No restrictions.
Owner's personal liability	Liability limited to shareholder's capital contributions to corporation.	Liability limited to shareholder's capital contributions to corporation.	Liability limited to member's capital contributions to LLC.
Transfer of equity	Shareholders may freely transfer stock, unless restricted in certificate of incorporation, bylaws or shareholders agreement.	Shareholders may freely transfer stock, unless restricted in certificate of incorporation, bylaws or shareholders agreement, but transfer to wrong type of owner will cause corporation to lose its S corporation status.	Economic rights may be transferred; full rights (i.e., voting and management) may be transferred only with approval of all members, unless otherwise provided in operating agreement.
MANAGEMENT			
Identity of managers	Centralized management; shareholders elect directors, and directors appoint officers.	Centralized management; shareholders elect directors, and directors appoint officers.	Very flexible; members can specify management structure in operating agreement to mimic corporation, general or limited partnership, or hybrid; generally, all members may manage or they may delegate management to managers in operating agreement.
Persons with authority to bind company	Officers; board of directors as a whole.	Officers; board of directors as a whole.	Generally, any member (if member-managed) or manager (if manager-managed), or as provided in operating agreement.
Voting	Based on number of voting shares.	Based on number of voting shares.	Based on members' profit percentages, unless otherwise provided in operating agreement. For NJ LLCs formed after March 18, 2013, each member has an equal vote, unless otherwise provided in operating agreement.

	C corporation	S corporation	LLC
Formalities	Annual shareholders meeting required to elect directors, and minutes to memorialize major decisions (but may be done by written consent in lieu of meeting); failing to follow corporate formalities makes it easier for a court to pierce the corporate veil and hold shareholders personally liable.	Annual shareholders meeting required to elect directors, and minutes to memorialize major decisions (but may be done by written consent in lieu of meeting); failing to follow corporate formalities makes it easier for a court to pierce the corporate veil and hold shareholders personally liable.	None required.
TAXATION – ON FORMATION			
Taxation on formation	Corporation's issuance of stock to shareholders in exchange for money, property or services is not taxable to corporation. Generally, shareholders' receipt of stock in exchange for money or property (not services) is not taxable to shareholders if immediately after the exchange they are in control of 80% of all shares of stock. Shareholder's receipt of stock in exchange for services is taxable to shareholder based on the value of the stock received, unless stock cannot be transferred and there is a substantial risk of forfeiture (e.g., employee's right to stock ownership is conditional, such as returning the stock if he doesn't complete 5 years of service), in which case it will not be taxable income at the time of receipt.	Corporation's issuance of stock to shareholders in exchange for money, property or services is not taxable to corporation. Generally, shareholders' receipt of stock in exchange for money or property (not services) is not taxable to shareholders if immediately after the exchange they are in control of 80% of all shares of stock. Shareholder's receipt of stock in exchange for services is taxable to shareholder based on the value of the stock received, unless stock cannot be transferred and there is a substantial risk of forfeiture (e.g., employee's right to stock ownership is conditional, such as returning the stock if he doesn't complete 5 years of service), in which case it will not be taxable income at the time of receipt.	LLC issuance of membership interest to members in exchange for money, property or services is not taxable to LLC. Generally, members' receipt of membership interest in exchange for money or property is not taxable. Generally, if a member receives a capital interest (i.e., capital account with positive value – meaning an immediate share of liquidation value of LLC) in exchange for services, the member has taxable income based on value of membership interest. If a member receives only a profits interest (i.e., capital account of zero – meaning only a share of future profits of LLC), the member does not have taxable income.
Tax basis	Corporation's basis in property received from shareholder is equal to shareholder's basis in property. Shareholder's basis in stock is equal to his basis in property contributed to corporation. Where stock is received in exchange for services, shareholder's basis in stock equals value of stock.	Corporation's basis in property received from shareholder is equal to shareholder's basis in property. Shareholder's initial basis in stock is equal to his basis in property contributed to corporation. The tax basis will increase and decrease with income, loss, deductions and credits passed through to shareholder from corporation, and will decrease with cash distributions (but not below zero). Where stock is received in exchange for services, shareholder's basis in stock equals value of stock.	LLC's basis in property received from member is equal to member's basis in property. Member's initial basis in membership interest is equal to his basis in property contributed to LLC. The tax basis will increase and decrease with income, loss, deductions and credits passed through to member from LLC, and will decrease with cash distributions (but not below zero). Where membership interest is received in exchange for services and is a capital interest, member's basis in membership interest equals value of membership interest. Where membership interest is received in exchange for services and is a profits interest, member's basis in membership interest equals zero.

	C corporation	S corporation	LLC
TAXATION – DURING OPERATIONS			
Levels of taxation	Two; C corporation pays tax on its income, and shareholders pay tax on any dividends received from corporation.	One; S corporation's income, loss, deductions and credits pass through to shareholders pro rata and reported on each shareholder's personal income tax return.	One; LLC's income, loss, deductions and credits pass through to members based on agreed share (i.e., allocation) and reported on each member's personal income tax return. LLC can elect to be taxed as a C corporation or an S corporation (provided it satisfies S corporation requirements).
Taxable income	Corporation pays taxes on its income and shareholders pay taxes on the dividends or other distributions received from the corporation.	Each shareholder is taxed on his pro rata share of the corporation's income based on percentage ownership, whether or not the income is distributed to the shareholders.	Each member is taxed on his allocable share of the LLC's income based on agreement of members, whether or not the income is distributed to the members. For NJ LLCs formed after March 18, 2013, each member receives equal distributions, unless otherwise provided in operating agreement, which may result in each member being taxed on an equal share of LLC's income.
Distributions to owners	Distributions to shareholders made from corporation's earnings and profits are taxed as dividends. Distributions to shareholders in excess of corporation's earnings and profits are not taxed, but reduce shareholder's tax basis in stock. Distributions that exceed shareholder's tax basis are taxed as capital gains.	Distributions to shareholders are tax-free (because shareholders already paid taxes when income was allocated to them pro rata); however, distributions that exceed a shareholder's adjusted tax basis in stock are taxed as capital gains.	Distributions to members are tax-free (because members already paid taxes when income was allocated to them); however, distributions that exceed a member's adjusted tax basis in membership interest are taxed as capital gains.
Special allocation of income among owners	Not permitted.	Not permitted; allocations are made pro rata based on stock ownership percentages.	Permitted, allocations are made as agreed by members, but allocations must have "substantial economic effect." IRS has several complex tests to determine whether allocations have substantial economic effect, but allocations will pass tests so long as economic effects eventually are the same as the tax effects.
Deductibility of losses	Losses deductible at corporate level (losses do not pass through to shareholders), but losses can be carried back or forward.	Losses pass through to shareholders, but there are limitations (e.g., loss deductions limited to tax basis in stock and amount at risk, and passive activity loss rules).	Losses pass through to members, but there are limitations (e.g., loss deductions limited to tax basis in membership interest and amount at risk, and passive activity loss rules).

	C corporation	S corporation	LLC
Corporate tax rates	Federal corporate income tax rate – 15% to 39%, but typically 34% or 35%. NJ corporate income tax rate – 6.5% to 9% on NJ source income.	N/A, unless there is a “built-in gains” tax (see taxation on sale of business, below).	N/A
Personal tax rates	Federal income tax rate for shareholders – 10% to 39.6%, but personal dividend tax rates are: – 0% for taxpayers in 10% and 15% tax brackets – 20% for taxpayers in 39.6% tax bracket – 15% for taxpayers in other tax brackets – plus 3.8% Medicare tax if shareholder has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly NJ personal income tax rate – 1.4% to 8.97%.	Federal income tax rate for shareholders – 10% to 39.6% Plus a 3.8% Medicare tax if distributions are otherwise taxable and shareholder has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly NJ personal income tax rate – 1.4% to 8.97%.	Federal income tax rate for members – 10% to 39.6% Plus a 3.8% Medicare tax if distributions are otherwise taxable and member has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly NJ personal income tax rate – 1.4% to 8.97%.
Special taxes or rules	Accumulated earnings tax on earnings and profits accumulated by corporation and not distributed to shareholders (to avoid taxes on dividends), which is intended to encourage payment of dividends.	To avoid future problems, should elect S corporation status within 2½ months of formation. All shareholders must consent to S corporation election (more than 50% of shareholders may revoke S corporation status).	Sale of more than 50% of membership interests in 12 month period terminates multi-member LLC for tax purposes.
Accounting method	Accrual method required (recognize income when earned, not when cash received), unless gross revenues are below $5 million per year (or the corporation is a qualified personal service corporation).	Generally, accrual method or cash method, but accrual method is required when goods are sold from inventory.	Generally, accrual method or cash method, but accrual method is required when goods are sold from inventory or there is a C corporation as a member and the LLC has gross revenues of more than $5 million per year.
Tax returns	Corporation files Form 1120; if dividends are paid, it provides Form 1099 to shareholders.	Corporation files Form 1120S (information return) and provides Form K-1 to shareholders for their pro rata share of income and other items.	Multi-member LLC files Form 1065 (information return) and provides Form K-1 to members for their allocable share of income and other items. Single-member LLC is a disregarded entity and no tax return is filed by LLC (all income and other items are reported on member’s personal tax return).

	C corporation	S corporation	LLC

TAXATION – ON TERMINATION			
Taxation on sale of business (see below for tax rates on ordinary income and long term capital gains)	Sale of stock: Shareholder pays income tax on gain resulting from sale of stock (i.e., sale proceeds less tax basis). Sale of assets: Corporation pays income taxes on gain resulting from sale of assets, and shareholders pay income taxes on gain from their receipt of sale proceeds received from corporation.	Sale of stock: Shareholder pays income tax on gain resulting from sale of stock (i.e., sale proceeds less adjusted tax basis). Sale of assets: Corporation does not pay income taxes on gain resulting from sale of assets (which can be ordinary or capital gain based on nature of asset); the gain passes through to shareholders, who pay income taxes on their personal tax returns. However, corporation may have to pay "built-in gains" tax if corporation was a C corporation and converted to an S corporation within five years from the sale.	Sale of membership interest: Member pays income tax on gain resulting from sale of interest (i.e., sale proceeds less adjusted tax basis); some gain may be taxed as ordinary income and not as capital gain. Sale of assets: LLC does not pay income taxes on gain resulting from sale of assets (which can be ordinary or capital gain based on nature of asset); the gain passes through to members, who pay income taxes on their personal tax returns.
Tax-free reorganizations	Corporation can merge with another corporation, generally resulting in tax-free treatment to corporation and shareholders.	Corporation can merge with another corporation, generally resulting in tax-free treatment to corporations and shareholders, but a merger can result in the loss of S corporation status based on number or type of shareholders.	Generally, LLC may merge with corporation, but the merger may not be tax-free.
Liquidation	Corporation recognizes gain or loss, and pays taxes, on distribution of property to shareholders as if it sold property at fair market value. Distributions to shareholders are treated as if shareholders sold their stock.	Corporation recognizes gain or loss on distribution of property to shareholders as if it sold property at fair market value, but gain or loss passes through to shareholders and each shareholder's tax basis in his stock is adjusted (which in effect results in one level of taxation). Distributions to shareholders are treated as if shareholders sold their stock.	LLC may sell its assets and distribute cash to members, who would have a gain to the extent the distribution exceeds his adjusted tax basis in his membership interest. LLC may distribute its property to each member, and member's tax basis in property would be equal to LLC's tax basis in such property.
Long term capital gains tax rates (for assets held for one year or longer)	Federal capital gains tax rates for shareholders – 0% for taxpayers in 10% and 15% tax brackets – 20% for taxpayers in 39.6% tax bracket – 15% for taxpayers in other tax brackets – plus a 3.8% Medicare tax if shareholder has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly	Federal capital gains tax rates for shareholders – 0% for taxpayers in 10% and 15% tax brackets – 20% for taxpayers in 39.6% tax bracket – 15% for taxpayers in other tax brackets – plus a 3.8% Medicare tax if distributions are otherwise taxable and shareholder has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly	Federal capital gains tax rates for members – 0% for taxpayers in 10% and 15% tax brackets – 20% for taxpayers in 39.6% tax bracket – 15% for taxpayers in other tax brackets – plus a 3.8% Medicare tax if distributions are otherwise taxable and member has modified adjusted gross income over $200,000 if filing single and $250,000 if married filing jointly

	Note that there are no capital gains tax rates for C corporations; such gains are taxed as ordinary income.		
COMPENSATION			
Wages	Shareholders who are employees pay income taxes on wages received from corporation; shareholder-employee will receive a Form W-2 for wages.	Shareholders who are employees pay income taxes on wages received from corporation; shareholder-employee will receive a Form W-2 for wages.	Although members can provide services to an LLC, legally they cannot be employees. Compensation for such services is often known as a “guaranteed payment” (because members are entitled to such payment even if LLC does not make a profit), and is reported on a member’s Form K-1.
IRS tests	Corporation may deduct *reasonable* compensation paid to shareholder-employee, but IRS may determine that *excessive* compensation was paid to shareholder to avoid double taxation and a portion should have been paid as dividends, which are not deductible.	Corporation cannot pay excessive dividends instead of compensation to shareholder-employee to avoid employment taxes because IRS may determine that compensation paid to shareholder-employee is *inadequate* and impute additional wages to shareholder.	
Withholding, and employment taxes	Corporation is required to withhold federal and state income taxes and employee’s portion of social security and Medicare taxes from employee’s compensation. Corporation pays one-half of employment taxes. Employee pays one-half of employment taxes like any other employee, plus a 0.9% Medicare tax if shareholder’s compensation income is over $200,000 if filing single and $250,000 if married filing jointly. Corporation must pay federal unemployment taxes (FUTA).	Corporation is required to withhold federal and state income taxes and employee’s portion of social security and Medicare taxes from employee’s compensation. Corporation pays one-half of employment taxes. Employee pays one-half of employment taxes like any other employee, plus a 0.9% Medicare tax if shareholder’s compensation income is over $200,000 if filing single and $250,000 if married filing jointly. Dividends and other distributions to shareholders are not considered compensation for employment tax purposes. Corporation must pay federal unemployment taxes (FUTA).	LLC is not required to withhold (except in the case of foreign members); instead, members pay estimated taxes. Member pays self-employment taxes (i.e., employer and employee portions of social security and Medicare taxes) on guaranteed payments, plus a 0.9% Medicare tax if member’s compensation income is over $200,000 if filing single and $250,000 if married filing jointly. Member who is “active” in the business of LLC pays self-employment taxes on allocable share of income, even if member does not receive cash distribution and even if member does not receive a guaranteed payment (i.e., salary), plus a 0.9% Medicare tax if member’s compensation income is over $200,000 if filing single and $250,000 if married filing jointly. (continued on next page)

	C corporation	S corporation	LLC
			Member is “active” if (i) he can be held personally liable for the debts of LLC, (ii) he works more than 500 hours per year in LLC’s business, or (iii) he has authority to legally bind LLC to contract with third party. Inactive members are not subject to self-employment taxes. Members are not subject to federal unemployment taxes (FUTA).
Employee benefits	Shareholder must be a paid employee to receive employee benefits. Generally, these benefits are not taxed to the shareholder-employee, and are deductible expenses for corporation.	Shareholder must be a paid employee to receive employee benefits. For shareholder-employee who owns more than 2% of corporation, some benefits are taxable, and are not deductible expenses for corporation.	Member must provide services to LLC and receive guaranteed payments (i.e., salary) to receive “employee” benefits. Such benefits are taxable to the member as a guaranteed payment, and are not deductible expenses for the LLC.
Stock options and other equity incentive plans	Incentive stock option plans are permitted. Corporation can grant stock options to employees. With incentive stock option plans, the grant of the option and the exercise of the option are not taxable to employee; instead, employee is taxed when stock is sold. With other types of stock option plans, employee may be taxed when options are granted, when options are exercised, and when stock is sold.	Incentive stock option plans are permitted. Corporation can grant stock options to employees. With incentive stock option plans, the grant of the option and the exercise of the option are not taxable to employee; instead, employee is taxed when stock is sold. With other types of stock option plans, employee may be taxed when options are granted, when options are exercised, and when stock is sold.	Incentive stock option plans are not permitted, but other types of equity incentive plans are permitted, such as profits interests and options to acquire capital interests (although not well understood by employees). Legally, employee who becomes a member will no longer be an employee and must pay self-employment taxes. Also, employee benefits will be taxed as guaranteed payments.

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