

**Limited Liability Companies versus S Corporations:
New thoughts on an old dilemma**

by Rebecca Shwayder Aman

Since the passage of the Virginia Limited Liability Company Act in 1991, the LLC versus S Corporation dilemma has been one that many new Virginia business owners encounter when choosing their business entity. Generally speaking, limited liability companies (LLCs) enable businesses to take advantage of the best of both the corporate and partnership worlds: offering the tax flexibility of partnerships as well as the state law benefits, such as limited liability, of a corporation. For these reasons, the LLC has become the most popular entity of choice for small business owners, young professionals and entrepreneurs over the last decade. When a new business owner considers what entity he should form in order to transact business, increasingly an LLC first comes to mind; however, the complete answer may be a bit more complex.

One less familiar structure that some business owners are choosing is an LLC that elects to be taxed as an S Corporation (S Corp). Why would a business owner establish an LLC only to be taxed as an S Corp? An S Corp has a distinct tax advantage over the LLC in certain types of businesses, such as a business in which the return on an owner's service to the company is greater than his or her time involvement.

To better understand this benefit, it is important to note that an S Corp is not a legal entity in the same way that an LLC or general corporation is an entity. An S Corp begins as a general corporation under state law. The "S" is a tax status, which is elected by the corporation, under the Internal Revenue Code. Because an S Corp is a regular corporation under the Virginia Stock Corporation Act, it is subject to the same formalities and requirements as any corporation, such as having a board of directors and annual meetings. Furthermore, the IRS imposes a laundry list of ownership limitations and requirements on an S Corp, which if the corporation fails to meet at any time can subject the corporation to penalties, additional obligations and a loss of S status.

Given the IRS requirements imposed on S Corps and the preference of most small business owners for a more flexible structure with fewer legal formalities, their inclination towards the LLC is logical. That said; some businesses may still benefit from the tax treatment of an S Corp.

One of the key differences in tax treatment between LLCs and S Corps relates to self employment taxes. An LLC owner who actively participates in the business of the LLC risks all of his income from the LLC being subject to self employment taxes. The LLC owner cannot separate income which should be treated as compensation from income which should be classified as a distribution (or “dividend” in corporate lingo). Conversely, S status enables a participating owner to separate his income from company profits. For example, the owner of a company that makes widgets may very well put in similar amounts of time overseeing and managing the company, whether 1000 or 10,000 widgets are sold. At some point, the company’s revenue becomes less a function of the owner’s service to the company and more a function of the number of widgets sold. With S status, the company can pay the owner a fair wage for his services rendered, subject to payroll taxes, and a distribution to him of his share of any profits, not subject to payroll taxes.

An LLC which elects to be taxed as an S Corp can provide such business owners with both the informalities and flexibility of an LLC and the tax treatment of an S Corp. As a result, the LLC owners get their desired tax treatment plus the benefits of an LLC. While an LLC that elects S status still must meet the IRS requirements for S status tax treatment, should the LLC ever fail to meet these requirements, it would simply revert to the LLC default tax treatment of a partnership or sole proprietorship. That is, the LLC would not face the double taxation regime imposed on a corporation losing S status.

The above illustration explains one possible structure for a small business owner; however, each business is unique. Furthermore, the law continues to evolve. Recently debated in the Senate was a provision that would have subjected all of the profits of some professional service S corporations to self employment taxes. While that proposal did not succeed, it does serve to highlight the ever-changing nature of the legal landscape. For these reasons, we recommend that you discuss your unique business situation with an experienced attorney or accountant. JBWK’s Business Law Group can assist your business or organization with determining the most appropriate structure for your business needs.