Choosing Between a LLC and a Corporation

A very common question among people starting a business is what type of business should they form?

There is no blanket answer for this. One thing we do always recommend, however, is that you choose some type of entity that will protect you from personal liability. That is, you don't want to expose your personal assets, such as your home, your cars or your savings, to liabilities or lawsuits that may come as a result of the business. This is why we seldom recommend doing business as a sole proprietor.

The most common types of entities that provide liability protection are corporations and limited liability companies, or LLCs. We have summarized key similarities and differences for these entities in the table below.

Note that s-corporations and c-corporations are both corporations, so they are viewed the same for liability protection. The only differences between them relate to taxation.

	LLC	S-CORPORATION	C-CORPORATION
Ownership	• Unlimited number of persons or entities called Members • Different classes of ownership allowed	• Owners called Shareholders • Limited to 100 • Types of shareholders also limited • Only one class of stock allowed	• Unlimited number of persons or entities called Shareholders • Different classes of ownership allowed
Liability of Owners	• Limited - Owners generally not personally liable	• Limited - Owners generally not personally liable	• Limited - Owners generally not personally liable
Duration	• May exist for specific term or be perpetual	• Perpetual	• Perpetual
Management	• May be member-managed • Members may elect one or more managers	• Shareholders elect Board of Directors • Board appoints Officers to run day to day activities	• Shareholders elect Board of Directors • Board appoints Officers to run day to day activities
State Compliance	• Annual renewal fee with state • No specific formalities to be followed	• Annual renewal fee with state • Must follow formalities of meetings and minutes	• Annual renewal fee with state • Must follow formalities of meetings and minutes
Distributions	• Highly flexible in how income is allocated	• Must be in proportion to stock ownership	• Each class of stock must be in proportion to ownership

Taxation	• Taxed as a partnership by default – no election necessary • No federal taxation, reduced state taxation • Income or loss is reflected on owners' tax returns • Income to owners considered self-employment income	• Must file election with IRS to be s-corp • No federal taxation, reduced state taxation • Income or loss is reflected on owners' tax returns • Income to owners not considered self-employment income	• No special election necessary • Corporation pays tax on its income to federal and state • Owners may not deduct losses on their personal tax returns • Owners pay tax again when they take money out

Pros and Cons of C-Corporations

Pros:

- It's easier to raise money from investors, because they are familiar with this structure. Also, the securities laws favor c-corporations. If there are any plans for a public offering down the road, a c-corporation should be used.
- It's easier to offer incentives like stock options, etc. to key employees.

Cons:

- You have to follow all the corporate formalities to remain valid.
- Income will wind up being double taxed. That means the corporation pays tax on its income, and then the owners pay tax again when they take the money out as dividends. The corporation also pays tax at a higher rate than the personal tax rates.
- You have to be concerned about other taxes, such as the accumulated earnings tax or the personal service corporation tax.
- Owners cannot deduct losses on their personal taxes.

Pros and Cons of S-Corporations

Pros:

- Income only gets taxed once, at the shareholder level. The corporation doesn't pay federal tax on its income (states can be a different story).
- If you have a small number of owners, and they are all individuals, then you may want an s-corporation. The income that passes through to the owners is not considered self-employment income under IRS rules. This means the owners don't pay self-employment tax (Social Security and Medicare) on that income.
- Owners can deduct losses on their personal taxes.

Cons:

- You have to follow all the corporate formalities to remain valid.
- Certain types of entities, like trusts and LLCs, cannot be shareholders.
- You can't be creative in how the income is distributed to owners. Everyone has to be treated exactly the same, in proportion to their stock ownership. This means, for example, that you could not issue stock options as an incentive to a key employee.

Pros and Cons of LLCs

Pros:

- You have lots of flexibility in deciding how income and losses get divided among the owners.
- You can set up multiple classes of ownership. If you want to use equity in the company as an incentive for employees, you have a great deal of flexibility in setting it up however you wish.
- Income only gets taxed once, at the owner level. The LLC doesn't pay federal tax on its income (states can be a different story).
- There are no set formalities that must be followed.
- Owners can deduct losses on their personal taxes.

Cons:

- The income that passes through to the owners is generally considered self-employment income under IRS rules. This means the owners may have to pay self-employment tax (Social Security and Medicare) on that income.
- LLCs can be more expensive to set up and maintain, depending on the fees your state charges.

As you can see, there are many factors you will want to consider. The best approach is to educate yourself as much as you can, and consult a qualified professional to assist you in your decision. You have the ability to set up your business any way you want to. However, once you set it up, you have to live with your choices for the duration of the business, so be sure you make the best choices possible from the start.

Find out more about how your business can increase its cash flow by contacting us, click here.