THE VELD GROUP

LOS ANGELES • TOKYO
SAN DIEGO • LAS VEGAS

CHOOSING THE FORM OF BUSINESS ORGANIZATION

A person who wants to start a business can choose from a variety of different types of business entity formations. For instance, a person can form a business as a sole proprietor, a corporation, a Limited Liability Company (LLC), and many others. This article will primarily focus on the corporation structure (C Corporation and S Corporation), and the LLC. It will also analyze and discuss the C and S Corporation models by first, comparing and contrasting their characteristics, and second, providing advantages and disadvantages of both business structures. Finally, we will address the LLC and show the advantages and disadvantages of this model as well.

BACKGROUND OF CORPORATIONS

The C corporation is the standard, default corporation, while the S corporation must be specifically elected as it has its own special tax status with the IRS. The S corporation gets its name because it is defined in Subchapter S of the Internal Revenue Code. To elect S corporation status when forming a corporation, Form 2553 must be filed with the IRS, and all S corporation guidelines must be met. If a person forms a corporation and takes no action, the corporation will be designated as a C corporation by default. In continuation, the S-Election must be made and filed within approximately 45 days of incorporating, or the corporation will remain a C- Corp until the following year when the shareholders will have their next opportunity to file. An S corporation is not itself subject to income tax; rather, shareholders of the S corporation are subject to tax on their pro rata shares of income based on their shareholdings. To qualify to make the S corporation election, the corporation's shares must be held by resident or citizen individuals or certain qualifying trusts. A corporation may qualify as a C corporation without regard to any limit on the number of shareholders, foreign or domestic. These two Corporation types hold many similarities and differences that one must analyze in order to establish his/her own corporation.

SIMILARITIES

C corporations and S corporations share many similar qualities:

Limited liability protection. Both offer limited liability protection, so shareholders (owners) are typically not personally liable for the corporation's debts and liabilities.

Separate entities**.** Both the S corporation and C corporation are separate legal entities created by a state filing. Formation documents must be filed with the state. These documents, typically called the Articles of Incorporation or Certificate of Incorporation, are the same for both C and S corporations.

Structure**.** Both have shareholders, directors and officers. Shareholders are the owners of the company and elect the board of directors. The board of directors oversees and direct corporation affairs and decision-making, but the board of directors is not responsible for the day-to-day operations of the corporation. Instead, the board of directors elects officers to manage the daily business affairs.

Corporate formalities. Both are required to follow the same internal and external corporate formalities and obligations, such as adopting bylaws, issuing stock, holding shareholder and director meetings, filing annual reports, and paying annual fees.

DIFFERENCES

Despite their many similarities, S corporations and C corporations also have distinct differences:

Taxation. Taxation is often considered the most significant difference for small business owners when evaluating S corporations and C corporations. C corporations are separately taxable entities. C Corporations file a corporate tax return (Form 1120) and pay taxes at the corporate level. They also face the possibility of double taxation if corporate income is distributed to business owners as dividends, which are considered personal income. Tax on corporate income is paid first at the corporate level and again at the individual level on dividends. On the other hand, S corporations are treated as pass-through tax entities. S corporations file an informational federal return (Form 1120S), but no income tax is paid at the corporate level. The profits/losses of the business are instead "passed-through" the business and reported on the owners' personal tax returns. Any tax due is paid at the individual level by the owners.

Personal Income Taxes. With both types of corporations, personal income tax is due both on any salary drawn from the corporation, and from any dividends received from the corporation.

Corporate ownership. C corporations have no restrictions on ownership, but S corporations do. For instance, S corporations are restricted to no more than 100 shareholders, and the shareholders must be US citizens/residents. S corporations cannot be owned by C corporations, other S corporations, LLCs, partnerships or many trusts. Also, S corporations can have only one class of stock (disregarding voting rights), while C corporations can have multiple classes. C corporations, therefore, provide a little more flexibility when starting a business if you plan to grow, expand the ownership, or sell your corporation.

ADVANTAGES OF S CORPORATIONS

There are four major federal income tax advantages to making the S-Election:

Single level tax**.** Corporate profits and losses are passed through to the shareholders (owners) of the corporation, thus eliminating the potential for the "double taxation" faced by C corporations.

Net Losses can be deducted on personal income tax returns. While the losses of a C corporation can only offset the corporation's earnings, the net operating losses of an S corporation can be passed through to the individual shareholders and deducted on their individual tax returns in the year the loss occurs.

Minimization of self-employment tax and FICA. With an S corporation, the shareholders can minimize both self-employment and FICA taxes by creating a balance between a reasonable salary and dividends. Dividends (the corporate profits distributed to the shareholders) are not subject to either self-employment tax or FICA.

Tax rate. A personal service S Corporation is not subject to the flat 35% income tax rate. With an S Corporation, the corporate profits and losses are passed through to the shareholder-employees who will pay ordinary personal income tax.

DISADVANTAGES OF S CORPORATIONS

Despite the many advantages listed above, an S- Corp (excluding personal service corporations) cannot avail itself of the six following benefits afforded to C corporations:
Exclusion. A C corporation may exclude up to 50% of the gain on the sale of "qualified small business stock.
Tax deduction of fringe benefits. The shareholders of a C- Corp may avail themselves of tax-free fringe benefits such as health and accident insurance, while the S - Corp is prohibited from deducting the costs of such fringe benefits provided to shareholder-employees who own more than 2% of the outstanding shares.

Number of Shareholders. The C corporation can have more than 100 shareholders, while an S corporation must have less than 100 shareholders.

Ownership. The C corporation can be owned by other corporations, non-resident aliens, LLCs, and other S - Corps, while an S - Corp can only be owned by individuals, estates, and certain qualified trusts.

Inspection. The shareholder-employees of a C - Corp are scrutinized less by the IRS, while those same shareholder-employees of an S- Corp are scrutinized to ensure they receive a "reasonable salary" before any non-wage distributions (dividends) may be made to them.

Losses. Unlike a C - Corp that can deduct and carry forward all losses, an S - Corp shareholder may not deduct corporate losses that exceed his or her "basis" in the corporate stock, which equals the amount of the shareholder's investment in the corporation plus or minus a few adjustments.

WHEN A C-CORP MIGHT BE BETTER

A C corporation is often the better choice if five factors are at play:

Non-Citizenship. One or more of the shareholders are not U.S. citizens, or are resident aliens.

Numerous shareholders. If the corporation envisions having more than 100 shareholders.

Stock choices. If the corporation requires, or can benefit from, different classes of stock.

Public company. If the corporation is a publicly traded company.

Non personal service corporation. If the corporation is not a personal service corporation and its earnings are such that a qualified CPA has determined that the C corporation offers beneficial tax treatment. This may be the case if the individual shareholders are in the upper income tax brackets because high income shareholders who have elected S status will find they are required to pay income tax on their share of an S corporation's profits, whether or not they take the money out of the corporate account. Consequently, if a corporation is not a personal service corporation and the shareholders are in the higher income tax brackets, the shareholders of that corporation may be better off remaining a C corporation.

THE LLC

The LLC is a type of hybrid business structure that is now permissible in all 50 states. It is designed to provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. The owners of an LLC are members, and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration.

ADVANTAGES

There are four primary advantages to the LLC:

Limited Liability. Owners of a LLC have the limited liability protection of a corporation.

Flexible profit distribution. Limited liability companies can select varying forms of distribution of profits. Unlike a common partnership where the split is 50-50, an LLC has much more flexibility.

No corporate minutes. Corporations are required to keep formal minutes, have meetings, and record resolutions. The LLC business structure requires no corporate minutes or resolutions, and it is generally easier to operate.

Flow through taxation. All of the LLC's business losses, profits, and expenses flow through the company to the individual members. Members avoid the double taxation of paying corporate tax and individual tax. Usually, this will be a tax advantage, but circumstances can favor a corporate tax structure.

DISADVANTAGES

Although there are many advantages in forming an LLC, there are two distinct disadvantages:

Limited life. Corporations can live forever, whereas an LLC is dissolved when a member dies or undergoes bankruptcy.

Going public. Business owners with plans to take their company public, or issuing employee shares in the future, may be best served by choosing a corporate business structure.

WHAT SHOULD A PERSON DO AS A POTENTIAL BUSINESS OWNER?

There are pluses and minuses for all three business entities discussed above. Usually, C corporations make no sense for small businesses due to double taxation on income and on proceeds of sale. However, if the business incurs losses, you probably want to claim them personally, thus favoring an S corporation. An LLC has many of the advantages of the other forms of business entities and few of the disadvantages. However, it may not be wise to form an LLC if the person aspires to take the company public. Whatever you decide, get some advice first, and pay attention to the tax rules.