

CREATING A BUSINESS--ENTITY COMPARISON
NONTAX FACTORS

Factor	S Corporation	Limited Liability Company	C Corporation
Available in All States	Yes, but may be taxed as a C corporation.	Yes.	Yes.
Formal Acts Required	Yes.	Yes. Must be filed with state office.	Yes.
Limited Liability of Owners	All shareholders.	All members unless otherwise provided in LLC statutes.	All shareholders.
Number of Owners	Limited to 100.	No limit. Some LLC statutes, such as the Illinois Act, permit a single member.	No Limit.
Type of Owner	Must be an individual who is not a nonresident alien, a qualified trust, a qualified retirement plan, or a charitable organization. Code §1361.	No limitations.	No limitations.
Multiple Classes of Ownership	Only one class of stock allowed but difference in voting rights permitted. Code §1361(c)(4).	No restrictions.	May be multiple classes of ownership such as preferred and common share classes.
Permissible Business	No limitations, except states may not allow certain professional services to be performed through a corporation.	No limitations, except some states may not allow some professional services to be performed by an LLC.	No limitations, except that some states may not allow certain professional services to be performed through a corporation.
Complexity of Operating Agreement	Generally simple.	Simple to complex.	Shareholder agreement can be simple to complex
Participation in Management	No restrictions.	No restrictions.	No restrictions

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Election Required	Yes. Form 2553 must be filed by the 15th day of the 3rd month of the year.	No.	No.
Classification as a “Corporation” for Federal Tax Purposes	Yes, but subject to S corporation rules.	No. Can elect affirmatively to be taxed as a partnership or corporation.	Yes.
Conversion to LLC	Gain can occur to the corporation, which is passed on to the shareholder.	Not applicable.	Yes, but deemed to be a liquidation first which can have serious tax consequences
Flexibility of Allocations of Income and Distributions	None, as income and distributions must be allocated in accordance with stock ownership.	Flexible as long as allocations have substantial economic effect under Code §704(b).	None.
Retroactive Changes to Operating Agreement	No.	Yes.	No.
Entity or Aggregate Theory Applied for Tax Purposes	Entity.	Either	Entity only.
Ownership in Profits Without Equity Ownership	Can have phantom stock, etc., but care must be exercised to avoid second class of stock.	Can have a profits interest. See Rev.Rul. 93-27, 1993-1 Cum.Bull. 32.	Can have phantom stock.
Ownership of Subsidiary Corporation	No restrictions. Can elect to treat a 100-percent-owned subsidiary as a qualified Subchapter S subsidiary, which is a disregarded entity.	No restrictions.	No restrictions.
Step-Up (or Down) of Underlying Assets in Connection with Purchase or Inheritance of Interest in Entity	No.	If election under Code §754 is made by the entity.	Yes.
Effect of Liabilities on Owners	Included in basis only if debt is owed directly to the shareholder.	Generally all members can include all debts in basis.	Liabilities have no effect on owners
Double Tax	Generally no.	No.	Yes
Subject to Alternative Minimum Tax	Tax preference items passed through to shareholder.	Tax preference items passed through to members	Yes
Timing of Taxation of Income in Owner	In year that S corporation’s year ends, whether paid or not.	In year that LLC’s year ends, whether paid or not.	Not Applicable.

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Capital Losses	Flow through to shareholders. Available as offset against capital gain plus \$3,000.	Flow through to members. Available as offset against capital	Yes
Deductibility of Losses	Deducted by shareholders to the extent of basis in stock and loans to corporation.	Deducted by members to extent of basis.	Deducted by shareholders to the extent of basis in stock.
Limitations on the Accumulations of Income	None.	None.	Limitation on Accumulation of Surplus
Subject to State Taxation as a Corporation	Generally no, but some states tax S corporations as C corporations.	Generally no, but some states (Florida and Texas) tax LLCs as corporations.	Yes, if state tax is applicable.
Subject to Personal Holding Company Tax	No.	No.	Possible.
Form for Reporting Income	Form 1120-S.	Form 1065.	Form 1120.
Taxable Year	Generally calendar year unless Code §444 election made.	Must have taxable year of majority member or of all majority members; otherwise, the calendar year unless Code §444 election made.	May have a fiscal year, but technical rules apply.
Employment Taxes on Earnings	Shareholder is liable only to the extent paid out as compensation. Distributed and undistributed earnings not subject to tax.	Not clear. Under Prop.Treas.Reg. §§1.1402(a)-2(g) and 1.1402(a)-2(h), a member is not subject to self-employment tax unless the member (a) has personal liability for the LLC's debts, (b) has authority to contract on behalf of the LLC, or (c) participates in the LLC's business for more than 500 hours during the LLC's taxable year.	Shareholder is liable only to the extent paid out as compensation.
Unreasonable Compensation Issues	Generally none, unless too small in order to avoid employment taxes.	Generally none.	Unreasonable Compensation Rules Apply.
Fringe Benefits	Owner of more than two percent of entity generally cannot receive tax-free fringe benefits.	Members generally not eligible for tax-free fringe benefits.	Shareholders are generally eligible for fringe benefit programs.
Transfers of Interests Causing Problems	S election could terminate if stock is transferred to non-qualifying shareholder.	LLC could terminate if 50 percent or more of interest in capital and profits is sold or exchanged in a 12-month period. Code	Generally, transfers are restricted only by agreement or by state or securities laws.