

Imke Ratschko

SMALL BUSINESS ATTORNEYS

IN SHORT

LLC

The LLC offers a very flexible structure. Members can agree to special allocations of profits and losses.

LLCs have no limitations on the number and kind of owners.

LLCs are expensive to form.

LLCs can be more expensive for the members with respect to self-employment taxes.

S CORPORATION

An S corporation is cheaper to form than an LLC.

More people are familiar with the structure of an S corporation.

It may be possible to save money on self-employment taxes.

S corporations require ongoing formalities to preserve their limited liability shield.

S corporation status is not recognized by New York City, thus the S corporation is subject to corporate level tax.

CALL
212.253.1027
FOR MORE INFO

FAQ about the most frequently formed business entities for small businesses.

LLC or Corporation?

Many small business owners end up deciding between a New York S corporation and a New York limited liability company (LLC) when choosing a formal legal structure for their New York business. Both entities offer limited liability and a startup friendly tax treatment. But which entity is right for your small business? The following are some frequently asked questions with respect to the two business entities.

What is an S Corporation?

An S corporation is a (regular) business corporation that elected a special tax treatment with the federal tax authorities and/or the New York State tax authorities.

Otherwise, an S corporation's characteristics are just like a regular business corporation, which means that it is a legal entity that can be formed by one or more persons. Once a corporation is formed, the S corporation (not its owners in their personal capacity) will enter into all contracts, issue all invoices and undertake all business activities.

Note: Professionals can only form a professional corporation.

What is a Limited Liability Company?

A limited liability company (LLC) is a business entity that can be formed by one or more persons or other business entities. Once an LLC is formed, the LLC (not its owners in their personal capacity) will enter into all contracts, issue all invoices and undertake all business activities.

Note: Professionals can only form a professional limited liability company.

How do I form an S Corporation?

You start by forming a regular business corporation.

The formation of a corporation requires the filing of a "certificate of incorporation" with New York's Department of States.

Once the corporation is in existence, you will have to elect S corporation status with the federal and state tax authorities.

How do I form an LLC?

The formation of an LLC requires the filing of "articles of organization" with New York's Department of State.

Who can form an S Corporation?

Only individual U.S. citizens or U.S. residents can form an S corporation.

Who can form an LLC?

Any person or business entity.

How many Shareholders can an S Corporation Have?

An S corporation can only have a maximum of 100 shareholders all of which have to be individuals (some exceptions apply).

How many Members can an LLC have?

An LLC can have an unlimited number of members.

Who are the Owners of an S Corporation?

The owners of an S corporation are called shareholders. The corporation issues share certificates to the shareholders.

ers in exchange for something of value, like cash, services or property.

Who are the Owners of an LLC?

The owners of an LLC are called members. You become a member by contributing something of value (cash, services, property) to the LLC and receiving a membership interest in return.

How much does it cost to form an S Corporation?

It costs about \$195 to form a corporation in New York, excluding legal fees.

How much does it cost to form an LLC?

It costs about \$1300 to form a limited liability company in New York, excluding legal fees.

The main costs of formation stem from the fact that limited liability companies are required to publish their formation in two newspapers. Depending on your location, this publication requirement can be quite costly. The estimated cost of formation above is based on New York county's expensive newspapers (about \$1000), it may be cheaper in other counties.

How long does it take to form an S Corporation?

For \$195, your corporation will be in existence within 24 hours. However, you normally have to wait a couple of days to receive the necessary documents in the mail to prove that your corporation has been formed. This may be necessary for opening a bank account.

How long does it take to form an LLC?

You can form an LLC within 24 hours. However, you normally have to wait a couple of days to receive the necessary documents in the mail to prove that your LLC has been formed. This may be necessary for opening a bank account.

Many banks will also require you to show an operating agreement (see discussion below) before they will open an account for your LLC.

The publication requirement has to be completed within 120 days of formation. Notwithstanding, you can start doing business with your LLC as soon as it is born. If you fail to fulfill the publication requirement, your business loses the authority to conduct business in New York with the expiration of the 120 day period.

Does an S Corporation offer limited liability to Shareholders?

As long as you keep up with all corporate formalities, a corporation offers almost complete limited liability. Shareholders only risk losing the initial investment in the corporation. Creditors normally cannot reach the shareholder's personal assets.

Does an LLC offer limited liability to its Members?

Yes, the LLC is liable on all business debts, not the members personally. If the business goes under, creditors of the business cannot reach the personal assets of the members. Be aware though, that creditors, landlords and so forth may ask you for a personal guaranty knowing about the limited liability of the LLC.

What formalities are required to maintain an S Corporation?

Among other formalities, S corporations require annual shareholder and director meetings. Important decisions by the S corporation must be documented in "minutes" or "written resolutions" of shareholders' or directors' meetings. The payments you take from the S corporation have to be labeled as salary to you or distributions. Some of it has to be salary and requires that you actually do your own payroll.

Formalities are important to preserve the "limited liability shield" of the S corporation.

What formalities are required to maintain an LLC?

LLCs require less ongoing paperwork than S corporations; however, unless the operating agreement (see below) of the

LLC states otherwise, the LLC must also hold annual member meetings.

Formalities are important to preserve the "limited liability shield" of the LLC.

Can an S Corporation issue Shares with different economic rights?

No. All shares of the S corporation must have the same economic rights to profits, distributions and liquidation of assets. In other words, a shareholder who owns 50% of the shares of the S corporation can only receive 50% of the distributions of the S corporation.

Can an LLC have Membership Interests with different economic rights?

A special feature of an LLC is that the members can agree to share profits and losses in proportions different from their membership interests. In other words, the members could agree that 100% of the profits of the LLC are to be distributed to one member for the first three years, despite the fact that that member owns only 50% of the LLC and normally should have received only 50% of the profits and losses.

But these so called "special allocations" have to follow quite complicated tax rules to make them permissible. This adds a layer of complexity and extra cost to the management and accounting for the LLC.

Who manages an S Corporation?

A "board of directors" manages the affairs of the corporation through officers. Officers of a corporation are often named president, vice president, treasurer, secretary, chief operating officer and so forth. Sometimes the law or the "by-laws" of a corporation provide that the shareholders have to approve certain actions by the corporation. Bylaws are rules that govern the corporation. When a corporation is formed, the initial directors approve the original bylaws of the corporation.

All three groups in the corporation, directors, shareholders, officers, can be the same person. In other words, if you form

a corporation and are the only shareholder, you will also be the only director and may be several officers in one.

Who manages an LLC?

An LLC can be managed by its members or by appointed managers. Unless the articles of organization of the LLC provides for management by managers, the LLC is managed by its members.

What is a Shareholders Agreement and do I need one?

Shareholders can enter into a shareholders agreement to regulate certain matters that come with their share ownership and management of the corporation. For example, unless you agree with your fellow shareholders in a shareholders agreement that the shares are not "freely transferable", any shareholder would be able to sell his shares to a third person. Such person would then become a co-owner of the business.

Thus, unless you are the sole shareholder of your corporation, it is advisable to enter into a shareholders agreement.

What is an Operating Agreement and do I need one?

Members of an LLC (even a sole member of an LLC) must enter into a written operating agreement.

Similar to a shareholders agreement, an operating agreement regulates ownership of the LLC and the business affairs of the LLC. For example, you can put restrictions on the transferability of the membership interests.

Does the S Corporation pay Taxes?

Not on the federal level, but for exceptions in New York State and New York City, see note below.

A regular business corporation is a taxpayer separate from its shareholders. The corporation pays taxes on its profits. When the corporation distributes profits to the shareholders (called dividends), the shareholder have to pay tax again on such distribution. This is called "double taxation". By electing S corporation

status, S corporations avoid this double taxation.

Each individual S corporation shareholder will include her share of the S corporation's income, loss, and deductions on her individual state and federal tax return. For this reason, an S corporation is also known as a "pass-through entity."

Note:

New York State does not exclude s corporations from all corporate level taxation.

New York City does not recognize S corporation status. Consequently, a New York S corporation having income from New York City sources will be taxed as a corporation for New York City tax purposes and has to pay New York City's General Corporation Tax.

Does an LLC pay Taxes?

A one-member LLC is treated as a "disregarded entity" for tax purposes. The only member reports income, losses, and deductions of her LLC on her personal federal and state income tax return like a sole proprietor.

A multi-member LLC is normally treated as a partnership for tax purposes (you may elect to be treated as an s corporation, but that is beyond this short overview. Ask me if you must know) . Just like a partnership, the LLC does not pay taxes, but files an informational return.

Members report their share of the LLC's income, loss, and deductions on their individual state and federal tax return. For this reason, an LLC is also known as a "pass-through entity."

Can a Shareholder deduct Losses of the S Corporation?

Yes, a shareholder of an S corporation can deduct her share of the losses of the S corporation. However, there are limits. Compared to LLCs, S corporations allow for less loss deduction.

Can a Member deduct Losses of the LLC?

Yes, a member of an LLC can deduct her share of the losses of the LLC.

Do Shareholders have to pay Self-Employment Taxes on Money they receive from the S Corporation?

No. However, shareholders of an S corporation who work for the business have to pay themselves a reasonable salary. They are considered employees of the S corporation. Consequently, the S corporation has to withhold federal and state taxes from their salary, pay unemployment insurance and its share of social security and Medicare payments.

There still may be savings over the self-employment tax due from members of an LLC. S corporations can pay out all profits above a reasonable salary as dividends to their shareholders. There are no self-employment taxes or other employment taxes due on such payments. In determining a "reasonable" salary, be aware of the audit risks involved.

Do Members have to pay Self-Employment Taxes on Money they receive from the LLC?

Members who are actively involved in the business of the LLC have to pay 15.3% self-employment taxes on the first \$106,800 of their combined wages and net earnings, including the income allocated to them from the LLC.

Can a Shareholder be an employee of an S Corporation?

Yes, by default, anybody working actively in the S corporation is considered an employee; i.e. the corporation must do payroll for the employee: withhold federal and state taxes, pay its share of social security and Medicare, and pay unemployment insurance. The corporation can deduct the cost as expenses.

Can a Member be an Employee of an LLC?

No. A Member cannot be an employee of an LLC. Even though a Member can actively work in the management of the LLC and receive so called "guaranteed payments" similar to a salary, technically he or she would not be considered an employee.

Can an S Corporation choose a different Tax Status?

An S corporation can choose to abandon s corporation status and become a regular corporation again. There are limits and restrictions on how often the switch can be done.

Can an LLC choose a different Tax Status?

An LLC can choose to be taxed as a corporation or a partnership.

Can I raise money for the S Corporation from outside investors?

The S corporation can issue shares to investors in exchange for capital that can be used to grow the business. Investors will become owners of the corporation, but can be excluded from management (if they agree).

Can I raise money for the LLC from outside investors?

The LLC can issue membership interests to investors in exchange for capital that can be used to grow the business. Investors will become owners of the LLC, but can be excluded from management (if they agree).

For their own valid reasons, certain venture capitalists will require a corporation for their investment.

Bottom Line for S Corporations:

Pros:

An S corporation is cheaper to form than an LLC.

More people are familiar with the structure of an S corporation.

It may be possible to save money on self-employment taxes.

Cons:

S corporations put serious limitations on the number and kind of permitted shareholders.

S corporations do not allow for special allocations and are less flexible than LLCs.

S corporations put limits on loss deductions on the shareholder level.

S corporations require ongoing formalities to preserve their limited liability shield.

S corporation status is not recognized by New York City, thus the s corporation is subject to corporate level tax.

Bottom Line for LLCs:

Pros:

The LLC offers a very flexible structure. Members can agree to special allocations of profits and losses.

The LLC offers more possibilities for loss deductions.

LLCs have no limitations on the number and kind of owners.

LLCs require less ongoing formalities.

Cons:

LLCs are expensive to form.

LLCs are expensive to maintain when special allocations are chosen by the members.

LLCs can be more complex with respect to accounting procedures.

LLCs can be more expensive for the members with respect to self-employment taxes.

This article is for informational purposes only and does not constitute legal advice.