



LLC vs S-Corp: What's the Difference?



If you're starting (or have already started) your own business, you've probably heard about the advantages of incorporation. Corporations protect business owners from personal responsibility for debts and other liabilities of the business and have some built-in tax advantages when used wisely. Beyond that, incorporated businesses face fewer financial, legal, and regulatory obstacles than unincorporated entities. Where most business owners run into questions is not whether to incorporate, but which structure to utilize for maximum advantage.

This whitepaper provides an in-depth analysis of LLCs and S-Corporations, detailing their similarities, differences, advantages, and disadvantages. Read on to discover answers to the six most common questions about LLCs and S-Corporations.



What is an LLC and what are its advantages?

A Limited Liability Company, or LLC, is a legal business structure that separates the activities and finances of a business from that of its owners. LLCs are established by and through state law, often with minimal expense and compliance requirements.

The income earned by the business "passes through" to the owner's personal income tax return, avoiding the double taxation that C-Corporations face (C-Corps must first pay corporate taxes, then the owner must also pay taxes on their income, hence the term, "double taxation").

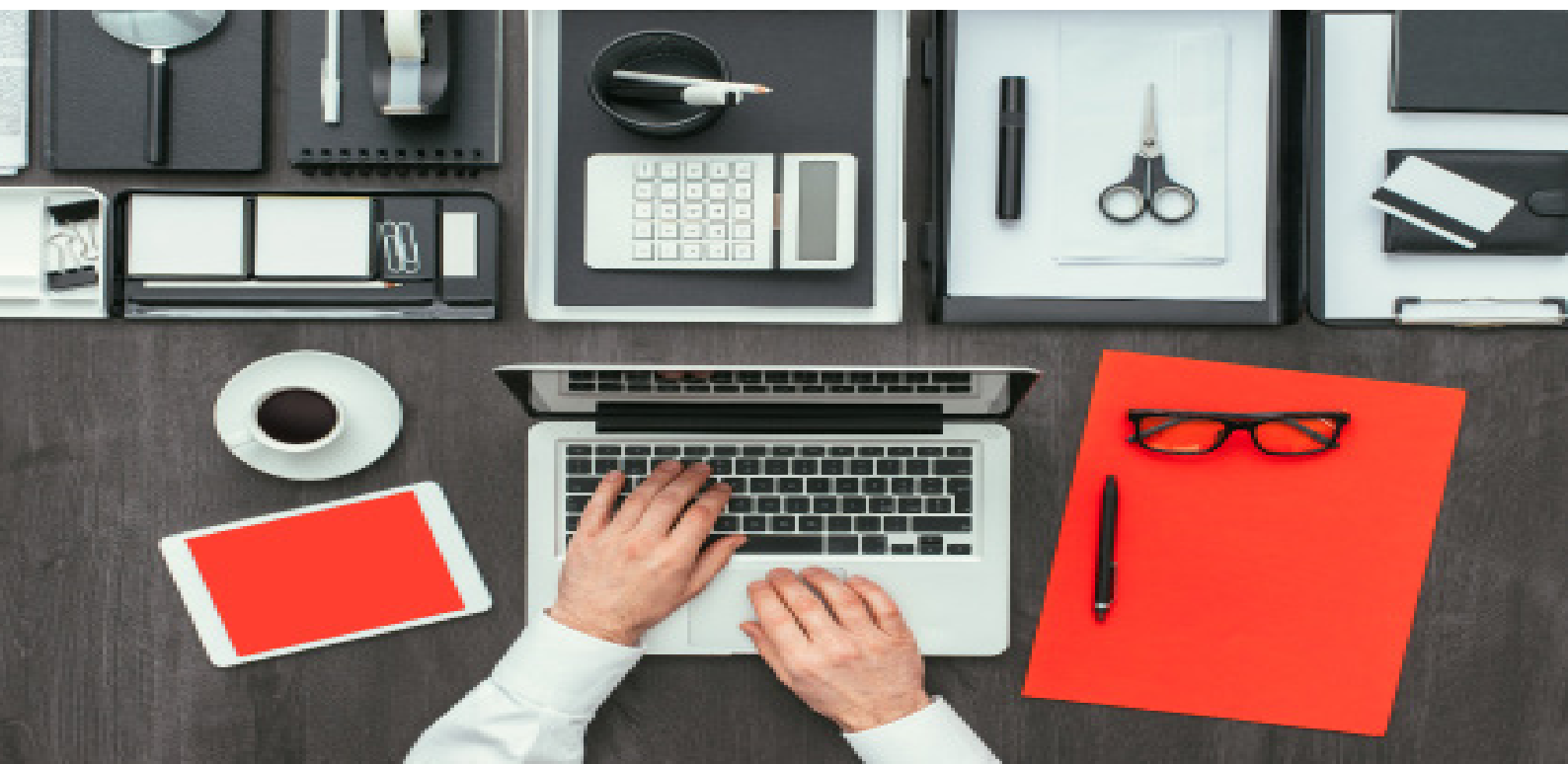
Unlike an S-Corp, LLCs can have an unlimited number of owners and the owners do not have to be U.S. citizens (owners can even be another corporation). LLCs have fewer reporting requirements than other corporate forms, and have a very different tax profile.



What are the Drawbacks of forming an LLC?

Because there is no LLC tax designation, a single-owner LLC is taxed as a sole proprietorship and a multimember LLC is taxed as a partnership, by default. If you fail to elect S-Corp status as a single-owner, you will have to pay Social Security and Medicare taxes not only on your personal income, but on the profits of your business as well. So even though LLCs may be simpler to establish and maintain, that simplicity may come at the cost of additional taxation.

Plus, LLCs may be more difficult to leave or sell if one owner decides to depart. Transfer of ownership must involve the approval of all owners and the corporation can be dissolved entirely due to a change in ownership. While LLCs are not subject to stringent requirements at the federal level that doesn't mean owners can get away without paperwork or compliance efforts. Most LLCs are subject to compliance mechanisms established by the state of incorporation and it is highly recommended that LLCs fulfill the same or similar legal requirements as other corporations to reduce risks and maximize asset protection for the owners.





What is an S-Corp and what are its advantages?

An S-Corporation is a tax election defined by the IRS, not a legal business structure. As previously discussed, the IRS will classify an LLC as either a sole proprietorship or partnership, by default. You have to file special paperwork for the IRS to recognize your business as an S-Corporation, but once established, the S-Corp can exist in perpetuity.

By taking advantage of the S-Corp election, business owners can save on self-employment taxes (including Social Security and Medicare). By electing S-Corp status, your reasonable salary will be considered a business expense. You will be required to pay Social Security and Medicare taxes on your reasonable, pre-established salary but NOT on the profits of the business.

Potential tax advantages in action:

Let's say your business clears \$150,000 and you have set your salary at \$50,000. On your tax return, you will report \$50,000 in personal income and \$100,000 in business profit. You will have to pay Social Security and Medicare taxes on your \$50,000 salary, but not on the business profit. Absent an S-Corp election, you will have to pay Social Security and Medicare taxes on the full \$150,000.





What are the Drawbacks of an S-Corp Election?

The tax advantages of S-Corporations come with some added burdens. Your tax return will likely be more complex, and you will need to ensure you're withholding taxes on your salary. S-corps can only be owned by U.S. citizens or lawful permanent residents (not corporations or foreign persons) and can only have a maximum of 100 shareholders. Your corporation also must have by-laws, annual meetings (at a minimum) and keep corporate records including meeting minutes.

Also, if you think you can report a meager \$5 salary and claim the rest of your income as business profits to avoid taxation, think again. Your salary will need to be reasonable to prevent an audit or penalties. A good rule of thumb is to pay yourself a salary that is commensurate with your role and experience, similar to what you'd be making through outside employment.





What are the Similarities of LLCs and S-Corps?

Both LLCs and S-Corporations provide owners with the benefits of limited liability protection and pass-through taxation. Both forms separate the business's finances and activities from that of the owners. Fortunately, the two corporate forms are not mutually exclusive. You can form an LLC and still elect S-Corp status for the purpose of taxation, and this is often advantageous for small, closely held businesses.

While it is wise to weigh your options prior to incorporation, the good news is you can make an S-Corp election at any time. If you would like to start out as an S-Corp, you need to file the appropriate paperwork within 75 days of formation. Otherwise, you can elect S-Corp status at any time, and it will apply to the next calendar year. For instance, if you choose to make an S election in September 2019, the IRS will acknowledge S-Corp status for the 2020 tax year, but not 2019.



Which Legal Structure is Better for Business?

The best legal structure for your business will depend on your specific goals and needs. If you plan on seeking large investments from outsiders or want to become a publicly traded company, a C-Corporation is probably the most prudent tax election.

If you plan on remaining a small business and want flexibility plus a reduction of paperwork and compliance requirements, an LLC will likely be more appropriate for you. If you plan to pay yourself a reasonable salary and not have any business profits left over, you probably won't need to make an S-Corp election.

If, however, you plan to pay yourself a salary and want your business to generate a profit above and beyond your salary, an S-Corp election could save you substantial money on self-employment taxes. Of course, if you want to take advantage of these tax savings it will require some more compliance on your part.

Final Thoughts

Business legal structures are not one-size-fits-all and your choice of structure will depend on your specific needs. You'll want to speak with knowledgeable accounting and legal professionals to create a strategy that meets your goals.

Our team of highly trained professionals can help you protect your business and your personal assets while minimizing tax burdens. Contact us for more information about accounting and tax solutions for your business.



About Hayashi Wayland

In 1976, Douglas Hayashi and Warren Wayland opened the doors to Hayashi Wayland. They based their partnership on the belief that a firm should measure its success by the success of its clients. They also believed that as a member of the community, the firm should work to strengthen it.

Today, Hayashi Wayland has grown to become the premier professional services firm on the Central Coast. We offer the greatest number of services of any firm in the area, from traditional accounting services to financial planning, and other consulting services.



Hayashi Wayland
1188 Padre Drive
Suite 101
Salinas, CA 93901



(831) 759-6300



info@hw-cpa.com



www.hw-cpa.com/

