CHOICE OF ENTITY: LLC, S-CORPORATION OR C-CORPORATION?

By: Darren M. Baldo, Esq., CPA, LL.M.

New Jersey State Bar Association, Business Law Section.

First Priority: Limited Liability Protection

When someone asks me whether or not to form a limited liability entity for a new or existing business, my response is, of course, "yes, absolutely." A limited liability entity provides a business owner with limited liability protection, meaning that their personal assets are not subject to their business liabilities. My answer never changes, regardless of how great their insurance policies may be because, first of all, not everything is covered under insurance and, secondly, the amount of insurance coverage may be insufficient to satisfy the claim.

A sole proprietorship is not an entity at all; it's just the proprietor in a business venture for himself or herself. The sole proprietor is absolutely and unfortunately at risk of losing everything including his or her personal assets because they are all subject to the claims of his or her business creditors, whoever they may be or become, either by virtue of a breach of contract or a slip and fall accident on their premises.

A partnership is not much better than a sole proprietorship because being in a partnership just means that you are putting two or more proprietors or entities together for that special common purpose: to earn a profit. A partnership, though a legal entity, is not going to provide limited liability protection to the partners unless the partnership is a limited partnership, in which case, there will still be at least one general partner that is still personally liable for all of the debts of the partnership. And, the limited partnership is not going to protect the purportedly limited partners from liability if such partners are actively engaged in the business.

Welcome Limited Liability Companies

Prior to the creation of the limited liability company (the "LLC") and the New Jersey Limited Liability Company Act (the "NJLLCA") in 1993, any partners that were actively engaged in the business were advised to create corporations to shield them from liability. So, the corporation was ultimately the entity of choice even when the primary venture was merely a partnership. Since 1993, partnerships have become basically useless for new businesses because businesses have had the ability to use the LLC instead of the corporation or the partnership.

The LLC provides limited liability protection for any and all of its members, no matter how passively uninvolved such member may be in the LLC business. Except for the discussion of taxation below, the discussion of the partnership as a legal entity ends here. The remainder of this article, therefore, addresses the distinctions from a legal and tax perspective between the corporation and the LLC.

When someone asks me which entity is the most appropriate, I start by saying that unless there is a compelling reason not to form an LLC, I recommend forming an LLC. The reasons I suggest the LLC as a starting point basically boil down to simplicity in administration, lower costs of compliance and tax benefits. But, it's not that simple to explain and understand because there are a lot of statutes, cases and tax laws that were involved in getting to that presumption. And, this article is certainly not a means for a full-blown course in this stuff; actually, in my opinion, a crash-course will not do. Each client's goals, business projections, tax situation and tolerance for administrative maintenance should be analyzed to determine the appropriate entity. Before the business formation analysis begins, it should be helpful to clarify for the client that there is no real difference in the amount of limited liability protection available between the corporation and the LLC.

Taxation: Some Federal and State Income Tax Rules

Understanding the federal and state income tax treatment of the different entities is quite possibly the most relevant in understanding the differences between these entities before even determining which entity is the most suitable. Corporations and LLCs operate under completely different tax regimes for both federal and state income tax purposes. Corporations have two different tax regimes, C Corporations and S Corporations. And, multiple-member LLCs are treated as partnerships for federal and state income tax purposes, except in the event that the LLC affirmatively elects to be treated as an association taxable as a corporation, in which case such LLC is still an LLC for legal purposes but a corporation for tax purposes.

It is very important to note that LLCs with only one owner, known as single-member LLCs, are treated as disregarded entities under federal and state tax laws, and as such, file tax returns as a sole proprietorship. Thus, many business owners may appreciate the simplicity in obtaining the limited liability protection coupled with the administrative ease, from a legal and tax perspective, of the single-member LLC. Moreover, since single-member LLCs may also affirmatively elect to be treated as an association taxable as a corporation (and even an S Corporation), business owners may further appreciate the flexibility afforded by the single-member LLC for income tax purposes.

For federal and New Jersey income tax purposes, corporations may elect to be treated as small business corporations under Subchapter S of the Internal Revenue Code, hence the name "S Corporations." See Federal Internal Revenue Code (the "Code") Section 1361, et seq. By making the "S election", the corporation is not taxed at the entity level on its income, except for the ridiculous New Jersey minimum tax discussed below. Rather, the income (or loss) flows through to the shareholders of the corporation, who report their distributable share of such income (or loss) on their respective income tax returns.

With the exception of the New Jersey minimum tax for corporations discussed below, to which S Corporations are subject, S Corporations and LLCs (not electing taxation as a corporation) are not subject to an entity level income tax. Rather, the income or loss of S Corporations and partnerships is passed through to its owners, who are required to report their distributable share of such income or loss on their respective federal and state income tax returns. Therefore, income may increase, whereas losses may reduce, the owners' federal and state income tax liabilities because it will be neither utilized nor suspended at the entity level.

If a corporation does not elect S Corporation status for tax purposes, then it is treated as what is known as a "C Corporation," under Subchapter C of the Code. See Code Section 1361(a)(2); see also Code Section 301, et seq. As a C Corporation, the corporation reports and pays tax on its income at the entity level. If the corporation has losses for any tax year, then such losses may be carried back two years and/or forward twenty years depending upon certain tax attributes of that corporation. Code Section 172.

Regardless of whether a corporation is an S Corporation or a C Corporation for income tax purposes does not change the legal character of that entity as just a corporation for legal purposes under the NJBCA. Accordingly, S Corporations and C Corporations get the same amount of limited liability protection under the law and the same ability to sue other persons or entities in court. In fact, the NJBCA does not even distinguish between S Corporations and C Corporations whatsoever; nor should it, as the S Corporation is merely a tax election.

The Corporate Double-Taxation Analysis

It is important to note that C-Corporation's shareholders are subject to an income tax on dividends from corporate income. Therefore, a C-Corporation is taxed on its earnings and then again on its dividends to shareholders. Hence, the potential for "double taxation," which in the past made the C Corporation an unfavorable choice of entity for business owners who wanted to distribute their corporation's earnings to themselves during the year or at or after the end of the year.

Due to the potential for double taxation, the C Corporation was an especially unfavorable choice of entity in the past because, a short time ago, the federal income tax rates for corporate income and shareholder dividend income were very high compared with today's tax rates. For tax years 2003 through 2008, dividends are taxed at the same rate as long-term capital gains: 15%. Therefore, the potential for "double taxation" is not as oppressive for small business owners who may pay a combined tax rate of say for example only 30%: 15% on the corporate income of less than $50,000, plus 15% on the dividend.

Due to the potential for double taxation, many small business owners who operate their businesses using the C Corporation have been duly advised by their Certified Public Accountants to "zero-out" their corporate income in the form of bonuses prior to the end of the tax year so as to avoid corporate income tax. Since the top federal income tax bracket for individuals for tax years 2003 through 2008 is 35%, zero-ing out corporate income in the form of compensation income to the individual recipient could result in higher income for that individual than if such individual/shareholder just took such additional money as a dividend taxed at only 15%, which is what most CPAs should now be advising, so long, of course, as "reasonable compensation" has been paid to such shareholder responsible for generating such corporate income, so as not to disguise the compensation as a dividend.

For business owners that intend to reinvest and keep their business earnings in their business year after year without paying dividends and without paying year end bonuses to zero out income, a C Corporation can be more tax-advantageous a strategy than forming any other entity because the combined federal and state income tax of C Corporations can for certain low-income corporations be less than the combined federal and state income tax caused by having such income pass through to the shareholders of an S Corporation or the members of an LLC. Most business owners, however, do not anticipate consistent reinvestment without cashing out the fruits of their labor each year, which is why we get back to the LLC again. Nevertheless, the business formation attorney should ask carefully what the business owner plans on doing each year with his or her entity's earnings, which may not be a topic of conversation that a business owner expects to, but should, have with his or her business formation attorney.

But, here's the worst case scenario for C Corporations. Assume that the corporation has been very successful and has substantially appreciated in value, so much so, that the corporation is ripe for sale at a very high purchase price. Now, assume that the purchaser of the corporate business insists on purchasing the assets of the corporations, rather than the stock, for cash only. The worst case scenario is that the sale of assets will cause an income tax at the corporate level, and then, to get the cash out to the shareholders, another tax as a dividend at the shareholder level. The double-taxation experienced by the business owners as a result of the asset sale for cash could be at least 15% more than if the assets were sold by an S Corporation or an LLC taxed as a partnership. Therefore, this worst case scenario may make the C Corporation a prohibitive choice of entity for those interested in an exit strategy, like a sale of the business.

Except for the income tax imposed on S Corporation income in New Jersey in 2007 at the rate of 0.67% for income in excess of $100,000 (which is completely phased out after 2007), see N.J.S.A. 54:10A-5(c)(2)(ii), S Corporations and LLCs (taxed as partnerships) do not experience the double tax because the income that flows through to them increases their tax basis in the equity interests in their respective entities. If and when that income is distributed to the owners, the basis increase effectively shelters the owners from tax; the net result is a reduction in basis upon the receipt of the distribution. Hence, there is only one level of tax despite the recognition and reporting of income followed by a distribution of such income.

S Corporations: Opportunities versus Eligibility Requirements

While S Corporations afford the owners interesting tax planning opportunities, they pose difficult eligibility requirements. For the aggressive tax planner, there are certain benefits in addition to the flow-through of income to avoid double-taxation. Some tax planning may be available to avoid overpaying self-employment tax, the tax bane of many a business owner's existence. Through careful planning, a business owner can report the income flowed through to him or her as income that may not be treated as self-employment income that would otherwise be subject to self-employment tax. Each business owner situation should be independently examined with their tax accountant and/or tax attorney to determine whether such a strategy is possible.

Also, in mergers and acquisitions, S Corporations have certain tax advantages over LLCs that are taxed as partnerships. S Corporations are permitted to participate in the tax-deferred reorganization rules under certain circumstances when stock of the acquiring corporation is used as part of the purchase price. See Code Section 368. For the amount of purchase price consideration allocated to such acquiror stock, the gain on the exchange is deferred until the seller ultimately sells the acquiror's stock. Accordingly, the S Corporation shareholder could defer the gain on the sale of the company for years while such shareholder continues to hold onto the acquiror stock. Note that the same rules apply for C Corporations.

However, in order to be eligible for S Corporation status, there are some fairly rigorous requirements. Pursuant to Code Section 1361(b)(1), in order to be eligible to have an S Corporation, the corporation cannot (a) have more than 100 shareholders, (b) have as a shareholder a person who is not a resident individual (except that certain trusts are permitted), (c) have more than 1 class of stock. Although the 100 shareholder requirement is usually not the show-stopper, the failure to meet one of the other requirements is usually what prevents many corporations from being able to elect S Corporation status.

For example, a violation of the single-class of stock requirement would occur if a corporation issued preferred stock to one of its shareholders but common stock to another. However, it is important to note that merely issuing voting common stock and nonvoting common stock to different shareholders does not violate this rule. Code Section 1361(c)(4). Also, since the S Corporation can only have resident individuals and certain trusts as shareholders, it is prohibited for LLCs, partnerships or C-Corporations to be shareholders.

The consequence of failing to qualify as an S Corporation after an election has been made and accepted by the Internal Revenue Service is a termination of the S election. Upon termination of the S Corporation status, the corporation reverts immediately to a C Corporation, in which case, corporate income is subject to income tax at the entity level and losses are no longer able to be flowed through to the shareholders. LLCs and C-Corporations, on the other hand, can have as many owners, different classes of equity ownership and as many different types of owners as they like. Therefore, due to the strict eligibility criteria required to elect and maintain S Corporation status, coupled with the availability of the LLC as an alternative entity, the popularity for S Corporations has waned dramatically.

<u>Increased Costs and Minimum Tax for Corporations</u>

For whatever reasons, states like New Jersey and Pennsylvania make it more costly to operate as a corporation because these states impose additional costs upon corporations that they do not impose upon LLCs. For example, New Jersey imposes a minimum tax of $500 per year on a corporation even if that corporation has zero income or even losses for that year. The minimum tax even applies to S corporations. New Jersey imposes a Gross Receipts Minimum Tax of between $500 to $2,000, depending upon the amount of gross receipts of the corporation for the year. If the S corporation's receipts are less than $100,000, then the tax is $500, regardless of whether the corporation had any income or loss. If the S corporation's receipts are $1,000,000 or more, then the tax is $2,000, regardless of whether the corporation had any income or loss. And, not only is this a tax on S corporations, which are generally not even subject to any federal entity-level tax, it is a tax on gross receipts rather than income.

LLCs, on the other hand, are taxed as partnerships (unless an election is made to be taxed as a corporation). As partnerships, LLCs are generally not subject to any entity-level income tax or gross receipts tax under federal or New Jersey income tax laws. However, in New Jersey, LLCs with more than two members are required to pay an annual fee of $150 per member. Also, for LLC members that do not reside in New Jersey, the LLC must pay a tax on behalf of nonresident members that have New Jersey-allocated income.

Also note that Pennsylvania imposes an obligation for corporations to publish their formation or registration in that state in two local newspapers or risk the inability to sue as a plaintiff and avail themselves of the courts in that state. However, for a Pennsylvania LLC, no such obligation exists. Note, that New York imposes the same type of publication obligation for both corporations and LLCs. Therefore, New Jersey corporations desiring to do business in their neighboring states have those state's laws with which to contend, thereby making the LLC seemingly the better alternative.

<u>Rigorous Corporate Formalities</u>

In all states, including New Jersey, corporate law imposes the requirement of following through with corporate formalities. Corporate formalities can include annual meetings, voting on election of directors, removal of directors and officers, keeping minutes of meetings, preparing and executing authorizing shareholder and director resolutions for corporate action (or inaction in certain cases). See N.J.S.A. 14A:1-1, et seq. (the New Jersey Business Corporation Act (the "NJBCA"). The risk of not following through with the corporate formalities is having the corporation itself, its directors and possibly even its shareholder being potentially subject not only to litigation but possibly even liability. Liability could arise in connection with actions performed or not performed without having the supporting governing minutes, director votes, shareholder votes, and/or resolutions necessary that should have otherwise authorized such action or inaction. See, e.g., N.J.S.A. 14A:3-2 (Ultra vires transactions). Moreover, shareholders may, in certain circumstances, be subject to liability if the court permitted the piercing of the corporate veil. Although the failure to act in accordance with the corporate by-laws or statute does not automatically give rise to damages, the risk is that such breach of corporate formalities could be damaging enough to cost shareholders plenty of money in legal fees defending such an action against them.

LLCs, however, are not subject to the formal requirements like those imposed by corporate law. Rather, the LLC statute is relatively barren when it comes to imposing any type of formalities upon the LLC and its members (owners of the LLC are referred to in the NJLLCA as "members") and/or managers. In fact, several sections of the New Jersey Limited Liability Company Act, N.J.S.A. 42:2B-1, et seq. (the "NJLLCA") effectively defer to the "operating agreement" of the members for many of the germane and material aspects of the LLC. See 42:2B-8 (purpose); 42:2B-9 (members', manager's rights and obligations); 42:2B-10 (indemnifications); 42:2B-15 (execution of certificates); 42:2B-22 (operating agreements); 42:2B-24 (dissociation of membership); 42:2B-26 (provisions of operating agreement on performance of members); 42:2B-27 (management); 42:2B-29 (classes and groups of managers); 42:2B-30 (performance of managers); 42:2B-33 (contributions of members). Many of these sections of the NJLLCA actually state "except as otherwise provided in the operating agreement…"

LLC Operating Agreements

Therefore, New Jersey effectively places the legal destiny of the LLC in the hands of its members, who are many times novices when it comes not only to business, but especially when it comes to understanding the law. Hopefully, such prospective LLC owners will consult at least one qualified attorney experienced in the drafting of operating agreements so that their operating agreement will be adequately negotiated and planned and sufficiently comprehensive as a working document to govern the LLCs start-up, operational, buy-sell events and other critical items for the LLC.

The NJLLCA's deference to the LLC operating agreement affords persons or entities interested in starting their own business in New Jersey in the form of an LLC the opportunity to have an agreement that governs virtually all of its business and legal events. Corporations, on the other hand, are subject to the long body of law found in the NJBCA, pursuant to which, although by-laws are required (see N.J.S.A. 14A:2-9), nowhere in the NJBCA does it defer to any shareholder agreement or other agreement to govern corporate law. Therefore, from a legal and governing perspective, LLCs are much more flexible than corporations because members of an LLC can craft their own operating agreement that in many respects can and will supersede the default statutory law, as expressly permitted by the NJLLCA.

Due to the ease of administration, simplicity and flexibility in governing the entity, lower costs of compliance and tax benefits, I recommend that clients carefully consider why they would not choose the LLC. As mentioned above, it all depends upon each client's short-term and long-term goals, business projections, tax situation and tolerance for administrative maintenance. Regardless of whatever entity is chosen, as long as it is chosen deliberately with careful advice and planning, it will most likely be a decision clients will not regret.

Darren M. Baldo, Esq., CPA, LL.M. is a business, tax and contract law and estate planning attorney with his own law office in Princeton Junction, New Jersey. Mr. Baldo is a member of the Business Law Section of the New Jersey State Bar Association and the Family and Small Business Committee. He is licensed to practice law in New Jersey and New York. He is also a Certified Public Accountant and has a Masters Degree (LL.M.) in Taxation.