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LLC vs. S Corporation - Corporate Law Aspects (and a few Tax Aspects)

Choice of LLC vs. S Corp is more of a tax issue than a legal issue. However, here I've discussed only the corporate law issues.

From a legal standpoint, but not a tax standpoint, Corps are less complicated, and therefore less costly, than LLCs. The corporate statutes include more defaults and assumptions than do the LLC statutes. However, the corporate law assumptions are not included in the LLC statutes; therefore we must draft the "absent" assumptions into the LLC agreement, where agreements are needed. Therefore, LLC Agreements are longer and more complex than Shareholder Agreements.

LLCs are more flexible as to classes of shares, allow multiple classes of shares, and allow shares that are profits-only interests (not ownership interests). LLCs allow shares that are ownership interests only (but not profits interests). You can choose to pay the LLC owners in varying ways and amounts or schemes among each other. However, with an S Corp, you can only have one class of shares, and they are all ownership and profits interests combined, and they all must be paid under the same payment scheme.

LLCs are more complicated, because they are flexible. With more complication and flexibility, comes more cost for the agreements in general. If you would ever have the need to take advantage of the flexibility, it would be worth the longer, more complex and more costly agreements. But if you will all have equal types of ownership, it may not be worth the extra cost.

If you may have an equity investor, it may be better to be a Corp, since equity investors often prefer corps to LLCs. (Investors don't like the pass-through "phantom income" they get hit with on K-1s from LLCs and S Corps. So they only like C Corps.)

However, if your investor is a LENDER (lending you money to be paid back on monthly/quarterly installments), rather than an EQUITY INVESTOR, then it doesn't matter if you are an LLC or a Corp.

LLCs are slightly more difficult for people to understand because they are different than Corps with their names and titles; however since LLCs are becoming more common, more people seem to understand them now:

- Corporations have Shareholders, a Board of Directors and Officers, and Issue Shares of Stock.
- LLCs on the other hand, have Members, a board of Managing Members, and Officers (optional but recommended), and Issue Membership Interests. (I insist

that all my LLCs use Officers and at least an initial set of organizing and operating resolutions, if there is not an operating agreement),

People often become confused by the Member and Managing Member titles and Interests instead of Shares, which is confusing enough to some people to want to avoid altogether.

However, those items above are only the corporate/legal issues; they are not the tax issues. Tax issues are much more significant. There are some income tax savings advantages to an LLC that may not occur in a Corp, and vice versa, that only a tax accountant can advise you on after understanding your personal tax situation.

The decision on LLC vs. S Corp is mainly an income tax-driven decision, and should be discussed with your tax advisor. Between an LLC and a corporation, there are issues, and perhaps differences, in:

- Income and employer tax you pay on the money you withdraw from the entity to pay yourself (employee versus nonemployee),
- Medical insurance you can pay for yourself as a shareholder and deduct
- Life insurance you can pay for yourself as a shareholder and deduct,
- Retirement benefits you can pay for yourself as a shareholder and deduct,
- Differences in capital gain vs. ordinary income treatment on property the company owns when it is sold,
- The tax effect of changing from one entity type to another,
- The tax effect of selling the business, and
- Other tax issues to be discussed with your tax advisor.

These are only the main issues that affect tax decisions on LLC vs. S Corp vs. C Corp. It is imperative to talk to a good business accountant who has experience in assisting with the decision of entity selection for a small business and all the related start-up and operational tax issues. (I can send you a list of good accountants whom we know and trust.)