



## Making the Choice between an S Corporation or Limited Liability Company

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### Introduction

For the closely-held business, choosing a business entity under which to operate used to be easy. The proprietor usually operated as a sole proprietorship, a partnership, or as an S Corporation. There were clear advantages and disadvantages to each one. The sole proprietorship and partnership had the advantage of simplicity and lack of formal arrangements. The S Corporation was for those individuals needing asset protection and a formal entity in which to operate.

Today the choice of business structure is not so easy. Generally, the use of sole proprietorships and general partnerships is very limited to home based businesses. Currently, most business people have the choice between operating as a Limited Liability Company or as an S Corporation. When deciding which entity to operate under, the business owner must take a lot into consideration. This month, we will focus on the comparison on the Subchapter S Corporation versus the LLC from the perspective of a business owner looking at the newer of the business entities, the Limited Liability Company.

### The Limited Liability Company

With an LLC, there are no restrictions on ownership. An S Corporation, on the other hand, does have restrictions on ownership. First, in order to hold an S Corporation status, a stockholder must be a resident and citizen of this country. Second, no more than 100 people are allowed to own the stock of an S Corporation at any one time. If the ownership requirements are violated, the company will lose its S Corporation status and it will not be allowed to hold S Corporation status for a number of years.

With an LLC, these restrictions (citizenship and limit on number of shareholders) do not exist and its status is not jeopardized. While most LLCs will maintain membership of well under 100 members, the option to expand the number of investors rapidly, does exist. Many immigrants just starting out can benefit from this form of business. On the other hand, a business owner, operating as an LLC has the advantage of looking to non-citizens as investors, increasing selling potential.

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## A CASE STUDY

### IRA Beneficiary

In a private letter ruling, the IRS has restated that the beneficiary of an individual retirement account (IRA) must be identifiable "without qualification" in order to avoid the application of the five year distribution rule for a required minimum distribution. In this case, the taxpayer designated the beneficiary of his IRA as the individuals "as stated in will."

The IRS found that this did not provide any identifiable beneficiaries. The IRS held that while a designated beneficiary does not need to necessarily be specified by name, it must be an individual that is identifiable under the plan and/or written document.

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**Formalities**

There are fewer formalities in maintaining an LLC as opposed to an S Corporation. This is a major convenience and aides in limiting tort and contractual liability; however, the LLC and S Corporation are both potentially subject to being disregarded as an entity if the owner does not obey statutory formalities. This process of disregarding the entity in court is what is known as "veil piercing". Generally, it happens when company owners do not observe formalities such as annual meetings, failure to elect officers, record meetings, keep paperwork, and otherwise use the business as an "alter ego".

The advantage here is that the LLC does not require as many statutory formalities as S Corporations. Hence the LLC can be a better insulator against liability if the occurrences of meetings and production of documents is going to be an issue.

Shares of an LLC are easier to put into a trust than an S Corporation. To put shares of an S corporation into a trust, special language and provisions must be used. It can be somewhat complicated and LLCs tend to work very well instead of S corporations for the purposes of trusts in transfer, estate, and business succession scenarios.

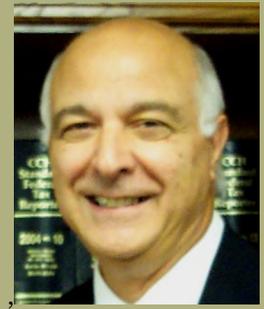
**Taxes**

During operation of an LLC, profits are taxed only at the shareholder level, the same as an S Corporation. Profits from the operation of the business "flow through" to the income statement of the owner. This does not mean distributions are taxed immediately; the income (revenue minus expenses per the tax return) of the LLC is taxed to the owner. This can be a significant disadvantage if the LLC does not pay out distributions. Owners can find themselves facing large tax bills with out the cash to cover it if the LLC has large profits, yet regular distributions are not made.

When winding up the affairs of the entity and dissolving, gains are taxed once. Nearly all businesses will eventually close their doors. Both the LLC and the S corporation offer the owners the chance to close the doors and be taxed only once on the sale of the assets.

**Conclusion**

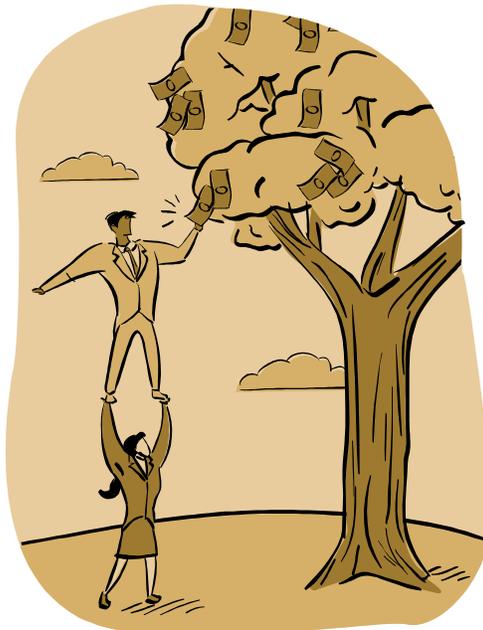
Limited Liability Companies are becoming more popular. This is because most business owners want a limit on liability, single layer taxation, want to limit the formalities and still enjoy the protections. The LLC is definitely worth consideration, next month we will look at the issue from the vantage point of the proprietor looking to operate as an S Corporation.



*Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.*

**Points of Interest**

- **For the closely-held business, choosing a business entity under which to operate used to be easy.**
- **.... a business owner, operating as an LLC has the advantage of looking to non-citizens as investors, increasing selling potential.**
- **The LLC is definitely worth consideration, next month we will look at the issue from the vantage point of the proprietor looking to operate as an S Corporation**



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## A CASE STUDY CONTINUED:

**Editor's Comment:** In determining a required minimum distribution from an IRA, only an individual can be designated as a beneficiary. However, the IRS has allowed a trust to be named as a beneficiary if certain requirements are met and the proper documentation is provided. In this case, none of these requirements were met. More specificity in naming the beneficiary was required. Readers are placed on notice to check the beneficiaries stated in their retirement programs to be sure that the names are spelled out to the satisfaction of the IRS requirements.



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## Legacy Advisors Has Relocated!

Effective June 1<sup>st</sup>, Legacy Advisors has relocated our Florida offices. Our market area hasn't changed: We still serve all of W Central Florida, and occasionally serve clients in other parts of Florida, and even out-of-state clients, but our office address is now: 970 Lake Carillon Drive Suite 300, St Petersburg, FL 33716. Our office number remains the same: 888.864.6610, our fax number remains the same: 866-353-0382, and our e-mail addresses remain the same.

### Why Consider Legacy M&A Advisors, LLC?

- We act as Single Agents, not Transaction Brokers. We represent you as our Client; we are your Agent.
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- We work with all qualified buyers, not just those who come to us directly.
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  - Assist clients who may be looking to raise capital

<sup>1</sup>Securities transactions conducted through StillPoint Capital LLC, Member FINRA/SIPC

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me directly, and in strictest confidence, at 813.299.7862, or via e-mail at [mertel@lmaallc.com](mailto:mertel@lmaallc.com)

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## Frequently Asked Questions...



**Q: I just opened a business and formed it as a Limited Liability Company under my state's laws. For federal tax purposes, how do I classify my LLC?**

**A: An LLC may be classified for federal tax purposes as a sole proprietorship, a partnership, or a corporation. If the LLC has only one owner, the LLC will automatically be treated as a sole proprietorship unless another election is made by the owner. On the other hand, if the LLC has two or more owners, it will be classified as a partnership unless an election is made. The election is made on IRS Form 8832. Unless the election is made, the classification will be the default classifications.**

**Q: I would like to set up a Subchapter S Corporation. How do I do this?**

**A: You must first file articles of incorporation with your respective state. Once this is done, IRS Form 2553 must be filled out to make the Subchapter S election.**

**Q: I am the owner of an S Corporation. If in any given year I do not take any money out of the company, will I have to pay taxes on the income from the business?**

**A: S Corporations are what is known as "flow through entities". If an S Corporation turns a profit, that profit flows through to the owner(s) of the company. Regardless of what distributions or cash the owner takes from the company, the shareholder will see income from the profit of the company.**

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