

2006

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Repository Citation

Tucker, Stefan F, "Comparison of S Corporations and LLCs" (2006). *William & Mary Annual Tax Conference*. 142.
<https://scholarship.law.wm.edu/tax/142>

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COMPARISON OF S CORPORATIONS AND LLCs

WILLIAM & MARY 2006 TAX CONFERENCE

NOVEMBER 17, 2006

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October, 2006

Comparison of S corporations and LLCs

	S Corp	LLC
I. STRUCTURE		
Organizational structure	<ul style="list-style-type: none"> • A corporation may only elect to be treated as an S corporation if it is a small business corporation • Small business corporation: a domestic corporation that: <ol style="list-style-type: none"> 1. is not ineligible 2. does not have more than 100 SHs 3. does not have any SH that is other than an individual, estate, or certain trusts 4. does not have any SH that is a non-resident alien; or 5. that does not have more than one class of stock (can have differences in voting rights) 	<ul style="list-style-type: none"> •
Management Structure	<ul style="list-style-type: none"> • Management is periodically elected by the owners • State law usually provides that the board of directors is to govern the affairs of a corporation 	<ul style="list-style-type: none"> • Limited only by the owner's imagination (can be managed by managers or members, or both) • Can have representative management in a manager-managed LLC with elected managers. • Managers do not have to stand for election • Managers may not have to be natural persons • Manager does not have to be a member • Can allocate different functions of the LLC to different managers

Scope of managerial authority	<ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> • Manager's managerial authority is limited to that set forth in the operating agreement
Formalities / Operational Requirements	<ul style="list-style-type: none"> • Same state law requirements as a C corporation • Must have officers and directors • Annual meeting typically required (held at a time designated in the bylaws) – this is where shareholders vote to hire and fire directors and to vote on fundamental changes • Shareholder votes require unanimous written consent or a meeting that satisfies notice, quorum, and voting requirements • Officers are selected and removed by the Directors • Director action requires unanimous written consent or a meeting that satisfies notice, quorum, and voting requirements • Books, records of account, and minutes from shareholder meetings must be kept as part of the normal course of business • Annual reporting required 	<ul style="list-style-type: none"> • Few legal requirements
Limitations on types of owners	<ul style="list-style-type: none"> • Nonresident aliens and entities other than certain trusts, estates, S corporations and tax-exempt shareholders may <u>not</u> own interests 	<ul style="list-style-type: none"> • There are no limitations on who may be a member or manager

Number of owners	<ul style="list-style-type: none"> No more than 100 shareholders 	<ul style="list-style-type: none"> As few as one member; no limit
Classes of ownership	<ul style="list-style-type: none"> Limited to one class of stock 	<ul style="list-style-type: none"> No limit
Governing Documents	<ul style="list-style-type: none"> Articles of Incorporation, bylaws, shareholder agreement 	<ul style="list-style-type: none"> Operating agreement or LLC agreement
Persons entitled to participate in ordinary decisions	<ul style="list-style-type: none"> Directors and officers 	<ul style="list-style-type: none"> Members and managers
Persons with authority to bind the organization	<ul style="list-style-type: none"> Officers 	<ul style="list-style-type: none"> Members (member-managed LLC) or managers (manager-managed LLC)
Permissible participation in management	<ul style="list-style-type: none"> Shareholders participate in management by electing directors 	<ul style="list-style-type: none"> Members or managers may participate in management
II. TAXATION		
Taxation of the owner	<ul style="list-style-type: none"> Each shareholder takes into account a pro rata share of the S corporation's items of income, deduction, loss and credit in the shareholder's taxable year in which the S corporation's taxable year ends The character of any such item is determined at the entity level Generally, the shareholders are directly taxed on the income of a corporation, whether distributed to them or retained by the corporation, and distributions are generally not taxed 	<ul style="list-style-type: none"> Single member – net income from a single member LLC would be subject to self-employment tax unless one of the exceptions to taxation applied Each member takes into account the allocated share of the LLC's items of income, deduction, loss and credit in the member's taxable year in which the LLC's taxable year ends The character of any such item is determined at the entity level Generally, the members are directly taxed on the income of an LLC, whether distributed to them or retained by the LLC, and distributions are generally not taxed

<p>Taxation of the organization</p>	<ul style="list-style-type: none"> • Pass through • generally not subject to tax, but an S corp. that was a C corp. and has C corp. earnings and profits must pay tax on excessive passive investment income and net recognized built-in gains • S corp. must file an information return – taxable income generally computed as though the S corp. is an individual, but any item that may have different tax treatment for different shareholders must be separately stated 	<ul style="list-style-type: none"> • Pass through • Single member – disregarded for tax purposes • Any other LLC – subject to partnership taxation under Subchapter K unless a different classification is elected • LLC must file an information return - taxable income generally computed as though the LLC is an individual, but any item that may have different tax treatment for different members must be separately stated
<p>Ability of owners to use losses of the organization</p>	<ul style="list-style-type: none"> • Loss deductions are limited to the shareholder's stock basis and loans made by the shareholder to the corporation • Losses are deductible by the shareholders in proportion to their shares of ownership • Shareholder must satisfy at risk rules and passive activity loss rules • Shareholder may carry forward disallowed losses, which are treated as incurred by the S corporation in the next taxable year • Disallowed losses and deductions are personal to the shareholder and cannot be transferred 	<ul style="list-style-type: none"> • Single member – owner may use losses to offset other income, except as limited by at-risk rules and passive activity rules • Any other LLC – member may use losses of the LLC to offset other income as limited by basis, at risk rules, and passive activity loss rules

Assets that may be owned	<ul style="list-style-type: none"> • If an S corp. has earnings and profits from a prior year in which it was a C corp., and passive income in excess of 25% gross receipts, then its excessive passive income is subject to a 35% penalty tax. If the condition exists for 3 years, S corp. election terminates at the beginning of the 4th year 	<ul style="list-style-type: none"> • An LLC is expressly authorized to hold real or personal property
Computation of basis	<ul style="list-style-type: none"> • Basis is initially the amount of cash contributed and the basis of property contributed • Increased by contributions to the corporation and loans to the corporation, BUT no increase in basis for debts of the corporation to any creditor, even if the shareholder is liable on the debt (however, the shareholder can take out a loan and then loan to the S corporation to get a basis increase) 	<ul style="list-style-type: none"> • Basis is initially the amount of cash contributed and the basis of property contributed • Increased by contributions • Increased by member's share of the LLC's debts
Dealer property	<ul style="list-style-type: none"> • An S corp. is better suited to insulate owners from the taint caused by dealer property since the treatment of a corporation as an entity distinct from its shareholders is firmly entrenched in the law 	<ul style="list-style-type: none"> • By contrast, an LLC (like a partnership) is sometimes treated as an aggregate of its partners rather than a separate entity
Sale of an interest in the organization	<ul style="list-style-type: none"> • Generally stock sales are treated as giving rise to capital gains and losses 	<ul style="list-style-type: none"> • The sale of an interest in an LLC is generally treated as the sale of a capital asset
Disposition of ownership interest at a loss	<ul style="list-style-type: none"> • May yield ordinary loss under Section 1244 	<ul style="list-style-type: none"> • Generally yields a capital loss

Allocations	<ul style="list-style-type: none"> • Allocations of income, loss, deduction, or credit must be pro rata among shareholders • The profits and losses are allocated on a strict per share, per day basis 	<ul style="list-style-type: none"> • Allocations may be made in any manner agreed upon by the members, so long as the allocations have substantial economic effect or are otherwise in accordance with the members' interests in the LLC
Contributions of property	<ul style="list-style-type: none"> • A contribution of property is taxable to the shareholder unless control tests are met and liabilities do not exceed the adjusted basis of the transferred property 	<ul style="list-style-type: none"> • Generally tax free
Contributed property with a built in gain or loss	<ul style="list-style-type: none"> • Unrecognized gain or loss from contributed property is shared by the shareholders on a per day, per share basis 	<ul style="list-style-type: none"> • Built in gain or loss must be allocated to the contributing member (who has the book/tax disparity)
Distributions of property	<ul style="list-style-type: none"> • A distribution of appreciated property will generally cause gain to be recognized at the corporate level (gain is recognized as if the property were sold for its fair market value on the date of distribution); such gain is shared pro rata among shareholders • The corporation does not recognize any realized loss for distributions of loss property • If an S corporation has no earnings and profits (from existence as a C Corp), amounts received by shareholders in distributions are tax free to the extent of the shareholder's basis; amounts received in excess of basis are treated as gain from the sale or exchange of an asset 	<ul style="list-style-type: none"> • Generally tax free

III. ESTATE PLANNING		
Owner's default right to payment on death	<ul style="list-style-type: none"> • The death of a shareholder does not require the corporation to repurchase the deceased shareholder's shares 	<ul style="list-style-type: none"> • On the death of a member, if the business of the LLC is continued, the legal representative of the deceased member may have the value of the member's interest at the time of dissociation, or, if later, at the expiration of the term
Basis adjustment under Section 754	<ul style="list-style-type: none"> • Not applicable 	<ul style="list-style-type: none"> • If a 754 election is not made, the sale of an appreciated LLC asset by the LLC causes the LLC, and therefore successor member (or estate of the deceased member), to recognize gain on the sale, even though the successor member or estate has a stepped up outside basis in his/her/its LLC interests • If a 754 election is made, the basis of the LLC's assets will be adjusted with respect to the successor member (or estate of the deceased member) thereby avoiding gain (on the difference between the old/deceased member's basis and the new member's stepped up basis) on the sale of the LLC asset • The outside basis for the new member/estate may be stepped down if the value of the asset has fallen below its basis; the 754 election would thus prevent the new member/estate from taking a loss on the sale of the asset

<p>Non-tax reasons for entity ownership of real estate</p>	<ul style="list-style-type: none"> • Non-voting stock can be used to shift ownership among family members without shifting control 	<ul style="list-style-type: none"> • LLCs (like FLPs) allow the owner to control the management of real estate and establish a plan for succession, no matter who the members are • Entities, like LLCs, protect the real estate from creditor claims that are made against any of the members or against any other real estate owned by a member in a different entity
<p>Continuity of life / period of duration</p>	<ul style="list-style-type: none"> • A corporation has perpetual duration unless limited in the Articles of incorporation 	<ul style="list-style-type: none"> • LLCs typically will have continuity of life in that the personal representative of the last remaining members may elect to continue the LLC

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