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S CORPORATION VS. LLC: THE BEST STRUCTURE FOR YOUR CALIFORNIA BUSINESS?

(OWNERSHIP, OPERATION, AND EMPLOYMENT TAX)

(Business Advisory No. 11)

Choosing the proper legal entity to hold and operate your California business is critical — taxes, liability, flexibility and other concerns should be taken into consideration. This Advisory will help you consider the relevant factors in determining the best type of legal structure for a new entity.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the mere distribution of this Advisory.

Preferred Business Entities; Liability Protection of Owners. Determining, during the formation stage of a new entity, whether a business should be structured as a corporation or a limited liability company, can be challenging for an entrepreneur or business owner. Corporations and limited liability companies (LLCs) are typically the preferred business structures for new ventures because, unlike sole proprietorships and partnerships, both offer personal protection to the owners from the liabilities of the business. This means that the owner of a company cannot be held personally responsible for the company's debts and liabilities. The personal assets of an owner are shielded from company liabilities. Because only the LLC or corporate assets are legally available to pay business debts, the owner of an LLC or corporation stands to lose only the money they've invested in the entity itself and not in their personal home, IRA, or other assets.

S Corporations and Limited Liability Companies. In researching the various business structures available to a business owner, you may consider an S corporation. S corporations and LLCs are similar in that they are both "pass-through" entities for tax purposes; the income (and losses) of these companies are passed through to their owners and reported on the owners' personal income tax returns, thereby eliminating the double taxation incurred by owners of a standard corporation (or C corporation). With a C corporation, there is a double tax because the net business income is subject to corporate income tax and the monies remaining (after the

Buynak, Fauver, Archbald & Spray, LLP

820 State Street, 4th Floor | Santa Barbara, California 93101 | (805) 966-7000 tel

433 Alisal Road, Suite C | Solvang, California 93464 | (805) 688-8090

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corporate income tax) are taxed a second time when they are distributed as dividends to its owners who then must pay personal income tax.

Determining Factors. So what are some of the advantages and disadvantages of a C Corporation, S Corporation or a LLC and how do you evaluate which structure is best for your business? To make this determination, an evaluation of each type of entity is necessary.

Like many legal matters, the answer depends on your own unique situation. A “cookie cutter” approach is not advisable, since even one unique factor can change the benefit involved in the typical scenario. If operational ease and flexibility are important to you, an LLC is a good choice. If you are looking to save on employment tax and your situation warrants it, an S corporation could work for you, as long as you are willing to meet the corporate maintenance requirements. Finally, there are tax considerations. If you have high gross receipts — but low profits — or initially experience a loss, an S Corporation probably is appropriate. If the venture will result in a one-time large sale or profit, then an LLC might be used. These issues, and those combined with ownership and operational factors, will play a role in your decision.

S Corporations. There are restrictions involving owners (or shareholders) of an S corporation. An S corporation can have no more than 100 shareholders, none of the shareholders can be nonresident aliens, and shareholders cannot be other corporations or LLCs. There can only be one type of stock, and profits/losses are divided exactly according to stock ownership.

An S corporation is operated in the same way as a traditional C corporation and must follow the same formalities and recordkeeping procedures as a C corporation. It must adopt Bylaws and hold regular meetings of shareholders and directors. Keeping records of these meetings can be crucial, especially if the corporation at some point becomes involved in litigation. The directors or officers of an S corporation manage the company and an S corporation has no flexibility as to how profits are split up amongst its owners. The profits must be distributed according to the ratio of stock ownership, even if the owners may feel it is more equitable to distribute the profits differently.

Limited Liability Companies. Limited liability companies offer greater flexibility in ownership and ease of operation, especially if there are partners who share ownership and/or profits disproportionately. There are no restrictions on the ownership of an LLC and profits can be shared as the members agree. An LLC is simpler to operate because it is not subject to the formalities by which S corporations must abide. An LLC can be member-managed (meaning that owners run the company) or it can appoint a manager who may or may not be an owner in the LLC. Owners of an LLC can distribute profits in any manner that they see fit.

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For example, let's assume that you and a partner own an LLC. Your partner contributed \$80,000 for capital, and you contributed \$20,000, but you perform 90% of the work to run the LLC business. The two partners have agreed that, in the interest of fairness, each share the profits on a 50/50 basis. As an LLC, you could do that, but with an S corporation, you could only take 20% of the profits while your partner would take the other 80%.

Compared to corporations, LLCs operate informally, as established by statute. Once Articles of Organization are filed with the Secretary of State, an LLC adopts an Operating Agreement and is not required to hold meetings of its members and record minutes of those meetings. Remember this is not the case for corporations. A corporation must hold an annual meeting of its shareholders to elect its board of directors, and the directors must hold at least one annual meeting to elect the corporate officers, and review and/or ratify the actions taken by the officers for the past year. Minutes must be kept of these meetings and be maintained in a binder or file by the corporate secretary. Even though the LLC is not required to hold these annual meetings, it is recommended that you document your business activities, annually.

Employment Tax: Savings vs. Paperwork. A major factor that differentiates an S corporation from an LLC is the employment tax that is paid on its earnings. Normally, an owner of an LLC is considered to be self-employed and as such, must pay a "self-employment tax" on all income of 15.3%, which amount goes toward Social Security, Medicare, etc. The entire net income of the business can be subject to self-employment tax.

In an S corporation, only the salary paid to the employee-owner is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules. Therefore, there is the potential to realize substantial employment tax savings. Let's look at an example:

- Kathryn owns a small motel. In keeping with the industry standard, Kathryn determines that a reasonable salary for a motel manager is \$35,000 and pays herself this sum. Kathryn's total earnings for the year are \$60,000: \$35,000 paid in salary and the remaining \$25,000 paid as a distribution from the S corporation. Kathryn's total employment tax is \$5,355 (15.3% of \$35,000).
- If Kathryn were the owner of an LLC, she would have to pay employment tax on the entire \$60,000, equaling \$9,180. But as an S corporation, she realizes savings of \$3,825 in employment tax.

One might assume that these savings could be further manipulated by reducing the salary to an extremely low amount and attributing the rest of one's earnings to distributions, but this would be an incorrect assumption. In practice, the IRS is careful to notice whether a salary is

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reasonable by industry standards. If it determines a salary to be unreasonable, the IRS will not hesitate to reclassify as salary, all distributions.

While owners of a corporation must pay their payroll taxes monthly or more frequently throughout the years, owners of LLCs can pay their self-employment tax yearly on April 15 (when income taxes normally are due) or make quarterly estimated tax payments (if they expect to owe taxes totaling \$1,000 or more). Corporations file their separate income tax returns. A single-member LLC files the same 1040 tax return and Schedule C as does a sole proprietor; partners in an LLC file the same partnership tax return as do owners of traditional partnerships.

The comparison chart below sums up the similarities and differences between the two business structures:

CHARACTERISTICS	S CORPORATION	LIMITED LIABILITY COMPANY
Liability Protection	Yes	Yes
Operational Control	Board of Directors/Officers	May be member-managed or manager-managed
Annual Meetings	Required annually for shareholders and board of directors	No required meetings by members
Flexibility/Ease of Operation	Subject to same formalities and record keeping rules as traditional C corporations	Yes
Federal Income Tax	Pass-through	Pass-through
Ownership Restrictions	Yes	No
Flexibility in Profit-Sharing	No	Yes
California Franchise Tax	\$800 per year plus 1.5% of net profit	\$800 per year plus an amount based on gross income/receipts, irrespective of profit
Employment Tax	Employment/payroll tax on salary; no employment tax on dividends paid to shareholders	Self-employment tax on total net income

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There is not one magical entity that works for everyone. An experienced business attorney can assist you in choosing the right structure for your business. The important thing to consider is the operational, legal and tax aspects of each structure as they apply to your situation.

As always, you should be sure that additional legislation has not been enacted or that court decisions have been rendered that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. If you have questions or concerns, you should discuss your individual situation with us or your own attorney. We look forward to being of assistance to you.

S. Timothy Buynak
Business and Tax Attorney

This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author at the number listed below.

Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start-up, through day-to-day operations and exit strategies.

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