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Which Entity Structure is Best for Your Business?

One of the most challenging decisions for any business is the type of entity structure to adopt. This is especially true of those entities that are new or have experienced significant changes within the entity, including ownership makeup. For privately-held businesses, the most common options are a C corporation, an S corporation and a Limited Liability Company (LLC).

In general, key considerations for the entity structure include flexibility and taxation. The taxation concerns, especially a single layer of tax and often an ability to command a higher sale price due to tax treatment, typically eliminate the C corporation alternative, leaving a choice between the S corporation and the LLC. Therefore, this analysis will primarily evaluate S corporations and LLCs, which are taxed as partnerships.

The table below summarizes the primary strengths and weaknesses of these two alternatives. The primary factors favoring an S corporation are a potential for reducing employment taxes and an ability to participate in a tax-free merger. The primary factors favoring the LLC are related to flexibility and an increased ability to deduct losses. Also, note that in general, an LLC can be transferred (or transformed) into a corporation without significant tax consequences, but the reverse is not true.

Attribute	S Corp.	LLC	Comments
Minimize payroll taxes	Yes	No	This issue may be reviewed in Congress
Participate in a merger	Yes	No	LLC can generally convert to an S corporation
Limit on type or number of owners	Yes	No	
Can have multiple classes of equity	No	Yes	For an S corporation, the only permitted difference is voting versus nonvoting stock
Owner basis for debt guarantees	No	Yes	S corporations require direct loans from the owners
Disproportionate distributions allowed	No	Yes	
Inside basis adjustments permitted upon ownership changes	No	Yes	Allows inside basis to be adjusted to outside basis – this is generally very desirable
Corporate Formalities	Yes	No	S corporations generally required to hold annual meetings, elect directors, keep minutes, etc.
Taxable Liquidation	Yes	No	
Ease of Ownership Interest Transfer	Yes	No	Loss on sale of S corporation stock could potentially yield preferential ordinary loss treatment (up to \$100,000)

As you can see, the advantages of an LLC typically outweigh the advantages of an S corporation. This is particularly true when one considers the increased scrutiny of both the IRS and Congress on the payroll tax advantages currently available to S corporations. However, the entity decision must be made keeping in mind the objectives of the entity, ease of formation and operation, taxation and exit strategy of the entity.



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