

# S Corp or LLC?

By:

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There are many choices of business entity—sole proprietorship, partnership, “C” corporation, “S” corporation, limited liability company (“LLC”) and more. However, for small businesses who have studied the many benefits of incorporation and choose to incorporate, the choice generally comes down to “S corporation or LLC?”.

## I. Attributes of Both S Corporations and LLCs

**Limited Liability** – Both the S Corporation and the LLC provide limited liability. The name “limited liability company” is misleading as all corporations offer limited liability. As discussed below, the LLC can, in certain instances, provide additional protection.

**Untaxed Entity** – Both the S Corporation and the LLC allow the business owner to avoid “double taxation.” Gains and losses “flow through” to the owners, and there is no federal or income tax owed by the business entity.

The S Corporation does require filing of a federal and state corporate income tax return, although no tax is owed. LLCs with more than one owner must file a partnership return; single person LLCs simply include their gains and losses on a “Schedule C” just as if they were not incorporated.

**Transferability, Control, Active/Passive/1099** – Both S corporations and LLCs provide very similar benefits in terms of the usual and customary benefits of operating as an incorporated entity rather than an unincorporated entity. This includes transferability of units; centralized control, if desired; active roles for workers versus passive roles for investors; and more. (See *Should You Incorporate Your Business?*)

## II. Advantages of an S Corporation over an LLC

**Avoiding Social Security Taxes** – A primary reason to choose an S corporation over an LLC is that an owner can often elect to take some of the gains of the business as “dividends” as opposed to “salary.” Both dividends and salary are subject to federal and state income taxes; however, true dividends on S Corporation stock paid from the earnings of the corporation are not subject to Social Security taxes. As Social Security taxes are becoming one of the most burdensome taxes, this fact alone makes the S Corporation the entity of choice for many businesspersons.

Because the LLC is not technically a corporation and has no “stock,” it cannot declare dividends. Gains flow to the owner as “earned income,” and therefore all gains are subject to federal and state income taxes and Social Security taxes.

**Costs and Fees** – The S Corporation generally costs less to form than an LLC. And, in North Carolina, the Secretary of State currently charges \$35 per year in fees for the S Corporation and, inexplicably, \$200 per year for LLCs.

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## III. Disadvantages of an S Corporation

**Restrictions on S Corporations** – Although the S Corporation form of entity is generally available to most citizens, not every business qualifies to be an S Corporation. To qualify as a “small business corporation:”

- The entity must be a domestic corporation;
- The entity must have no more than 75 shareholders
- Shareholders must either be individuals, an estate, or certain trusts (and not another corporation);
- Shareholders may not be non-resident aliens;
- Only one class of stock is permitted
- The corporation must have a tax year ending December 31 or ending at another date approved by the IRS for a valid business purpose;
- All shareholders must consent to the election

There are additional requirements named in the governing section of the Internal Revenue Code.

## IV. Advantages of an LLC over an S Corporation

**What is an LLC?** An LLC has been described as “a partnership that has been given limited liability.” In recent years, sole proprietorships have similarly been given the right by statute almost magically to change to an LLC and thereby secure limited liability. However, to understand the LLC, it is important to think “partnership” or think “sole proprietorship.” As it is not a corporation, it does not have stock, it does not have dividends, and it does not have stockholders. It has percentages of ownership or “units of ownership.” Owners are generally referred to as “members.” Control is generally in the “members” just as in the case of a partnership. If desired, control can be placed in separate managers, and corporate officers can be elected just as in the case of a corporation. Absent such special provisions, an LLC operates much like a partnership.

**Set it up and Forget it** – One of the primary advantages of the LLC is the “**single person LLC.**” For those who like simplicity, the single person LLC is a thing of beauty. An attorney files “Articles of Organization” (Not “Articles of Incorporation”) and prepares an “Operating Agreement.” Thereafter the owner may never again deal with organizational minutes, boards of directors, officers, bylaws, stock, corporate tax returns, annual meetings, special meetings, resolutions, and the like. Furthermore, at tax time the owner files the same “Schedule C” to his or her tax return as if he or she had never formed an LLC.

For a multi-party LLC (including a husband and wife), the primary difference is that a partnership tax return—federal and state—must be filed for the LLC. No taxes are owed by the entity; the partnership return is for information only.

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LLCs can be used for almost any business purpose. They are particularly attractive for passive investments—ownership of rental real estate, for example. Furthermore, LLCs do not face the detailed S Corporation restrictions—in particular the requirement that no “owners” be a corporation. Therefore, a corporation, which cannot own a S Corporation or stock in a S Corporation, can readily set up an LLC and limit its liability when starting a new venture that poses new or additional risks to the existing corporation.

**Additional Limited Liability**—When confronted with an actual judgment-creditor, the LLC can offer greater protection of assets than other business entities. For example, the judgment-creditor of an individual who has set up a corporation can, if unable to locate other assets, seize the corporate stock and sell it, just as other assets of a judgment-debtor can be sold. However, this cannot be readily done in the case of an LLC. Because an LLC is treated “like a partnership,” in North Carolina and some other states a judgment-creditor of the owner cannot simply attach and sell the “units of ownership” just as he could not attach assets of a partnership when he only had a judgment against one partner. Instead, the judgment-creditor is limited in his or her remedies to obtaining a “Charging Order” and directing only that the income being distributed to the owner be delivered over to the judgment-creditor. Because an LLC may not have any “income” (it may pay all income out as salary or only invest in rental real estate with no available income, or it may simply choose not to make distributions to partners), a judgment-creditor of the owner of an LLC simply cannot reach the assets in the LLC in many instances. Because the LLC is a relatively new phenomena there is not a great deal of case law addressing how judgment-creditors can pierce LLCs to get at assets of judgment-debtors.

On balance, the LLC, when compared to the S Corporation, appears to offer considerable additional protection against judgment-creditors of the owner of the entity.

### **V. Disadvantages of an LLC**

**The primary drawbacks to the LLC are:**

- 1) It generally costs a little more to set it up,
- 2) The North Carolina Secretary of State currently charges a fee of \$200 per year rather than a fee of \$35 per year for S Corporations, and
- 3) There is no opportunity to avoid Social Security taxes as with the S Corporation.



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