Choice of Entity for the Closely Held Business—Comparing LLCs and Subchapter S Corporations

Written By **Lee C. Hodge** (lch@wardandsmith.com)
May 25, 2018

While the Internal Revenue Code ("Code"), Subchapter C Corporation ("C Corp") will be the proper choice of entity for some closely held businesses (particularly in light of the federal tax reform package that became effective on January 1, 2018 that reduced the top C Corp tax rate from 35% to 21% and for entities looking to raise capital from angel investors or venture capital investors), most closely held businesses should be formed as either a limited liability company ("LLC") or a Subchapter S Corporation ("S Corp"). This article provides an overview of the main tax and non-tax differences between an LLC and an S Corp.

A Quick Terminology Review

First, an S Corp owner is referred to as a "shareholder" who holds "shares of stock" in the S Corp, whereas an LLC owner is referred to as an "interest owner or member" who holds an "interest" or a "membership" in the LLC.

Second, an S Corp is governed by "directors" and "officers," whereas an LLC is governed by "managers" or "company officials."

Corporate Formalities—Is Less Always More?

Under the North Carolina Business Corporation Act, an S Corp is required to hold an annual meeting of the S Corp's shareholders. While this requirement can be satisfied by either holding an actual meeting of the shareholders or documenting the annual meeting via an action by written consent signed by the shareholders without having an actual meeting, an LLC is <u>not</u> required to hold any type of annual meeting. Some business owners, especially the owners of a special purpose entity LLC that is formed to facilitate a specific real estate development project, prefer the ability to avoid the annual meeting requirement, while other business owners insist on holding annual or quarterly meetings to ensure that the business is operated in a transparent manner and all owners are well informed regarding the operation of the business.

Creditor Protection—The Charging Order

Compared to an S Corp, an LLC can provide heightened creditor protection for the LLC's owners. This is a result of North Carolina's Limited Liability Company Act, which provides that a creditor who holds a judgment against the owner of an LLC interest can only get a "charging order" against the LLC interest, whereas a judgment creditor of a shareholder in an S Corp can actually foreclose on the shareholder's S Corp shares and take ownership of those shares. The charging order in the LLC context requires the LLC to make cash or property distributions to the judgment creditor instead of making the distributions to the owner of the LLC interest. If properly structured, the charging order can protect a judgment debtor's ownership interest in the LLC interest and the other owners of the LLC.

Tax Differences—Where the Rubber Meets the Road

While the above-described differences between the LLC and the S Corp entity forms should be considered, the main differences between an LLC and an S Corp are found in the tax area.

- **Number of Shareholders**

  An LLC can have an unlimited number of owners, whereas under the Code, an S Corp can only have a maximum of 100 owners. The 100-owner limitation generally is not a major issue, particularly in the early stages of the life cycle of a business.

- **Types of Shareholders**

  There are no restrictions on who can be the owner of an LLC interest, but there are strict Code rules on who can be the owner of shares in an S Corp. Generally, other entities (such as an LLC, another S Corp, or a C Corp) cannot own shares in an S Corp, although one S Corp can own 100% of the shares of another S Corp if the parent S Corp makes the "Qualified Subchapter S Subsidiary" tax election. Additionally, only certain types of trusts (called "Grantor Trusts," "Electing Small Business Trusts," and "Qualified Subchapter S Trusts") can own shares in an S Corp.

- **Treatment of Debt**

  The LLC form can provide a tax advantage over the S Corp form if the entity is going to incur debt. In the LLC context, the owners of an LLC receive additional "outside basis" in their LLC interest when the LLC incurs debt, even if they do not personally guarantee the repayment of the LLC's debt, whereas an S Corp shareholder generally will not receive additional basis when the S Corp incurs debt, even if the S Corp owner personally guarantees the repayment of the debt. This additional basis can allow an owner of an LLC interest to take advantage of additional losses that are allocated to the owner and can decrease the amount of tax the owner pays if the LLC is sold.

  It is possible for an S Corp shareholder to obtain this same basis increase with respect to debt, but the S Corp shareholder would have to use a "back-to-back" loan structure in which the S Corp shareholder first borrows the money from the lender and then loans the money to the S Corp. The downside to the back-to-back loan structure is that the S Corp shareholder is personally liable for the repayment of the debt to the lender, whereas the LLC owner is not personally liable, unless the owner personally guarantees the repayment of the LLC's debt.

- **Taxation of Distributions Out of the Entity to the Owners**

When an LLC distributes cash or other property out to its owners, the distribution generally is tax-free to the owners and the owners generally step into the shoes of the LLC with respect to the tax attributes related to the distributed asset. However, in the S Corp context, the distribution out to the owners results in a "deemed sale" for tax purposes, which can trigger tax if the asset being distributed has appreciated in value while it was held by the S Corp.

- **Flexibility to Make Non-Pro Rata Allocations and Distributions**

  Owners of an LLC generally have a lot of flexibility in structuring how different tax items (such as depreciation deductions, or tax credits) will be allocated among the owners, and in structuring cash distributions to different categories of LLC owners. This flexibility in setting the economic structure of a deal can be very useful in real estate development deals or deals where there are different categories of owners who want to receive different economic results from the deal.

  An S Corp does not provide any of this flexibility, as all allocations and distributions from the S Corp must strictly be handled on a straight pro rata basis due to the S Corp "single class of stock" rule.

- **Employment Taxes**

  An S Corp can provide a tax advantage for owners of operating businesses that pay salaries, because it can pay the owners who are active in the business a "reasonable" salary and then distribute excess cash to the active owners via shareholder distributions. This allows an active owner to avoid paying certain employment taxes on the portion of the cash distributed as a shareholder distribution which would otherwise be owed if all of the cash is distributed via salaries.

  An LLC does not provide this tax advantage.

Conclusion

As you can see, there are a number of different factors that need to be addressed when the founders of a closely held business are deciding whether they should form their business as an LLC or an S Corp. The attorneys in Ward and Smith's Tax and Business Practice Groups have significant experience in helping founders of large, medium, and small closely held businesses determine which entity form is right for their new business venture, and we would welcome the opportunity to discuss this topic with you and your tax advisors.

--