

PROS AND CONS OF LLCs ELECTING S CORPORATION STATUS

An S corporation is a business corporation (or more recently, an LLC or partnership) organized under state law that elects to be treated, for income tax purposes, as a so-called “S corporation,” under Subchapter S of the Internal Revenue Code. S corporations have been around for over 60 years. They were enacted primarily to assist small business owners by permitting them the benefits of operating as a corporation (less personal

liability, etc.) and at the same time avoiding double income tax on business profits. Absent an S corporation election, a corporation and its owners are subject to double income tax: once at the corporate level in the year earned and again when profits are distributed to its owners. S corporations were arguably the most common choice of entity for new businesses until the advent of limited liability companies (“LLCs”), which were recognized by virtually all states by the end of the 1990s.

The primary disadvantage of an S corporation is that, in order to file a valid S corporation election, a number of technical requirements must be met. (See table below). It seems somewhat ironic that legislation designed to help small business has so many restrictions on its use. Perhaps more importantly, even if an S corporation election is filed and approved by the IRS, favorable tax treatment can be lost if one of the technical requirements ceases to apply. (e.g., the IRS has taken the position that if distributions to owners are not made at the same time and pro-rata according to stock ownership, the company may be deemed to have a class of preferred stock, thus forfeiting its S corp. status.)



Limitations and Prohibitions	S Corporations	LLCs
Unlimited number of owners permitted	No	Yes
Common and preferred shares permitted	No	Yes
Types of owners (natural persons and legal entities) permitted	No	Yes
Foreign owners permitted	No	Yes
Permitted to issue tax favored profits interests	No	Yes
Non-pro-rata allocation of income and deductions permitted	No	Yes
Timing of distributions to owners important	Yes	No
Must file tax return even if only one owner	Yes	No
Easy to lose favorable tax treatment	Yes	No

It is probably fair to say that LLCs have now usurped the historic position of S corporations as the most popular choice of legal entity for new businesses. As illustrated by the table above, the reason for this is quite simple: LLCs offer virtually all of the advantages of S corporations without the disadvantages. LLCs with a single owner do not even have to file income tax returns and those with more than one owner can avoid double taxation by electing to be treated as a partnership for tax purposes. The only exception is that under existing federal tax law, the owner of an LLC who renders services to the company cannot be a W-2 employee of his or her LLC. Therefore, the owner's compensation is not subject to payroll withholding and estimated tax payments are usually required. While this appears to be a significant disadvantage or at least an inconvenience, the prohibition can easily be avoided.

In light of the foregoing, why would any LLC elect to file an S corporation election? The only reason I have ever heard articulated is that, "They say' S corporations are less frequently audited by the IRS than LLCs." I am not aware of any studies that support that statement and I believe that any tax professional will advise that the likelihood of an IRS audit is much more impacted by the company's level of income and types of deductions claimed, rather than its choice of legal entity. If you have question on this issue or other business matters, please contact you regular PLDO attorney or PLDO Partner William F. Miller of our Corporate & Business Team at 401-824-5100 or email wmiller@pldolaw.com.



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