

Alberty.com - Fall 2001 Newsletter

We're sending this newsletter to you, as a customer of Alberty Publishing LLC, to bring you news about the law of limited liability companies and what's new at Alberty.com.

S Corporation or LLC?

Historically, the S corporation was the entity of choice for start-up businesses. This form of entity allowed losses incurred in the early years of the business to be passed through and reported on shareholders' tax returns and provided limited liability to shareholders, thereby protecting them from creditor claims if the business failed. The LLC is now available as an alternative to the S corporation and also offers pass-through tax treatment and limited liability. Which is the better choice?

There is no one right answer to this question. For some businesses, the employment tax advantages of an S corporation make this the best form of entity. But for many other businesses, the numerous advantages of an LLC make it a better choice.

S corporations have the edge when one considers employment taxes. All income of an LLC is subject to self-employment tax if it is allocated to a member involved in management, whereas S corporation income is subject to employment tax only if it is distributed in the form of compensation. Self-employment tax is imposed at the rate of 15.3 percent on the first \$80,400 of an individual's income from self-employment, so a start-up business that becomes profitable can realize substantial tax savings if it is organized as an S corporation rather than an LLC and if all or part of the income of the business is retained to provide working capital or is used to invest in capital assets.

But LLCs offer a number of other attractive features. For example, there are no limitations on the types of persons who may be members of an LLC. Since corporations, partnerships, and LLCs cannot generally own stock in an S corporation, using that form of entity for a start-up business may limit the field of potential investors in the business.

The ability of an S corporation to attract potential investors is further limited by the fact that all income, losses, tax items, and distributions must be allocated between S corporation shareholders based upon their stock ownership. With an LLC, these items can be allocated in accordance with the needs and desires of the members.

Another issue that may be of concern to potential investors, or to owners who hope to sell their start-up business after it becomes successful, is that the owners a business that is initially organized as an S corporation cannot take advantage of the special exclusion of one-half of the capital gains realized on the sale of stock in certain small business corporations. Owners of a business that is initially organized as LLC and is later converted to a corporation can, on the other hand, take advantage of this exclusion if the business qualifies and they hold their stock for five years prior to its sale.

LLCs are also more transparent than S corporations for income tax purposes. It is generally easier and less expensive from a tax standpoint to put assets into and to remove assets from an LLC, which provides flexibility in changing the structure of a start-up business.

Client Education

Neither an S corporation or an LLC is the right choice in all cases, and assisting a client in making a choice for a particular business can be difficult and time consuming. One way to expedite the decision making process is to provide your client with a summary of the advantages and disadvantages of the alternatives. Such a summary can introduce the client to unfamiliar concepts, help focus attorney-client discussions, and serve as written record of the considerations that led to the choice that this ultimately made.

Alberty Publishing Form 8.5, which is available for purchase from our Web site, is a form of a letter outlining the advantages and disadvantages of S corporations and LLCs in somewhat greater detail than the brief overview presented in this newsletter. The letter is designed to be sent by an attorney to his or her client in connection with client's selection of a form of entity for a new business.

Subscription Info

As a customer of Alberty.com, we'd like to continue sending you updates on the law of LLCs and about useful forms that can enhance your practice. But if you'd rather not receive our newsletters, just let us know by replying to this e-mail. A human being will be reading your e-mail, so just ask us to take you off our mailing list – no magic words are needed in the subject line.

We welcome your input or feedback about this newsletter. Please feel free to reply with any thoughts or requests. Thank you.

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