When Starting a New Business…

When starting a new business, one of the first big decisions is choosing the structure it is going to have.

Two of the most popular options are S corporations and Limited Liability Company (LLC). While they have many similarities, there are some key differences that establish each as being better for certain types of businesses.

S Corporations

An S Corporation, Subchapter S of the first chapter of the Internal Revenue Code, is a tax designation.

"Every S corporation begins as a C corporation and then you file an S corporation election [with the IRS]," Deborah Sweeney, CEO of MyCorporation, told Business News Daily. "The entity is a C corporation, but the S corporation election is a tax status."

Unlike a C corporation, where the business and owners are both taxed on the profits, an S corporation has a pass-through tax, which means owners and shareholders pay individual income taxes on any profits they receive.

"The taxes flow through the corporation and appear on the individual's tax returns," Sweeney said.

Todd Kulkin, an on-call attorney for Rocket Lawyer, said that in addition to avoiding the double taxation, the pass-through tax gives owners and shareholders the chance to pay a lower tax rate on profits.

"When you pass the tax liability through to the shareholders, it is taxed at the personal rate and not at the corporate rate," Kulkin said.

Requirements for S corporations include being a domestic company, having no more than 100 shareholders and issuing only one class of stock. Additionally, a large number of operational rules must be followed, such as filing an annual report, adopting bylaws, keeping proper stock transfer records and holding a yearly meeting with stockholders.

"That could be a lunch with your shareholders, but there has to be an official notice," Sweeney said of the meeting.

Follow Chad Brooks on Twitter @cbrooks76 or BusinessNewsDaily @BNDarticles. Also on Facebook & Google+. This story originally published on BusinessNewsDaily.

Not following these rules could result in owners loosing their liability protection, according to Sweeney. She said if a company is sued, for example, and the plaintiff's attorney finds out the business hasn't been holding annual meetings and keeping minutes, the S corporation designation could be found invalid by a judge, which would expose the business owner's personal assets to any judgments levied against them.

"If they don't [follow the rules], ultimately their corporate veil can be pierced, yielding an insufficient corporation," Sweeney said.

To become an S corporation, Kulkin said businesses must elect S status within the first two months of the tax year. They also have to make the designation every year to continue being considered an S corporation. **[Small Business Legal DIY? What's OK to Do Yourself]**

Limited liability company

LLCs offer business owners many of the same liability and tax advantages of an S corporation.

"They have a lot of similarities," said Barbara Weltman, a tax expert who has partnered with The Hartford on its Business Owners Playbook. "They both offer personal liability protection and they're both pass- through entities, which means the owner is going to pay taxes on their share of the profits."

However, LLC owners pay the self-employment tax on their share of the profits, which S corporation owners don't.

"There can be a substantial difference there," Weltman said.

Another key distinction between the two lies in the ownership structure. While S corporations have shareholders whoare given stocks, LLCs have members.

"Shares are much easier to transfer between a non-shareholder and shareholder, while membership is held much closer," Kulkin said. "That helps maintain control over who has controlling interest in the company."

After an LLC is formed, an operating agreement is written that spells out the rights, responsibilities and amounts of profits to which each member is entitled.

Follow Chad Brooks on Twitter @cbrooks76 or BusinessNewsDaily @BNDarticles. Also on Facebook & Google+. This story originally published on BusinessNewsDaily.

Aaron Young, business consultant and Laughlin Associates founder, said there is tremendous flexibility in how LLCs choose to divide ownership.

"It can be whatever the members agree to," Young said. "The distribution of gains and losses can bedivvied up however the members want to do it. It's not based on your stock ownership like a corporation."

One of the main benefits of an LLC is that it isn't bound by the same stringent operating procedures.

"I think the main reason people choose an LLC over an S corporation is that they don't have to have meetings, they don't have to give the notice [of a meeting], and they don't have to update their minutes or bylaws in the same fashion," Sweeney said.

Some businesses, including financial institutions and those in the insurance industry, are prohibited by law from becoming LLCs, Sweeney said.

What to consider

When deciding which option is best for the business, Young advises entrepreneurs to consider three questions. The first is, who is going to own it.

Young said LLCs are best for two or more owners, and said single owners should never form an LLC.

"If you are going to have a variety of people coming in that are going to be active in the company, LLC is the way to go," Young said. "All of those great flexibility and tax benefits go out the window if it is a one-member LLC."

The second question small businesses owners should consider is where they plan to get the money to start or expand the company. If owners have their sights on raising lots of capital from outside investors, Young said, an S corporation is the best choice.

Weltman said small business owners can choose to start as an S corporation and then, if they choose to raise money from more than 100 shareholders, remove their S status and revert to a C corporation.

"If you wanted to raise capital via equity crowdfunding, being a corporation makes it easy to do that," she said.

Follow Chad Brooks on Twitter @cbrooks76 or BusinessNewsDaily @BNDarticles. Also on Facebook & Google+. This story originally published on BusinessNewsDaily.

The final question to think about is what the business would look like if successful. Young said if success means having multiple classes of stock or raising money through crowdfunding, a corporation is the best option.

"You should always begin with the end in mind," he said. "You want to figure that out as best you can before you form the entity."

Sweeny said small business owners should be aware that they can change their structure if at some point they feel they are better suited for a different entity type.

"Your structure is not permanent," she said. "It is manageable to make a relatively simple form filing to change your status and structure."

Despite that, Weltman said business owners would be best served by choosing the best structure from the onset. She advises entrepreneurs to sit down with an adviser to inform the best decision.

"While it is possible to change at any point to go from one kind of entity to another, there can be tax costs if you do it down the road," Weltman said. "You want to start out on the right foot and pick the entity choice that is best suited to your situation from the get-go."

by Chad Brooks, BusinessNewsDaily Contributor

Follow Chad Brooks on Twitter @cbrooks76 or BusinessNewsDaily @BNDarticles. Also on Facebook & Google+. This story originally published on BusinessNewsDaily.