

LIMITED LIABILITY COMPANY OR "SUB-S" CORP?

Elizabeth C. Sandoval

When deciding to form an entity for a small business, owners often narrow their decision to choosing between forming a limited liability company or forming a "Sub-S" corporation. If established and continually conducted correctly, both types of entities allow for legal protection for its officers, directors, shareholders, owners and/or members and both allow for the avoidance of the double taxation applied to a standard corporation. The officers, directors and shareholders of a corporation, and the managers and members of a limited liability company, are each protected from liabilities to third parties for debts, obligations or liabilities of the entity or another of its agents, officers, directors, shareholders, managers, members or employees except in certain instances through their own acts, such as negligence, misconduct or guarantee. Further, both entities can be taxed like a partnership or sole proprietorship, where the entity itself is not taxed, but profits and losses flow through to its owners. While very similar, the structures do have some differences in how they are governed by both state law and tax law. These differences need to be considered both in terms of how the business will be structured at the start-up and how that structure may change over the years. The business owner can consider a few general issues in making his or her initial decision, prior to obtaining professional advice as to the possible existence of more in-depth legal and tax matters.

Rules regarding types of owners differ for the two entity types. Owners of a limited liability company are called members. Limited liability companies may have one or more members (with no maximum limit) and the members may be individuals, corporations, other limited liability companies and foreign entities. Certain types of business are not permitted to be limited liability companies. On the other hand, "Sub-S" corporations have limits on the number and types of shareholders. A "Sub-S" corporation may have up to 100 shareholders and may only have individuals, estates, exempt organizations and certain trusts as shareholders. Corporations, partnerships, limited liability companies and non-resident aliens may not be shareholders. In determining the number of shareholders, a husband and wife (and their estates) may be treated as one shareholder. In addition, all members of a family and their estates may be treated as one. Transfer of both membership interests and shares of stock is allowed; however, transfer is subject to the above-mentioned restrictions to maintain "Sub-S" status and subject to any operating agreement or shareholders agreement among owners.

Record keeping requirements can be less stringent for limited liability companies. Unlike a corporation which is required to hold at least annual meetings of its shareholders and directors, limited liability companies are not required to hold annual meetings of its members. Where the entity is anticipated to have a small number of directors and shareholders, the documentation of such meetings is minimal. Where, however, the anticipated numbers of directors and shareholders are large, this distinction can be significant.

The two entity types differ in allowable classes of ownership. Both the articles of organization of a limited liability company and the articles of incorporation of a "Sub-S" corporation may provide for classes or groups of members or managers to have different voting rights. A limited liability company may further specify different classes of ownership with respect to liquidation and dividend rights.

Taxation classification for each entity is obtained in different manners. A limited liability company may be treated for Federal income tax purposes as if it were a sole proprietorship, partnership or corporation. If it has only one owner, it will automatically be treated as a sole proprietorship (where the entity is disregarded for tax purposes and the taxes flow through directly to the owner), unless it elects to be treated as a corporation. If it has two or more owners, it will automatically be treated as a partnership, unless it elects to be treated as a corporation. To be taxed as a partnership or sole proprietorship, a limited liability company must not have more than two of the four characteristics that define corporations, these being: limited liability, continuity of existence, centralization of management and free transferability of ownership interests. Because limited liability is a main goal of the business owner, and because the small business owner will almost always have centralized management, the two characteristics that most typically must be overcome are continuity of existence and free transferability of ownership interests. The restriction on continuity of existence can be overcome by stating a specific period of duration in the articles of organization, with provisions allowing the members to vote to continue the company's existence upon expiration. Transferability of ownership interests can be limited through an operating agreement among members. A "Sub-S" corporation elects to receive such advantageous taxation status upon the consent of all shareholders on the Form 2553 and the filing with, and acceptance of, the form by the Internal Revenue Service.

The type of business to be conducted may dictate the type of entity. Generally a limited liability company can conduct any type of business. Some states do, however, prohibit banks and insurance companies from operating as a limited liability company; therefore, it is important to consider in which states such a business plans to operate. Certain businesses are ineligible for "Sub-S" status. These include banks and thrifts that use the reserve method of accounting for bad debts, insurance companies subject to tax under subchapter L of the Internal Revenue Code, possessions corporations and domestic international sales corporations.

It is important to note that professional service providers are subject to special rules. Under any business structure chosen, protection against liability may be limited for individuals who actually render a professional service in any capacity. Such an individual can be held liable for negligent and wrongful acts and omissions to the same degree he or she would be liable if that individual rendered the services as a sole practitioner. In addition, businesses organized to perform professional services may be restricted to only render one type of professional service. Further, an owner's interest in an entity providing a professional service may be transferrable only to a person who is licensed or registered to render the same professional service.

In summary, initial considerations in determining whether to form a limited liability company or a "Sub-S" corporation should include current and anticipated types and number of owners, the importance of different liquidation and dividend rights for its owners, certain taxation issues, and the type of business.