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Flow-through entities: Limited Liability Companies vs. S-Corporations

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The other day, I was teaching the rules of baseball to my 5 year old and I realized that certain exceptions were difficult to explain. For example, my son understands that a base runner can't advance to the next base if a fly ball is caught. However, he became extremely confused while we were watching the Met-Yankee game on Friday night. Jose Reyes was on third base and Carlos Delgado hit a fly ball to center field that was caught. However, Jose Reyes ran home after the ball was caught and scored the first run of the game. It took until the end of the weekend for my son to understand the concept of "tagging up." For those of you that are not baseball aficionados, Wilkipedia explains this concept fairly well.

I often have the same difficulty trying to explain business ownership concepts to my clients, and literature on this topic tends to overuse "accounting lingo" that is decipherable only by CPAs and Martians. Therefore, this article will explain the major differences between two types of flow-through entities, the Limited Liability Company (LLC) and the S-Corporation (S-Corp) in laymen terms.

Flow-through entities are not subject to the separate corporate income tax like C-Corporations. However, these entities must still file tax returns with income and loss information summarized on a schedule K-1 for each owner. Income or loss will flow-through to the respective owner's individual tax return (captured on schedule E), similar to a partnership. Both entities offer the same limited liability protection for owners, so that the owners are generally not personally responsible for the debts and liabilities of the business. Some of the major differences are summarized below:

S-Corporation

• Owners are referred to as shareholders and must be U.S. residents.

• Typically, shareholders cannot be other legal business entities.

• Limited to a maximum of 100 shareholders.

• More paperwork intensive - annual shareholder meetings are required and minutes of such meetings must be maintained.

• Shareholders can receive wages as W-2 employees.

• At the end of the tax year, all profit is assumed to be distributed to shareholders and must be picked up on the respective shareholder's individual tax return. Therefore, it is possible that shareholders would have to pay taxes on income distributions that they never received (same for LLCs).

• All profit or loss will flow-through in proportion to each shareholder's stock percentage (capital invested).

• Shareholders are not subject to self-employment taxes on S Corp profit, even if they actively participate in the business. However, the shareholder must be paid a reasonable employee salary for the active participation (which is automatically subject to FICA/Medicare employment taxes).

• 2% or more shareholders can deduct 100% of health insurance premium paid by the S-Corp as an adjustment to gross income on their individual tax return (form 1040 line 29) assuming such premium paid is included in the shareholder's W-2 as wages (see guaranteed payment discussion in LLC section).

Limited Liability Company

• Owners are referred to as members and do not have to be U.S. residents.

• No limit on members.

• Typically, members can be other legal business entities.

• Encouraged but not required to have annual meetings and is governed by an operating agreement.

• Members cannot receive wages as W-2 employees.

• Members are compensated either by cash distributions of profit, repayment of loans or guaranteed payments.

• Guaranteed payments are for certain specific services rendered by a member and are not contingent upon LLC earnings. Payment of a member's medical insurance premium constitutes a guaranteed payment.

• Flow-through of profit or loss does not have to be in proportion to the respective member ownership percentage.

• Members that actively participate in the business are subject to self-employment taxes on LLC profits as well as guaranteed payments. Members can deduct one-half of self-employment taxes on their individual tax return (form 1040 line 27).

• Actively participating members can deduct 100% of health insurance premium paid by the LLC (guaranteed payment) as an adjustment to gross income on their individual tax return (form 1040 line 29) up to the amount of flow-through profit only. Any excess is captured as an itemized deduction (subject to a threshold) on schedule A.

Selecting a business entity structure is a crucial step in the success of any business venture. Please seek the help of a tax professional accordingly.

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