

Advantages & Disadvantages of Using C Corporations Versus S Corporations Versus LLC's

In this article I will attempt to lay out my case for why it is usually a bad idea to use an LLC as an operating company in general, but specifically in Pennsylvania and Philadelphia. This case will be made from my 42 years' experience in practicing as an Accountant in the Philadelphia and suburban areas.

When advising a client to incorporate a business that is going to be used as an operating company, we always set up a C corporation. After discussions with the client, depending on their circumstances, we may advise the client to make the corporation an S corporation if this is what the circumstances warrant. These are evaluated depending on the capitalization, and how the net effects anticipated at the end of the year would impact the client's 1040 but more important their PA40. In all cases, if we are anticipating a net loss for the year, we will use Pennsylvania form Rev-976 "Election Not to Be Taxed as A Pa S Corporation" to opt out of the S election for the State of Pennsylvania. This is done because Pennsylvania individual tax laws do not permit deducting losses from one class of income from another class of income with a gain on the individual PA40 form. This also means that spouses filing a joint return cannot deduct losses of one spouse from gains of the other spouse.

Pennsylvania corporate law allows you to carry losses forward for five years. This means that by opting out of the S election for Pennsylvania tax purposes allows you to offset gains in one year from losses in a previous year on the PA RCT 101.

Pennsylvania tax law does not allow carryforward of losses on the individual PA40 from one year to the next. A taxpayer who sustains a loss in one year from participation as a shareholder in an S corporation would not be able to deduct this loss from a gain from that S corporation in the next year. The tax benefit from the loss is lost to the individual. The same loss rules apply to losses and gains from an LLC. In addition, you cannot get the benefit of losses and gains

combining if one is an S corporation and the other an LLC. However according to the PA40 Pennsylvania instruction booklet, you can deduct losses from an LLC or an S corporation against Schedule C income or Farm Income, and vice versa. You should check the rules in your individual states to see how those states laws will impact your decisions.

When setting up the business, start out as a C corporation and decide if the taxpayer should file for an S election using IRS form 2553 immediately or at a later date. You always have the option of changing a C corporation to an S corporation at any time during its operating life. In some cases when an existing corporation has a fiscal year end other than a calendar, you may be able to maintain that year without filing a tax return for a short year. In this case filling out the form 2553 should be done with care to not invalidate the ability to maintain the other then calendar year fiscal year end. However, recent changes in the IRS's rules and procedures would suggest using a calendar year if you are anticipating filing at a later date to become an S Corporation.

For some reason, the use of an LLC has taken on some mystical status. In actuality it is the least advantageous way to operate for an operating company, to distinguish from using an LLC for a real estate operating company. We will discuss this later in this article.

It seems that uninformed business owners and others who search the web for the information erroneously think that this is the most advantageous way to operate. In reality, this is the least advantageous way to operate an ongoing business. In reality an LLC is nothing more then an incorporated partnership. It benefits from the protection of corporate status but still has to follow partnership rules federally, in Pennsylvania and Philadelphia.

A single member LLC is considered a "Disregarded Entity," for federal and state tax purposes. A "Disregarded Entity" must file a Schedule C for federal and state tax purposes. The main drawback of using an LLC for federal taxes is "Self Employment Tax". I have a client who started out as an LLC, which was already established when they became my client, in the first year they made a nice profit and it cost them \$15,000 dollars in self employment taxes, in addition to the amount in

Philadelphia Net Profits tax because they are operating as an LLC. We filed for the S election for federal tax purposes. Philadelphia now allows a taxpayer to terminate the need to file a Philadelphia NPT tax return when they become an S Corporation. When filing for an S Corporation the shareholder must go on the payroll as an employee and no longer have to pay federal self-employment tax or the Philadelphia Net Profits tax on this income.

The IRS provides a remedy for LLC's that want to convert to being taxed as S corporations. An LLC wishing to change their filing status to avoid the "Self Employment Tax," needs to file a form 2553 and change the LLC to an S Corporation for federal tax purposes only. The accounting remains the same. Even though a partnership would usually not have payroll for its partners, when changing the tax status to an S corporation, we treat it as an S corporation and put the partners on the payroll. Keep in mind, Pennsylvania S Corporations and Pennsylvania LLC's file the same tax forms for Pennsylvania tax purposes. Therefore, it is not necessary to file the Rev-976 for Pennsylvania.

It is more prudent for the attorney to consult the accountant before advising a client setting up a new business on the type of entity they should choose. Meaning no offense to my colleagues in the legal profession, attorneys are not always aware of all the ramifications of S corporation versus C corporation versus LLC, as I have stated in this article.

The best procedure for a client looking to set up a corporate entity to start a new business is to sit down with their accountant first. Let the accountant discuss all the ramifications which include capitalization, financing, etc. Then the accountant would be in a position to advise the client to set up a C corporation initially, or to file for an S election immediately.

If the business is buying real estate in conjunction with the business, then an LLC should be used for the real estate part of the transaction. The operating company would then pay rent to the LLC and it would use the rental income to pay the mortgage and taxes. A client who is just setting up an entity to use for real estate investment with no employees

should always use an LLC. If the client is going to have employees in the real estate investment company, then I would consider a C corporation converting to an S.

In all cases it is prudent to do planning with the client before making a final decision as to the type of entity to use for operating a business.

I have laid out all of the advantages and disadvantages of using one type of operating entity versus another, from my experience as a practicing accountant for 42 years dealing with bars and restaurants, and small businesses in general. It is meant to be a guide and a basis for being more knowledgeable in this decision-making process.

Our firm, Dershowitz & Company, has a primary area of expertise in the food and liquor industry. We also prepare SBA qualified loan packages. These are acceptable to the banks for standard loan submission or to use for an SBA guaranteed loan. A sample of this loan package can be found on our website on the right under "All Services" then click on the tab "SBA Loan Presentation."

If you have any questions or comments, please visit my website at the web address listed below or send me an email.

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