

PLANNING FOR INCORPORATING A BUSINESS: LLC OR S CORPORATION

Many of our clients engage us to help them choose an appropriate business structure for their business and then incorporate the business. There are several types of business entities available in Maryland and choosing the appropriate structure depends on many factors, such as the type of business that will be operated, the ownership and management structure that is desired, the type and estimate of revenue and expenses expected and the taxation of the business desired. Usually a team of advisors is involved in the incorporating process that may include your attorney, accountant, financial advisor and banker.

A business is usually started by filing a document with the state's corporate charter department such as Articles of Incorporation for a corporation, Articles of Organization for a limited liability company (or referred to herein as an "LLC") or Certificate of Partnership for a partnership. There may be other documents required to effectuate the formality of the chosen business structure, but these initial documents are the beginning of the process. An employer identification number may be obtained from the IRS that will be used for tax filings and to open business financial accounts.

The LLC and the S corporation are widely used for business entities and we are often asked to help choose the appropriate structure. Each entity is used to protect the personal assets of the owners. If the owner is sued, only the entity's assets and not the personal assets of the owners are usually at risk.

An LLC's net income passes through to the owner (who is known as a Member) of the LLC, to be reported on the Member's personal return so as not to be taxed twice. If there is only a single member of the LLC, a separate income tax return need not be filed and rather the single member can report income on their personal income tax return using appropriate Schedules. Individual state law will govern the LLC operation but many states do not require corporate formalities to be followed by the Members. An LLC can have unlimited Members and can have allocations of profit or loss and distributions of cash flow that are different from the ownership percentages. Often, LLC members execute an Operating Agreement (similar to a partnership agreement) which dictates the operation, management, allocation of profit or loss and distribution of cash flow to members.

An S corporation is a federal tax election and not a formal state incorporated entity. A business may incorporate with the state's corporate charter department as a C corporation or an LLC and then file an election with the IRS by using Form 2553 to elect S corporation tax status. The owners of the S corporation are Stockholders and similar to the LLC, net income passes through to the Stockholders to be reported on their personal return so as not to be taxed twice. Where LLC income passed through to the Member will be subject to self employment income taxes (12.4% FICA and 2.9% Medicare), S corporation income passed through to the Stockholders may be paid as a salary to the Stockholders and the corporation can pay the payroll taxes which could be deducted as a business expense from the corporation's income. Note that S corporations are limited to

100 Stockholders (none of whom can be non resident aliens, partnerships and other corporations). Also, S corporations can only issue one class of stock and needs to make distributions in proportion to ownership percentages. There are also state formalities that need to be followed for corporations such as maintaining bylaws and having regular meetings.

There are other nuances for choosing the appropriate business structure but hopefully this helps to begin the process. Your advisors can help you to begin the incorporation process and to choose the appropriate structure for the business.