

PASS-THROUGH ENTITY CHOICES

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WHICH ONE IS A SMARTER CHOICE, THE LLC OR AN S CORPORATION?

The entity in which a person does business has far reaching impact. And yet, choosing the entity is often a “Quick Question” to which there is no quick answer. To decide if a particular business format is right or better takes a group effort. At the minimum, the group should consist of the business person, the attorney and the tax advisor.

Weighing the merits of an S corporation versus an LLC tends to be situation specific. However, some generalities may be made.

Familiarity. More S corporations are formed in the U.S. each year than any other entity. If you are looking for familiarity, the S corporation is “tried and true”. The LLC is relatively new and some uncertainties exist as to how tax and other laws might be applied.

Flexibility. If you are looking for flexibility, the LLC is a good choice. The LLC (when taxed like a partnership) offers greater flexibility than the S corporation, affording greater opportunity to pass through losses and withdraw assets tax free.

Payroll tax savings. The bottom line tax results in forming as an LLC or an S corporation are similar between the two entities with one exception. The potential for payroll tax savings available in the S corporation may be the major advantage of an S corporation over an LLC.

One owner. A single owner of an LLC is generally treated as a “disregarded entity,” (i.e., a partnership requires two or more owners) resulting in the business owner reporting income and expenses as a Schedule C sole proprietor. Many of the available benefits discussed in this article do not apply to a sole proprietor (even if the legal structure is an LLC). Inviting the speaker’s spouse to be a minority owner creates the second required owner (and a partnership). Only one owner is required in an S corporation.

State law differences. State law differences play an important part in making a choice between an S corporation and an LLC. See your local tax adviser for state tax considerations in choosing between the LLC and the S corporation.

COMPARISON FACTORS

The best choice is made by considering all of the facts and circumstances in each business situation. Below is a brief comparison of four major factors that should be considered by a business owner. Accompanying this article is a 67-factor entity comparison chart to help the business owner decide which of the five most common entities would be the best choice, e.g., C corporation, S corporation, partnership, Limited Liability Company, or sole proprietorship.

1. Which one will pay the *lowest income tax*? For federal purposes, income, deductions, gains, losses and credits flow out to the owners of both the LLC and the S corporation (except when an S corporation has C corporation earnings and profits). Thus, the business owner that operates as an S corporation or as an LLC generally pays the same federal tax on net income. But be careful about state income taxation. For example, an LLC in California may experience substantial state taxes not experienced by an LLC in Colorado. An S corporation in both states will be treated the same.

2. Will the *members benefit from entity losses*? Neither losses from an S corporation nor an LLC are deductible in excess of the owner's basis. But, basis will generally be greater in an LLC than in an S corporation. A member's share of the LLC's liabilities are added to his or her basis (see Internal Revenue Code §752). A shareholder in an S Corporation gets no basis for entity level debt.

Planning: The new business will frequently experience losses that have been paid for with borrowed money. The participants in this new business may have other sources of income (a job) until the new business is profitable. The increased basis in an LLC will permit the deduction of early losses against other sources of income.

3. Will the owners incur *unreimbursed expenses*? Unreimbursed expenses are more likely to result in a deduction to a LLC member than an S corporation shareholder. Frequently partners incur unreimbursed business expenses in carrying on the business of the LLC. Such expenses are fully deductible by the member on Schedule E (not as miscellaneous itemized deductions) if it is LLC policy that the expenses be paid personally (see PLR 9316003). An unreimbursed business expense of an employee/shareholder of an S corporation is a miscellaneous itemized deduction subject to a 2% of AGI reduction (i.e., some of the business expenses will be disallowed).

4. Which one will result in the *lowest payroll tax to the owners*? Self-employment tax/ FICA may be less on earnings from an S corporation for an owner who is involved in the business. §1402(a) defines "net earnings from self-employment" to mean the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business, plus his or her distributive share (whether or not distributed) of income or loss (exclusive of items requiring separate computation (§702(a)(8)) from any trade or business carried on by a *partnership* of which he or she is a member, unless a specific exception applies". Thus, general partners are subject to self-employment tax on *all*

their distributive share of partnership income, e.g, if the net income of the LLC is \$97,500, the LLC member would have to pay \$14,917.50 of self-employment tax (\$97,500 times 15.3%) in addition to any income tax.

Not true for an S corporation shareholder. As long as “reasonable compensation” is paid, the S corporation can pay both salary and dividends to the shareholder/employee. For example, if the S corporation bifurcated the \$97,500 and paid the shareholder/employee a \$30,000 salary with the remaining \$57,500 being classified as dividends, this would save the LLC member \$8,797.50 *per year!*

Warning: The S corporation owner must take a reasonable wage. This requires paychecks, payroll tax deposits, quarterly payroll tax reports and W-2 filings. This is tedious paperwork.

SO, WHAT IS THE ANSWER?

Maybe a little of each. If you are starting your business, the LLC is easy to form and losses flow out to offset other income. As the business grows and the profitability increases, consider converting the LLC at that time to an S corporation to take advantage of some payroll tax savings.

ENTITY COMPARISON CHART

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Formation Issues					
1. Ease of Forming	State law dictates formation.	Same as C corp. Continuous attention required!	Very easy for multiple owners to create; few formal restrictions. But, if done right , legal expenses higher than forming corporation to spell out formation, liquidation and dissolution agreements. Limited partnership and syndications also complicated and expensive.	State law dictates formation. California severely restricts businesses allowed to form as LLCs.	The easiest entity to form.
2. Choosing Type of Entity	Once articles of incorporation filed with state, entity is assumed to be C corporation for tax purposes.	To elect to be S corporation, must file Form 2553 with IRS by the 15 th day of the third month of starting business (see Rev. Proc. 2003.-43 for late filing), signed by all shareholders.	The “check-the-box” regulations allow domestic taxpayers to choose whether to be taxed as a partnership or a C corporation (see §1.301.7701-1 through -3). Taxpayer is a partnership if no Form 8832 election made to be taxed as C corporation.	Same as partnership.	Sole owner, who generally files Form 1040, Schedule C (business), E (rental), or F (farm) may “check-the-box” on Form 8832 and be taxed as an association/ corporation (see §1.301.7701-1 through -3).

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
3. Limited Liability	Limited liability. Stockholders generally not liable for debts of corp.	Limited liability.	Unlimited personal liability. General partner usually personally liable for partnership debts. But, a limited partner's liability normally limited to capital contribution. Limited partner loses limited liability if he or she participates in management.	Limited liability.	Unlimited personal liability.
Owners					
4. Number of Owners	Unlimited shareholders. (Watch out for security laws).	Limited to 100 (2007) owners with husband, wife and their estates counted as one. Family can be counted as one owner. Certain trusts (e.g., "electing small business trust") and qualified S corps eligible.	Unlimited number of partners allowed. (Watch out for security laws, e.g., over 10 partners may require SEC registration).	Same as partnership. IRS requires at least two members to be a partnership even though state law may permit only one member (an unrecognized entity for tax).	One, by definition. Two sole proprietors working together are called a partnership (but see <i>Dunnegan</i> , TC Memo 2002-119 where husband and wife permitted to split income into two Schedule C's).
5. Eligible Investors/ Owners	No limitations.	Limited to individuals, estates, certain domestic trusts, Qualified S Corp owners and certain tax-exempt orgs. No non-resident aliens.	No limitations.	No limitations.	Individuals only.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
6. Different Classes of Ownership Interests	Unlimited voting stock classes. Different debt classes permitted. (Be careful about thinly-capitalized corps; §385).	Only one class of stock permitted (identical liquidation and dividend rights.) Voting right differences permitted.	Can have general partners and different classes of limited partners.	Different classes of members permitted, e.g., all members can vote on new members & only some members vote on management.	Not applicable.
7. Voting Rights	May have voting and non-voting shares.	May have voting & non-voting shares. Difference in voting rights does not terminate the S election.	Voting rights may be structured in any manner by partnership agreement.	Voting rights may be structured in any manner by operating agreement.	Not applicable
Transfers into Entity					
8. Tax-free Exchange of Property for Interest Available for Both Corporation and Partnership	Exchange of property for stock generally not taxable unless liability in excess of basis (§351). Securities are treated as taxable boot. 80% control must exist for non-recognition. Liabilities assumed reduce stock basis unless liabilities exceed Shareholder's adjusted basis (§357). Stock for services subject to limitations (§83).	Same as C corporation.	Exchange of property for partnership interest generally not taxable unless liability exceeds basis (§721): <i>Partnerships are more flexible to form as no 80% control is required.</i> Exceptions to the tax-free provisions include disguised sales and receipt of a capital interest for services. Partnerships are subject to allocation and characterization rules for contributed property (§704(c)); §724).	Same as partnership.	No taxing provisions

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
9. Effect of Liabilities on Basis	Share of corporation's liabilities does not increase Shareholder's basis unless debt is recharacterized as equity and related interest deduction is not allowed (§385).	Corp's liabilities do not increase Shareholder's basis. But direct loans from Shareholder to S corp create a loan basis for purposes of determining the amount of deductible loss.	General partner's share of liabilities increases basis, <i>both recourse and nonrecourse debt!</i> Limited partner's basis only increased by share of nonrecourse debt.	Member's share of liabilities, both recourse and nonrecourse, increase basis.	Not applicable.
10. Transfer of Mortgaged Property to Entity	Generally, no income on debt relief. Only if the liability exceeds the adjusted basis of the property transferred will taxable boot be created (§357).	Same as C corporation.	Generally, no income on debt relief. Gain is recognized only if the pro rata debt relief exceeds the sum of the adjusted bases of the property transferred (§731 and 752.)	Same as partnership.	No tax consequences.
11. Trading Services for Interest	Stock for services generally taxable compensation to extent of value of stock received (§83).	Same as C corporation.	No income IF partner receives a "profits interest" only. If partner receives a capital interest for performing services, taxable income exists under §83.	Same as partnership.	Not applicable.
12. Property Contributed with Built-in Gain or Loss	Can be shifted to non-contributing shareholder.	Can be shifted to non-contributing shareholder.	Built-in gain or loss stays with contributing member under 704(c.)	Same as partnership.	Not applicable.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
13. Use of Debt	Equity, not debt may exist if excessive loans by shareholders (§385). Characterization at issuance is binding on shareholder (§3859(c)).	Shareholder loans may be second class of stock unless debt safe harbor rules met. Why? Priority payment to a shareholder is not based on stock ownership!	No limitations.	Same as partnership.	Not applicable.
Operational Issues					
14. Management	Owner/managers control closely-held corps; As spelled out in articles and by-laws, top management controls larger corps - making this the winner!	Same as C corporation.	All general partners can participate in management, unless partnership agreement establishes central management. But if limited partner participates in management, he or she may lose limited liability.	Members often want to be part of centralized management. This will not impact tax status as a partnership or the member's limited liability.	Owners are generally managers.
15. Accessibility of Outside Capital or Financing	Very flexible; can sell common or preferred stock, sell bonds, and borrow.	Limited; can have only one class of stock. S corp bonds cannot be deemed second class of stock. Owners generally have to guarantee loans.	Partnership's generally have capital contributions and borrow money only from partners and banks.	Same as partnership. Owners may have to guarantee loans.	Depends on credit worthiness of sole proprietor.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Accounting					
16. Federal Tax Rates	15% 1st 50K 25% 50K-75K 34% 75K-100K 39% 100K-335K 34% 335K-10M 35% 10M-15M 38% 15M-18.3M 35% 18.3M-up PSC: 35% All	Use the shareholder's personal rates except: 35% built-in gain, net passive income, etc.	Use the partner's individual tax rates.	Use the LLC member's individual tax rates.	10% to 35% (2007) graduated rates.
17. Taxable Year-end Adoption	Any fiscal or calendar year end may be adopted. However, personal service corporations must met minimum distribution rules.	Generally, a calendar year end must be adopted unless business purpose can be shown. Exceptions available to P/S's, such as §444 election also available to S corps.	Generally, a calendar year end must be adopted unless business purpose can be shown (see §706(b)). Year-end of majority shareholder exception also available. §444 election allows a P/S to adopt a taxable year-end that results in up to a three-month deferral, e.g., Sept., Oct., Nov., year end with §444 prepayment.	Same as partnership.	Generally, a calendar year end must be adopted.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Income					
18. Who Reports Income or Loss?	C corporation reports all tax activity, regardless of distributions to shareholders.	Shareholders are taxed on their share of income, whether or not distributed. Losses can be deducted to extent of Shareholder's adjusted basis plus money loaned to S corp §1366(d).	Partners are taxed on their share of income regardless of distributions. Losses deductible to extent of partners basis under §704(d).	Same as partnership.	Sole proprietor reports income or loss according to their accounting method.
19. Allocation of Income and Deductions	Not applicable. Not a pass-through entity.	Allocated on a per share, per day basis (§1377(a)(1)) unless election made to close books because Shareholder leaves (§1377(a)(2) or Shareholder disposes of 20%+ in 30-days §1.1368-1(g)(2)).	Very flexible. Income and loss allocated in accordance with the partnership agreement as long as there is substantial economic effect (§704(b)(2)). These allocations may be complicated to spell out though. If no special allocations, amounts allocated to partners based on their partnership interest.	Same as partnership.	Not applicable.
20. Allocation of Income to Family Members	Not applicable.	Seven types of trusts available. Dividend distributions to family members is a way to split income. Re-allocation similar to family partnership rules, except capital is not required to be a material income producing factor.	The family partnership rules restrict allocations to non-service partner (i.e., family member), unless capital is a material income-producing factor.	Same as partnership.	Not applicable. But can pay children reasonable compensation as employees.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
21. Dividend Income from C Corps and Investments	C corp is entitled to a 70%, 80% or 100% deduction against dividends received depending on its ownership interest in the corp making the dividend.	Maintains character as separately stated income item when allocated to Shareholder. Is taxable as passive income if S corp has C corp E&P.	Maintains character as separately stated item of income when allocated to partner.	Same as partnership.	Taxable income reportable on Schedule D and taxed at capital gain rate (5/15% in 2007).
22. Restrictions on Passive Investment Income	Not applicable.	For an S corp with C corp E&P, excess passive investment income can trigger a 35% penalty tax and termination of the S status after three consecutive years .	Not applicable.	Not applicable.	Not applicable.
Expenses					
23. Charitable Contribution	Deductible but limited to 10% of taxable income. Excess carried forward over 5 years. Promotion expenses are not charitable contributions (PLR 9309006).	Not deductible by S corp but character maintains and flows through to shareholder as separately stated deduction.	Not deductible by partnership but maintains character as separately stated deduction when flowing through to partner (§702).	Same as partnership.	Deductible on Schedule A subject to 30%/ or 50% AGI limitations with the remaining amounts carried forward for 5 years (§170(d)).

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
24. Section 179 Expensing Allowance	Allows up to \$112,000 (2007) of normally depreciable §1245 property to be expensed, but can't create a loss.	Pass-through to shareholder. But, limitations apply both at the S corp level and again at the Shareholder level.	Pass-through to partner. Limitations apply both at the partnership level and again at the partner level.	Same as partnership.	Allows up to \$112,000 (2007) of normally depreciable §1245 property to be expensed, but can't create a loss. Aggregation of net trade or business incomes (including wages) permitted.
25. Fringe Benefits	Are available to all shareholder-employees. But generally cannot discriminate in favor of highly-compensated employees.	Available only to shareholder-employees owning $\leq 2\%$ of stock. Fringe benefits added to salary for other Shareholder's. Apply P/S fringe benefit rules (§1372).	Fringe benefits provided to partner for services rendered in capacity as partner are generally treated as guaranteed payments (e.g. health insurance premiums are included in partner's gross income) [Rev. Rul. 91-26.]	Same as partnership.	Not applicable. Fringe benefits are paid to employees, and sole proprietors are not employees for this purpose. Can hire spouse and provide benefits to him or her (PLR 9409006; ISP).
26. Deducting Expenses Paid Personally by Owner	Deductible on Sch. 2106, Form 1040, subject to 2% AGI "haircut".	Same as C corp.	Deductible on Schedule E, "above the line" if called for in partnership agreement.	Deductible on Schedule E, "above the line".	Deductible on Schedule C, "above the line".

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
27. Retirement Plans	Shareholder-employees are entitled to participate in corporation's regular qualified plan. <i>Pre-FICA payments.</i>	Same as C corporation.	Partners may participate in self-employed qualified plans. Limitations are similar to corporate plans.	Same as partnership. But watch out for §1.1402(a)(2) on actually vs. not actually involved for SE purposes.	Self-employed individuals can establish individual retirement accounts (IRA), simplified employee pensions (SEP) or qualified retirement (KEOGH) plan. Essentially any plan corporate employees may have.
28. §105 Medical Insurance Deductions for Owner/ Employees	Unlimited - And all 100% above the line!	Deductible by S corp but included in $\leq 2\%$ Shareholder's gross income but not FICA wages (Rev. Rul. 91-26). Shareholder can deduct 100% for AGI (§162(l)) but see IRS Headline 163 (May 2006).	Health insurance premiums paid on behalf of a partner as compensation for services are "guaranteed payments." Partners can deduct 100% adjustment for AGI (Rev. Rul. 91-26).	Same as partnership.	Self-employed can deduct 100% adjustment for AGI after SE tax (i.e., not deductible on Sch. C, thereby increases SE taxable income).
29. §106 Medical Reimbursement Plans for Owner/ Employees	Available if nondiscriminatory plan adopted.	Not available when employees are over $\leq 2\%$ shareholder and family because of attribution rules.	Not available to partner. Can hire spouse and provide tax-free fringe benefits to him or her (See Rev. Rul. 71-588; LTR 9409006).	Same as partnership.	Available when employees are family.
30. §79 Life Insurance	Available; \$50,000 limit.	Not available	Not available	Not available	Not available

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
31. Limit on Contributions per Participant (\$415 Limit)	Maximum 25% of compensation, up to \$45,000 (2007) per participant; see different rules for SIMPLE.	Same as C corp.	Same as C corp.	Same as C corp.	Same as C corp.
32. Loans to Participant	Loans permitted, other than from IRA, subject to IRS limitations. Loan must be documented, carry applicable federal interest rate and be fully amortized over 60 months.	Same as C corp.	Same as C corp.	Same as C corp.	Same as C corp.
33. Salaries Paid to Owners	Deductible salaries can be paid to shareholder-employees. FICA and FUTA tax must be paid on salaries.	Same as C corporation.	Called guaranteed payments and are subject to self-employment tax. Partners are not employees (Rev. Rul. 69-184).	Distribution to LLC member subject to SE tax if LLC member acts as a managing member (actively involved in business.)	Can't pay salary to yourself!
34. Subject to FICA, Medicare or SE Tax?	Yes, on wages paid to owner- employees.	Yes, on wages paid to owner-employees. But, dividends paid are NOT subject to tax.	Yes, as to allocable share of trade or business income and/or guaranteed payments for general partners. No, as to unearned income allocable to limited partners.	Same as partnership. (Prop. Reg. §1.1402(a)-18).	Yes, on net profit before retirement plan contributions and/or 100% deduction for health insurance deduction.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
35. Reasonable Compensation Problems	A problem! If salary deemed too high, excess compensation recharacterized into dividends denying corp deduction and increasing corporate taxable income.	A problem! If salary deemed too low, any dividends received may be recharacterized into salary, subject to 15.3% FICA tax. If salary deemed too high, 2nd class of stock exists!	Not applicable unless LP status is used to avoid SE income.	Not applicable unless non participating member status is used to avoid SE income.	Not applicable.
Capital Gain and Losses					
36. Capital Gains	Net capital gains are taxable at ordinary income rates - as high as 35%.	Capital gains flow through to shareholder. If S corp was previously C corp, gain may be taxable at the corporate level also to extent of built in gain (§1374).	Capital gains flow through to partners.	Same as partnership.	Reportable as either long-term or short-term capital gain on Schedule D. Net long-term capital gains maximum tax rate is 15%.
37. Capital Losses	Net capital losses are not currently deductible but may be carried back 3 years or forward 5 years to be used against capital gains. No \$3,000 capital loss per year exception.	Not deductible by S corp but flows through to shareholders.	Not deductible by partnership but maintains character as separately stated item when flowing through to partner (§702).	Same as partnership.	Net capital losses are generally limited to \$3,000 per year.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Net Operating Losses					
38. Net Operating Loss	Carried back 2 years, forward 20 years (2007) unless elect to carry forward only. May be limited if ownership change (§382).	Not deductible by S corp but character maintains and flows through to Shareholder as separately stated deduction. Used to calculate individual NOL.	Not applicable at partnership level. Any losses maintain character as separately stated income or deduction when flowing through to partner (§702). Used to calculate individual NOL which is carried back 2 years, forward 20 years (2007) unless elect to carry forward only.	Same as partnership.	Individual net operating loss is excess of allowable deductions over gross income. No deduction for personal or dependency exemptions. Limitations on capital losses and deductions.
Limits on Deductions and Losses					
39. Limitation on Deducting Losses	No basis limitation rules exist that are similar to P/S and S corp. Net operating losses may be carried back and forward. The at-risk and passive loss limitation rules only apply to certain closely-held corp.	Losses are limited to the extent of Shareholder's basis in S corp stock and shareholder loan account. Such losses are subject to the at-risk rules (§465) and the passive loss limitation rules (§469).	Losses are deductible by partner to extent of partner's basis in partnership interest. Such losses are subject to the at-risk rules (§465) and the passive loss limitation rules (§469).	Same as partnership.	No basis limitation on losses but such losses are subject to the at-risk rules (§465) and the passive loss limitation rules (§469). Net operating losses may be carried back and forward.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
40. At-risk Limitation Rules	At-risk rules only apply if at any time during last half of taxable year more than 50% of outstanding stock value is owned directly or indirectly, by not more than 5 individuals (§542(a)(2)).	Applicable at Shareholder level. Amount at risk is generally equal to the shareholder's stock basis and loans from shareholder to corporation.	Applicable at partner level. But no increase in partner's basis for non-recourse loans or share of recourse loans made by the other partners. Exception applies for certain realty loans.	Same as partnership.	Generally limits a taxpayer's deductible loss to amount taxpayer has at risk (cash contribution, adjusted basis of property, and personal liability loans) with respect to the activity.
41. §469 Passive Loss Limitations	Applies only to personal service corporations and certain closely-held corporations.	Passive gross income and deductions not deductible by S corp but character maintains and flows through to Shareholder as separately stated items.	Passive gross income and deductions not deductible by partnership but character maintains and flows through to partners as separately stated items. The activity may be a business to one partner and a passive activity to another partner, depending on if the individual materially participated. Passive to limited partner.	Same as partnership.	Losses from passive activities, to the extent they exceed income from such activities, generally may not be deducted against other income such as salaries, interest and dividend income. Exceptions for actively managed real estate and real estate professionals exist.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Self-dealing					
42. Gains on Transaction Between Owner and Entity May Create Ordinary Income!	Most sales between corp and shareholder are deemed arm's length. But sales of depreciable property between shareholder and controlled corporation are recognized as ordinary income (ordinarily capital gain) [§1239].	Same as C corporation.	A partnership may deal with a partner at arm's length, but generally, capital gain treatment is denied on sale of certain property between partner and partnership (§707(b)(2)). Also, sales of depreciable property between partner and partnership are recognized as ordinary income (ordinarily capital gain) [§1239].	Same as partnership.	Self-dealing not permitted.
43. Losses on Transaction Between Owner and Entity	Losses are disallowed if shareholder owns more than 50% in value of stock (§267).	Same as C corporation.	Losses are disallowed if partner owns more than a 50% interest in partnership (§707(b)(1)).	Same as partnership.	Self-dealing not permitted.
Paying Taxes					
44. California State Income Tax	Generally liable for state income tax.	California imposes a 1.5% income tax on the S corporation taxable income. Plus tax imposed at the shareholder level.	California imposes an \$800 annual franchise tax on LPs. Plus tax is imposed at the partner level.	California imposes an \$800 annual tax and an annual fee based on gross receipts. Plus tax is imposed at the member level.	Tax imposed on the individual level.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
45. Federal Income Taxes	Generally liable for regular tax, alternative minimum tax, personal holding company tax, accumulated earnings tax, and estimated tax.	Generally not liable for tax. If S corp previously a C corp, it may be liable for the 35% BIG tax, the 35% excess net passive income "sting" tax, LIFO recapture tax, and related estimated tax.	No federal income tax .	Same as partnership.	Tax imposed on the individual level.
46. Chance of IRS Audit	average = 3.05% assets: <\$250,000 =1.33% \$250K-\$1m.=3.94%	1.02%	0.61%	Unknown.	Individual = .92% Sch C with total gross receipts (TGR) TGR under 25,000=2.24% TGR \$25 - 100,000=2.41% TGR over \$100,000=3.91%
47. Personal Holding Tax	Potential tax of 15% imposed on undistributed personal holding company income of certain corporations.	Not applicable.	Not applicable.	Not applicable.	Not applicable.
48. Accumulated Earnings Tax	35% (2007) penalty tax if corporation accumulates unreasonable earnings (§531). Testing starts above \$250,000; \$150,000 for PSCs (§337).	Not applicable.	Not applicable.	Not applicable.	Not applicable.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
Loss of Pass-through Status					
49. Inadvertent Termination of Pass-through Status	Not Applicable.	1. Transfers of shares to an ineligible Shareholder terminates S status. 2. Sting Tax: Excess passive income for three consecutive years if Sub-C E&P exist (terminates S status.) 3. Transfer of stock creating majority Shareholder who wishes to revoke S election can cause minority Shareholder a problem.	Generally not a problem. A termination may occur on the sale or exchange of a 50% or more interest in partnership capital and profits within a 12 month period. However, a new partnership is usually created. This may affect basis of partnership interest.	Same as partnership.	Not applicable.
50. Loss of Pass-through Status	Not Applicable.	S corp. can elect to revoke.	Can't lose partnership status.	Can't lose partnership status.	Can't lose individual status.
Distribution Issues					
51. Distribution Rights	No limitations.	Each share must have identical distribution rights or will have second class of stock.	No limitations.	No limitations.	Not applicable.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
52. Regular Distribution (cash)	Same dollar taxed twice, once at corporate level and again as a dividend (effective federal rate may be as high as 58%!) Taxable as a dividend distribution to extent of earnings and profits. Distributions in excess of E&P are capital gains (if §341 doesn't apply). Required to be taken into account at receipt.	Generally tax-free to extent of stock basis unless C E&P exists, then not taxed to extent of AAA. (Similar to partnerships). Basis does not include S corp liability. Required to be taken into account at receipt.	Distribution is tax-free to extent of partners adjusted basis in partnership with capital gain in excess of basis (§731). An advance or withdrawal is not required to be taken into account until last day of the partnership's taxable year.	Same as partnership.	Not applicable. An advance or withdrawal is not required to be taken into account until taxable year end.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
53. Distribution of Appreciated Property	Double taxed as deemed a taxable sale at fair market value from C corporation to shareholder (§311(b)). Also taxable dividend to shareholder (§331). No "General Utilities" doctrine available.	Deemed a taxable sale at fair market value from S corporation to shareholder, but prorated gain increases shareholder's basis.	Generally, no gain or loss is recognized to either the partnership or the partner (§731) unless unrealized receivables and/or inventory items involved (§751). Partner's basis in the property is usually the partnership's basis. Exceptions: distribution within 2 years may be a disguised sale. If contributed asset is distributed out to anyone within 5 years, it is a sale.	Same as partnership.	Not applicable. Conversion of certain business property into personal use may create recapture income.
54. Distribution of Earnings Subsequent to Year End	Taxable as a dividend to the Shareholder if current and/or accumulated E&P exist.	No tax effect until distribution exceeds tax basis and AAA account. Distribution in excess of AAA account is a dividend to extent of C E&P.	No tax consequences until distribution exceeds partner's adjusted basis in partnership account.	Same as partnership.	Not applicable.
Disposition Issues					

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
55. Transfer of Business, Stock or Partnership Interest	Stock easily transferred unless corp bylaws restrict, e.g., mandatory buy-sell agreement, rights of first refusal, option, etc.	Same as C corp. But charter should provide that stock cannot be transferred to ineligible shareholder (e.g., a C corp), unless agreed to by all shareholders.	Generally transfer rights limited, and may require approval of all partners. May cause termination of old partnership and creation of new one. Exception: limited partners generally allowed to freely assign interests.	Generally transfer rights must be limited under state law. Membership consists of both financial rights & management rights. Full membership rights may require majority or unanimous consent.	No limitations, extremely flexible.
56. Stock Dividend and §306 Stock	Can have a nontaxable distribution of additional shares of stock. If preferred stock is distributed as a nontaxable dividend, the preferred stock is §306 stock if C corp has E&P.	Same as C corp, except distribution of preferred stock terminates S election!	Not applicable.	Not applicable.	Not applicable.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
57. Distributions in Redemption of Interest	Generally, classified as a dividend unless a distribution is a §302(b) deemed sale resulting in capital gain treatment.	Tax-free to the extent of stock basis. Any excess distribution results in capital gain treatment.	For a withdrawing partner, payments received in exchange for property, including stated goodwill, are treated as a sale or exchange (§741, but see §751(b) ordinary income treatment). All other payments are taxed as guaranteed payments or as a distributive share of income (§736).	Same as partnership.	Not applicable.
58. Gain on Sale of Interest	Capital gain treatment. (Small business stock gets 50% exclusion, §1202).	Capital gain treatment. No §1202 capital gain treatment.	Capital gain treatment (§741). But see §751(b) ordinary income treatment.	Same as partnership	Assets of business are sold. Generally, taxpayer would have capital gain with ordinary income recapture on §1231 property.
59. Step-up Basis upon Transfer by Owner	Not applicable. (Corporations acquiring 80% of the stock of another corp may elect step-up via §338).	Not applicable.	§754 optional basis adjustment - new buyer can increase basis in partnership assets. A partnership is permitted to adjust the basis of its assets to reflect the purchase price by a new partner for his interest (§734 & §743).	Same as partnership.	Not applicable as assets of business, not business interest is being sold.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
60. Character of Loss on Sale or Worthlessness	Generally a capital loss, unless it is §1244 stock, making the loss an ordinary loss.	Same as C corporation.	Loss on sale of partnership interest is usually capital (§741). Sale of depreciable assets can create §1231 ordinary loss.	Same as partnership.	Not applicable as assets of business, not business interest is being sold. §1231 loss on sale of depreciable assets is ordinary.
61. §1244 Max Loss	\$50,000 singles, \$100,000 MFJ.	\$50,000 singles, \$100,000 MFJ.	Not applicable.	Not applicable.	Not applicable.
Liquidation Issues					
62. Capital Losses	Offset capital gains only.	Flow-through to shareholders.	Flow-through to partners.	Flow-through to members.	Maximum \$3,000 to offset ordinary income.
63. How Liquidation Elected	Normally needs approval of shareholders.	Same as C corp.	Generally by partnership agreement or by mutual agreement of partners.	Same as partnership.	Owner decides when and where.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
64. Complete Liquidation	Double taxation: Gain is taxed at both corporate level (sale of asset to Shareholder and/or to 3rd party) and shareholder level (sale of stock back to C corp).	Single taxation: Gain is calculated at corporate level and passed out to Shareholder, which increases basis of Shareholder's stock basis. Double taxation occurs if S corp subject to the BIG tax, §1374.	No immediate taxation: Distribution is tax-free as long as distribution does not exceed partner's adjusted basis in partnership interest. (§751 hot asset rules on unrealized receivables and inventory items may also apply).	Same as partnership.	Not applicable as assets of business, not business interest is being sold.
Estate Planning Issues					
65. Basis Adjustment on Death of an Owner	Step-up in stock basis to fair market value is available (§1014). No elective adjustment to basis of assets within the corporation is available.	Same as C corporation.	Step-up in basis to fair market value at death is available for beneficiaries. A partnership is permitted, by election, to adjust the basis of its assets to reflect the stepped-up basis for the new partner for his or her interest (§754 & §743).	Same as partnership.	Step-up in basis available under §1014.

Feature	C-Corporation	S-Corporation	Partnership	Limited Liability Company	Sole Proprietorship
66. Valuation Discounts at Death	Minority discounts are common (25% to 55%) depending on degree of management and liquidation control.	Same as C corporation.	Minority discounts are common, based on lack of control and illiquidity.	Probably same as partnership.	Common.
67. Ease of Transfers by Gift	Shares are easily transferred.	Same as C corporation.	Generally restricted by partnership agreement. Partners interest should be expressed in units to make transfer easier.	Same as partnership.	Difficult: transfers of business by gift is deemed transfer of each asset, including good will, and not one gift of entire business.