



Choosing—Or Changing— Your Firm's IRS Status

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An organization’s structure is a big consideration, which may also impact the amount of taxes they are obligated to pay. Here are some of the issues related to LLCs, S-Corps and C-Corps.

The LLC

Many entrepreneurs start out thinking that establishing an LLC (limited liability company) is the “best” way to start their firm. In fact, LLCs are the most common organizing structure for small businesses. It’s true that LLCs can be relatively inexpensive and easy to set up depending on the state they are organized in, and they offer personal liability protection, shielding an owner’s personal assets from business debt or legal obligations incurred by the LLC.

Paperwork and compliance retirements

In terms of ease of set up, initial articles of organization and an operating agreement are nearly all the paperwork required to form an LLC, other than a new rule requiring the filing of a BOI (beneficial ownership information) report.

The Corporate Transparency Act, passed in January 2021, now requires that nearly all business entities, including LLCs, report owner information at the federal level. Existing businesses must file a BOI by January 1, 2025 and new entities must file both ownership and applicant details at inception. LLC owners and applicants will now reside on a federal database that can be accessed by financial institutions and law enforcement agencies.

But at a certain point, some LLC owners may want to rethink their structure.

Tax considerations

Taxes for an LLC must be filed annually. Some small business owners may find that the LLC and K-1 tax preparation fees for their LLC can be relatively high as opposed to being a sole proprietor with a Schedule C added to their personal 1040 return. And as an LLC grows or its operations become more complex, the actual taxes owed can also become more of an issue.

In fact, LLC owners pay taxes on all net profits from their business, just as sole proprietors do, and self-employment taxes are higher than employee taxes. That’s why after consultation with the appropriate tax, financial and legal advisors, LLC owners may want to consider changing their tax status to an S corporation in some cases.

The IRS does allow for a business entity’s tax status to change, but not all types of businesses can choose to become S-Corps; it’s important to work with qualified tax, legal and financial advisors who can help you analyze your situation.



The S-Corp

An S-Corp is named after Subchapter S of the Internal Revenue Code (IRC). Like an LLC, an S corporation offers protection for personal property from lawsuits or debt collections incurred by the business. But an S-Corp can offer tax advantages as well.

Pass-through federal taxes

S corporations are considered pass-through entities because their taxable revenues, earnings and profits aren't taxed at the federal level. Instead, an S-Corp's federal taxes pass through to owners (who are technically shareholders) who pay them via their own personal tax returns, thus avoiding double taxation.

The S-Corp does pay state and local taxes.

Lower self-employment taxes

With an S-Corp, self-employment taxes can also be lower. S corporations pay the owner or owners a salary and only pay payroll taxes on that salary amount, while other distributions can be taken which aren't subject to self-employment tax.

The IRS sets the self-employment tax rate as a percentage of your net earnings from self-employment. This rate typically consists of 12.4% for Social Security and 2.9% for Medicare taxes, with an additional Medicare tax applied to self-employment income above a certain threshold.

Paperwork and compliance requirements

The number of shares that an S-Corp will have is decided on by the owner/s and must be detailed in its articles of incorporation when the business is formed or its status changed. S corporation shareholders must number no more than 100 people and must be either U.S. citizens or residents and human beings with the exception of certain trusts and estates.

Unlike an LLC, an S-Corp has shareholders, directors and officers. While management requirements for an S-Corp are less rigorous than a C-Corp, compliance requirements are stricter with an S-Corp than they are with LLCs. S-Corp owners can run into trouble with the IRS if they don't keep detailed records or pay their employees "reasonable" salary amounts. Quarterly and annual reports are required, even if an S-corporation has only a sole proprietor who is both board member and employee. Minutes must be recorded, decisions noted and business records kept accurately and up to date.

If a company is looking to raise or borrow money, banks and investors are more likely to provide funds to an S corporation or C corporation than they are to an LLC.



The C-Corp

For business owners looking to raise money through investors, sell shares or are planning to take their company public someday, a C corporation might be the right structure.

Like LLCs and S-Corps, a C corporation offers protection against personal liability—indeed it may offer the strongest protection, with no risk to your home, personal savings accounts or other assets should the corporation fail. A C corporation is totally separate from your personal assets.

By becoming a corporation, owners can create and sell shares of stock and even reward and retain employees by providing company shares as part of their employee incentive package. In fact, C-Corp ownership belongs to the stockholders. The more stock you own, the higher the percentage of the company that belongs to you.

There is also no limit to the number of owners or shareholders of a corporation, and stock can even be sold to foreign investors. While a C-Corp can have many owners and shareholders, it is required to register with the Securities and Exchange Commission (SEC) when selling securities or "going public" with an IPO (initial public offering). The ability to offer shares of stock allows the corporation to obtain large amounts of capital which may fund new projects and future expansions.

Paperwork and compliance retirements

C-Corps are fairly complex and are usually the most expensive business structure to set up and maintain, and it's advisable to work with attorneys, financial advisors and CPAs or tax professionals. You must create bylaws, elect a board of directors, hold board and shareholder meetings annually at a minimum and keep meeting minutes. C corporations are required to file annual reports, financial disclosure reports and financial statements, and they must keep corporate bylaws on the premises of the primary business location.

There are also a number of rules that need to be followed regarding the issuance or transfer of stock, keeping a stock register and paying out dividends.

Tax considerations

C-Corps are subject to double taxation because they pay taxes on their profits, and taxes are also deducted from any dividend payments made to shareholders. So as an owner or major shareholder, you are paying corporate taxes, payroll taxes and other taxes through the business, as well as income and/or capital gains taxes on your personal return.

While owners of LLCs and S-Corps can deduct business losses on their personal taxes, this is not an option for owners and shareholders of a C-Corp. Losses can only be deducted on the C-Corp's tax return.

It's advisable to work with attorneys, financial advisors and CPAs or tax professionals when deciding whether or not to change your company's legal structure. If a change is indicated or recommended based on your situation or goals, there are three basic ways a firm's structure can be changed:

Statutory Conversions

Most states allow for this, the simplest type of conversion, although rules vary. Often, it's a matter of filing a simple form laying out the details, terms and conditions of how LLC members will be converted into shareholders.

Statutory Mergers

In some cases, you must execute a merger. You must first form a new corporation, apply for a new EIN, then merge assets and liabilities to the new entity. You must file all the correct documents with the applicable Secretary of State and follow all state laws.

Non-Statutory Conversions

If neither a statutory conversion or merger is available or allowed, you must dissolve the LLC, start a corporation and arrange for the transfer of the LLCs assets and liabilities to the new corporation. Corporate shares must be issued to LLC members and additional steps may be required. You may need a new EIN number. It's recommended that you work with attorneys and other experts to avoid any adverse legal implications.

If you have questions about your business or your business structure, please reach out to us for a personal consultation.

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This article is provided for information purposes only, and should not be construed or relied upon as tax, legal or financial advice. In all cases, you should consult with your own tax, legal and financial advisors for recommendations about your unique situation and set of circumstances before establishing, making decisions or making any changes to your business' structure.

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