

The S Corporation vs. the LLC: What is Right for Your Small Business?

by Janet DeShazo

One of the most common questions asked by entrepreneurs is whether to form their business entity as an LLC or an S Corporation. I will tell you up front: I am very partial to the S Corporation, as I believe it is right for most small businesses. Here's why.

The Similarities

Both the LLC and the S Corporation provide adequate legal protection. Both are closely-held entities, meaning that the income from the business flows directly to the partners' or stockholders' tax returns. The tax on that income is assessed differently, however, in most instances.

The Differences

For the LLC owner/partner that is actively involved in the business, the income derived from the LLC is subject to income tax (federal and state, if applicable) and Social Security and Medicare taxes (FICA). That means that the profits and the draws taken by the LLC partner are subject to these taxes. Because the partner cannot be on the payroll, the taxes that would have ordinarily been withheld, and the company's matching portion, must be assessed on the personal tax return. It also means that the owner/partner must remit quarterly estimated taxes to cover this anticipated liability. The problem with this method is two-fold.

First, it forces the owner/partner to be extremely disciplined, saving the tax money and remitting it faithfully on a quarterly basis. For most of us, that is extremely difficult, since adequate cash flow in small business is often a challenge. It is extremely easy to use that money for other needs, leaving a huge liability at tax time. I say huge because the federal taxes will be at least 30% because the liability includes the FICA taxes as well as federal income tax. If there is a state income tax in your state, then that is additional.

Secondly, this method is complicated because it is based entirely on estimated profits, and does not take into account the owner/partner expense. Further, it often makes for an inconsistent and loose method of compensation for the owner/partner. The psychological effect of receiving a "paycheck", knowing that no tax has been withheld, is troublesome at the least.

The process is entirely different for the S Corporation owner.

The owner can draw a reasonable salary, subject to all applicable payroll taxes because any or all stockholders can be on the payroll. Only the salary is subject to payroll taxes; the profits after payroll expenses are subject only to federal and state income taxes, not FICA taxes. This method solves the two problems confronting the LLC owner/partner.

The S Corporation owner can set a reasonable salary for herself, and pay that amount consistently throughout the year. This method establishes the discipline required to compensate the owners involved in the business, and subsequently brings order to their personal lives. The amount of tax due can be significantly less because the profits (after payroll and other expenses) are not subject to FICA tax which is 15.3%! So, the tax is greatly reduced, and the psychological effect of being compensated and paying the taxes along the way is priceless!

The following 2 tables show the tax effects on LLC owners vs. S corporation owners. Obviously, the tax savings are impacted by the amount of the S corporation owner's salary. As the salary increases, the tax savings lessen. Overall, I like the S Corporation because the tax burden is less, and because the payroll process brings order and discipline to the life of the owner.

EXAMPLE 1

	LLC	S Corp	Difference
Total Income	\$150,000.00	\$150,000.00	\$0.00
Expenses (not including owner payroll)	\$50,000.00	\$50,000.00	\$0.00
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Owner Payroll	\$0.00	\$35,000.00	\$35,000.00
Owner Payroll Taxes	\$0.00	\$2,677.50	-\$2,677.50
Net Income	\$100,000.00	\$62,322.50	\$37,677.50
FICA Taxes due on reportable income	\$15,300.00	\$0.00	\$15,300.00
Actual Taxes Due or Paid	\$15,300.00	\$5,355.00	\$9,945.00
			Tax Savings

EXAMPLE 2

	LLC	S Corp	Difference
Total Income	\$150,000.00	\$150,000.00	\$0.00
Expenses (not including owner payroll)	\$50,000.00	\$50,000.00	\$0.00
			-
Owner Payroll	\$0.00	\$80,000.00	\$80,000.00
Owner Payroll Taxes	\$0.00	\$6,120.00	-\$6,120.00
Net Income	\$100,000.00	\$13,880.00	\$86,120.00
FICA Taxes due on reportable income	\$15,300.00	\$0.00	\$15,300.00
Actual FICA Taxes Due or Paid	\$15,300.00	\$12,240.00	\$3,060.00
			Tax Savings

