LLC, Corp., Sub-S: What's the Difference?

by Gregory J. Cava

The kind of business organization you choose, whether it be a corporation, a limited liability company, or another entity, has important ramifications for your personal and tax liability. Different entities offer different advantages and disadvantages. For example, while some types can shield you from personal liability, they may also create a corporate structure in which your business income gets taxed as well as your paycheck. Some other entities offer liability protection without being subject to corporate tax, by acting as a conduit through which income travels to you and gets taxed only once, as personal income.

The choice of business entity should be made in close consultation with your lawyer, accountant, and tax advisor. This article will discuss some of the chief differences between the most common business entities, but be forewarned: This explanation is a summary only and is not legal or tax advice, nor is it a substitute for obtaining proper legal and tax advice tailored to your circumstance.

Partnerships

Traditionally, when Smith and Jones went into business they formed a partnership. Partnerships can be informal, where parties simply do business under a trade name; for example, Smith & Jones Decks. To minimize misunderstandings and avoid lawsuits, partners should make their expectations clear at the outset in the form of a written partnership agreement. As a partnership is viewed as a conduit for income and not a unique entity under American law, earnings are not taxed in the partnership itself but pass through to each partner and are then taxed.

A partnership requires responsibility and, more important, trust. A partner can legally bind the partnership, which can then be held liable for the debts and obligations created by any one of the partners. This can work well in a professional association like a medical, legal, or accounting practice, but it's clearly not suitable to a venture where the venturers want to attract capital through subscriptions (similar to stock issues) from individual investors. The venturers would not want investors to be able to bind the venture, and investors wouldn't want to be liable beyond their investment dollars.

Most states permit so-called "limited partnerships" that allow purely passive investors or limited partners to have some limited liability while a general partner or partners operate the partnership. These are cumbersome, however, because every change to the limited partnership agreement has to be filed with the state.

Corporations

A corporation is like an artificial person. It's formed to engage in an enterprise, traditionally for the purpose of limiting the liability of the owner-investors to their investment. A corporation is owned by holders of the shares of the corporation and is governed by its articles of incorporation and bylaws, which together form the "constitution" of the corporation. Unlike a partnership agreement, bylaws may be amended without state filing.

In accordance with the requirements of the bylaws, the shareholders elect a board of directors to manage the affairs of the corporation. The directors elect officers who operate the corporation on a day-to-day basis. And because it is an artificial person, it needs a name that signifies its status as a corporation. Laws vary but usually require that the name contain the words Corporation, Company, Incorporated, or Limited, or a recognized abbreviation for one of these, like Corp., Co., Inc., or Ltd.

Corporations are separate taxable entities and pay federal and often state income taxes at a special rate for corporations. This rate is usually significantly higher than an individual's tax rate.

Title 26, Subtitle A, Subchapter S of the U.S. Internal Revenue Code allows certain eligible domestic small businesses, subject to a number of limitations and conditions, to receive different tax treatment from regular ("Schedule C") corporations by making a timely written election. This makes the corporation a "Sub-S" corporation. Ineligibility under the law or the failure to make and file the proper election in a timely manner can subject corporate income to the higher Schedule C rate, so special care is required.

Although not particularly relevant to deck builders, many states also have professional corporations and professional partnerships (often signified by those words or the abbreviations P.C. or P.A.). These are typically limited to such professions as doctors, lawyers, engineers, and the like and reflect the law that these professionals are generally not permitted to limit their professional liability to their clients.

Limited Liability Companies

A limited liability company is a form of business entity available in most states. It provides a more flexible mechanism to obtain corporate limited liability but is taxed like a partnership, offers more flexible management, and often has lower filing fees. Limited liability companies are not suitable for all ventures, but have become a standard business form for many real estate ventures, small businesses, and sole proprietorships.

Limited liability companies typically have members rather than shareholders; the members are the owners and may also be the managers, reflecting the hands-on management style practiced in most small businesses. A limited liability company may be professionally managed or may elect a member as a manager who functions like a CEO and COO rolled into one. In Connecticut, a limited liability company can be a sole proprietorship with a single person as the member and manager. If there is more than one arms-length member, the limited liability company should also have an operating agreement that governs the conduct of the business and the rights of the members, much like a partnership agreement or set of corporate bylaws. Like a corporation, the limited liability company must include in its name words required by law: Limited Liability Company, LLC, L.L.C., Company, Co., Limited, Ltd.

Some states, like Connecticut, also have registered limited liability partnerships that provide some limited liability to the partners.

Consult a Lawyer

No matter which form of organization you use, it is critical to obtain qualified legal counsel familiar with corporate practice. Laws governing business entities and the degree of liability limitation vary by state and type of entity, and you can by your actions lose what protection the law allows. Business entities don't come with an owner's manual, so seek and follow legal advice to protect your business and your assets. ❖

Gregory J. Cava is an attorney in Roxbury, Conn.