Which Business Type Is Right for Me – C Corp, S Corp or LLC?

Whether you've purchased an existing business or want to start a new company, you must first decide which form of organization (or "business entity") is best for you. There are several business types, and each has advantages and disadvantages. Make sure that you consult with your attorney or accountant about which type of business is most beneficial for your particular situation before making a final decision.

What is a C corporation?

The standard corporation, or C corporation, is a separate legal entity owned by shareholders. You form the corporation by filing incorporation documents with a state and paying the related filing fees. The corporate structure limits each owner's (shareholder's) personal liability for the corporation's business debts to the amount invested in the company by the shareholder.

Who should consider a C corporation?

A C corporation might be the right business type for you if you:

- May need venture capital for financing.
- Want flexible profit-sharing among owners.
- Want company earnings to stay in your business so that it can grow.
- Want flexibility to spread the business earnings between the corporation and shareholders for tax-planning purposes.
- Want flexibility to set salaries for employees/owners to minimize Social Security and Medicare taxes.
- Want flexibility to provide (through the corporation) substantial health and medical benefits and other fringe benefit programs for things like education, life insurance, and transportation costs.
- Want to be able to easily sell your business.
- Want to provide an accountable plan for travel & entertainment.
- Want to be able to offer stock options to employees.
- Expect your business to own real estate.
- Prefer to lower your risk of IRS audit exposure, since there is a higher audit rate for business income that is reported solely on Schedule C of Form 1040 (U.S. Individual Income Tax Return).

What is an S corporation?

An S corporation is a standard corporation that has elected a special tax status with the IRS. The formation requirements are the same as those for C corporations: incorporation documents must be filed with the state and appropriate filing fees paid. The S corporation's special tax status eliminates the double-taxation that can occur with a C corporation's income. A corporate income tax return is filed, but no tax is paid at the corporate level. Instead, business profits or losses "pass-through" to shareholders and are then reported on their individual tax returns. Any tax due is paid by shareholders at their individual tax rates.

Who should consider an S corporation?

An S corporation might be the right business type for you if:

- You want to take advantage of benefits that the corporate business type holds, but you want to take advantage of pass-through taxation.
- You want flexibility to set salaries for employee/owners to minimize Social Security and Medicare taxes.
- Flexibility of accounting methods is desired, because corporations must use the accrual method of accounting unless they are considered to be a small corporation (with gross receipts of $5,000,000 or less) and S corporations typically don't have to use the accrual method unless they have inventory.

- Lower risk of IRS audit exposure is desired, because S corporations file an informational tax return (Form 1120 S U.S. Income Tax Return for an S Corporation) and there is a higher audit rate for business income that is reported solely on Schedule C of Form 1040 (U.S. Individual Income Tax Return).

Key differences between C corporations and S corporations

While C corporations and S corporations may seem very similar, there are big differences:

- **Taxation.** C corporations are separately taxable entities and file a corporate tax return, reporting profits or losses. Any profits are taxed at the corporate level, and losses don't pass through for use by the shareholders to offset other taxable income. The profits of C corporations face possible double taxation when corporate income is distributed to shareholders as dividends. First, the corporation pays tax on its corporate income; then, the shareholders pay personal income tax on the same income when it is distributed to them as dividends. S corporations, however, are pass-through tax entities so there is no tax paid at the corporate level. Profits and losses are passed-through the corporation and reported on the shareholders individual tax returns. Any tax due is then paid by the shareholders at their individual tax rates.
- **Corporate ownership.** C corporations can have an unlimited number of shareholders, while S corporations are restricted to no more than 100 shareholders. Also, C corporations can have non-US citizens/residents as shareholders, but S corporations cannot. S corporations cannot be owned by C corporations, other S corporations, LLCs, partnerships, or many trusts. C corporations are not subject to those same restrictions. S corporations can have only one class of stock (disregarding voting rights), while C corporations can have multiple classes.
- **S corporation election.** A corporation must elect to become an S corporation by making a timely filing of Form 2553 with the IRS, and all shareholders of the corporation must agree in writing to the S corporation election.

What is a limited liability company?

The limited liability company (LLC) offers an alternative to corporations and partnerships by combining the corporate advantage of limited liability protection with the partnership advantage of pass-through taxation. With this tax status, the LLC's income is not taxed at the entity level; however, the LLC typically completes a partnership return if the LLC has more than one owner. The LLC’s income or loss is passed through the LLC and reported on owners' individual tax returns. Tax is then paid at the individual level.
You form an LLC by filing incorporation (organizational) documents with a state and paying the related filing fees. LLCs also have fewer ongoing formalities and obligations than corporations.

Who should consider an LLC?

An LLC might be the right type of business for you if:

- Your startup company anticipates losses for at least two years and you want to be able to pass the losses through to yourself and the other owners.
- Flexibility for accounting methods is desired, because LLCs are not required to use the accrual method of accounting as C corporations typically are.
- Your business may own real estate.
- You want management flexibility, since LLCs offer more flexibility than corporations in terms of how the management of the business is structured.
- You wish to minimize ongoing formalities. Unlike corporations, which are required to hold annual meetings of directors and shareholders and keep detailed documents and records for all corporate meetings and major business decisions, LLCs do not face strict ongoing meeting and documentation requirements.
- You want flexibility for sharing profits among owners.