WHEN FORMING A NEW BUSINESS, ask yourself: Why not a limited liability company (“LLC”)? The question is not rhetorical. The LLC form is not always the best choice for a new business. An LLC is the right choice, however, in a majority of cases. Accordingly, an LLC should be the first form to consider for a new business.

Although state LLC statutes vary greatly, an LLC may now be formed under the laws of any state or the District of Columbia. Most (not all) multi-member LLCs are classified as partner-

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ships for federal income tax purposes under the Internal Revenue Code of 1986, as amended (the “Code”). See Treas. Reg. §§301.7701-1 to -4. Accordingly, except as otherwise stated, we will treat “LLCs” and “partnerships” as equivalent. Many of the advantages discussed in this article are advantages that LLCs have over S corporations, rather than over partnerships. The liberalization of the S corporation rules by the Jobs Creation Act of 2004 only slightly reduced the disadvantages of S corporations as compared to LLCs. The LLC will still be the preferred entity in most cases.

The tax differences between partnerships and multi-member LLCs are relatively minor compared to the differences between S corporations and multi-member LLCs. A multi-member LLC may differ from a state law partnership in various respects, such as the degree of liability protection, flexibility in governance, and waivability of fiduciary duties, as well as in aspects of state, local, federal, or foreign tax treatment. For purposes of this article, however, the differences between LLCs and state law partnerships will mostly be ignored.

This article is not intended as a comprehensive analysis of the pros and cons of various forms of entity. Our purpose, rather, is to encourage you to think first of the LLC. From that starting point, you may nevertheless find compelling reasons to choose another form of entity.

YOU CAN PAY ONE TAX INSTEAD OF TWO • An LLC is generally treated as a partnership for federal income tax purposes. Accordingly, the LLC itself is not subject to federal income tax, and all of its income, gain, loss, deduction, and credit are passed through to its members. §701 (All section references are to the Code unless otherwise indicated). Thus, operating a business through an LLC means one level of federal income tax, at the member-level.

By contrast, a C corporation is subject to an entity-level federal income tax on its income, and amounts distributed to shareholders are generally subject to an additional federal income tax at the shareholder level. §§11, 301. Accordingly, income earned by a C corporation and distributed to its shareholders is generally subject to two levels of taxation. S corporations are generally not subject to a corporate-level tax, except when the S corporation was formerly a C corporation, or when the S corporation acquired a C corporation in a tax-free transaction. See §§1374, 1375.

C corporations often attempt to “zero out” income by deducting salary, rent, interest, and other expenses. Depending on the circumstances, however, it can be difficult or impossible to “zero out” a C corporation’s income. A plan to “zero out” a C corporation’s income is especially prone to failure if the C corporation has assets that appreciate in value. Real estate is the classic example of an appreciating asset. But less obvious examples—including goodwill—can create massive tax liabilities. The limits of a strategy based on “zeroing out” income often become painfully apparent on a sale or other disposition of the business. Even a business formed as an S corporation can face difficult problems in these situations.

Example—Business Develops Goodwill

A and B form consulting firm X. X operates for several years without paying any corporate-level tax. X builds up valuable goodwill among customers. A and B then join Y LLC, a larger consulting firm, and take along the goodwill developed by X. A and B receive equity in Y LLC, but no upfront cash payment.

• If X is a C Corporation: Assuming that the goodwill is an asset of X, X is taxable as if it sold the goodwill at fair market value in a liquidating transaction. A and B are taxable as if X distributed the goodwill to them.
• If X is an S Corporation: In this case, X's gain on the deemed sale of the goodwill is passed through to A and B who are taxable on such gain. In addition, A and B will be taxable on the deemed distribution to them, to the extent the distribution exceeds A's and B's tax bases in the S corporation stock. §1368(b).

• If X is an LLC: X has no taxable income, and in general neither does anyone else. The transaction should be characterized as a partnership merger under section 708(b)(2)(A) and Treas. Reg. §1.708-1(c).

In the foregoing example, X might have been able to avoid corporate-level tax on its operating income for a long period, but faced a day of reckoning when A and B tried to join another firm.

The example is biased in favor of the LLC form. If the acquirer is a corporation instead of an LLC, A and B might be able to receive acquirer stock in a tax-free corporate reorganization described in section 368(a)(1). Moreover, even if X is a corporation, and the acquirer an LLC, it may be possible to argue—in the right circumstances—that the goodwill is a personal asset of A and B (i.e., is owned by A and B individually, rather than by X), so that corporate gain is not triggered on a deemed disposition of the goodwill. See Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998).

The adverse impact of the double tax was reduced under legislation enacted in 2003. Most C corporation dividends to individual shareholders are taxable at long-term capital gain rates (normally, a maximum of 15 percent). The special tax rate on dividends, which is scheduled to last through 2008, reduces, but does not eliminate, the disadvantages of double tax. The adverse impact of double tax is also mitigated by the ability of C corporations to accumulate earnings without paying dividends. The ability to accumulate earnings is constrained, however, by the personal holding company tax and the accumulated earnings tax. §§531, 541.

YOU CAN CAPITALIZE IT ANY WAY YOU WANT • An LLC has nearly unlimited flexibility in the types of equity and debt interests that it may issue to its members. An LLC may issue all manner of common interests, preferred interests, vested or unvested interests, debt, and options to acquire any of the above. By comparison, an S corporation cannot have more than one class of stock, although differences in voting rights are permitted and an S corporation may issue multiple classes of debt. §1361(b)(1)(D). The “one class of stock” requirement for S corporations precludes the complex economic sharing arrangements among equity owners that business deals often demand, and that LLCs can accommodate. Moreover, creativity in structuring debt may be fatal to S corporation status, since in some circumstances a debt instrument or obligation may be treated as an impermissible second class of stock. Treas. Reg. §1.1361-1(l)(4)(ii). The operating rules of S corporation tax are simpler than those that apply to multi-member LLCs, but this simplicity is in large part a reflection of the inflexible requirements of S corporation capitalization.

Although a C corporation may have multiple classes of both debt and equity, the fact that a deduction is available for interest but not dividends tends to favor debt capital over equity capital, at least when the C corporation's shareholders are not entitled to a dividends-received deduction. The tax advantage of debt may distort capitalization decisions for C corporations, creating higher debt to equity ratios than would otherwise make sense. Tax considerations influence financing decisions for an LLC as well, but often not to the same extent as for a C corporation.
YOU CAN PASS THROUGH LOSSES •
Losses incurred by a C corporation do not pass through to its shareholders. Accordingly, shareholders do not receive a direct tax benefit from a C corporation’s losses, as may shareholders in an S corporation or members in an LLC. Although the pass-through of losses of both LLCs and S corporations is limited by the bases of the owners (§§704(d), 1366(d)), the liabilities of an S corporation (unlike the liabilities of an LLC) are not included in the owners’ bases. The exclusion of entity-level liabilities from the basis of S corporation shareholders reduces the amount of losses that can flow through to the shareholders. (As explained below in connection with distributions, this basis rule also tends to make the distribution of financing proceeds taxable to the shareholders.) Nevertheless, despite the inclusion of LLC debt in the bases of the LLC members (§752), there are numerous restrictions on the deduction of losses that are passed through from an LLC. See, e.g., §§465, 469 and 704(d).

ANYONE CAN OWN AN LLC • Any type of person—whether an individual or an entity—may be a member of an LLC. This is not necessarily to say that LLCs may engage in any type of business, although there are relatively few limits. State law or professional ethics requirements sometimes prevent professionals (e.g., doctors, attorneys or accountants) from operating in LLC form. Conversely, certain states have specifically limited membership in limited liability partnerships to licensed professionals in the same discipline.

An S corporation imposes the tightest restrictions on membership—it cannot have as a shareholder a person who is a nonresident alien, or a person other than an individual, an estate, or one of certain types of trusts or tax-exempt corporations specified in the Code. §§1361(b)(1)(A), (B) and (C); 1361(c)(2) and (6). In principle, just one ineligible shareholder of an S corporation, such as a partnership or a corporation, will cause the S corporation status to terminate. The restrictions on S corporation membership arise under the tax rules rather than under state business entity principles. “S corporation” is strictly a tax concept. An S corporation need not even be a “corporation” under state law. See Treas. Reg. §301.7701-3T(c-1)(v)(C); Pvt. Letter Rul. 200450012 (Aug. 26, 2004).

There is no minimum or maximum number of LLC members. Entities formed as partnerships under state law, however, require at least two members. S corporations cannot have more than 100 shareholders, although all members of a “family” can be treated as one shareholder. §1361(b)(1)(A). This limit on the number of S corporation shareholders, effective for tax years beginning after December 31, 2004, is a liberalization of the prior rule. Before the American Jobs Creation Act of 2004, the upper limit on S corporation shareholders was 75, and only a husband and wife could be treated as one shareholder. (The 2004 Act eased several other S corporation rules, but the changes were generally minor. These changes perhaps have the greatest impact on community banks. Banks cannot be classified as partnerships for tax purposes, and so for them the potential advantages of partnerships over S corporations are irrelevant. To achieve pass-through tax treatment, a bank must qualify as an S corporation.)

Although anyone may own an interest in an LLC, there are some practical limitations. For example, if ownership of the interest would cause an LLC to be classified as a publicly traded partnership for federal income tax purposes, the LLC may be taxed as a corporation. §7704(a). In general, an LLC will be treated as a publicly traded partnership if interests in the LLC are traded on an established securities