About this Template:

The following client letter is a template for you to customize and use with your own clients who need more information on the differences between LLCs and S corporations.

Western CPE is pleased to share this as a free resource for the tax community, but you must read it for yourself, agree with its contents, and customize it for your own business.

This client letter was originally distributed as part of the 2024 Federal Tax Update and 2024 California Federal Tax Update. Check out these CPE courses for more resources and a wealth of practical know-how to take your tax practice to the next level.

Client Letter:
LLC Versus S Corporation Letter

Dear Client,

As your tax planning expert, I wanted to provide a comparison of an LLC versus an S corporation to help inform your entity choice for your business.

Formation and Ongoing Administration

LLCs are generally simpler and less expensive to establish. There is less paperwork and fewer formation requirements. LLCs also have fewer complex administrative regulations and formalities than S corporations. However, both LLCs and S corporations require separate tax filing and tax documentation maintenance.

Liability Protection

LLCs provide liability protection similar to S corporations, so owners' personal assets are generally protected from business lawsuits and debts. However, LLC protection can be lost if formalities are not properly followed. Please consult with your business attorney on the liability issues.

Ownership Restrictions

LLCs have no limits on number of owners while S corporations can only have up to 100 shareholders and restrictions on foreign, entity, and nonresident alien owners apply. Also, S corporations can only have one class of stock while LLC membership interests can have different classes.

Tax Treatment

The biggest difference between an LLC and an S corporation is how they are taxed. A multimember LLC by default is treated as a partnership. This means the business itself does not pay income taxes. Instead, the LLC's profits and losses pass through to the owners' personal tax returns, where they report their share on their individual 1040 forms. LLCs can also elect to be taxed as a C or S corporation if they prefer, but the default is a partnership.

In contrast, an S corporation has a special tax status under the Internal Revenue Code that provides pass-through taxation similar to a partnership. S corporations do not pay income tax at the entity level. Instead, the profits and losses of the entity pass through to the shareholders' personal tax returns.

However, there are some key differences in how the pass-through taxation works:

- Owners of an LLC pay self-employment tax on their entire share of business net income. This includes both active both active and passive members.
- Owners of an S Corporation only pay self-employment tax on their reasonable salary or wages from the business. Distributions of profits beyond their salary are not subject to self-employment tax.
- S corporations provide more flexibility to manage the owner's salary and distributions to optimize the self-employment tax burden.
- LLCs may be subject to state-level LLC taxes or franchise taxes that S corporations may avoid.

In summary, the pass-through taxation of an S corporation can potentially result in lower self-employment taxes compared to an LLC, depending on how the owners structure their compensation. But LLCs offer more flexibility in terms of profit distributions and tax elections.

Continuity of Organization

S corporations have continuity in the event of a triggering event like owner death or withdrawal. LLCs must technically dissolve if such an event occurs unless the operating agreement states otherwise.

I recommend we schedule a meeting to discuss these points in more detail and how they relate to your specific business goals and financial situation. Please don't hesitate to contact me with any questions or to set up an appointment.

Best regards,
[Your name]
Tax Planning Expert