

## **Entity Choice: Limited Liability Company vs. Subchapter C Corporation**

By Fredric H. Aaron, Esq.\*

My legal practice deals with many clients who are looking to set up a business in New York. When they approach me, I try to get a sense of the type of business they will be doing, such as a real estate brokerage, or a restaurant, or even a magazine or newspaper. The key is to find the right form of entity for the business.

New York State currently offers the following entity choices for people who are planning to do business in the state: sole proprietorship, partnership, limited partnership, C corporation, S corporation, foreign corporation, limited liability company (LLC) and limited liability partnership (LLP). Each one has different liability protections and tax consequences. No form is necessarily better than another; it is all a matter of finding the right entity to fit the nature of the business.

Two of the most popular forms for businesses are the LLC and the C corporation. The C corporation is a corporation which pays income taxes like a person, and then can distribute income to its shareholders. In order to form a C corporation, a person will need to file a Certificate of Incorporation with the New York Department of State. Once the Certificate is approved, the person will have to draft By-laws and resolutions which govern how the corporation is operated, elect the first Board of Directors and appoint officers to operate the corporation. Also, the person will have to apply for an Employer Identification Number (“EIN”) with the Internal Revenue Service (“IRS”) for the corporation and specify the tax form which the corporation will use for filing and paying its annual taxes. The corporation will have the power to conduct business in New York, hire employees and pay dividends to shareholders out of its earnings.

Similarly, to form an LLC, a person will have to file Articles of Organization with the New York Department of State. Once the Articles are approved, the person will have to draft the Operating Agreement for the LLC which governs how the LLC is operated. In addition, the person will have to place a classified advertisement in a local newspaper announcing the formation of the LLC. Finally, the person will have to apply for an EIN with the IRS for the LLC.

In general, there are no limitations as to who can own an LLC or a C corporation. Any person can buy a membership interest in an LLC or a share in a C corporation. Another corporation, LLC or partnership can also buy a membership interest in an LLC or a C corporation. Investments can also come from trusts.

Despite the foregoing, there are a number of differences between the two entity types. First, the LLC does not pay taxes. All profits and losses are allocated to the members of the LLC on a basis equal to their percentage ownership of the LLC, unless stated otherwise in the LLC’s Operating Agreement. If the LLC makes a profit and decides not to distribute it to the members, the members will still be taxed on the profit as if they received it from the LLC. This is not the case with C corporations, which pay their own taxes on the profits of the business. If the C corporation makes a profit but

does not distribute it to shareholders, the shareholders will not have to pay a tax on the profit. They will only pay a tax if they receive a dividend from the C corporation.

There is another major difference for a foreign investor. The foreign investor who invests in an LLC will have to acquire a social security number from the IRS prior to making the investment (unless he or she already has one), and will have to file an annual tax return for his or her interest in the LLC. This is not the case with C corporations. Here, the only time there may be a tax is if the foreign shareholder receives a dividend. And even then, there may be no tax depending on the treaty status between the United States and the foreigner's home country.

C corporations have been around for a very long time. In the United States, many of the cases upon which the rules governing C corporations are based were decided hundreds of years ago. Corporate law in New York and Delaware, for example, are matters of well-settled precedent. Any attorney setting up a corporation and advising its investors will know the answer to practically any question posed regarding the corporation. LLCs, on the other hand, were only developed in the last decade. New York State began permitting the formation of LLCs only twelve years ago. Therefore, a great deal of the legal precedent regarding the operation of LLCs has not yet been determined. This lack of certainty can create problems for potential investors. Also, the Operating Agreements for LLCs are not standardized documents, so anyone planning to invest in an LLC should consider retaining an attorney to review the Operating Agreement before any investment is made.

Not every type of legal entity is right for every business. You should contact an attorney before creating any business or making an investment. Good prior planning can avoid potential problems which may arise further down the road.

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