



DESCHUTES DISCOVERY

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SHOULD YOU FORM AN S CORPORATION OR A LIMITED LIABILITY COMPANY?

BY RODNEY P. MOCK, ATTORNEY AT LAW

If you own a business as a sole proprietor or are thinking of starting a business, you may be wondering whether you should structure your business as an S corporation or a limited liability company ("LLC"). The answer to this question is that it depends on your particular circumstances. An LLC is by far a superior vehicle compared to an S corporation, although there are certain limited advantages to an S corporation that one should consider when structuring a business; namely, saving money on employment taxes.

1. DO I QUALIFY FOR S CORPORATION STATUS?

An S corporation starts out just like a C corporation under Chapter 60 of the Oregon Revised Statutes and both are viewed as domestic corporations for state law purposes. In order to obtain the special status of being an S corporation (and avoid the double taxation associated with C corporations) an S corporation must make an S corporation election pursuant to Section 1362(a) of the Internal Revenue Code ("IRC"). This election must be made by all of the shareholders of the corporation at the time of the election.

In addition, the corporation must qualify as a "small business corporation" under IRC § 1361(b)(1), which is defined as a domestic corporation that does not have: (a) more than 75 shareholders, (b) shareholders that are not individuals (i.e., non-qualifying trusts, LLCs, partnerships, C corporations, etc.), (c) a nonresident alien as a shareholder; (d) and more than one class of stock. There are also certain "ineligible corporations" listed in IRC § 1361(b)(2) which do not qualify for S corporation status.

What does this all mean for your business decision? This means that your inquiry into whether or not you want to be an S corporation may end with the fact that you do not qualify for the S corporation election. For example, you would not qualify as an S corporation if you wanted to have more than one class of stock, if you wanted a non-resident alien shareholder in your corporation, if you wanted an LLC as a shareholder, or if you wanted more than 75 shareholders.

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2. YOU QUALIFY FOR S CORPORATION STATUS. NOW WHAT?

Assuming your organization qualifies for S corporation status, if you make a timely election during the taxable year you will be viewed as an S corporation and continue to be treated as an S corporation until your status is revoked by the shareholders under IRC § 1362(d)(1) or you no longer qualify (i.e., you have more than 75 shareholders, a non-resident alien joins as a shareholder, etc.). By making the S corporation election, you will be treated as a “pass-through” entity for tax purposes. This means that all of the corporation’s losses, deductions, credits and income will be “passed-through” (i.e., through the entity) to the shareholders pursuant to IRC § 1366(a)(1); and your organization will be treated like an LLC in that there will be only one level of taxation - at the shareholder level and not the entity level - thus you avoid double taxation.

The limitations of the pass-through treatment of an S Corporation, however, are that it is “pro-rata” based on a shareholder’s percentage of ownership interest in the corporation and you do not have the ability to make “special allocations” of the passed-through tax items as you do in an LLC. An LLC is controlled by partnership law in the IRC which allows you to make special allocations to certain LLC members regardless of their ownership interest in the LLC so long as certain rules are followed. In other words, an LLC can provide you with much more flexibility over an S corporation in deciding which member will include certain tax-implicated items such as depreciation, deductions, and losses on their tax returns.

3. WHAT ABOUT LIMITED LIABILITY?

Limited liability for an S corporation and an LLC is generally the same. Both forms of ownership provide limited liability protection to their owners (i.e., the shareholders and the members). This means that the owners of these entities cannot be held personally responsible for the company’s debts or actions because the liability of the company is “limited” to the assets of the company unless the owners engage in wrongful acts or personally guarantee debts of the company. Therefore, in deciding between organizing as an S corporation or LLC, liability protection is not a factor as both entities provide superior protection compared to a non-corporate entity such as a partnership or sole proprietorship.

4. IF LLCs ARE SUPERIOR, WHY WOULD YOU WANT AN S CORPORATION?

An LLC has one minor flaw compared to an S corporation, that being employment taxes (i.e., Social Security and Medicare). Under the right circumstances, an S corporation may be a more desirable business entity because of the money you can save on employment taxes. With an LLC, the members of the LLC will pay employment taxes of 15.3 percent on all of the salary and profits of the LLC that are distributed to them. On the other hand, when an owner of an S corporation pays himself or herself a salary, only that salary is subject to employment tax. The remaining profits of the corporation the owner receives as a shareholder from the corporation are distributed to the shareholder as corporate distributions (i.e., dividends) and thus are not subject to employment tax.

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The salary a shareholder of an S corporation receives, of course, must be a "reasonable salary" for his or her services. Although setting up an S corporation to save on self-employment taxes may appear attractive at first glance, one must remember that the legal and accounting costs associated with setting up an S corporation are going to be more significant because the S corporation has more rigid corporate formalities to follow compared to an LLC and one must be prepared to do the administrative paperwork of payroll withholdings. Failing to follow the IRS payroll withholding rules can result in severe penalties and interest.

Therefore, in deciding on whether to go the S corporation route to save on self-employment taxes, one must discuss with his or her accountant the exact savings involved, then compare that to the administrative burden and expense associated with payroll withholding.

5. OTHER THINGS YOU SHOULD KNOW.

Selecting a business entity depends on the facts of any given situation. As demonstrated in this article, there are numerous factors to consider. By far this office's vehicle of choice is the LLC because of its liability protection, tax flexibility, and simplicity.

There are additional factors - mainly tax driven - that you must consider when forming a business entity. Some of these include: (1) whether the entity will have distributions of appreciated property; (2) the exit strategy of the owners; (3) whether you contemplate the business being sold in a stock-for-stock transaction; (4) whether the shareholders intend to transfer their ownership interests into a revocable living trust for estate planning purposes; and (5) whether the entity will own real property subject to substantial debt.

Selecting the right business entity vehicle does not have to be a daunting task. At Merrill O'Sullivan, LLP, we can assist you in navigating through the pros and cons of the various forms of ownership to ensure that you select the business form that is appropriate for you.

DEPARTURE OF PARTNER BRIAN J. MACRITCHIE

After 15 years of practicing law as a Partner of Merrill O'Sullivan, LLP, Brian J. MacRitchie is moving his practice to the firm of Hurley, Lynch & Re, P.C. effective September 20, 2005. Beginning October 3, 2005, his new office telephone number and address will be (541) 317-5505, 747 Millview Way, Bend, Oregon 97702, and new e-mail address will be bjmacritchie@hrl-law.com. We have enjoyed our association with Brian through the years and wish him all the best in his new practice.

RECEPTIONIST CHANGE

After 9 years of providing professional, warm, and invaluable service as receptionist to Merrill O'Sullivan, LLP, Jeanine Soriano has retired from the workforce to enjoy more time with her family, and pursue her notable artistic talent as a painter and sculptor. She will, however, return on occasion to assist as necessary. Jeanine was an integral member of the Merrill O'Sullivan, LLP team, as well as an absolute gem, and will be missed. We send Jeanine our best in her new endeavors!

Our new receptionist is Angela Ward who recently moved to Bend from the Portland area. She is quickly establishing herself as a terrific receptionist and we are happy she has joined us!



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DAVID G. BROWN

David was born and raised in Williamsburg, Virginia. He was valedictorian of his high school class in 1991. He attended and graduated from Duke University in Durham, North Carolina, cum laude, with a joint degree in History and Classical Studies. While at Duke University, David worked as a bicycle mechanic. He followed this interest to Moab, Utah, where he worked for a mountain bike guiding company and in a bicycle shop for a short period following graduation. He has published several articles featured on GQ's website including "Men.Style.Com Bicycle Buyer's Guide" and "Young and Shiftless, The Rapidly Growing Cult Of The One-Speed Bike." He next lived for three years in rural Japan teaching English in a Japanese junior high school. David speaks Japanese fluently.



David received his Juris Doctorate degree from the University of Oregon in 2002, at which time he served as the Outreach Coordinator for the Oregon Law Students Public Interest Fund. David's areas of practice reflect his eclectic personality: Civil and Business Litigation, General Business and Corporate Law, Commercial Transactions, Employment Law, Construction Law, and Domestic Relations. He is a member of the Oregon State Bar, and is admitted to practice in the U.S. District Court, District of Oregon. David is also the author of Amended and Supplemental Pleadings, Oregon Civil Pleading and Practice CLE, 2004.

David has resided in Oregon for six years and has practiced law in Central Oregon for three years. He loves to spend his free time with the light of his life, Monica. Among other things, David's interests include photography, rock climbing, kayaking, cycling, and skiing. He tries to live his life by the mantra of Jackie Robinson: "You are not dead yet, so die or do something!"

For more information regarding our legal services, please contact our office at (541) 389-1770 or visit <http://www.merrill-osullivan.com>.

Patricia L. Heatherman is the Editor of Deschutes Discovery. If you have questions regarding this issue, please contact Ms. Heatherman at (541) 389-1770 or e-mail feedback to lawfirm@merrill-osullivan.com.

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