

Should LLCs Convert to S Corporations?

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For the past ten years, the limited liability company (“LLC”) was the entity of choice for most businesses due to the ease of administration, flexibility and creditor protection benefits. However, with the recent change in the tax law, discussed below, it may be time to revisit the tax classification of LLCs.

Effective this year, all income earned from LLCs not taxed as S corporations that are engaged in an active business is subject to self-employment taxes imposed at a rate of 12.4% (up to the social security maximum -- \$113,700 for 2013) and a 2.9% rate for Medicare (without any maximum). Also beginning this year, there is an additional 0.9% tax for Medicare (bringing the total to 3.8%) for individuals earning in excess of \$200,000 (\$250,000 for couples filing married filing jointly). There is also a new 3.8% Medicare tax (with no maximum) on income not derived in an active business including interest, dividends, annuities, royalties and rents, and income from a passive activity of a trade or business.

An advantage of operating as an LLC taxed as an S corporation is the ability to avoid the self-employment tax on part of the company’s earnings. The IRS requires LLCs taxed as S corporations to pay their members reasonable compensation which remains subject to employment taxes. However, any income earned from the LLC taxed as an S corporation in excess of the reasonable compensation is not subject to self-employment tax. In addition, because the income is earned from an active business, it will also avoid the new 3.8% Medicare tax on unearned income.

A disadvantage of operating as an LLC taxed as an S corporation is that all distributions above the amount designated as compensation must be paid to the members in proportion to their ownership percentages in the LLC. In addition, all income must be allocated in proportion to their ownership percentages. Therefore, LLCs electing to be taxed as S corporations lose the flexibility of making disproportionate distributions and income allocations which are available to LLCs taxed as partnerships. However, many people think that the loss of this feature is more than offset by the employment tax savings.

To illustrate: Assume a two-member LLC with net income of \$1 million. If the LLC continued without making an S election, each member will pay a total of \$33,098.80 in employment taxes. If the LLC elects to be taxed as an S corporation, and if the members



agree that \$50,000 is reasonable compensation for each of them, the total in employment taxes payable by each member will be only \$8,100.

The deadline to make the S corporation election is March 15. In our experience, the cost of converting from LLC to S corporation status should not exceed around \$2,000.

For more information, please contact your attorney, Gray Reed attorneys [Jennifer Gurevitz](#) or [Tom Rhodus](#) at 214.954.4135, or visit www.grayreed.com.