

## **The Business Lawyer's Quick Guide to Choice of Entity: Corporation vs. LLC**

**By**  
**Gianfranco A. Pietrafesa, Esq.<sup>\*</sup>**  
**and Jason Zoranski, Esq.<sup>†</sup>**

There are many different types of business entities, including corporations, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, and even sole proprietorships. Historically, the most popular type of entity was the corporation, but in the last twenty years, the limited liability company ("LLC") has become the entity of choice. The key reasons for this shift are that an LLC provides its owners with limited liability protection (like a corporation) and more favorable tax treatment (like a partnership). Also, since the rights and obligations of LLC owners are largely contractual, an LLC provides its owners with greater flexibility in structuring management, voting, and economic terms. The corporation, however, remains an important entity, and may provide its owners with favorable tax treatment by electing to be treated as an S corporation for tax purposes.

This resource summarizes some of the general advantages and disadvantages of (1) a corporation taxed as a C corporation, (2) a corporation taxed as an S corporation, and (3) an LLC taxed as a partnership (with two or more owners) or a disregarded entity (with one owner). It then reviews the more important characteristics of these types of business entities and their tax treatment.

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<sup>\*</sup> [Gianfranco A. Pietrafesa](#) is a partner in the firm of [Archer & Greiner, P.C.](#), in Hackensack, New Jersey, where he represents clients in corporate and business transactions, including the formation of business entities. He is a former Chair of the Business Law Section of the New Jersey State Bar Association and the author of numerous articles on corporate and LLC law. He can be reached at [gpietrafesa@archerlaw.com](mailto:gpietrafesa@archerlaw.com) or 201.498.8559.

<sup>†</sup> [Jason Zoranski](#) is an associate in the firm of [Archer & Greiner, P.C.](#), in Voorhees, New Jersey, where he represents clients in federal and state income tax matters. He can be reached at [jzoranski@archerlaw.com](mailto:jzoranski@archerlaw.com) or 856.616.2604.

## Summary of Business Entity Advantages and Disadvantages

<b>C Corporation</b>	
<i>Advantages</i>	<i>Disadvantages</i>
Owners have limited liability. <sup>1</sup>	C corporations pay income taxes, and then their shareholders pay income taxes when they receive dividends from the corporation; therefore, there is double taxation. <sup>2</sup>
Multiple classes of stock are permitted with different economic interests (e.g., common and preferred stock). <sup>3</sup>	C corporations must observe corporate formalities such as annual meetings and written minutes. <sup>4</sup>
There are no restrictions on number, type, or citizenship of owners.	
Owners may freely transfer shares of stock (unless otherwise restricted in writing). <sup>5</sup>	
Incentive stock options for employees are permitted.	
Corporate law is well settled.	

<b>S Corporation</b>	
<i>Advantages</i>	<i>Disadvantages</i>
Owners have limited liability. <sup>6</sup>	There is a maximum of one hundred shareholders. <sup>7</sup>
Owners may freely transfer stock to permissible types of owners (unless otherwise restricted in writing). <sup>8</sup>	S corporations must observe corporate formalities such as annual meetings and written minutes. <sup>9</sup>
Incentive stock options for employees are permitted.	There is only one class of stock permitted, although there may be voting and nonvoting shares. <sup>10</sup>
There is one level of taxation, shared pro rata among owners based on their ownership percentages. <sup>11</sup>	Only U.S. citizens, resident aliens, estates, and certain types of trusts may be owners; no entities (except single-member LLCs owned by a natural person and treated as a disregarded entity for tax purposes) may be owners. <sup>12</sup>
Corporate law is well settled.	Owners pay income taxes on the corporation's income, even if they do not receive cash ("phantom" income). <sup>13</sup>

<b>Limited Liability Company</b> (taxed as a pass-through entity, such as a partnership)	
<i>Advantages</i>	<i>Disadvantages</i>
Owners have limited liability. <sup>14</sup>	A person may become a member only with the consent of all members (unless otherwise agreed in writing). <sup>15</sup>
Multiple classes of membership interests are permitted, including profits interests.	LLC law is not as developed as corporate law.
There are no restrictions on number, type, or citizenship of owners.	Offering incentive equity to employees is more complex and not well understood by employees.
Management is flexible (management structure can mimic a corporation, a partnership, or a hybrid) <sup>16</sup>	Self-employment taxes apply for owners who are active in the LLC. <sup>17</sup>
There is one level of taxation, shared pro rata among owners based on their ownership percentages or agreement (may elect to be taxed as a C corporation or an S corporation) <sup>18</sup>	Owners pay income taxes on the LLC's income, even if they do not receive cash ("phantom" income). <sup>19</sup>
There are no "corporate" formalities. <sup>20</sup>	

### **Business Entity Characteristics**

	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
<b>Formation</b>			
<i>Method of Formation</i>	File certificate of incorporation with the state. <sup>21</sup>	File certificate of incorporation with the state. <sup>22</sup>	File certificate of formation with the state. <sup>23</sup>
<i>Governing Documents</i>	Certificate of incorporation; bylaws; and, if desired, shareholder agreement	Certificate of incorporation; bylaws; and, if desired, shareholder agreement	Certificate of formation and operating agreement
<i>Designation of Owners</i>	Shareholders	Shareholders	Members
<i>Number of Owners</i>	One or more shareholders	One to one hundred shareholders, with spouses (and family members) counted as one shareholder <sup>24</sup>	One or more members
<i>Eligible Types of Owners</i>	No restrictions	Individual U.S. citizens and resident aliens only; estates and certain trusts; no corporations, LLCs (unless a disregarded entity with a natural person as the member), or other business entities <sup>25</sup>	No restrictions
<i>Capital Structure</i>	No restrictions on number or types of classes of stock (e.g., common stock and preferred stock)	One class of stock only, with both voting and nonvoting shares allowed <sup>26</sup>	No restrictions
<i>Owners' Personal Liability</i>	Liability is limited to the shareholder's capital contributions to the corporation. <sup>27</sup>	Liability is limited to the shareholder's capital contributions to the corporation. <sup>28</sup>	Liability is limited to the member's capital contributions to the LLC. <sup>29</sup>
<i>Transfer of Equity</i>	Shareholders may freely transfer stock, unless restricted in the certificate of incorporation, bylaws, or shareholder agreement. <sup>30</sup>	Shareholders may freely transfer stock, unless restricted in the certificate of incorporation, bylaws, or shareholder agreement; but transfer to the wrong type of owner (see eligible types of owners, above) will cause the corporation to lose its S corporation status. <sup>31</sup>	Economic rights may be transferred; full rights (i.e., voting and management) may be transferred only with approval of all members, unless otherwise provided in the operating agreement. <sup>32</sup>
<b>Management</b>			
<i>Identity of Managers</i>	Centralized management. Shareholders elect directors, and directors appoint officers. <sup>33</sup>	Centralized management. Shareholders elect directors, and directors appoint officers. <sup>34</sup>	Very flexible. Members can specify the management structure in the operating agreement to mimic a corporation, a general or

	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
			limited partnership, or a hybrid; generally, all members may manage or delegate management to managers in the operating agreement. <sup>35</sup>
<i>Persons with Authority to Bind the Company</i>	Officers and board of directors as a whole <sup>36</sup>	Officers and board of directors as a whole <sup>37</sup>	Generally, any member (if member-managed) or manager (if manager-managed), or as otherwise provided in the operating agreement <sup>38</sup>
<i>Voting</i>	Based on number of voting shares. <sup>39</sup>	Based on number of voting shares. <sup>40</sup>	Based on members' profit percentages, unless otherwise provided in the operating agreement.  For N.J. LLCs, each member has an equal vote, unless otherwise provided in the operating agreement. <sup>41</sup>
<i>Formalities</i>	An annual shareholder meeting is required to elect directors, and minutes to memorialize major decisions (but this may be done by written consent in lieu of a meeting); failing to follow corporate formalities makes it easier for a court to pierce the corporate veil and hold shareholders personally liable. <sup>42</sup>	An annual shareholder meeting is required to elect directors, and minutes to memorialize major decisions (but this may be done by written consent in lieu of a meeting); failing to follow corporate formalities makes it easier for a court to pierce the corporate veil and hold shareholders personally liable. <sup>43</sup>	None required.
<b><i>Taxation on Formation</i></b>			
<i>Taxation on Formation</i>	<p>The corporation's issuance of stock to shareholders in exchange for money, property, or services is not taxable to the corporation.<sup>44</sup></p> <p>Generally, shareholders' receipt of stock in exchange for money or property (not services) is not taxable to the shareholders if immediately after the exchange they are in control of 80% of all shares of stock (otherwise, it is a taxable exchange).<sup>45</sup></p>	<p>The corporation's issuance of stock to shareholders in exchange for money, property, or services is not taxable to the corporation.<sup>48</sup></p> <p>Generally, shareholders' receipt of stock in exchange for money or property (not services) is not taxable to the shareholders if immediately after the exchange they are in control of 80% of all shares of stock (otherwise, it is a taxable exchange).<sup>49</sup></p>	<p>LLC issuance of membership interest to members in exchange for money, property, or services is not taxable to the LLC.<sup>52</sup></p> <p>Generally, members' receipt of a membership interest in exchange for money or property is not taxable.<sup>53</sup></p> <p>Generally, if a member receives an unrestricted and transferable capital interest in exchange for services, the member has taxable income</p>

	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
	<p>A shareholder's receipt of stock in exchange for services is taxable to the shareholder based on the value of the stock received, unless the stock cannot be transferred and there is a substantial risk of forfeiture (e.g., the employee's right to stock ownership is conditional, such as returning the stock if they don't complete service for a certain number of years), in which case such restricted stock will not be taxable income <i>at the time of receipt</i>.<sup>46</sup> However, a shareholder may make a Section 83(b) election to be taxed <i>at the time of receipt</i> on the value of the stock received.<sup>47</sup></p>	<p>A shareholder's receipt of stock in exchange for services is taxable to the shareholder based on the value of the stock received, unless the stock cannot be transferred and there is a substantial risk of forfeiture (e.g., the employee's right to stock ownership is conditional, such as returning the stock if they don't complete service for a certain number of years), in which case such restricted stock will not be taxable income <i>at the time of receipt</i>.<sup>50</sup> However, a shareholder may make a Section 83(b) election to be taxed <i>at the time of receipt</i> on the value of the stock received.<sup>51</sup></p>	<p>based on the value of the membership interest.<sup>54</sup> If the capital interest cannot be transferred and there is a substantial risk of forfeiture (e.g., the member's right to the membership interest is conditional, such as returning the membership interest if they don't complete service for a certain number of years), receipt of the restricted capital interest will not be taxable income <i>at the time of receipt</i>.<sup>55</sup> However, a member may make a Section 83(b) election to be taxed <i>at the time of receipt</i> on the value of the stock received.<sup>56</sup></p> <p>If a member receives only a profits interest (i.e., capital account of zero—meaning only a share of future profits of the LLC), the member does not have taxable income.<sup>57</sup></p>
<i>Tax Basis</i>	<p>The corporation's basis in property received from the shareholder is equal to the shareholder's basis in the property.<sup>58</sup></p> <p>The shareholder's basis in stock is equal to their basis in property contributed to the corporation.<sup>59</sup> Where stock is received in exchange for services, the shareholder's basis in stock equals the value of the stock.</p>	<p>The corporation's basis in property received from the shareholder is equal to the shareholder's basis in the property.<sup>60</sup></p> <p>The shareholder's initial basis in stock is equal to their basis in property contributed to the corporation.<sup>61</sup> The tax basis will increase and decrease with income, loss, and deductions passed through to the shareholder from the corporation, and will decrease with cash distributions to the shareholder (but not below zero).<sup>62</sup> Where stock is received in exchange for services, the shareholder's basis in stock equals the value of the stock.</p>	<p>The LLC's basis in property received from the member is equal to the member's basis in the property.<sup>63</sup></p> <p>The member's initial basis in membership interest is equal to their basis in property contributed to the LLC.<sup>64</sup> The tax basis will increase and decrease with income, loss, and deductions passed through to the member from the LLC, and will decrease with cash distributions to the member (but not below zero).<sup>65</sup> Where membership interest is received in exchange for services and is a capital interest, the member's basis in membership interest equals the value of the membership interest. Where membership interest is received in exchange for services and is</p>

	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
			a profits interest, the member's basis in the membership interest equals zero.
<b><i>Taxation During Operations</i></b>			
<i>Levels of Taxation</i>	Two: The C corporation pays taxes on its income, and shareholders pay taxes on any dividends received from the corporation. <sup>66</sup>	One: The S corporation's income, loss, and deductions pass through to shareholders pro rata based on their ownership percentages and reported on each shareholder's personal income tax return. <sup>67</sup>	One: The LLC's income, loss, and deductions pass through to members pro rata based on their agreed ownership percentages (i.e., allocation) and reported on each member's personal income tax return. <sup>68</sup>  The LLC can elect to be taxed as a C corporation or an S corporation (provided it satisfies S corporation requirements). <sup>69</sup>
<i>Taxable Income</i>	The corporation pays taxes on its income, and shareholders pay taxes on the dividends or other distributions received from the corporation. <sup>70</sup>	Except in unusual circumstances, <sup>71</sup> the S corporation does not pay income taxes; <sup>72</sup> instead, each shareholder is taxed on their pro rata share of the corporation's income based on percentage ownership, whether or not the income is distributed to the shareholders. <sup>73</sup>	Each member is taxed on their allocable share of the LLC's income based on the agreed ownership percentages of members, whether or not the income is distributed to the members. <sup>74</sup>  For N.J. LLCs, each member receives equal distributions, unless otherwise provided in the operating agreement, which may result in each member being taxed on an equal share of the LLC's income.
<i>Distributions to Owners</i>	Distributions to shareholders made from the corporation's earnings and profits are taxed as dividends. <sup>75</sup>  Distributions to shareholders in excess of the corporation's earnings and profits are not taxed but reduce the shareholder's tax basis in stock. Distributions that exceed the shareholder's tax basis are taxed as capital gains. <sup>76</sup>	Distributions to shareholders are tax-free (because shareholders already paid taxes when income was allocated to them pro rata); however, distributions that exceed a shareholder's adjusted tax basis in stock are taxed as capital gains. <sup>77</sup>	Distributions to members are tax-free (because members already paid taxes when income was allocated to them); however, distributions that exceed a member's adjusted tax basis in membership interest are taxed as capital gains. <sup>78</sup>
<i>Special Allocation</i>	Not permitted.	Not permitted. Allocations	Permitted. Allocations are

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<i>of Income Among Owners</i>		are made pro rata based on stock ownership percentages. <sup>79</sup>	made as agreed by members, but allocations must have “substantial economic effect.” <sup>80</sup>  The IRS has several complex tests to determine whether allocations have substantial economic effect, but allocations will pass tests as long as economic effects eventually are the same as the tax effects. <sup>81</sup>
<i>Deductibility of Losses</i>	Losses are deductible at the corporate level (losses do not pass through to shareholders), but losses can be carried forward. <sup>82</sup>	Losses pass through to shareholders, <sup>83</sup> but there are limitations (e.g., loss deductions are limited to tax basis in stock and amount at risk, and passive activity loss rules). <sup>84</sup>	Losses pass through to members, but there are limitations (e.g., loss deductions are limited to tax basis in membership interest and amount at risk, and passive activity loss rules). <sup>85</sup>
<i>Corporate Tax Rates</i>	The federal corporate income tax rate is 21%. <sup>86</sup>  The N.J. corporate income tax rate is 6.5% to 9% on income from N.J. sources. <sup>87</sup> However, in 2024 through 2028, the top rate will increase to 11.5%. <sup>88</sup>	N/A, unless there is a “built-in gains” tax (see “Taxation on Sale of Business,” below).	N/A.
<i>Personal Tax Rates</i>	The federal income tax rate for shareholders is 10% to 37%, <sup>89</sup> but personal qualified dividend tax rates are 0%, 15%, or 20%—depending on filing status and tax bracket <sup>90</sup> —plus a 3.8% net investment income tax if the shareholder has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly. <sup>91</sup>  The N.J. personal income tax rate is 1.4% to 10.75%. <sup>92</sup>	The federal income tax rate for shareholders is 10% to 37%. <sup>93</sup>  Plus, there is a 3.8% net investment income tax if distributions are otherwise taxable and the shareholder has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly. <sup>94</sup>  The N.J. personal income tax rate is 1.4% to 10.75%. <sup>95</sup>	The federal income tax rate for members is 10% to 37%. <sup>96</sup>  Plus, there is a 3.8% net investment income tax if distributions are otherwise taxable and the member has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly. <sup>97</sup>  The N.J. personal income tax rate is 1.4% to 10.75%. <sup>98</sup>
<i>Special Taxes or Rules</i>	There is an accumulated earnings tax on earnings and profits accumulated by the corporation and not distributed to shareholders	To avoid future problems, S corporation status should be elected within two and a half months of formation.	N/A.

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	(to avoid taxes on dividends), which is intended to encourage payment of dividends. <sup>99</sup>	All shareholders must consent to S corporation election (S corporation status may be revoked with consent of shareholders owning more than 50% of shares). <sup>100</sup>	
<i>Accounting Method</i>	The accrual method is required (recognize income when earned, not when cash is received), unless gross revenues are below \$25 million per year (or the corporation is a qualified personal service corporation). <sup>101</sup>	Generally, the accrual method or cash method is required, but the accrual method is required when goods are sold from inventory. <sup>102</sup>	Generally, the accrual method or cash method is required, but the accrual method is required when goods are sold from inventory <sup>103</sup> or there is a C corporation as a member and the LLC has gross revenues of more than \$25 million per year. <sup>104</sup>
<i>Tax Returns</i>	The corporation files Form 1120; if dividends are paid, it provides Form 1099 to shareholders.	The corporation files Form 1120S (information return) and provides Schedule K-1 to shareholders for their pro rata share of income and other items.	The multimember LLC files Form 1065 (information return) and provides Schedule K-1 to members for their allocable share of income and other items.  The single-member LLC is a disregarded entity, and no tax return is filed by the LLC (all income and other items are reported on the member's personal tax return).
<b><i>Taxation on Termination</i></b>			
<i>Taxation on Sale of Business</i>  (see below for tax rates on ordinary income and long-term capital gains)	<p>Sale of stock: Shareholders pay income taxes on gain resulting from the sale of stock (i.e., sale proceeds less tax basis).</p> <p>Sale of assets: The corporation pays income taxes on gain resulting from the sale of assets, and shareholders pay income taxes on gain from sale proceeds received from the corporation.</p>	<p>Sale of stock: Shareholders pay income taxes on gain resulting from the sale of stock (i.e., sale proceeds less adjusted tax basis).</p> <p>Sale of assets: The corporation does not pay income taxes on gain resulting from the sale of assets (which can be ordinary or capital gain, based on the nature of asset); the gain passes through to shareholders, who pay income taxes on their personal tax returns. However, the corporation may have to pay "built-in gains" tax if the corporation was a C corporation and</p>	<p>Sale of membership interest: Members pay income taxes on gain resulting from the sale of interest (i.e., sale proceeds less adjusted tax basis); some gain may be taxed as ordinary income and not as capital gains.</p> <p>Sale of assets: The LLC does not pay income taxes on gain resulting from the sale of assets (which can be ordinary or capital gains, based on the nature of asset); the gain passes through to members, who pay income taxes on their personal tax returns.</p>



	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
		converted to an S corporation within five years of the sale.	
<i>Tax-Free Reorganizations</i>	<p>The corporation can merge with another corporation, generally resulting in tax-free treatment to the corporation and shareholders.<sup>105</sup></p> <p>Other types of tax-free reorganizations<sup>106</sup> are beyond the scope of this article.</p>	<p>The corporation can merge with another corporation, generally resulting in tax-free treatment to corporations and shareholders,<sup>107</sup> but a merger can result in the loss of S corporation status based on the number or type of shareholders.</p> <p>Other types of tax-free reorganizations<sup>108</sup> are beyond the scope of this article.</p>	Note: The tax treatment of mergers involving LLCs is complex, may have varying tax treatments, and is beyond the scope of this article.
<i>Liquidation</i>	<p>The corporation recognizes gain or loss, and pays taxes, on distribution of property to shareholders as if it sold property at fair market value.<sup>109</sup></p> <p>Distributions to shareholders are treated as if shareholders sold their stock.<sup>110</sup></p>	<p>The corporation recognizes gain or loss on distribution of property to shareholders as if it sold property at fair market value, but gain or loss passes through to shareholders, and each shareholder's tax basis in their stock is adjusted (which in effect results in one level of taxation).<sup>111</sup></p> <p>Distributions to shareholders are treated as if shareholders sold their stock.<sup>112</sup></p>	<p>The LLC may sell its assets and distribute cash to members, who would recognize a gain to the extent the distribution exceeds their adjusted tax basis in their membership interest.<sup>113</sup></p> <p>The LLC may distribute its property (i.e., assets) to each member, and the member's tax basis in property would be equal to the LLC's tax basis in such property.<sup>114</sup></p>
<i>Long-Term Capital Gains Tax Rates</i>  (for assets held for one year or longer; otherwise, short-term capital gain, which is taxed at ordinary income tax rates)	<p>The federal capital gains tax rate for shareholders is 0%, 15%, or 20%—depending on filing status and tax bracket<sup>115</sup>—plus 3.8% net investment income tax if the shareholder has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>116</sup></p> <p>Note that there are no capital gains tax rates for C corporations; such gain is taxed as ordinary income.<sup>117</sup></p>	<p>The federal capital gains tax rate for shareholders is 0%, 15%, or 20%—depending on filing status and tax bracket<sup>118</sup>—plus 3.8% net investment income tax if the shareholder has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>119</sup></p>	<p>The federal capital gains tax rate for members is 0%, 15%, or 20%—depending on filing status and tax bracket<sup>120</sup>—plus 3.8% net investment income tax if the shareholder has modified adjusted gross income over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>121</sup></p>
<b>Compensation</b>			

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<i>Wages</i>	Shareholders who are employees pay income taxes on wages received from the corporation; the shareholder-employee will receive a Form W-2 for wages.	Shareholders who are employees pay income taxes on wages received from the corporation; the shareholder-employee will receive a Form W-2 for wages.	Although members can provide services to an LLC, legally they cannot be employees. <sup>122</sup> Compensation for such services is often known as a “guaranteed payment” <sup>123</sup> (because members are entitled to such payment even if the LLC does not make a profit) and is reported on a member’s Schedule K-1.
<i>IRS Tests</i>	The corporation may deduct <i>reasonable</i> compensation paid to the shareholder-employee, but the IRS may determine that <i>excessive</i> compensation was paid to the shareholder to avoid double taxation and a portion should have been paid as dividends, which are not deductible. <sup>124</sup>	The corporation cannot pay excessive dividends instead of compensation to the shareholder-employee to avoid employment taxes because the IRS may determine that compensation paid to the shareholder-employee is <i>inadequate</i> and impute additional wages to the shareholder. <sup>125</sup>	N/A.
<i>Withholding and Employment Taxes</i>	<p>The corporation is required to withhold federal and state income taxes and the employee’s portion of Social Security and Medicare taxes from the employee’s compensation.<sup>126</sup></p> <p>The corporation pays one-half of employment taxes.<sup>127</sup> The employee pays one-half of employment taxes like any other employee, plus a 0.9% Medicare tax if the employee’s compensation income is over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>128</sup></p> <p>The corporation must pay federal unemployment tax (FUTA tax).<sup>129</sup></p>	<p>The corporation is required to withhold federal and state income taxes and the employee’s portion of Social Security and Medicare taxes from the employee’s compensation.<sup>130</sup></p> <p>The corporation pays one-half of employment taxes.<sup>131</sup> The employee pays one-half of employment taxes like any other employee, plus a 0.9% Medicare tax if the employee’s compensation income is over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>132</sup></p> <p>Dividends and other distributions to shareholders are not considered compensation for employment tax purposes (and, therefore, are not subject to taxes under the Federal Insurance Contributions Act (“FICA”)).<sup>133</sup></p>	<p>The LLC is not required to withhold (except in the case of foreign members); instead, members pay estimated taxes.<sup>135</sup></p> <p>Members pay self-employment taxes (i.e., employer and employee portions of Social Security and Medicare taxes) on guaranteed payments,<sup>136</sup> plus a 0.9% Medicare tax if the member’s compensation income is over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>137</sup></p> <p>A member who is “active” in the business of the LLC pays self-employment taxes on their allocable share of income, even if the member does not receive a cash distribution and even if the member does not receive a guaranteed payment (i.e., salary),<sup>138</sup> plus a 0.9% Medicare tax if the member’s compensation</p>

	<b>C Corporation</b>	<b>S Corporation</b>	<b>LLC</b>
		The corporation must pay federal unemployment tax (FUTA tax). <sup>134</sup>	<p>income is over \$200,000 if filing single and \$250,000 if married filing jointly.<sup>139</sup></p> <p>Members are “active” if (i) they can be held personally liable for the debts of the LLC, (ii) they work more than 500 hours per year in the LLC’s business, <u>or</u> (iii) they have authority to legally bind the LLC to contract with a third party.<sup>140</sup></p> <p>Inactive (or limited) members are not subject to self-employment taxes (other than guaranteed payments).<sup>141</sup></p> <p>Members are not subject to federal unemployment tax (FUTA tax).<sup>142</sup></p>
<i>Employee Benefits</i>	<p>The shareholder must be a paid employee to receive employee benefits.<sup>143</sup></p> <p>Generally, these benefits are not taxed to the shareholder-employee and are deductible expenses for the corporation.<sup>144</sup></p>	<p>The shareholder must be a paid employee to receive employee benefits.<sup>145</sup></p> <p>For a shareholder-employee who owns more than 2% of the corporation, some benefits are taxable and are not deductible expenses for the corporation.<sup>146</sup></p>	<p>The member must provide services to the LLC to receive “employee” benefits, and payment of such benefits is generally considered guaranteed payments (i.e., salary) to the member.<sup>147</sup></p> <p>Such benefits are taxable to the member as a guaranteed payment and may or may not be deductible expenses for the LLC.<sup>148</sup></p>

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<sup>1</sup> N.J. STAT. ANN. § 14A:5-30. (All citations to [New Jersey Statutes](#) are current through L. 2024, c. 109, effective Jan. 13, 2025.)

<sup>2</sup> 26 U.S.C. § 11(a) (hereinafter “I.R.C.”). (All citations to the [I.R.C.](#) are current through P.L. 119-1, effective Jan. 29, 2025.)

<sup>3</sup> See N.J. STAT. ANN. § 14A:2-7(1)(d), (e).

<sup>4</sup> *Id.* §§ 14A:5-2, 14A:6-3(1).

<sup>5</sup> *Id.* § 14A:7-12.

<sup>6</sup> *Id.* § 14A:5-30.

<sup>7</sup> I.R.C. § 1361(b)(1)(A).

<sup>8</sup> See N.J. STAT. ANN. § 14A:2-7(1)(d), (e).

<sup>9</sup> *Id.* §§ 14A:5-2, 14A:6-3(1).

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<sup>10</sup> I.R.C. §§ 1361(b)(1)(D), 1361(c)(4).  
<sup>11</sup> *Id.* §§ 1363(a), 1366.  
<sup>12</sup> *Id.* §§ 1361(b)(1)(B), 1361(b)(1)(C).  
<sup>13</sup> *Id.* § 1366; *see* Knott v. Comm’r, T.C.M. 1991-352 (“We find the legislative history to be unequivocally clear in its direction that income of the S corporation need not be distributed in order to be included in the taxable income of the shareholders.”).  
<sup>14</sup> N.J. STAT. ANN. § 42:2C-30(a).  
<sup>15</sup> *Id.* § 42:2C-31(c).  
<sup>16</sup> *See, e.g., id.* § 42:2C-37(a).  
<sup>17</sup> I.R.C. §§ 1401, 1402(a).  
<sup>18</sup> *Id.* §§ 701, 702, 704(a) (partnerships); Treas. Reg. §§ 301.7701-2(a) (disregarded entities), 301.7701-3(a) (election eligibility). (All citations to the [U.S. Treasury regulations](#) are current through Feb. 28, 2025.)  
<sup>19</sup> I.R.C. §§ 702(a), 706(a); *see also* United States v. Basye, 410 U.S. 411, 453 (1973) (partnerships) (“Few principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share.”); Treas. Reg. § 301.7701-2(a) (disregarded entities).  
<sup>20</sup> N.J. STAT. ANN. § 42:2C-30(b).  
<sup>21</sup> *Id.* § 14A:2-7(2).  
<sup>22</sup> *Id.*  
<sup>23</sup> *Id.* § 42:2C-18(a).  
<sup>24</sup> I.R.C. §§ 1361(b)(1)(A), 1361(c).  
<sup>25</sup> *Id.* §§ 1361(b)(1)(B), 1361(b)(1)(C).  
<sup>26</sup> *Id.* §§ 1361(b)(1)(D), 1361(c)(4).  
<sup>27</sup> N.J. STAT. ANN. § 14A:5-30.  
<sup>28</sup> *Id.*  
<sup>29</sup> *Id.* § 42:2C-30(a).  
<sup>30</sup> *Id.* § 14A:7-12(2).  
<sup>31</sup> *Id.*  
<sup>32</sup> *Id.* § 42:2C-31(c).  
<sup>33</sup> *Id.* §§ 14A:6-1, 14A:6-15.  
<sup>34</sup> *Id.* §§ 14A:6-1, 14A:6-15.  
<sup>35</sup> *Id.* § 42:2C-37.  
<sup>36</sup> *Id.* §§ 14A:6-1(1), 14A:6-15(4).  
<sup>37</sup> *Id.* §§ 14A:6-1(1), 14A:6-15(4).  
<sup>38</sup> *Id.* § 42:2C-37.  
<sup>39</sup> *Id.* §§ 14A:5-10, 14A:5-11(1).  
<sup>40</sup> *Id.* §§ 14A:5-10, 14A:5-11(1).  
<sup>41</sup> *Id.* § 42:2C-37(b)(2).  
<sup>42</sup> *Id.* §§ 14A:5-2, 14A:6-3(1).  
<sup>43</sup> *Id.* §§ 14A:5-2, 14A:6-3(1).  
<sup>44</sup> I.R.C. § 1032(a).  
<sup>45</sup> *Id.* § 351(a).  
<sup>46</sup> *Id.* §§ 83(a), 351(d). The tax consequences upon vesting of restricted stock are beyond the scope of this article.  
<sup>47</sup> *Id.* § 83(b).  
<sup>48</sup> *Id.* § 1032(a).  
<sup>49</sup> *Id.* § 351(a).  
<sup>50</sup> *Id.* §§ 83(a), 351(d). The tax consequences upon vesting of restricted stock are beyond the scope of this article.  
<sup>51</sup> *Id.* § 83(b).  
<sup>52</sup> *Id.* § 721.  
<sup>53</sup> *Id.*  
<sup>54</sup> Treas. Reg. § 1.721-1(b)(1).  
<sup>55</sup> I.R.C. § 83(a).  
<sup>56</sup> *Id.*  
<sup>57</sup> Rev. Proc. 93-27, 1993-2 C.B. 343, *as clarified by* Rev. Proc. 2001-43, 2001-34 I.R.B. 191.  
<sup>58</sup> I.R.C. § 362(a).  
<sup>59</sup> *Id.* § 358.

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<sup>60</sup> *Id.* § 362(a).

<sup>61</sup> *Id.* § 358.

<sup>62</sup> *Id.* § 1367.

<sup>63</sup> *Id.* § 723.

<sup>64</sup> *Id.* § 722.

<sup>65</sup> *Id.* § 705.

<sup>66</sup> *Id.* §§ 11(a), 61(a)(7).

<sup>67</sup> *Id.* § 1366.

<sup>68</sup> *Id.* §§ 701, 702.

<sup>69</sup> Treas. Reg. § 301.7701-3(a).

<sup>70</sup> I.R.C. §§ 11(a), 61(a)(7).

<sup>71</sup> *See, e.g., id.* §§ 1375(a) (relating to excess net passive income); 1374 (relating to the built-in gains tax).

<sup>72</sup> *Id.* § 1363(a).

<sup>73</sup> *Id.* § 1366; *see* Knott v. Comm’r, T.C.M. 1991-352 (“We find the legislative history to be unequivocally clear in its direction that income of the S corporation need not be distributed in order to be included in the taxable income of the shareholders.”).

<sup>74</sup> I.R.C. §§ 702(a), 706(a); *see also* United States v. Basye, 410 U.S. 411, 453 (1973) (“Few principles of partnership taxation are more firmly established than that no matter the reason for nondistribution each partner must pay taxes on his distributive share.”).

<sup>75</sup> I.R.C. §§ 301(c), 316(a).

<sup>76</sup> *Id.* § 301(c).

<sup>77</sup> *Id.* § 1368.

<sup>78</sup> *Id.* § 731.

<sup>79</sup> *Id.* § 1366.

<sup>80</sup> *Id.* § 704(b).

<sup>81</sup> *See, e.g.,* Treas. Reg. § 1.704-1.

<sup>82</sup> I.R.C. § 172.

<sup>83</sup> *Id.* § 1366.

<sup>84</sup> *Id.* §§ 465, 469, 1366(d).

<sup>85</sup> *Id.* §§ 465, 469, 704(d).

<sup>86</sup> *Id.* § 11(b).

<sup>87</sup> N.J. ADMIN. CODE § 18:7-3.6 (current through [New Jersey Register](#), Vol. 57, No. 6, March 17, 2025.)

<sup>88</sup> N.J. STAT. ANN. § 54:10A-5.41a. The “Corporate Transit Fee” of 2.5 percent applies to annual New Jersey allocated taxable net income greater than \$10 million during tax years 2024 through 2028, increasing the top tax rate from 9 percent to 11.5 percent.

<sup>89</sup> I.R.C. § 1. Current single individual tax rates can be found at [Federal Income Tax Rates and Brackets](#), IRS.GOV (last updated Feb. 13, 2025).

<sup>90</sup> I.R.C. § 11(h)(11) (“qualified dividends”).

<sup>91</sup> *Id.* § 1411.

<sup>92</sup> N.J. STAT. ANN. § 54:2-1(a)(7), (b)(7).

<sup>93</sup> I.R.C. § 1. Current single individual tax rates can be found at *Federal Income Tax Rates and Brackets*, *supra* note 89.

<sup>94</sup> I.R.C. § 1411.

<sup>95</sup> N.J. STAT. ANN. § 54:2-1(a)(7), (b)(7).

<sup>96</sup> I.R.C. § 1. Current single individual tax rates can be found at *Federal Income Tax Rates and Brackets*, *supra* note 89.

<sup>97</sup> I.R.C. § 1411.

<sup>98</sup> N.J. STAT. ANN. § 54:2-1(a)(7), (b)(7).

<sup>99</sup> I.R.C. § 531.

<sup>100</sup> *Id.* § 1362.

<sup>101</sup> *Id.* § 448.

<sup>102</sup> Treas. Reg. § 1.446-1(c)(2).

<sup>103</sup> *Id.*

<sup>104</sup> I.R.C. § 448(a)(2).

<sup>105</sup> *Id.* §§ 354, 361, 368, 1032(a).

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<sup>106</sup> *See id.* § 368(a).

<sup>107</sup> *Id.* §§ 354, 361, 368, 1032(a).

<sup>108</sup> *See id.* § 368(a).

<sup>109</sup> *Id.* § 336; *see also id.* § 337 (nonrecognition treatment in the case of a corporate shareholder).

<sup>110</sup> *Id.* § 331; *see also id.* § 332 (nonrecognition treatment in the case of a corporate shareholder).

<sup>111</sup> *Id.* §§ 336, 1367; Treas. Reg. § 1.1367-1(d)(1).

<sup>112</sup> I.R.C. § 331.

<sup>113</sup> *Id.* § 731.

<sup>114</sup> *Id.* § 732.

<sup>115</sup> *Id.* § 1(h).

<sup>116</sup> *Id.* § 1411.

<sup>117</sup> *Id.* § 11(a).

<sup>118</sup> *Id.* § 1(h).

<sup>119</sup> *Id.* § 1411.

<sup>120</sup> *Id.* § 1(h).

<sup>121</sup> *Id.* § 1411.

<sup>122</sup> Rev. Rul. 69-184, 1969-1 C.B. 256.

<sup>123</sup> I.R.C. § 707(c).

<sup>124</sup> *Id.* § 162; Treas. Reg. § 1.162-7(a).

<sup>125</sup> *See, e.g.,* Rev. Rul. 74-44, 1974-1 C.B. 287; *Joseph Radtke v. United States*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd per curiam*, 895 F.2d 1196 (7th Cir. 1990); *Watson v. United States*, 757 F. Supp. 2d 877 (S.D. Iowa 2010), *aff'd*, 668 F.3d 1008 (8th Cir. 2012).

<sup>126</sup> I.R.C. § 3102.

<sup>127</sup> *Id.* § 3111.

<sup>128</sup> *Id.* § 3101.

<sup>129</sup> *Id.* § 3301.

<sup>130</sup> *Id.* § 3102.

<sup>131</sup> *Id.* § 3111.

<sup>132</sup> *Id.* § 3101.

<sup>133</sup> The FICA tax is imposed on “wages,” as defined under I.R.C. § 3121.

<sup>134</sup> I.R.C. § 3301.

<sup>135</sup> *Id.* § 6654.

<sup>136</sup> Treas. Reg. § 1.1402(a)-1(b).

<sup>137</sup> I.R.C. § 3101.

<sup>138</sup> *Id.* § 1402(a).

<sup>139</sup> *Id.* § 3101.

<sup>140</sup> Prop. Treas. Reg. § 1.1402(a)-2. Please note that proposed regulations generally may not be relied upon by taxpayers, unless they contain an express statement permitting reliance, and are not binding on taxpayers or the courts. Prop. Treas. Reg. § 1.1402(a)-2 does not contain a reliance statement. However, the Internal Revenue Service (“IRS”) has a general policy of not taking litigation positions that “would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations.” IRM 32.1.1.2.2(3) (Aug. 2, 2018). Additionally, the *Internal Revenue Manual* provides that “[i]f there are no final or temporary regulations currently in force addressing a particular matter, but there are proposed regulations on point, the Office of Chief Counsel generally should look to the proposed regulations to determine the office’s position on the issue.” *Id.*

<sup>141</sup> I.R.C. § 1402(a)(13).

<sup>142</sup> Rev. Rul. 69-184, 1969-1 C.B. 256.

<sup>143</sup> *See, e.g.,* I.R.C. §§ 125, 132; Prop. Treas. Reg. § 1.125-1(a)(1); Treas. Reg. § 1.132-1.

<sup>144</sup> *See, e.g.,* I.R.C. §§ 119, 125, 132, 162(a); Treas. Reg. § 1.162-10(a).

<sup>145</sup> *See, e.g.,* I.R.C. §§ 125, 132; Prop. Treas. Reg. § 1.125-1(a)(1); Treas. Reg. § 1.132-1.

<sup>146</sup> *See, e.g.,* I.R.C. §§ 79, 105, 106, 119, 132(f), 1372(a). Additionally, Proposed Treasury Regulation § 1.125-1(g)(2) would apply to prohibit 2 percent shareholders from participating in a cafeteria plan.

<sup>147</sup> *See, e.g.,* I.R.C. § 132; Treas. Reg. § 1.132-1. *But see* Prop. Treas. Reg. § 1.125-1(g)(2) (prohibiting partners from participating in cafeteria plans); Rev. Rul. 91-26, 1991-1 C.B. 184; Notice 2005-8, 2005-4 I.R.B. 368.

<sup>148</sup> *See, e.g.,* Rev. Rul. 91-26, 1991-1 C.B. 184; Notice 2005-8, 2005-4 I.R.B. 368; I.R.C. § 106.