

LLC vs. S-corp: how do I get up to speed?

I have a prospective client coming in for a brief consultation on the benefits of an LLC vs. an S-corp. He is getting ready to partner up with four other people, and they're insisting on S-corp. I know that the two aren't necessarily mutually exclusive.

I want to put together a brochure, because I figure this is a question I will be getting often. Does anyone have a starting point that cites to statutes and IRS regs? I have some basics down from law school and Google, but I want to see the laws for myself.

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Choice of entity presentations in CLE for your area can provide good insight. CCH has some good choice of entity discussions that are not state specific.

Darrell G. Stewart, Texas

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On the tax implications of partnership vs s corp taxation, look at the publications on irs.gov; several major law firms have articles on the choice of entity topic on their website that you can find through a Google search. Those sources would be free and quick to access. State bar CLE materials or ABA CLE materials would be the next place I'd look if you're not finding what you want.

Patricia C. Meringer, Florida

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Do yourself and your client a favor: Refer the client to someone who already has the relevant expertise.

Steven Finell, California

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"Do yourself and your client a favor: Refer the client to someone who already has the relevant expertise."

From time to time I see this type of advice, which often makes me pause -- how would a young attorney (or someone expanding into a new practice area) is supposed to ever gain experience/start practicing law? This is a type of matter that many solos/small firm lawyers often handle; we are not talking here about a catastrophic injury case or capital murder case, right?

Ekaterina Schoenefeld, New Jersey

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True, however, the choice of the wrong type of entity can sometimes lead to dire tax consequences, for example, I have seen what could have been avoidable tax liabilities in the tens of millions which resulted from real estate being dropped into a C-corporation.

Brian Yacker, California

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Gaining experience is best done through mentorship, CLE's, etc. Do not discount the impact of inadequate legal advice. It doesn't have to be fatal to be catastrophic. That's like saying, "How's a young doctor supposed to figure out how to do surgery? Don't refer to an experienced surgeon, just google the procedure. What's the worst that can happen?" Our first duty should be to the potential client, not the learning curve of the practitioner.

There is a lot of misleading information on the internet. I spent significant portions of my bankruptcy consultations re-educating clients who have decided that Google should be relied upon for accurate and complete legal information.

People are paying for accurate information. If the attorney doesn't have it, it is in the client's interest to refer out.

I too have seen the unfortunate side of inadequate business formation advice. Reorganizing a sole proprietor is far easier and more economical than with an entity. I have had potential clients lose significant assets because their accountant told them they should be an LLC, without even considering the viability of the entity. I assure you that any benefit of entity formation was clearly trumped by the loss of assets in a bankruptcy.

Michelle Kainen, Vermont

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Ditto what Michelle and Brian said. While it is called the practice of law, there has to be a limit. There is a big difference between being "inexperienced" at actually doing the work (but having spent more than enough CLE hours and self-studying hours) and trying to figure it out the law for the first time with a real case/client by googling or literally reading a couple of articles (no matter how good they are).

Veronica Alicia Silva, Illinois

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I agree with Ekaterina - how are new solos to get clients? This is very troubling to me. Twenty years ago when I started my practice, I didn't know any solos who hadn't practiced law for at least 3 or 4 years. Today, I routinely receive emails from solos right out of school or following a short clerkship. There simply aren't many jobs.

Meanwhile, many of the trends in the legal profession favor experienced lawyers. That \$39/hr phone call service that Avvo just launched is potentially a source of cash of a lawyer with a couple of years under his or her belt who can answer the question in short order. But a new solo could require hours to respond. Likewise, new services - like Legal Zoom's lawyer review or UpCounsel, Law Trades and Priori Legal all want lawyers with 5-10 years of experience.

Perhaps the better response would be advice on how to find a competent lawyer to mentor this fellow through the process.

Carolyn Elefant, District of Columbia

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Selecting the LLC format compared with other entities is something that almost every young lawyer should learn. I read recently that in Minnesota, as an example, formation of LLCs outnumbered corporations by six to one.

Might as well get started. I've heard that law school training is surprisingly weak on LLCs.

Mentoring is good, but I think CLE by professionals is the way to learn quickly. I personally like the online offerings of Lawline, especially since I can buy package deals and watch them at my convenience.

Norm Solberg, Japan

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I don't know if this has changed since, but when I graduated in 2011, we spent almost 2 whole days on LLCs in my bizorg class. I had another professor who talked about them a little more (an adjunct, who was also practicing) and he warned me that I would need to know about them when I got into practice. The fact that they never talked about LLCs in the classes was part of his pet peeve w/r/t/ legal scholarship.

Justin Meyer, New York

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I want to clarify the point I was trying to make. I am not saying new solos should not get clients and refer them out. I just find that many lawyers, young or not, are somewhat cavalier about doing work in areas of the law they know very little about. That is the point I was trying to make, and I think that is also what Michelle and Brian were saying.

I am not saying Mathew was being cavalier, my point was to stress that he

needs to be careful and prepare. It's not about newbies not taking the client, or declining right away, it's just about being thorough and responsible practitioner, who researches and studies the law to advise clients accurately. To many of us, that should be a given. I used to think that, with rare exceptions, lawyers "practiced" law that way (responsibly, being thorough, treading with caution). However, the longer I am in practice, the less rare those exceptions seem.

Some areas of the law are more complex than others and attorneys (young and seasoned ones) should be mindful of that and prepare properly (CLEs, find a good mentor, self-study) \*before\* handling a matter for a client (as opposed to taking a client in a new area with bare bones basic knowledge of it and try to learn most of it while representing their first client).

Corporate taxation is up there among the really technical ones in which small mistakes can be highly costly and catastrophic to the client. Same is my guess about patent law and estate planning. Same is my area (ERISA/QDROs). Almost every week I will come across an attorney with plenty years of experience who has handled a few QDROs in his/her career and feels competent to make such assertive statements that are utterly wrong (or draft QDROs with the word "excluded" instead of "included" that will cost their client over \$10,000). Luckily for them, their clients will most likely never find out. Not even the popular 3-day intensive seminar on ERISA basics can prepare a practitioner to do what I do responsibly. You need to pack several hours of self-studying and several more shadowing an experienced practitioner (Nicole, if you are reading this, this is something I was planning to say to you when we talk tomorrow).

To Carolyn's point on the trend in the legal profession favoring

experienced lawyers, I completely agree. Why is it that lawyers are not required to complete something similar to a doctor's residency requirement?

I have friends who are lawyers in Germany. After law school, before their bar exam, they have to go through something like a two year rotation completing various internships (clerking for a judge, working with a practitioner, supervised pro-bono work, etc.) similar to a doctor's residency. I was jealous of that when I was starting my career. There is a new project here of the Chicago Bar Foundation called Justice Entrepreneurs Project. Hopefully there will be more like this across the country  
<http://chicagobarfoundation.org/jep/>

Veronica Silva

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Vermont used to have a six month clerkship requirement that had to be completed before being sworn in. That has been eroded over the years because it was viewed as unfair for those who were working for peanuts (or free) for six months to get their clerkship requirement met. Then there were those who could not find a clerkship situation and it was a complete barrier to admission. Those who were waiving in were particularly unhappy about it. For those waiving in I could understand, however I was disappointed to see such a lack of recognition of the value that the program provided to new graduates.

Michelle Kainen

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"Gaining experience is best done through mentorship, CLE's, etc. Do not discount the impact of inadequate legal advice. It doesn't have to be fatal to be catastrophic. That's like saying, "How's a young doctor supposed to figure out how to do surgery? Don't refer to an experienced surgeon, just google the procedure."

Michelle (and others),

Nowhere in my post did I suggest that a new attorney should "just google" and do it. Neither did I imply that giving an inadequate legal advice is okay. (By the way, if the "LLC vs. S-Corp" question is analogized with doing a surgery, then what would be a proper "doctor" analogy for a death penalty case?)

I completely agree with you that "gaining experience is best done through mentorship, CLE's, etc." However, this is not always feasible. I don't think it is realistic for a new/young attorney who recently opened his/her office just do nothing but read books and go to CLEs on various subjects -- all without taking any clients. We all have bills to pay, right?

Similarly, "learning through mentorship" is great but it is not necessarily easy. While many bar associations do offer now mentorship programs (of varying quality), finding a good mentor is not always easy or may take some time.

The original question was "how do I get up to speed"? In my view, recommending a good book/CLE/treatise or even offering to speak 10-15 minutes on the phone about a specific matter/question would have been far more helpful. I have seen on Solosez a great range and variety of substantive law questions asked and answered by lawyers from various



backgrounds/levels of experience, which is great. (I believe, in a way, this list serves as a mentorship resource). But when, once in a while, I see the "do a favor, refer it out" type of advice to a young attorney or someone new to a particular practice area, I think it is rather discouraging.

Ekaterina Schoenefeld

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All you new solos reading these threads, without experience might as well quit or find a job then!!!

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Millions of new lawyers have handled cases without the requisite experience. Just jump in knowing you don't know everything.

From what I've heard, insurance defense firms throw their new lawyers right into trial. Sink or swim.

Matthew, I get this question all of the time (used to be a small business/formation attorney before jumping into personal injury). The differences will be state specific. You didn't list your state (you should) but I see you're in Arkansas?

Prospects are most impressed when I tell them, there is no such thing as an S-Corp (sort of). You can't go to your Secretary of State office and form an S-Corp. Subchapter S and Subchapter C are IRS elections. Corporations

vs. LLC's is a state specific issue. For example, in California we have Statutory Close Corporations which minimize a lot of the formalities required of regular corporations. LLC's on the other hand don't have that many formalities at all. LLCs are flexible. LLC's may or may not have higher fees/state taxes.

So the decision is 2 level. Decide which entity you want, based on Arkansas rules/laws/procedures. Then decide how it's taxed. Most of the time, if they choose a corporation, most small companies are not going to want to be taxed under Sub-Chapter C. So it's (1) Form Corporation under state law. (2) Choose Subchapter S with the IRS. Must be done within 90 days or something.

IF they choose an LLC, they can leave it alone and it'll be taxed as a pass through entity (sole prop/partnership), but you can also elect to tax it under Subchapter S, just like a corporation. There are some differences between pass-through taxation and Subchapter S taxation, even though it's mostly pass through. Google for differences (self-employment tax on distributions being the biggy).

Joseph D. Dang, California

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You can absolutely do this yourself. In addition to the tax issues (well covered here) I also talk to clients about the "soft" issues -- do they want a board of directors? the formalities of the corporate form? Do they loathe the idea of forced meetings? Will anyone ever take notes? And the

tax benefit of an S Corp sounds great, but it depends on how much money you will actually make. Maybe all the work of doing payroll isn't worth it because the client won't earn enough money.

Nanci Bockelie, Utah

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Thank you for the encouragement and the key things to look for. I will only be representing this partner, and it sounds like everyone else is going to have attorneys. Does that come with any subtle tactical considerations? One concern of mine is that people may try to test me, to the detriment of my client. Which may be paranoia speaking because this is a group of friends, so it sounds like an easy negotiation to make sure everyone is happy.

I figure that I will ask my prospective client his preferences and do my best to protect him and his interests.

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In my experience, the AZ Rule ER 1.1 and similar versions are always helpful to new practitioners. The shorthand version I learned was: Get competent through study; Or Associate with competent experienced counsel; Or punt and refer it out.

Also see the relevant comment from Arizona's ER 1.1 Duty of Competence:

2] A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly-admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.

Mauricio Ramon Hernandez, Arizona

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You need to partner up with someone who knows what they're doing. The last thing you want is to be in a room full of experienced lawyers and realize you have no idea what they're discussing. You'll look bad in front of the client and the other lawyers, which will hurt you doubly. Moreover, you will put your client at a disadvantage because you won't know the subtleties of the entities.

Yes, an LLC is a disregarded entity for tax purposes, but some states (such as California) tax them. Others (such as Illinois) charge prohibitive annual fees (\$250+ per year; \$500 to form). S-Corporations have a 'reasonable compensation' requirement for shareholder/employees that has bitten more than one person. And if your client is not actively involved, the 3.9% Net Investment Income tax (or if they are, the additional .9%

Medicare tax) could apply. But that will depend upon how much income there is. So there are a lot of nuances to know (and other things, like how to respond to "Hey...let's form in Nevada, so there's no income tax, and we can have annual meetings in Vegas paid for by the company!" [Short answer: you don't avoid state income tax by forming in Nevada, unless you only do business in Nevada]).

Friends are the worst people to do business with. Remember college? Remember how the rule was (or at least it was when I was in college) "never room with your best friend?" Because if you do, you'll wind up hating each other (and at least 3 close friends roomed together on my dorm floor; all three hated each other profusely by the end of the first semester, and switched roommates for the second semester). Well, business is the same way - all friends and fun, loosey-goosey until someone says "Hey, Bob's getting a bigger share than I am," and look out. Then the lax record-keeping, and don't-worry-about-it-it-all-washes-out attitudes will catch up, and costs will spiral, litigation will ensue, and blood will spill.

Good luck. It's not that you can't do this, it's just that you're not in a position to do this alone.

Greg Zbylut, California

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One correction to Greg's post. An LLC may be treated as a disregarded entity if it qualifies, however it is a pass-through entity. Those are two entirely different things.

Michelle Kainen

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"Which may be paranoia speaking because this is a group of friends, so it sounds like an easy negotiation to make sure everyone is happy."

No, you're right to be paranoid about a group of friends going into business together. This is a recipe for disaster when personal feelings go sour in a business context. Feelings get hurt more easily, etc.

One piece of advice is to be very clear about who your client is (the one person, not the other potential business partners or the to-be-formed entity). Then be clear again, and again.

Find yourself a CLE along these lines, even if you don't get CLE credit for it (I've not taken this one):

[http://www.nbi-sems.com/Details.aspx/LLC-vs-INC-Which-Entity-is-Best-for-Small-Business-Clients-Audio-CD-Course-Book/R-62457CDRA%7C?NavigationDataSource1=Ntk:TitleLocation2%7cllc+corporation%7c3%7c,Ny:True,Rpp:20,Ro:0,Nra:pEventDate%2bpEventStartTime%2bCredit+Hours%2bpCreditRecordCreditHours%2bCredit\\_C2%2bpStandardPrice%2bSeminar+Location%2bScope+of+Content%2bpLocationCity%2bpDescription%2bpDivision%2bpProductId%2bpProductDescription%2bProductCode+\(HIDDEN\)%2bpAdditionalFormats%2bpEventId%2bpAltSpaceDesc%2bpEventIndicator](http://www.nbi-sems.com/Details.aspx/LLC-vs-INC-Which-Entity-is-Best-for-Small-Business-Clients-Audio-CD-Course-Book/R-62457CDRA%7C?NavigationDataSource1=Ntk:TitleLocation2%7cllc+corporation%7c3%7c,Ny:True,Rpp:20,Ro:0,Nra:pEventDate%2bpEventStartTime%2bCredit+Hours%2bpCreditRecordCreditHours%2bCredit_C2%2bpStandardPrice%2bSeminar+Location%2bScope+of+Content%2bpLocationCity%2bpDescription%2bpDivision%2bpProductId%2bpProductDescription%2bProductCode+(HIDDEN)%2bpAdditionalFormats%2bpEventId%2bpAltSpaceDesc%2bpEventIndicator)

There are a lot of providers out there with these kinds of courses. I am sure there is one in Arkansas.

Good luck,

Dineen Pashoukos Wasylik, Florida

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Virginia has a booklet on how to do it. The rest of it is something you can easily learn. Which is better from a tax perspective? Get a taxCAP involved.

Mitchell Goldstein

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"I figure that I will ask my prospective client his preferences and do my best to protect him and his interests."

WHAT? How is this individual supposed to have "preferences" between an LLC and a corporation with a Subchapter S election? He is coming to you to find out what form of organization is in his best interest. The answer might be one, the other, or something else. To advise on this question, the advisor must know the pros and cons of each type of organization as they apply to the particular business. Likewise, you cannot "protect him and his interests" if you don't know which type of entity is in his best interest in the first place. Normally, one type of structure will be in the best interest of all the owners. The disputes arise over other things, such as capital contributions, division of income, and allocation of the power to make business decisions,.

You say that you "will only be representing this partner." LLCs have members, not partners. Corporations have shareholders, not partners. Only partnerships have partners.

Finally, you refer to the individual as a "prospective client." You don't perform legal services for a prospective client; you only perform legal services for a client. Advising someone on what type of entity best suits that person's interests, or even the consequences of each, constitutes legal services.

Steven Finell

