

## California LLC vs. an S Corporation: Which is Better?

There is a challenge when considering what entity to operate through in California. Both an S Corporation and LLC are flow through entities. The challenge is that California treats these entities differently at the state level.

Here is a general rule of thumb found in a tax planning guide:

S corporations that are doing business in California must pay a 1.5% net income tax. LLCs are not subject to this tax, but must pay an entity-level fee based on gross receipts. If the business operates at a loss, the corporation form is generally preferable. If the entity operates at a profit, then the LLC will generally result in the lesser tax liability.

Now, let's look at this closer.

First, the S corporation. It must pay 1.5% net income tax. That means if the S corporation has a net income of \$50,000 it would pay a tax of \$750. Here is a chart to compare levels of tax:

<b>Net Income</b>	<b>Tax Rate</b>	<b>Tax Due</b>
\$50,000	1.5%	\$750
\$75,000	1.5%	\$1,125
\$100,000	1.5%	\$1,500
\$150,000	1.5%	\$2,250
\$200,000	1.5%	\$3,000
\$300,000	1.5%	\$4,500
\$400,000	1.5%	\$6,000
\$500,000	1.5%	\$7,500
\$800,000	1.5%	\$12,000
\$1,000,000	1.5%	\$15,000

Now, let's compare this to an LLC in California:

LLC's in California taxed as partnerships must pay an entity level tax based on the "total income" reportable to California for the tax year. "Total income" means worldwide gross income, plus the cost of goods sold, paid or incurred in connection with the LLC's business. In 2003, the tax ranged from \$900 to \$11,790, as follows:

<b>Total Income From All Sources</b>	<b>Fee/Tax</b>
Over \$250,000, but less than \$500,000	\$900
\$500,000 or more, but less than \$1,000,000	\$2,500
\$1,000,000 or more, but less than \$5,000,000	\$6,000
\$5,000,000 or more	\$11,790

Let's compare the S corporation and the LLC:

1. If you are in a business that has about \$500,000 in gross sales and has about a 15% net profit margin (very good) that will equal \$75,000 in net income.

If your business was an S corporation, the S corporation would pay a tax of \$1,125. If it was an LLC it would pay a tax of \$900 plus \$800 in franchise tax. In this example, the LLC would pay a higher overall fee.

Let's make some comparisons based upon a 15% net profit margin (for LLC's add the \$800 per year franchise tax).

Gross Sales	Net Income	LLC Tax	S Corp Tax
\$200,000	\$30,000	\$- 0 -	\$450
\$275,000	\$41,250	\$900	\$619
\$600,000	\$90,000	\$2,500	\$1,350
\$900,000	\$135,000	\$2,500	\$2,025
\$1,200,000	\$180,000	\$6,000	\$2,700
\$6,000,000	\$900,000	\$11,790	\$13,500

Let's make some more comparisons based upon a 25% net profit margin (remember to add the \$800 per year franchise tax fee to the LLC's overall tax bill).

Gross Sales	Net Income	LLC Tax	S Corp Tax
\$200,000	\$50,000	\$- 0 -	\$750
\$275,000	\$68,750	\$900	\$1,031
\$600,000	\$150,000	\$2,500	\$2,550
\$900,000	\$225,000	\$2,500	\$3,375
\$1,200,000	\$300,000	\$6,000	\$4,500
\$6,000,000	\$1,500,000	\$11,790	\$22,500

What can we conclude from this?

1. If your company has very high net profits, it will pay more tax with a S corporation. If your business has under \$250,000 you will pay less tax at the STATE level as an LLC. But you may pay potentially more in SE taxes and therefore it would make overall more sense to be an S corporation.
2. If you are operating at a loss, an S corporation would make sense to a certain point. If you have a business generating \$900,000 a year and have a loss, you may be much more protected in an LLC and it may be worth spending the \$2,500 in LLC fees to gain that protection over an S corporation.
3. If you are going to be extremely profitable it would make more sense to be an LLC, ie, over \$700,000 in net profits.