

**Multi-Owner Maine LLC
Distinguished from
Maine Business Corporation Electing “S” Status**

Experience has indicated some accountants do not fully understand either the similarities nor differences between a Maine multi-owner limited liability company and a Maine business corporation which has elected “S” status under the Internal Revenue Code. These will be explained here.

First, it is important to bear in mind that the “legal status” of a Maine limited liability company is not the same thing as its status with either the federal Internal Revenue Service (IRS) nor Maine Revenue Services (MRS). The purpose of the limited liability company statute in Maine is to provide a less administratively cumbersome process for permitting the owners of a business to protect their personal assets from seizure for the liabilities of the business than is possible with a Maine business corporation. Both structures permit the owner(s) [i.e., stockholders of a business corporation] to legally separate their personal assets from those of the business and thereby “insulate” them against the liabilities the business may incur.

A Maine limited liability company enables the owner(s) to manage the company in a much less cumbersome manner than does a Maine business corporation. In the case of an LLC management is achieved pursuant to an Operating Agreement. If the LLC has a single owner the Operating Agreement simply vests all authority in the single owner (the “Managing Member”) without the necessity of a meeting of stockholders, issuance of stock, election of directors and officers, and preparation of minutes of various meetings. Management will resemble that of a sole proprietorship business. The IRS and MRS treat a single-owner Maine LLC as a “disregarded entity”, which means the company does not have to file annual income tax returns; rather, the owner reports the revenues and expenses of the company on a Schedule C to his personal annual form 1040 tax return. Should the owner die the owner’s estate will determine the disposal of the business.

For those LLCs which have more than one owner, however, the Operating Agreement functions not only as the source of management authority but also as a partnership agreement among the owners. The Operating Agreement designates the limits of authority bestowed upon the Managing Member and identifies those matters on which there must be agreement between the various owners. Such an agreement frequently includes provisions for disposal of the interest of an owner who dies or must withdraw from the business. The IRS and MRS treat a multi-owner Maine LLC as a “partnership” for tax purposes, meaning the LLC must file an annual income tax return with the IRS and MRS, but it pays no income tax itself. Instead, the LLC issues a form K-1 to its owners reporting their individual share(s) in the net earnings of the business. Copies of these forms K-1 are sent to the IRS and MRS and so the owner(s) of the LLC must report similar amounts of income on their personal income tax returns.

When a single-owner LLC applies to the IRS for an employer identification number (EIN) the name, address and social security number of the owner will be included in the application. If there is only one owner the LLC will be treated as a “disregarded entity” and the EIN issued to the company will appear on the Schedule C of the owner’s personal annual 1040 income tax return.

However, when an LLC with more than one owner applies for an EIN the names, addresses and social security numbers of each of the owners will be included in the application. The IRS and MRS

will record the LLC as a “partnership” for tax purposes and will expect the Company to file annual tax returns and the owners to report their respective shares of the net income reported on the Company’s tax return.

A Maine business corporation is a significantly different creature. In place of a Certificate of Formation as filed to create a Maine LLC, Articles of Incorporation will be filed with respect to the business corporation. The incorporators will adopt bylaws and appoint the first Board of Directors. Thereafter, periodic meetings of the owners, i.e., the stockholders, will be required to elect directors, usually annually. The directors will meet to elect officers who will have executive authority to manage the corporation in accordance with both the Articles of Incorporation and the By-laws. The authority of the officers will be described generally in the by-laws. Some major business decisions – such as merger, acquisition or purchase/sale of major assets – may require either Director or stockholder approval. This is a far more cumbersome process than the management of a Maine LLC.

When the business corporation applies to the IRS to secure an EIN it will have to elect the “status” in which its obligations for taxes and reporting will be determined. There are two different statuses from which the corporation can select. It can choose to be treated as a “C corporation”, or an “S corporation”. In the former case the corporation will be required to file annual income tax returns and pay tax on its net income. Then, when the corporation distributes some of its net income to the owners/stockholders in the form of dividends the owners/stockholders will pay tax again on the money they receive from the corporation. The corporation will issue an annual form 1099 to each owner/stockholder reporting the income actually distributed to the stockholders in the form of dividends.

If the corporation elects “S” status the corporation will file annual income tax returns on its net income, but like a partnership, will provide to each owner/stockholder a form K-1 on which will be reported each stockholder’s share of the corporation’s net income. So, in this respect an “S” corporation resembles a partnership.

A Maine LLC may register with the IRS for treatment as an “S” corporation which can have some tax benefits. Ordinarily, however, such benefits will not be of significant value until the business achieves a level of financial success that would permit the owners to take distributions of profit that would be free of income tax to the extent of their basis in the ownership of the corporation. Thereafter, once the owner’s basis reaches zero (\$0.00) further distributions would be taxed at long term capital gains rates, rather than ordinary income tax rates.

Why would someone choose to be an “S” corporation rather than a multi-owner LLC? The LLC form works well with businesses with relatively few owners. But each time a new owner is added to an LLC determining the value of the share to be provided to the new owner gets increasingly difficult. As the number of owners of the LLC increases management becomes more difficult. So, using the business corporation structure can be more suitable for businesses which expect to grow over time and may need occasional injections of additional capital. The corporate structure permits the issuance of more stock and its sale to new participants. An “S” corporation can have up to 99 participating stockholders. So, the “S” status has distinct commercial and legal advantages that may not be possible with a multi-owner LLC.

Some accountants tell owners of newly established LLCs that they need to achieve “S” status. This simply is confusing two separate and distinct concerns: (1) the legal structure that best suits the business – a limited liability company or a business corporation; and (2) how the particular structure is treated by the IRS and MRS. If the business will be best served by the limited liability company structure, it can still obtain the tax “treatment” it may need. Conversely, if the plans for the business suggest that the business corporation structure will better meet its future needs, it can also obtain the appropriate tax treatment. The choice of the proper and appropriate structure is a legal matter, not a tax concern.