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"S" Corporation v. Limited Liability Company: Part 1

Many people are familiar with the "flow through" tax benefits enjoyed by the so-called "S" corporation. Instead of paying corporate tax, the corporation's income or loss "flows through" to the owners' tax returns every year, regardless of how much cash is actually received. For many years, and mostly for this very reason, a properly structured "S" corporation has been the optimal legal entity for a private company. What most people don't know is that someone who obtains a judgment against the owner of "S" corporation stock (a "judgment creditor") can seek to satisfy that judgment by taking that person's stock. Such a judgment could result from, for example, damages resulting from the alleged negligence on the part of the owner in his/her personal life or in a business capacity that is not sufficiently insured against. Once the judgment creditor takes the stock, it can vote the stock and exercise whatever powers the "former" owner had as a shareholder. In many cases, this power is used to force a liquidation of the company and a sale of its assets to satisfy the judgment. In this sense, ownership interests in "S" corporations do not provide any asset protection for their owners.

Limited Liability Companies, on the other hand, can provide their owners with both asset protection *and* "flow through" taxation. In fact, the "flow through" aspect of the LLC can work to put asset protection on the offensive by penalizing the judgment creditor of an LLC owner. Specifically, the LLC statute prohibits the levy or "taking" of a LLC owner's interest by limiting the judgment creditor to a "charging order" remedy. In a properly structured and maintained LLC, this means that the judgment creditor can never acquire the right to exercise the owner's vote; it only has the right to receive any distribution the owner would have been entitled to, if any.

Of course, waiting for a distribution is not a good position for most creditors, because the IRS attributes the income that flows through the LLC to the persons who have the right to receive distributions. In the meantime, the LLC remains free to continue paying its normal operating expenses, including salaries.

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