Limited Liability Company

A limited liability company (LLC) is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership.

The "owners" of an LLC are referred to as "members." Depending on the state, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs.

Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are "passed through" the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

Limited liability company benefits

LLCs protect business owners, also referred to as members, from being held personally liable for the actions of the LLC. This limited liability typically protects you from the personal risks involved if a lawsuit were to arise concerning your business — safeguarding your personal assets. A couple additional benefits of an LLC include:

Flexibility in management.

Corporations have a set management structure where directors oversee the major business decisions and officers are responsible for the day-to-day running of the business. LLCs do not have the same formal management structure.

Pass-through taxation.

With pass-through taxation, taxes are not paid at the business level. If you choose to become an LLC, income/loss would be reported on your personal tax return. If any taxes were due, they would be paid on the individual level.

LLC Tax Obligations

In the eyes of the federal government, an LLC is not a separate tax entity, so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC's members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do, so check with your state's income tax agency.

Since an LLC is not recognized as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law.

Advantages of an LLC

- **Limited Liability.** Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is like the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability - members are not necessarily shielded from wrongful acts, including those of their employees.
- **Less Recordkeeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S-Corporation, there is less registration paperwork and their start-up costs are lower.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Limited Life.** In many states, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. However, you can include provisions in your operating agreement to prolong the life of the LLC if a member decides to leave the business.
- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

Combining the Benefits of an LLC with an S Corporation

There is always the possibility of requesting S corporation status for your LLC. The LLC remains a limited liability company from a legal standpoint, but for tax purposes it can be treated as an S corporation. Be sure to contact the state's income tax agency where you plan to file your election form. Ask about the tax requirements and if they recognize elections of other entities (such as the S corporation).

LLC vs. Corporation:

- **Business losses.** The "S corporation advantage," allows business owners to use business losses — like those incurred during the startup phase — on their personal tax returns as deductions.
- **Self-employment taxes.** An S corp. can provide savings on self-employment or Social Security/Medicare taxes, and it allows owners to offset non-business income with losses from the business — unlike a C corp. which is a completely separate tax entity.
- **Ownership restrictions.** Neither the LLC nor the C corporation have restrictions on the number of owners the business can have or who can be an owner. S corporations, however, have a number of restrictions. S corporations can have no more than 100 owners, and owners cannot be "non-resident aliens." Additionally, S corporations can not be owned by C corporations, LLCs, other S corporations or non-qualified trusts.
- **Dividends and venture capitalists.** C corps are often the preferred incorporation choice of developing businesses. Owners can hold different types of stock interests (including preferred and common stock), which allow for different levels of dividends. This is one reason why venture capitalists choose C corporations when they offer funding to a business. Investors are attracted to the prospect of dividends (often higher dividends) if the corporation makes a profit.
- **Earnings.** C corps can retain and accumulate earnings (within reasonable limits) from year to year.