



Limited Liability Companies (LLCs)

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“For every tax problem there is usually a solution that is straightforward, uncomplicated and Wrong.”

Introduction

When first selecting the format for a new business, many smaller businesspersons (particularly) rarely consider an LLC, unless they are alerted in the beginning by their lawyer or CPA. Their usual concerns are only: (a) “whether to incorporate or not” and if so, (b) “whether to select a C or S corporate form.” Yet an LLC, for *tax* purposes, can be classified into *whatever* form of business is desired. So it should at least be considered as part of the initial process in formation of any business or investment entity.

LLCs are business entities created under *state* laws. They are owned by their “members” (like partners). In general they provide the tax advantages of a partnership with the personal liability protection of a corporation — or even more so. While they are frequently compared to S corporations, they have greater flexibility than S corporations (or partnerships), as we will discuss. Each state has its own LLC laws and establishes their own characteristics. Unfortunately, the laws vary from state to state. Forming an LLC in your home state and operating it in *another* state can be complicated. LLCs may have a limited life, depending on state law. In some states, it takes affirmative votes of all members to continue operations after a member dies or withdraws.

An LLC can be treated for *tax purposes* as:

- ✔ A partnership (most typical).
- ✔ An individual proprietorship or investment vehicle (an unincorporated entity).
- ✔ A trust.
- ✔ An association taxable as a corporation (extremely rare).
- ✔ LLCs with two or more members are automatically taxed as partnerships (file Form 1065), unless they *elect* to be taxed as a corporation (not recommended).
- ✔ One-member LLCs are automatically taxed as sole proprietors (file Schedule C), unless they *elect* to be taxed as a corporation (not recommended).

As you can see, for tax purposes, any LLC can be adapted to different business and investment forms. The issue of whether members of LLCs are subject to self-employment tax on their distributive share of income has not yet been entirely resolved. Owners that “materially participate” in the operation of the LLC may be subject to self-employment tax on their entire share of the entity’s income. There are no final rules from the IRS on this point. However, the IRS has issued *proposed* rules that

can be relied upon. These proposals won't make a lot of LLC owners happy, since they require payment of social security taxes in many cases. For the moment, one can follow these proposals or not, with the understanding that you are gambling in the event of an IRS audit — if you ignore these proposed rules. They IRS says that you owe social security taxes on your net earnings from an LLC *if*:

- ✱ You provide personal services to the LLC in such fields as law, accounting, medicine, consulting, sales, etc.
- ✱ You are personally liable for the debts of the LLC *and* can sign contracts obligating the LLC.
- ✱ In some cases, if you work more than 500 hours annually for the LLC.

GENERAL CAUTION: By its very nature, all the following discussions contain many legal and/or quasi-legal comments. You *must* consult your own attorney in every case to discuss whether these general comments would in fact apply to your particular situation. This is not a *legal* guide to LLCs — and don't try to use it as such!

LLC vs. Limited Partnership

For federal income tax purposes there is no difference between a limited partnership and an LLC. *However the LLC typically offers greater legal liability protection than even that of a limited partnership.* Analyze this:

- ✱ Even a limited partnership must have at least *one* general partner who is subject to unlimited liability.
- ✱ Limited partners who participate in the management of the limited partnership can be treated as if they were general partners — and then become subject to unlimited liability, as above.
- ✱ In contrast, *all* members of an LLC can participate fully in management of the entity with *no* exposure to unlimited liability.
- ✱ No member of an LLC is ever personally liable for *any* of the LLC liabilities — except to the extent of their investment in the LLC (or if a personal guarantee were made for some liability).

Doing business in a different state from your home state may cause legal complications

- ✱ LLC members can have larger “tax bases” than in a limited partnership.
- ✱ An existing partnership can usually convert to an LLC without any tax consequences to either the entity or the individuals. (The “partners” then become “members” in the LLC.)

LLC vs. General Partnership

Contrary to general partnerships, LLC members are not personally liable for the debts and obligations of the entity. In a general partnership, *all* partners have unlimited liability.

LLC vs. All Partnerships

Some attorneys are still reluctant to recommend LLCs, simply because they are relatively new. There is not a lot of case law and IRS rulings about LLCs. This makes some of them nervous.

As stated earlier, because the different laws of each *state* govern LLCs, doing business in a different state from your home state may cause legal complications. There is no overall *federal* LLC law.

As a generalization, there are probably more LLC-type *partnerships*, than any other form. Some attorneys feel that almost every partnership should be an LLC instead.

Certain states may tax LLCs in different manners than other entities, including partnerships. For example, California specially taxes every LLC classified as a partnership or proprietorship. The tax ranges from \$900 to \$11,970, based on the *gross* receipts of the LLC (*not* the net profit), as follows:

Gross Income	Tax
Less than \$500,000	\$ 900
\$500,000 to \$999,999	2,500
\$1 million to \$4,999,999	6,000
\$5 million or more	11,970

LLC vs. S Corporation

An S corporation is a type of incorporated partnership, in that the S corporation

usually pays no taxes, but all profits and losses “pass through” to the shareholders. Thus there is a basic similarity to an LLC-type partnership, but consider the following differences:

- ✱ An S corporation is limited to 100 shareholders, while there is no limit on the number of LLC members.
- ✱ An S corporation can have only one class of stock, so that all shares have the same profit/loss distribution rights and liquidation rights. The LLC can have multiple classes of members with *different distribution rights* (and also liquidation rights). There is no limit on the number of possible variations of these distribution rights in an LLC.

EXAMPLES: One class of LLC member could receive a guaranteed profit distribution (e.g., 9%) before another class of member receives anything. Or, there might be one class of member not entitled to *any* profit distributions — but who receives a disproportionate share of any *losses* (or even all of them). Or, one class of member might receive all the depreciation deductions, while other classes are excluded. Almost any variation is possible (e.g., CPA members get all the cash distributions while lawyer members get nothing, or, all members born in Chicago get double the cash distributions of all others, etc.).

- ✱ Similarly, in liquidation, only the LLC could provide for variations similar to the examples above regarding distribution rights. Thus certain members could (for example) receive liquidation distributions of *specified* assets, or *disproportionate* amounts of the liquidation distributions, or other cunning ideas.
- ✱ S corporation shareholders *cannot* include the debts of the corporation in their tax basis, while the LLC members can include their share of the LLCs indebtedness in their tax basis (very handy if you are deducting losses, which cannot exceed your tax basis).

- ✦ S corporations cannot have a shareholder that is a corporation, partnership, nonresident alien, or LLC. There is no restriction on the types of LLC members — even aliens from outer space qualify.
- ✦ Shareholders in S corporations who receive non-cash property distributions are generally taxed if the fair market value of the property distributed exceeds its adjusted basis in the S corporation. The LLC can usually distribute property to its members with no tax consequences to them.
- ✦ The LLC (if classified as a partnership) can make a Sec. 754 election to increase the tax basis of its assets, in the event of the death of a member or other transfer of its ownership interests. S corporations cannot.
- ✦ Some states do not fully recognize the federal tax status of S corporations. For example, while S corporations pay no federal income tax, California levies a 1.5% tax on the net income of S corporations (and also taxes LLCs, see earlier).

LLC vs. C Corporation

The C corporation is the “typical” corporation, with these differences from the LLC:

- ✦ The income of a C corporation may be taxed *twice*, since the corporation pays taxes on net income and the shareholder is taxed again on dividends received. The LLC is only subject to one level of taxes on income reported by the members.
- ✦ The C corporation cannot specially allocate income or losses to shareholders — while the LLC can do so (see discussion above).
- ✦ The C corporation is subject to double tax on liquidation (levied on both the corporation *and* the shareholders) — the LLC is not.
- ✦ All approved fringe benefits paid are fully deductible by the C corporation, and do not represent income to the shareholders. However, there is *no* deduction allowed the LLC for fringe benefits paid for members owning 2% or more of the entity (although they may be deductible by the individual).
- ✦ The failure to follow certain administrative formalities can make the C corporation officers susceptible to “piercing the

corporate veil” and possible personal liability. Not true in an LLC.

- ✦ The possible IRS “unreasonable compensation” attack on C corporation salaries of officers cannot be used against LLC managers (or other members).
- ✦ C corporations may be subject to an accumulated earnings tax and/or a personal holding company tax, while the LLC cannot.
- ✦ The C corporation can elect to use a fiscal year while the LLC (like regular partnerships) must almost always use a calendar year.
- ✦ The LLC (if classified as a partnership) can make a Sec. 754 election to increase the tax basis of its assets, in the event of the death of a member or other transfer of its ownership interests. C corporations cannot.
- ✦ Nonresident members of an LLC will usually be taxed on their income by the state in which the LLC is domiciled. Nonresident C corporation shareholders are not taxed on dividends received by the state in which the corporation is located.
- ✦ There are a number of other technical advantages in favor of the LLC.

Real Estate Ventures

Whether normally structured as partnerships, or individually owned, many (perhaps most) lawyers now recommend that real estate ventures be structured as LLCs, almost entirely because of increased liability protection for the individuals. In the case of individual owners this recommendation is approaching 100%, while there may be certain situations in which partnerships are favored over LLCs.

Joint Venture of Two or More Corporations

If a corporate subsidiary were formed, 70% to 80% of any dividends would be tax-free to the parent corporations. If an LLC is formed instead, there is only one level of taxation (in effect 100% tax-free dividends), with the same limited liability — a tax saving on 20% to 30% of dividend income.

Family Estate Planning

Typically a family limited partnership (FLP) or S corporation is used as part of sophisticated estate planning for wealthier individuals. There is much greater flexibility afforded in an LLC instead. (Reread the sections on partnerships and S corpora-

tions vs. LLC.) Further, *trusts* of all kinds can be LLC members, which opens the door to all kinds of creative estate planning.

Venture Capitalists

These folks will almost always prefer the LLC. They get limited liability, yet with management control, one level of taxation, and control over special distribution and liquidation rights.

Health Insurance Premiums

Generally, fringe benefits paid on behalf of any LLC member owning 2% or more are not deductible by the LLC (same rule for partnerships and S corporations). However, in the case of health insurance premiums, the *individual* is allowed an “above-the-line” deduction on his or her personal income tax return, equal to 100% of such premiums.

Another Caution

We have been told that a *single-member* LLC affords less protection for the personal assets of that member-owner than if there are multiple members in the LLC. Check with your own lawyer.

Summary

The advantages of an LLC are easy to appreciate:

- ✦ Limited liability protection for *all* the members — including the managers. Members are generally not liable for debts of the LLC.
- ✦ Favorable “pass-through” taxation rules of partnerships. Double taxation of most C corporations is avoided.
- ✦ Members can be individuals, corporations, trusts, partnerships or other LLCs.
- ✦ There is no limit to the number of members.
- ✦ Any or all members can participate in the management of the LLC.
- ✦ There can be different classes of ownership, with different participation/distribution privileges.
- ✦ Distributions (both operating and liquidating) do *not* have to be directly proportionate to the members’ ownership percentages (as is true in both S and C corporations).
- ✦ LLC members can include their share of all the LLC’s indebtedness in their tax basis (very handy if you are deducting losses, which cannot exceed your personal tax basis).




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- ✱ Even if the fair market value of the property distributed exceeds its adjusted basis, the LLC can usually distribute property to its members with no tax consequences to them.
- ✱ The LLC, but not any corporation, can make a Sec. 754 election to increase the tax basis of its assets, in the event of death of a member or other transfer of its ownership interests.

The disadvantages of an LLC:

- ✱ The laws relating to LLCs are relatively new and untested. LLCs are somewhat uncharted territory and many conservative lawyers are reluctant to recommend them broadly. If you want legal and tax certainty, the LLC may not yet be for you (or only in some circumstances).
- ✱ The LLC laws vary from state to state. The LLC must determine how it will be treated for both tax and liability purposes in other states.
- ✱ Certain states may tax LLCs in different manners than other entities, including partnerships.
- ✱ There is *no* deduction allowed the LLC for fringe benefits paid for members owning 2% or more of the entity.
- ✱ LLCs may have a limited life, depending on state law. In some states, it takes affirmative votes of all members to continue operations after a member dies or withdraws.
- ✱ The LLC (like regular partnerships) must almost always use a calendar year.

Look all this over and at least *consider* an LLC. About 10 minutes after the first LLC law was passed, almost every national CPA firm in the US converted to LLC/LLP status. What does that tell you? 

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