A Guide to LLCs

Forming a Limited Liability Company

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Introduction

Most business owners want to save money in taxes and reduce their personal risk. Forming a limited liability company (LLC) is a smart way to accomplish both of these goals without adding a lot of extra paperwork and corporate formalities. Even if you are running a business with just one employee (yourself), you can still take advantage of these benefits by operating your business as an LLC.

Sole Proprietorships and General Partnerships

A sole proprietorship and general partnership are two of the least expensive forms of business to start. If you currently operate a small business by yourself then you operate a sole proprietorship. If you are currently in business with one or more partners, then you are part of a general partnership. Many new small businesses are either a sole proprietorship or general partnership. Both types of business are easy to maintain and are relatively inexpensive to set up. But a number of other factors can make a sole proprietorship and general partnership the most expensive types of business over the long run.

A sole proprietorship and general partnership can be the most expensive types of business over the long run.

As a sole proprietor or general partner, you put your personal assets at risk for liability. You also miss out on potential tax savings and enjoy fewer options for growing your business. Finally, when it comes time to sell or hand down your sole proprietorship, it can't be done. Sole proprietorships can't continue beyond the life of the owner.

Corporations

The primary advantage of a corporation is that its owners, known as stockholders (or shareholders), are not personally liable for the debts and liabilities of the corporation.

Once brought to life by filing articles of incorporation with the state, a corporation can act much like a person. It can own and operate a business, hire employees, buy and sell goods and services, enter into contracts, lease or buy real estate, maintain its own checking and savings accounts, and sue and be sued. A corporation is not affected by the death or bankruptcy of any shareholder, officer or director. Instead, it continues to exist as long as it complies with the state requirements and corporate formalities.

LLCs

An LLC is a type of business structure that combines features of the corporation with those of the sole proprietorship or partnership. The primary advantage of an LLC is that it affords its members personal liability protection without all of the corporate formalities.

An LLC also has the flexibility to be taxed as a corporation or as a pass-through entity, similar to a sole proprietorship or general partnership (for more about pass-through entities, see the Tax Savings and Flexibility section).

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Advantages of Forming an LLC

Liability and Asset Protection

As a sole proprietor, you and your business are legally inseparable. In other words, your company's debts are legally your debts. A lawsuit brought against your business would be a lawsuit brought against you personally. This means your home, car, savings and investments could all be taken from you should your business get sued and you lose or your business goes into debt. In a general partnership, the risk is even greater. This is because each partner can independently make decisions that impact the partnership as a whole. If one partner makes a bad decision, both partners are on the hook for the entire amount of any damages.

By contrast, an LLC is viewed as a legally distinct entity. If your business hits hard times, you are not personally held responsible for any debts or court judgments. Moreover, if the business fails, you won't have to carry your business debts over to your next venture. Whatever your line of business, protecting yourself against personal liability can help you avoid a potentially disastrous situation.

If your business hits hard times, you are not personally held responsible for any debts or court judgments.

While LLCs can protect you from personal liability, this protection is not absolute. You and other LLC members may be liable for the debts of an LLC if:

- You personally guarantee a debt,
- You intermingle personal funds with LLC funds,
- Your LLC has minimal capitalization or minimal insurance, and/or
- Your LLC fails to pay state taxes or otherwise violates state law.

Tax Savings and Flexibility

When it comes to taxes, LLCs have the option of being taxed as a pass-through entity (like a partnership or sole proprietorship) or as a corporation. By default, your LLC is recognized by the IRS as a pass-through tax entity. In other words, it "passes" income, deductions, losses, gains and tax credits directly through to you and any other members. These amounts are reported on your individual return, and you pay taxes at your individual tax rate. In addition, if you actively participate in running your LLC, you are allowed to deduct operating losses against your regular income.

LLC members are not required to pay unemployment insurance taxes on their own salary. However, members must pay self-employment taxes on any salary they receive and on any company profits allocated to them.

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Ease of Transfer

Ownership interests in an LLC may generally be sold to third parties without disrupting the continued operation of the business. On the other hand, selling interests in a general partnership requires much more time and effort and a sole proprietor must individually transfer assets, business licenses, bank accounts, permits and other legal documentation.

If you have plans to one day pass your family business down to the next generation, an LLC can help smooth the transition. Legally speaking, as a sole proprietor, your business is inseparable from you, which means when you die, your business dies along with you. Without converting your business to another business structure or implementing some very sophisticated estate planning strategies, your heirs may have a very difficult time inheriting your life's work.

If you have plans to one day pass down your family business, an LLC can help smooth the transition.

Other Benefits

In addition ot the benefits shown above, the LLC offers other benefits, including:

- **An LLC has no ownership restrictions.** With an LLC, your business can retain any number of members. By comparison, an S corporation cannot have more than 100 shareholders, and each must be a resident or citizen of the United States. None of these restrictions apply to an LLC.
- **An LLC provides living trust flexibility.** As a member of an LLC, you are free to place your membership interests into a living trust for your beneficiaries. By contrast, placing shares of an S corporation into a living trust can be difficult.
- **An LLC can make it easier to raise capital.** With an LLC, you have more options available to raise capital. Additionally, you can admit new members by selling membership interests and can create new classes of membership interests with different voting or profit characteristics.

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Real Estate Investments and LLCs

In recent years, LLCs have become the entity of choice for those investing in real estate. Liability protection is the primary reason most people choose to place property in a business entity. And while both corporations and LLCs offer this key benefit, the LLC's tax structure and ease-of-use make it especially advantageous for real estate ventures. Some other differences between corporations and LLCs:

Many real estate investors choose to place individual properties in separate LLCs to further limit their liability.

Double Taxation

C corporations are subject to double taxation—once at the corporate level and once again when dividends are distributed to shareholders.

Capital Gains Tax Treatment

The preferential 15% long-term capital gains tax rate is not available to C corporations. Instead, any corporate profits from the sale of real estate are taxed at the regular corporate income tax rate (from 15% up to 35%). Furthermore, when the corporation distributes the sale proceeds to the shareholders, the shareholders are taxed on the dividends.

Limits on Passive Income by S Corporations

Although the sale of real estate by an S corporation may qualify for capital gains tax treatment (and is not subject to double taxation), an S corporation may lose its special "S" tax status if its passive income exceeds 25% of gross receipts for three consecutive years. In other words, if an S corporation collects only passive rental income, the IRS could revoke its "S" status, rendering it a C corporation for tax purposes. Furthermore, the excess passive income would be taxed at the highest corporate rate of 35%.

Separate LLCs for Enhanced Liability Protection

Many real estate investors choose to place individual properties in separate LLCs to further limit their liability. With separate LLCs, a liability incurred by one property (e.g. a lawsuit) would not affect the other properties in the investor's portfolio. The LLC's minimal maintenance and ease-of-use make this sophisticated strategy both cost-effective and relatively simple to employ.

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Operating and Maintaining an LLC

While an LLC is generally easier to maintain than a corporation, some regular record keeping and government filing is required to keep your LLC in good standing with the state.

LLC Formalities

Separate Personal and Business Finances

Because an LLC is a distinct legal entity, all LLC finances and transactions must be kept separate from the personal finances of LLC members. Therefore, it is essential that you establish a separate bank account for your LLC and pay all expenses, as well as profit payouts, from this account. In addition, written records should be kept of all major LLC decisions. If you have employees, you must also obtain a separate Federal Employer Identification Number (EIN).

Annual Reports

After the initial government filings, most states require an LLC to file a short annual report form with the same state office where the articles of organization were filed. These forms typically require basic information, such as names and addresses of current LLC members and/or managers. They might also request the name and address of the LLC's registered agent and the office for service of process or receipt of legal documents. In most states, a filing fee is required with the annual report.

Tax Returns

Income tax filings will vary depending on whether you choose pass-through tax treatment or you make a special election to receive corporate tax treatment.

- **LLCs with pass-through tax treatment.** If you are the only member of your LLC, the LLC will not have to file a separate tax return. Instead, you'll report all your income or losses on your personal IRS 1040 form and attach a Schedule C, Profit or Loss from a Business. You will also need to file a Schedule SE, Self-Employment Tax Return.

  If your LLC has multiple members, you and the other members will report your individual incomes from the LLC on your individual tax returns. In turn, the LLC is required to file an informational return using IRS Form 1065. Attached to this form should be a Schedule K, which is used to report the profits, losses, credits and deductions allocated to the members of the LLC. In addition, the LLC must file a Schedule K-1 for each member and report that member's share of the profits and losses.

- **LLCs with corporate tax treatment.** Your LLC can elect corporate tax treatment by filing IRS Form 8832. Once filed, the IRS will treat your LLC as a separate tax entity. The LLC will then have to file a corporate tax return, IRS Form 1120, Corporate Income Tax Return, and estimate and pay its own taxes at the appropriate corporate tax rate. The LLC can also elect to be treated as an S corporation, in which case it would file IRS Form 1120S.

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How LLCs Compare to Other Business Structures

Although LLCs offer many benefits, they may not be the right choice for every type of business. When choosing a business structure, it's important to understand the differences between common business entities. The following section compares the LLC to other common business entities and highlights the advantages and disadvantages of each. As always, it is a good idea to consult a lawyer and tax professional before making a decision that has tax and legal implications for your business.

LLCs Compared to C Corporations

- **Fewer corporate formalities.** C corporations are required to have director and shareholder meetings. LLCs are not.
- **Simpler management structure.** C corporations must have a board of directors. LLCs do not.
- **Ease of transferring interest into a living trust**. Placing your company interest in a living trust can be accomplished more easily for members of an LLC than for a C corporation.
- **Tax flexibility.** Unlike LLCs, C corporations are subject to double taxation. Double taxation occurs when shareholders pay taxes on dividends at the same time that the corporation pays taxes on its profits.
- **Loss deduction.** Members who are active participants in the business of an LLC are able to deduct its operating losses against their regular income to the extent permitted by law. Shareholders of C corporations are not able to deduct operating losses from their income.
- **Profit recognition.** A C corporation does not have to immediately distribute its profits to its shareholders in the form of a dividend. This means that shareholders in a C corporation are not always taxed on the corporation's profits. Because an LLC is treated as a pass-through entity, the profits of the LLC are included in a member's income.
- **Fewer fringe benefits.** Employees of an LLC who receive fringe benefits, such as group insurance, medical reimbursement plans, medical insurance and parking, must treat these benefits as taxable income. The same is true for employees who own more than 2% of an S corporation. However, employees of a C corporation who receive fringe benefits do not have to report these benefits as taxable income.

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LLCs Compared to S Corporations

- **Fewer corporate formalities.** Corporations must hold regular meetings of the board of directors and shareholders and keep written corporate minutes. On the other hand, the members and managers of an LLC need not hold regular meetings.
- **Simpler management structure**. LLCs are not required to have a formal board of directors (known as board of managers or managers in an LLC). The owners of an LLC can make all important company decisions directly.
- **No ownership restrictions.** S corporations cannot have more than 100 stockholders, and each stockholder must be a resident or citizen of the United States. There are no such restrictions placed on an LLC.
- **Potential tax disadvantage.** An LLC does not enjoy the same self-employment tax savings as an S corporation. Instead, single member LLCs must pay self-employment tax on both salary and profit. However, an LLC can make an election with the IRS to be treated like an S Corporation for tax purposes.
- **Greater acceptance of corporations.** Since limited liability companies are still relatively new, some banks or vendors may be reluctant to extend credit to LLCs. In addition, some states restrict the types of business an LLC may conduct.
- **Flexible capitalization structure.** S corporations cannot have more than one class of stock. There are no such restrictions placed on LLC membership interests.

LLCs Compared to Limited Liability Partnerships (LLPs)

- **Limited liability for malpractice.** While an LLC provides limited personal liability, it does not provide protection for members from the malpractice of other LLC members. With an LLP, professionals are protected from the malpractice of their partners.
- **Distribution of profits.** LLCs cannot make distributions to members if doing so would make the business insolvent—that is, unable to pay its debts as they become due. An LLP has no such limitations.

LLCs Compared to Limited Partnerships (LPs)

- **Debt liability.** In an LLC, all members are covered by the cloak of limited liability protection. In contrast, an LP must have at least one general partner who is personally liable for the debts and other liabilities of the business.

Where to Form an LLC

Most people choose to form their LLC in their state because it's easier and often the most cost-effective option. If you form an LLC in a different state, you may still need to register your company in your state, which requires a separate filing fee and subjects you to your state's taxes.

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Business Entity Comparison Chart

	Limited Liability Company	Sole Proprietorship/ General Partnership	S Corporation	C Corporation
Formation	State filing required.	No filing required, unless doing business under an assumed name.	State filing required; Subchapter S election typically must be made within 60 days of formation.	State filing required.
Personal Liability	The owners (called members) are generally not liable for the company's debts.	The owner is liable for all the debts of the business.	The owners (called "shareholders") are generally not liable for the company's debts.	The owners (called "shareholders") are generally not liable for the company's debts.
Formalities and Record-keeping	Formal meetings and minutes are not required; however, annual state reports are required.	No formalities.	Formal board and shareholder meetings and minutes are required, and annual state reports required.	Formal board and shareholder meetings and minutes are required, and annual state reports required.
Management and Operation	Management is flexible, like a partnership; typically, an operating agreement outlines management duties. A board of managers is optional.	Sole proprietor has full control. Partnerships have a flexible management and operational structure.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operation.	Managed by the directors, who are elected by the shareholders; directors appoint officers, who run the day-to-day operations.
Taxation	An LLC is pass-through by default, but members may elect to be taxed as a C corporation or S corporation instead.	The company does not pay tax on its profits, but instead, income and loses are "passed through" to the owners, who must pay taxes on their proportionate share of the company's income.	The company does not pay tax on its profits, but instead, income and loses are "passed through" to the owners, who must pay taxes on their proportionate share of the company's income.	Taxed at the entity level. If dividends are distributed to shareholders, dividend income is taxed at the individual level.
Tax Reporting	See Sole Proprietorship/ General Partnership; LLCs may also elect to be taxed as a C or S corporation.	All income for sole proprietorships is reported on Form 1040, Schedule C. Partnerships report income on Form 1065, with profit distributions on Schedule K-1.	S corporations report income on Form 1120S, with salaries reported on Form W-2 and profit distributions on Schedule K-1.	C corporations report income on Form 1120, with salaries reported on Form W-2 and any profit distributions on Form 1099-DIV.
Ideal For	Owners wanting the liability protection of a corporation with less corporate formalities, and the simplicity of pass-through taxation of income.	Owners wanting minimal formalities, maximum flexibility, and not worried about personal liability.	Owners wanting the liability protection of a corporation, with the simplicity of pass-through taxation of income.	Owners needing maximum tax and ownership flexibility combined with liability protection.

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LegalZoom's LLC Service

The limited liability company (LLC) has grown in popularity, especially with entrepreneurs. Like other formal business structures, LLCs can offer liability protection and tax savings, but unlike corporations, they are relatively easy to maintain. The LLC's simplicity and ease-of-use make it an ideal choice for small businesses.

LegalZoom can help you form an LLC for your business. With our easy 3-step process, you can set up your LLC from your home or office for as little as **$99 plus state fees**.

1. Complete an Online Questionnaire

Answer a few simple questions online. Most people complete it in 15 minutes or less.

2. We File the LLC Papers

We complete the required documents and file them with the proper state agency.

3. Your LLC is Complete

We deliver the filed articles of organization to you, along with a personalized operating agreement. We can even obtain your Federal Tax ID Number (EIN).

Questions?

To learn more about LegalZoom's LLC service or to get started, call us at (888) 381-8758 Monday–Friday from 6 a.m.–7 p.m. and Saturday from 10 a.m.–2 p.m. PT.

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