

What Is An LLC?

A Limited Liability Company, or LLC, is rather new form of business structure. It must be permitted by the state your business is in, but most states now allow LLC formation.

An LLC is designed to provide the best of both worlds:

- The limited liability features of a corporation
- The tax efficiencies and flexibility of a partnership.

An LLC would be more complex to set up than a partnership would be.

Owners are 'members', and the duration of the LLC is usually determined when the organization papers are filed. The time limit can be continued if desired by a vote of the members at the time of expiration.

LLC's must not have more than two of the four characteristics that define corporations:

1. Limited liability to the extent of assets;
2. Continuity of life;
3. Centralization of management;
4. Free transferability of ownership interests.

Some of the advantages of an LLC over a corporation are noted below:

Fewer corporate formalities. Corporations must hold regular meetings of the board of directors and shareholders and keep written corporate minutes. Members and managers of an LLC need not hold regular meetings.

No ownership restrictions. S-corporations cannot have more than 100 stockholders, and each stockholder must be an individual who is a resident or citizen of the United States. Also, it is difficult to place shares of an S-corporation into a living trust. None of these restrictions or difficulties apply to an LLC (or a C-Corporation).

Ability to deduct operating losses. Members who are active participants in the business of an LLC are able to deduct operating losses of the LLC against their regular income to the extent permitted by law. Shareholders of an S-corporation are also able to deduct operating losses, but not shareholders of a C-corporation.

Tax flexibility. By default, an LLC is treated as a "pass-through" entity for tax purposes, much like a sole proprietorship or partnership. However, an LLC can also elect to be treated like a corporation for tax purposes, whether as a C-corporation or an S-corporation.

On the other hand, there are a number of disadvantages as well:

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Advantages of Corporations:

Profits are not subject to social security and Medicare taxes. Like a sole proprietorship or a partnership, salaries and profits of an LLC are subject to self-employment taxes. With a corporation, only salaries, and not profits, are subject to such taxes.

Greater Acceptance. Since limited liability companies are still relatively new, not everyone is familiar with them. In some cases, banks or vendors may be reluctant to extend credit to limited liability companies. Moreover, there are restrictions as to the type of business that an LLC may conduct in some states.

Greater variety of, and fewer taxes on, fringe benefits. Corporations offer a greater variety of fringe benefit plans than any other type of business entity. Various retirement, stock option and employee stock purchase plans are available only for corporations. Plus, while sole proprietors, partners and employees owning more than 2% of an S-corporation must pay taxes on fringe benefits (such as group-term life insurance, medical reimbursement plans, medical insurance premiums and parking), stockholder-employees of a C-corporation do not have to pay taxes on these benefits.

Income Shifting. Although C-corporations are subject to double taxation, they also offer greater tax flexibility. In a C-corporation, you can use income shifting to take advantage of lower income tax brackets.

Here is an example of “Income Shifting”.

- Assume that a business earns \$100,000.
- As a sole proprietorship, a business owner who is married (filing jointly) would be in the 25% income tax bracket.
- As a corporation, assume that the business owner takes \$50,000 in salary and leaves \$50,000 in the corporation as a corporate profit.
- The federal corporate tax rate is 15% on the first \$50,000.
- Furthermore, the business owner is now in the 15% tax bracket for his or her personal income tax.
- This can reduce your overall tax liability by over \$8,000.

This article is intended to be used as an introduction and a guideline. Seek professional assistance before making a decision about how to structure your small business.