

Title:

Is the Limited Liability Company the Right Entity for Your Business?

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Summary:

Should you operate your business as a corporation? Or is there another, simpler alternative? The Limited Liability Company (LLC), the newest type of legal entity that exists in the United States. An ideal marriage between the tax advantages of the limited partnership and the limited liability feature of the corporation for many, the LLC might have a place in your business structure and be a powerful estate planning tool as well.

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Article Body:

Should you operate your business as a corporation? Or is there another, simpler alternative. You've probably noticed that in the past decade there are more and more businesses with their names followed by the letters "LLC" instead of "Inc.". "LLC" stands for Limited Liability Company, is the newest type of legal entity that exists in the United States, and for many entrepreneurs it is the ideal marriage between the tax advantages of the limited partnership and the limited liability feature of the corporation. Now available in all 50 states---even to non-U.S. citizens--most likely the LLC should have a key place in your business structure.

When it comes to legal entities for conducting business, limited liability companies are the newest kid on the block in the United States. The state of Wyoming was the first to pass legislation, in 1977, to establish this new entity. By 1999 all fifty states in the United States had enacted legislation to allow the formation of this exciting new legal entity.

But why is the LLC so attractive, so irresistible to legislators? And why have so many entrepreneurs opted for the LLC instead of a "C" corporation, or even an "S" corporation? And most important, how do you decide if it's right for you?

Perhaps the most important reason is for the popularity of the LLC that the it satisfies the demands of both accountants and attorneys. Accountants tend to

prefer the Limited Partnership ("LP") because they are concerned about the dangers of "double taxation" if their clients use a corporation: If your corporation pays dividends, the corporation pays taxes on its profits, and its shareholders pay taxes again on those same profits when they are taxed on the dividends they receive. By contrast, attorneys usually prefer the greater asset protection offered by the limited liability that the corporation has to offer to all its owners.

Let's begin with an understanding of what the limited liability company is. Basically it is a partnership among its owners, who are called "members". The LLC is like a limited partnership (and an S-corporation), because it is a "pass-through entity"--each partner's or member's share of the net gain or loss for the year "flows through" to the individual tax-payer's 1040 individual tax return. There is no separate tax to which the LLC itself is subject. On the other hand, the LLC is also like a corporation, because unlike the limited partnership--which requires a general partner, who is responsible for all results of all decisions and actions of the partners--all its owners benefit from limited liability.

People choose to form LLCs basically for the same reasons that they would elect to set up an S-corporation or a limited partnership. The LLC, like the S-corporation, is attractive if you have earned income that puts you in a high tax bracket, and you would like to be able to offset that income with the losses that you can normally expect to incur in your first years in a business. When I formed my first business entity twenty years ago, my husband and I selected the S-corporation. We both had salary income that placed us in a high tax bracket, and we knew that our new consulting business would incur significant capital expenses in the first few years. After all, we would have to purchase new equipment such as a fax machine, a laser printer, personal computers, and the replaceable supplies to operate them. We were also aware that it would take some time to build a clientele, so our income from the business would take a few years to take off. The S-corporation allowed us to carry the losses we incurred onto our individual 1040 tax returns. The losses were deducted from our gross personal salary income, and we paid dramatically lower taxes.

If you can get this advantage from an S-corporation, why would you bother with an LLC? The LLC has a number of advantages over the S-corporation:

1. First, LLC does not have the limitations that the S-corporation has on who can be a member of the LLC. Only individuals, estates, some trusts, and other S-corporations can be members of an S-corporation. Individuals (shareholders) must be either U.S. citizens or residents. By contrast, the LLC is not subject to these limitations. Thus, it is an ideal entity that you can combine with

other entities in your business structure. For example, you can have a corporation or other legal entity be a member of an LLC.

2. The LLC has much greater flexibility for allocation of rights, profits, and assets than the S-corporation. The S-corporation can have only one class of stock: In other words each share of stock has the same rights as every other share. This means that the allocation of profits and assets is extremely rigid. If Parties A and B are equal shareholders in a corporation, and the corporation decides to distribute its profits of \$10,000, then A and B must each receive \$5,000. This might not necessarily be equitable if one partner was much more active and produced a much greater share of the profits than the other. The LLC allows for A to receive, say, \$8,000 if its business activities generated 80% of the profit, leaving B with the remaining 20%, or \$2,000. This can be very attractive in a partnership in which there is a significant difference in the amount of capital and ongoing business activity that the partners are contributing to the business.

3. The LLC is not subject to the same corporate formalities that are required of the S or C corporation. While the LLC must still maintain appropriate LLC records and bookkeeping, it is not required to be managed by a board of directors and maintain minutes of regular board of directors meetings.

4. Unlike the S-corporation, liquidation of an LLC is generally not a taxable event. As your personal and business financial situation change over time, you may determine that it is no longer in your interest to maintain a "pass through" entity for your business. Once your business begins to turn a regular profit after the relatively high costs of the first year or two, you may decide that a C-corporation that is taxed at a maximum of 25% (unless it is a personal service corporation) would be more advantageous to you. If you have been operating as an S-corporation and you liquidate it by selling the liquidated assets to the shareholder(s) at their fair market value, the liquidation will be a taxable event. This does not apply to the LLC. This is one of the factors that makes the LLC particularly attractive for holding real estate.

5. The concept of the charging order makes the LLC especially effective for asset protection. This makes it a particularly attractive entity for holding real estate. The corporation should not be used to hold real estate, because if the corporation is sued, the court might award shares in the corporation in the judgment. Control of the corporation translates into control of the property, and you effectively lose control over your real estate holdings. By contrast, the charging order, used with Limited Liability Companies as with Limited Partnerships, gives the plaintiff only the right to receive income distributions

from the interest of the party or parties against whom the suit was brought. The charging order grants no voting rights or management powers. Thus, the existing managers or members could vote simply not to distribute income, thus leaving the plaintiff with no recourse; yet the plaintiff will have to pay taxes on the income allocated to her, even though the funds were not distributed(!). This offers a strong incentive for the plaintiff to negotiate for a settlement.

Clearly, the LLC is a powerful tool for protecting your assets against financial predators. If you use it for real estate holdings, you can maximize this protection by holding each piece of real estate in a separate LLC. Thus, if one LLC comes under attack from financial predators, the operations affecting only a single property will be affected.

Disadvantages of the Limited Liability Company

Needless to say, there are some disadvantages with the LLC--otherwise there would not be remain so many other attractive options for structuring your business. Why might the LLC not be the best option for you?

1. Increased taxes for LLC members in high tax brackets. Once your LLC is making a profit, its income passes through the individual members, who are taxed directly on that income, whether it is actually taken out of the LLC or not. Thus, members who are in a high tax bracket might pay higher taxes than they would if they used a C-corporation, which is subject to lower marginal tax rates. Proper planning of disbursements for expenses and other aspects of the business could overcome this disadvantage.

2. Higher initial filing fees for LLCs in some states. Some states may levy heavier tax obligations on LLCs in their initial years. Our home state of California requires that an LLC pay a minimum \$800 tax in its first year, while corporations are exempt in their first year--whether the business has any earnings or not! It can still be worthwhile for you to start an LLC: If you have high start up costs, tax savings in the thousands of dollars will outweigh these higher filing fees.

3. Unlike corporations, LLCs do not have continuity of life, that is they are limited usually to a specific period of time (say, 50 years) depending on the state.

If an LLC member dies, the remaining members may vote to continue the LLC business. LLC interests can be gifted to other family members; and the LLC can have a trust or family limited partnership as a member, thus providing for effective estate planning.

4. The LLC is a relatively untested entity. There is the large body of case law on corporations but on LLCs. We may also expect to see changes in the laws governing LLCs as the implications of this new entity become more apparent to legislators.

Space does not permit coverage of all the advantages and disadvantages of LLCs, but clearly the LLC can be a powerful tool for operating your business, protecting your assets, and planning your estate. It is easy and inexpensive to set up on your own, if you use one or more of the items on our Wealth Structuring Resources page.

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