

CPA Continuing Education
Society of PA
Russell Valante
President
Madison Bank Building
1767 Sentry Parkway West
Blue Bell, PA 19422
215.619.3920
rvalante@jmsonline.com
www.cpasocietypa.org

Limited Liability Company (LLC)

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What is it?

A limited liability company (LLC) is a hybrid of a partnership and a corporation. An LLC can be treated like a corporation for liability purposes and can be taxed as a partnership (or even a sole proprietorship). When taxed as a partnership, income, losses, and other tax attributes pass through to the owners either pro rata or as allocated in the operating agreement (also referred to as a limited liability company agreement or a member control agreement). Such an allocation of tax attributes is referred to as each member's distributive share. Creation of the LLC was an attempt to provide investors with the primary advantages of some of the other business entities but without their major drawbacks. Unlike a limited partnership, for example, an LLC typically permits all of its members to participate in management of the business without compromising their liability protection. Because LLCs are a relatively recent innovation, however, there is a lack of uniformity among the states as to how they are to be treated. The following discussion assumes that the LLC is taxed as a partnership for both federal and state purposes.

When can it be used?

Can be used in many situations

The limited liability company (LLC) form of entity is a good choice for almost any type of business venture with a small number of active investors. It is well suited for real estate investments, passive investments, or joint ventures between existing business (under certain conditions). It is suitable for certain medical service organizations and for family businesses that want to keep control within the family. While LLCs are appropriate in many situations, some states do not allow the practice of a profession (such as law) through an LLC.

Strengths

May be relatively simple and inexpensive to create and operate

A limited liability company (LLC) may be relatively inexpensive and simple to create and maintain. However, because an LLC is a creature of state law, it does require a bit more effort than a partnership. You must file articles or a certificate of organization (a document that outlines the company's purpose and structure, and provides contact information) with your state and create an operating agreement in which you prescribe, among other things, how the LLC is to operate and the relationship between members.

No limit on the number and type of owners

An LLC is unlimited in the number and type of members it may have. Most states allow single-member LLCs. In addition, an LLC can have other business entities (such as partnerships, corporations, trusts, and estates) as members. Compare this to an S corporation, which is limited to 100 shareholders meeting certain eligibility criteria.

Profits taxed only once

An LLC that is taxed as a partnership will not be assessed an entity-level tax. Instead, the members will pay income tax on the profits of the LLC. Single-member LLCs may be permitted under state law to be taxed as sole proprietorships. Therefore, an LLC is not subject to the double taxation often associated with a C corporation.

Caution: The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act) and the Tax Increase Prevention and Reconciliation Act of 2005 mitigate at least some of the of double taxation burden of a C corporation. These laws provide that dividends received by an individual shareholder from domestic corporations (and qualified foreign corporations) are taxed at lower long-term capital

gains tax rates. Pre-2003 Tax Act rules taxed these dividends at higher ordinary income tax rates. The lower rates apply to tax years beginning after 2002 and before 2011. Absent further legislative action, dividends will again be taxed as ordinary income starting in 2011.

Members can deduct losses and have them "specially allocated"

Members can deduct the losses of an LLC on their personal tax returns. Most significantly, within certain limitations, a member can have deductions "specially allocated" to him or her. This means that a larger number of deductions can be allocated (within certain limitations) to the member who pays the most taxes--say, for example, because he or she is in the top individual tax bracket.

Tip: This feature gives an LLC an advantage over an S corporation, as shown in the following example:

Example(s): Ken is a 25 percent member-manager of an LLC. The operating agreement allocates 50 percent of all losses to him. The LLC has had \$50,000 in losses this year alone. Ken can deduct 50 percent of this \$50,000 (\$25,000) on his personal tax return. If, instead, Ken were an S corporation shareholder, his deduction would be limited to his percentage of ownership in the corporation (25 percent).

Tip: Your method of allocating losses should be recorded in your operating agreement and must also have a substantial economic effect for it to be valid.

Tip: An LLC is a good idea if you anticipate large losses in the first several years of operation, because it allows members to reap immediate tax savings by deducting losses on their personal tax returns.

LLC can have centralized management

Generally, all members of an LLC participate in management. The members may, if they wish, elect a small committee of managers, in which case only the managers have the power to "bind" the LLC and its members (i.e., to make them responsible for the managers' acts).

A member's "basis" is increased by his or her share of LLC recourse liabilities

A member can increase his or her basis in an LLC by the member's allocation of the recourse liabilities of the LLC. A recourse liability is one where the member bears an economic risk of loss, such as an obligation to repay the LLC's creditors upon a liquidation.

Tip: This feature also gives the LLC an advantage over an S corporation, as shown in the following examples:

Example(s): Example 1: Ken, a member in an LLC that is taxed as a partnership, paid \$1,000 for his 50 percent interest in the LLC. Thus, Ken's basis in the LLC is \$1,000. Subsequently, the LLC borrows \$20,000 from a third party. Ken, who assumes liabilities of the LLC in proportion to his ownership interest, now has a basis of \$11,000.

Caution: While basis may increase with increased liabilities allowing more losses to be deducted, basis will be subsequently reduced as liabilities are paid down or when the business is sold and the liabilities are paid off.

Example(s): Example 2: Assume the same facts as in the preceding example, except that Ken is instead a 50 percent shareholder in an S corporation. Because S corporation shareholders cannot increase their basis by loans from third parties, Ken's basis will remain at \$1,000 despite the \$20,000 loan to the S corporation.

Examples 1 and 2 as a chart

	Old Basis	Liabilities Added to Basis	New Basis
LLC Member	\$1,000 +	(\$20,000/2)	= \$11,000 (Basis reduces as liability is paid down)
S Corporation Shareholder	\$1,000 +	\$0	= \$1,000

Members can "assign" their interests

Absent a contrary provision in the operating agreement, members can assign their LLC interests to another person or entity without restriction. An assignment, in contrast to outright sale, is only the transfer of economic rights (i.e., the transferee generally gains only the right to receive profits or deduct losses).

Tip: You can restrict a member's right to assign or sell his or her interest by including a restrictive provision in the operating agreement.

LLC is flexible in sharing profits and control

With certain limitations, an LLC can create ownership interests that would provide preferential treatment when profits are distributed to the members or that would disallow participation in management by certain members. An LLC can thereby regulate the sharing of profits and control (unlike an S corporation, which is relatively inflexible in this regard).

Members can generally contribute appreciated property tax free

You can generally contribute property to the LLC in exchange for your LLC interest. Such a contribution is tax free, even if the property has appreciated in value since you purchased it. An example of such a transfer is when a member exchanges real property (e.g., an office building to be used by the LLC) for an ownership interest in the LLC.

Liquidation of an LLC is generally tax free to members

Generally, when an LLC is liquidated (i.e., when all of its assets are distributed to the LLC's members), the LLC and its members are not taxed. However, the LLC members may recognize gain or loss to the extent money is distributed to the members in liquidation of the LLC. An S corporation, by comparison, will be treated as if it sold the assets to the shareholders at fair market value (FMV). Thus, the taxes on this deemed sale by the corporation flow to the shareholders.

Tradeoffs

Members can typically bind the limited liability company (LLC)

Because all members of an LLC generally manage the business, all can bind the LLC. However, this is usually addressed in the operating agreement.

Tip: If the LLC agreement provides for the members to elect a committee of managers, those member-managers will typically be the only members capable of binding the LLC. In that regard, the LLC is analogous to a limited partnership in which, generally, only the general partners (as opposed to limited partners) can manage and bind the business.

Life of LLC may be limited

The life of an LLC is typically limited. States may, for example, limit the life of an LLC to less than 30 years. In addition, the LLC lacks continuity of life. The withdrawal, death, bankruptcy, retirement, insanity, expulsion, or resignation of a member dissolves (ends) the LLC for "nontax purposes." In other words, the LLC no longer exists under state law, though it may still be taxed by the IRS as a partnership. However, most operating agreements address this issue and provide for the continued existence of the LLC. Some states are currently revising limitations on the life of an LLC.

Tip: An LLC will, however, dissolve for "tax purposes" when one of two things occurs. The first is a cessation of business. This means that no portion of the business is conducted by any of the members. The second scenario is when there are exchanges or sales (within any 12-month period) that total 50 percent or more of the total interest in the LLC's profits or capital. If the LLC continues to operate after either of these events, it will be treated as if it were newly created.

Tip: Members may avoid dissolution if they place a provision in the operating agreement that permits the remaining members to continue the business after a member withdraws. No provision in the operating agreement can prevent an LLC from terminating for "tax purposes."

LLC may be treated differently state to state

Because the LLC is a fairly recent development, courts have not had sufficient opportunity to render the types of decisions that would provide some predictability as to how this new entity will be regarded. In addition, states differ from one another as to how they treat LLCs that operate within their jurisdictions. Thus, your LLC may be treated somewhat differently in each state in which it conducts business. This could mean higher administrative costs.

Members typically cannot sell their LLC interest

Generally, a member cannot sell (as opposed to assign) his or her LLC interest unless every member consents to the transfer or the operating agreement provides for such sale. Otherwise, the sale of a member's interest may dissolve the LLC for nontax purposes.

Tip: Members may avoid dissolution if they place a provision in the operating agreement that permits the remaining members to continue the business after a member withdraws.

Members typically have the right to withdraw from the LLC

Unless members are restricted from doing so through a provision in the operating agreement, a member generally has the right to withdraw from the LLC. Such an act may cause the LLC to dissolve for nontax purposes.

Tip: One solution is to place a provision in the operating agreement that both disallows members to withdraw and permits remaining members to continue the business whenever a member ceases to be associated with the LLC. Though a member may nonetheless withdraw, the member might now be sued for violating the operating agreement. If this seems harsh, think about this: A member with no such incentive to remain could unilaterally dissolve the whole LLC against the wishes of all other members merely by withdrawing!

Fringe benefits are taxable to member-employee

An LLC can generally provide tax-free benefits (such as life, disability, and health insurance) to nonmember employees. However, LLC members are taxed on the cost of fringe benefits received, although the member may be able to deduct a percentage of the cost of health insurance. Contrast this with a C corporation, whose shareholder-employees typically receive fringe benefits tax free.

How to do it*

Consult an attorney

You should consult an attorney experienced in business planning. Your attorney should be familiar with your state's laws prescribing the requirements you will need to fulfill.

File articles or a certificate of organization and create a written operating agreement

You must deliver a document called the articles (or certificate) of organization to the secretary of state. State law dictates what this document should contain. (Your attorney can help you.) You should also create a written operating agreement. In it, you should dictate, among other things, how the limited liability company is to operate and in what manner profits and losses are to be shared by the members.

*Checklist is not exhaustive.

Tax considerations

The following discussion assumes that the limited liability company (LLC) is being taxed as a partnership (as most are), not as a corporation.

Members can deduct losses and generally have them specially allocated

Members can deduct the losses of the LLC on their personal tax returns. Most significantly, a member can generally have deductions "specially allocated" to him or her. This means that a larger number of deductions could be given to the member who pays the most taxes (say, for example, because he or she is in the top individual tax bracket). The result is potentially lower taxes for that member.

Tip: This feature gives the LLC an advantage over the S corporation, as shown in the following example:

Example(s): Ken is a 25 percent member-manager of an LLC. The operating agreement allocates 50 percent of all losses to him. The LLC has had \$50,000 in losses this year alone. Ken can deduct 50 percent of this \$50,000 (\$25,000) on his personal tax return. If, instead, Ken were an S corporation shareholder, his deduction would be limited to his percentage of ownership in the corporation (25 percent).

Tip: Your method of allocating losses should be recorded in your operating agreement. The method of allocation chosen must have a substantial economic effect for it to be valid.

Tip: An LLC is a good idea if you anticipate large losses in the first several years of operation, because it allows members to reap immediate tax savings by deducting losses on their personal tax returns.

Losses limited to member's basis

A member's distributive share of losses is limited to the member's basis in the LLC--generally, what the member paid for his or her LLC interest plus (among other things) his or her pro rata share of the LLC's liabilities.

Tip: Losses that exceed a member's basis may be carried over and deducted in a subsequent year.

Example(s): Assume the same facts as in the previous example: Ken is a 25 percent member, and the operating agreement allocates 50 percent of all losses to him. The LLC has had \$50,000 in losses this year alone. Ken can deduct 50 percent of this \$50,000 (\$25,000). However, because his "basis" (what Ken contributed to the LLC for his 25 percent interest) is only \$20,000, Ken can deduct that amount only and will have to carry the remaining \$5,000 loss to the subsequent year.

and deduct it then.

A member's basis is increased by share of LLC recourse liabilities

A member can increase his or her basis in the LLC (the number against which the member can deduct losses) by the member's allocation of the recourse liabilities of the LLC. A recourse liability is one where the member bears an economic risk of loss, such as an obligation to repay the LLC's creditors upon a liquidation.

Tip: This feature gives the LLC an advantage over the S corporation, as shown in the following examples:

Example(s): Example 1: Ken, a member in an LLC that is taxed as a partnership, paid \$1,000 for his 50 percent interest in the LLC. Thus, Ken's basis in the LLC is \$1,000. Subsequently, the LLC borrows \$20,000 from a third party. Ken, who assumes liabilities of the LLC in proportion to his ownership interest, now has a basis of \$11,000 ($\$1,000 + \$20,000/2$).

Caution: While the member's basis may increase with increased recourse liabilities allowing more losses to be deducted, basis will be subsequently reduced as liabilities are paid down or when the business is sold and the liabilities are paid off.

Example(s): Example 2: Assume the same facts as in the previous example, except that Ken is instead a 50 percent shareholder in an S corporation. Because S corporation shareholders cannot increase their basis by loans from third parties, Ken's basis will remain at \$1,000 despite the \$20,000 loan to the S corporation.

Examples 1 and 2 as a chart

	Old Basis	Liabilities Added to Basis	New Basis
General Partner	\$1,000 +	(\$20,000/2)	= \$11,000 (Basis reduces as liability is paid down)
S Corporation Shareholder	\$1,000 +	\$0	= \$1,000

Members taxed on their distributive share of income

A member is taxed on his or her distributive share of LLC income regardless of whether it is actually distributed to the member. Note, though, that if a member's share of income is retained by the LLC, his or her basis is increased dollar for dollar. This ensures that a member is not taxed twice--once when the LLC retains earned income, and again when the member sells his or her LLC interest or later distributes the income. Alternatively, as you may have guessed, when LLC income is distributed to a member, there is a corresponding decrease in his or her basis.

Tip: An LLC (or any other pass-through entity, for that matter) that anticipates retaining earnings for business purposes should consider distributing enough income so that each member can pay his or her tax liability.

Members subject to self-employment tax

A member may render services to the LLC. Payment for such services may be referred to as a guaranteed payment. Such payments are typically subject to self-employment (SE) tax. In addition, the SE tax will typically be imposed upon a member's distributive share of LLC income.

Tip: If a committee of managers is elected, however, nonmanaging members will typically be

treated like limited partners in a limited partnership. They will not have to pay SE tax on their distributive share. Generally, a member will be treated as a limited partner unless the member (1) has personal liability for LLC liabilities, (2) has the authority to "bind" the LLC, or (3) has significantly participated in LLC business (more than 500 hours during the LLC's tax year).

Wages to member-employees are generally considered business expenses by the LLC

Wages paid to members who render services to the LLC may be referred to as guaranteed payments. Such payments are considered business expenses of the LLC and are deducted, like all other business expenses, from LLC earnings. The remainder is considered profit (or loss). This profit (or loss), reported by the LLC on Form 1065 and Schedule K-1, is either distributed to the members or retained by the LLC. The members then report their shares of profit (or loss), regardless of whether anything has actually been distributed, on their personal tax returns and pay tax thereupon (or deduct any loss).

Example(s): Ken and his sister Liz are 50 percent members in a donut shop, an LLC. Ken is paid \$10,000 a year for donut making (guaranteed payment). Liz provides no services. Last year, the shop had \$70,000 in income. Assuming no other business expenses, the amount to be distributed to both Ken and Liz or held by the LLC is \$60,000 (\$70,000 - Ken's \$10,000). Of this amount, Ken and Liz may each receive 50 percent, or \$30,000. Ken pays income tax on \$40,000 (\$30,000 + \$10,000 salary), and Liz pays taxes on \$30,000.

Tip: If, however, a guaranteed payment is conditioned upon LLC profits, the payment is considered a portion of the member's distributive share and is therefore not treated as a business expense. Such payment would not be combined with other business expenses and would not get subtracted from LLC earnings.

Example(s): For his services, Ken has instead been promised his 50 percent LLC interest or \$30,000, whichever is greater. The donut shop has \$50,000 in income. Because 50 percent of \$50,000 is \$25,000, Ken gets \$30,000. The amount that is considered a guaranteed payment is \$5,000 (\$30,000 - \$25,000). Thus, Ken's \$30,000 represents his distributive share of LLC income (\$25,000) as well as his salary (guaranteed payment of \$5,000). The amount to be distributed to the other members or held by the LLC is \$20,000 (\$50,000 - Ken's \$30,000).

Fringe benefits: deductible by LLC, taxable to member-employee

Fringe benefits are generally deductible by the LLC. An LLC can generally provide certain tax-free benefits (such as life, disability, and health insurance) to nonmember employees. However, like most S corporation shareholders, LLC members are taxed on the cost of fringe benefits received, although the member may be able to deduct a percentage of the cost of health insurance. Contrast this with a C corporation, whose shareholder-employees typically receive fringe benefits tax free.

Members can generally contribute appreciated property tax free

You can contribute property to the LLC in exchange for your LLC interest. Such a contribution is generally tax free even if the property has appreciated in value since you purchased it. An example of such a transfer is when a member exchanges real property (e.g., an office building to be used by the LLC) for an ownership interest in the LLC.

Liquidation of an LLC is generally tax free to members

Generally, when an LLC is liquidated (i.e., when all of its assets are distributed to LLC members), neither the LLC nor the members are taxed. However, the LLC members may recognize gain or loss to the extent that money is distributed to the members in liquidation of the LLC. An S corporation, by comparison, will be treated as if it sold the assets to the shareholders at fair market value (FMV).

Restrictions on deductibility for nonmanaging members

A member can take deductions to the extent of his or her basis in the LLC. In LLCs that have an elected committee of managers, the nonmanaging members will typically be treated like limited partners. As such, the

members will be subject to the passive loss limitation rules. Generally, these rules limit the deductions for losses if the taxpayer does not materially participate in the business.

Gift and estate taxes

For information, see the separate discussion on Business Succession Planning.

Questions & Answers

What type of documentation is needed to form a limited liability company (LLC)?

The laws vary by state, but generally you will be required to file articles (or a certificate) of organization with the secretary of state, which contains general information including the name and address of the LLC, and business to be engaged in. Filing of this document creates the LLC. You should also prepare an operating agreement that specifies the relationship of LLC members and how the LLC will operate. State law specifies other information to be included in these documents, as well as default provisions if the operating agreement is silent on certain matters, and the filing procedure.

Does an LLC have unlimited life?

The life of an LLC may be limited by state law, in some cases to less than 30 years. Although the LLC may cease to exist under state law as a result of the withdrawal, death, bankruptcy, retirement, insanity, expulsion, or resignation of a member (these issues are often addressed in the operating agreement), the entity may still be taxed by the IRS as a partnership.

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Janney Montgomery Scott LLC Financial Consultants are available to discuss the suitability and risks involved with various products and strategies presented. We will be happy to provide a prospectus, when available, and other information upon request.

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