Wolters Kluwer

CT

ESSENTIAL COMPLIANCE INSIGHTS

WHY AND HOW TO FORM AN LLC: ESSENTIALS OF THE LLC BUSINESS TYPE

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In the "alphabet soup" of entity choices, the limited liability company (LLC) is a frequent favorite. Whether you've been in business a while or you're just starting out, it's good to get a grip on some essentials of the LLC business type.

WHAT IS AN LLC?

An LLC is a separate entity that can have its own rights and responsibilities, similar to an individual or corporation. For example, LLCs can buy property, lend money, invest money, make contracts, sue and be sued. States typically require annual report filings for LLCs, similar to corporate annual reports.

The owners of an LLC are called "members" (similar to shareholders of a corporation). Some classes of members may have different or greater rights than others.

WHY FORM AN LLC?

Sole proprietors often form a single-member LLC to help protect their personal assets (like a family home or car) from business debts. When they do so, the IRS still treats the individual as a sole proprietor for income taxes. It "disregards" the LLC and business income "flows through" onto the single-member individual's Form 1040. This helps keep things simple compared to a corporation, which requires a separate tax return.

HOW TO FORM AN LLC

Forming an LLC generally involves properly filing your Articles of Organization (also called a Certificate of Organization or another name depending on the state), designating your registered agent, and paying the state's fee. You'll also typically adopt an operating agreement. Even if your state doesn't technically require an operating agreement, it's usually better for your business if you have one.

States vary in what they ask for in the Articles of Organization. Generally, the states ask for the following type of information:

- LLC's name
- LLC's registered agent and registered office
- Who's forming the LLC

The state may also ask you to list the LLC's purpose (e.g., a general purpose like "all lawful business" or a more specific purpose). You may also need to list whether the LLC will be managed by managers (a manager-managed LLC) or by members (a member-managed LLC).

continued on page 2

LLC OPERATING AGREEMENT: WHAT DOES IT DO?

An LLC's operating agreement is your LLC's basic governing document. It provides rules for your LLC's business and affairs and for the relations among the LLC, its managers, and its member/owners.

CT Tip: *The operating agreement is pivotal – it serves as an official "rulebook" for almost every aspect of your LLC.*

The LLC operating agreement typically includes things like:

- ownership interests
- voting rights
- buy-sell provisions
- management
- dissolution
- allocation of profits and losses
- distributions
- capital contributions
- admission and withdrawal of member/owners

A very wide variety of terms and provisions could be included in an LLC operating agreement. This flexibility can be very beneficial, especially if you'd like certain owners to have greater shares of certain items.

CT Tip: *Operating agreements are important because they influence your tax situation and your control, voting, and financial rights in your LLC. Talk to your attorney about your operating agreement.*

Some states do restrict some terms in operating agreements. But for the most part, you have a great amount of flexibility in what you place in your agreement.

CT Tip: *If an LLC does not have an operating agreement, then the state's "default" rules generally apply. But these aren't always the best ones for you or your business.*

LLC MANAGEMENT: IS YOUR LLC MANAGED BY MEMBERS OR MANAGERS?

A noteworthy benefit of LLCs (unlike corporations) is the degree of choice you have in your management structure. An LLC may be managed by all member/owners or by a designated group of "managers."

In a member-managed LLC, every member has an equal right to manage the LLC's business, unless otherwise provided in the operating agreement.

In a manager-managed LLC, certain persons are designated as managers to run the business. These managers could be non-member "outsiders" as well as members.

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If you want a manager-managed LLC, you have to say so in the Articles of Organization or in the operating agreement (depending on the state). Otherwise, states consider an LLC to be member-managed.

CT Tip: *Either way (i.e., member-managed or manager-managed), you could still appoint officers and delegate to them the running of daily operations.*

LLC TAX TREATMENT: PASS-THROUGH TAXATION OR ELECTIVE?

LLCs automatically enjoy pass-through taxation (also called flow-through taxation) under IRS rules, unless you elect otherwise.

CT Tip: *Because of pass-through taxation, the LLC doesn't pay its own taxes on its income the way a C Corporation does. Instead, the LLC acts like a conduit.*

The LLC's income, gains, deductions, losses, etc. essentially "flow through" to LLC owner/members to be taxed on their returns.

CT Tip: *Pass-through taxation is popular for avoiding the C Corporation's "double-taxation" dilemma. Unlike LLCs, C Corps are separate taxpayers that pay tax on their income (the "first" tax). Shareholder-owners generally pay tax again on dividends (the second, or "double" tax). Pass-through entities like LLCs avoid the first tax on business income – only the owners are taxed.*

continued on page 3

With pass-through taxation, LLC owners have to pay tax on the income – even if the business doesn't distribute money out to them. Some investors don't like this – they prefer corporations where business income is taxable to the business entity (instead of flowing through onto the investor's return).

LLC with only one owner

The IRS taxes an individual owner of a single-member LLC as a sole proprietorship for income taxes (e.g., on Form 1040, Individual Income Tax Return). The IRS considers a single-member LLC to be a "disregarded" entity – it generally treats the business as part of the owner's tax return.

LLC with two or more owners

LLCs with two members or more don't pay income tax – but they do have to file an information return, because the IRS taxes them like a partnership. LLC owners pay tax on their share of business income on their own returns.

CT Tip: *Many states follow these IRS rules – but not all. When you talk with your advisor about your business taxes, be sure to discuss your state and local tax treatment.*

Electing different taxation

Under the IRS "check-the-box" regulations, it's possible to elect that an LLC be taxed like an S Corporation or C Corporation (instead of like a sole proprietorship or partnership). If you'd like to go this route, it's best to consult an advisor who's familiar with the intricate rules involved, especially if you'd like S Corp status.