

TAX STRATEGY GUIDE

Limited Liability Companies (LLCs)



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Limited Liability Companies (LLCs)

A limited liability company (LLC) is a business entity organized in the United States under state law. Unlike a partnership, all of the members of an LLC have limited personal liability for its debts. Depending on elections made and the number of owners, an LLC may be classified for federal income tax purposes as a partnership, corporation, or an entity disregarded as separate from its owner.

LLCs	
<i>Ownership</i>	<ul style="list-style-type: none"> • Unlimited number of members. • Non-U.S. citizens or residents allowed. • Can be owned by other corporations, partnerships, trusts, or LLCs.
<i>Class of ownership interest</i>	Different membership classes allowed.
<i>Transfer of ownership</i>	Member approval often required.
<i>Formalities</i>	Recommended: <ul style="list-style-type: none"> • Adopt operating agreement. • Issue membership shares. • Hold and document annual member meetings.
<i>Existence</i>	Some states require dissolution date. Events such as death or withdrawal of member can cause LLC to dissolve.
<i>Income allocation</i>	May decide to allocate income in any method agreed to by members.
<i>Self-employment (SE) tax</i>	Members subject to SE tax on guaranteed payments and also distributive share of income.

This information applies to LLCs in general, and different rules may apply to special situations, including banks, insurance companies, or nonprofit organizations that are LLCs. Check your state's requirements.

Forming an LLC

Choose a business name. Your business name must be different from any existing LLC in your state, it must indicate that it is an LLC, and must not include words restricted by your state.

File the articles of organization. The articles of organization is a document that is filed with your Secretary of State that makes your LLC a legal entity and includes information such as your business name, address, names of members, and your resident agent. There is usually a filing fee.

Create an operating agreement. Most states do not require operating agreements, but they are highly recommended, especially for multi-member LLCs. The operating agreement structures your LLC's finances and organization, and provides rules and regulations for its operation. Sometimes tax treatment can be dictated by a written operating agreement. Default tax rules of multi-member LLCs will split income and expenses evenly, unless otherwise noted in an operating agreement.

Hold and document annual member meetings. If the operating agreement requires an annual meeting, these meetings must be held and documented. Failure to adhere to provisions in the operating agreement and other formalities could result in loss of liability protection for your LLC.

Apply for an EIN. An employer identification number (EIN) is a nine-digit number assigned by the IRS used to identify the tax accounts of employers and certain others who have no employees. If you will hire employees or have an LLC with multiple members, you need to apply for an EIN. See IRS Form SS-4, **Application for Employer Identification Number**, or apply online at www.irs.gov.



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Classification of an LLC

Default classification rules. An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes). See **Single Member LLCs—Disregarded Entities**, later.

Elected classification. If an LLC does not want to be classified under the above default classifications, it can elect to be classified as an association taxable as a corporation or as an S corporation. After an LLC has determined its federal tax classification, it can later elect to change that classification. See IRS Form 8832, **Entity Classification Election**.

LLCs Classified as Partnerships

If an LLC has at least two members and is classified as a partnership, it generally is subject to the same filing and reporting requirements as partnerships. For certain purposes, members of an LLC are treated as limited partners in a limited partnership. For example, LLC members are treated as limited partners for purposes of material participation under the passive activity limitation rules.

Change in default classification. If the number of members in an LLC classified as a partnership is reduced to only one member, it becomes an entity disregarded as separate from its owner. However, if the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classification as a disregarded entity will not apply.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

Single Member LLCs—Disregarded Entities

If an LLC has only one member and is classified as an entity disregarded as separate from its owner, its income, deductions, gains, losses, and credits are reported on the owner's income tax return. For example, if the owner of the LLC is an individual, the LLC's income and expenses would be reported on one of the following schedules filed with the owner's Form 1040.

- Schedule C, **Profit or Loss From Business (Sole Proprietorship)**,
- Schedule E, **Supplemental Income and Loss**,
- or
- Schedule F, **Profit or Loss From Farming**.

Employment taxes and certain excise taxes. If the LLC pays wages to employees, employment taxes must be reported and paid in the name and EIN of the LLC rather than in the name and EIN of the single member owner. The single-member LLC is also required to use the LLC's name and EIN to register for certain excise taxes.

Self-employment tax. An individual owner of an LLC treated as a disregarded entity is not an employee of the LLC. The owner is subject to self-employment tax on the net earnings in the same manner as a sole proprietorship.

Taxpayer identification number. For all income tax purposes, a single-member LLC classified as a disregarded entity must use the owner's Social Security Number (SSN) or EIN. This includes all information returns and reporting related to income tax.

LLCs Classified as Corporations

An LLC with either a single member or more than one member can elect to be classified as a corporation rather than be classified as a partnership or disregarded entity under the default rules.

An LLC classified as a corporation is subject to the same filing and reporting requirements as a corporation. The entity may elect to be treated as an S corporation if it otherwise qualifies.

C corporation. If the entity is treated as a C corporation, it is taxed on its taxable income and distributions to members are includible in each member's gross income to the extent of the corporation's earnings and profits (double taxation).

S corporation. If the entity elects to be an S corporation, the corporation is generally not subject to an income tax. The income, deductions, gains, losses, and credits of the corporation pass through to the members.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 73.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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