

LLC's Corporations, Sole Proprietorships, Partnerships

LLC's compared to corporations

Should I form a corporation or an LLC? It is a common question among business owners and one that deserves careful consideration. While both are excellent choices for personal liability protection, each structure offers its own set of distinct advantages. Choosing the right one for your company depends on your particular business, operational needs, and tax strategy.

Advantages of LLC's:

Fewer corporate formalities. Corporations must hold regular meetings of the board of directors and shareholders, keep written corporate minutes and file annual reports with the state. On the other hand, the members and managers of an LLC need not hold regular meetings, which reduces complications and paperwork.

No ownership restrictions. S-corporations cannot have more than 100 stockholders, and each stockholder must be a natural person who is a resident or citizen of the United States. There are no such restrictions placed on an LLC.

Ability to use the cash method of accounting. Unlike a C-corporation, which often must use the accrual method of accounting, most limited liability companies can use the cash method of accounting. This means that income is not earned until it is received.

Ability to place membership interests in a living trust. Members of an LLC are free to place their membership interests in a living trust. It is difficult to place shares of an S-corporation into a living trust.

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

Tax flexibility. By default, LLC's are treated as a "pass-through" entity for tax purposes, much like a sole proprietorship or partnership. This means that LLC's avoid double taxation. Furthermore, an owner of an LLC is not required to pay unemployment insurance taxes on his or her own salary. However, an LLC can also elect to be treated like a corporation for tax purposes, whether as a C-corporation or an S-corporation.

Disadvantages:

Profits subject to social security and Medicare taxes. In some circumstances, owners of an LLC may end up paying more taxes than owners of a corporation. Salaries and profits of an LLC are subject to self-employment taxes, currently equal to a combined 15.3%. With a corporation, only salaries (and not profits) are subject to such taxes. This disadvantage is most significant for owners who take a salary of less than \$90,000.

Owners must immediately recognize profits. A C-corporation does not have to immediately distribute its profits to its shareholders as a dividend. This means that shareholders in a C-corporation are not always taxed on the corporation's profits. Because an LLC is not subject to double-taxation, the profits of the LLC are automatically included in a member's income.

Fewer fringe benefits. Employees of an LLC who receive fringe benefits, such as group insurance, medical reimbursement plans, medical insurance and parking, must treat these benefits as taxable income. The same is true for employees who own more than 2% of an S-corporation. However, employees of a C-corporation who receive fringe benefits do not have to report these benefits as taxable income.

LLC's compared to sole proprietorships and partnerships

The following section outlines the advantages and disadvantages of an LLC as compared to a sole proprietorship and partnership.

Advantages:

Owners are not personally responsible for company debts. This is the most important attribute of an LLC. In a sole proprietorship and partnership, the owners are personally responsible for the debts of the business. If the assets of the sole proprietorship or partnership cannot satisfy the debt, creditors can go after each owner's personal bank account, house, etc. to make up the difference. By contrast, if an LLC runs out of funds, the owners are usually not liable.

Please note that under certain circumstances, an individual member may be liable for the debts of an LLC. These circumstances include:

- If a member personally guarantees a debt.

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- If the LLC fails to have a separate bank account and personal funds are intermingled with LLC funds.
- If the LLC has minimal capitalization or minimal insurance.
- If the LLC fails to pay state taxes or otherwise violates state law (like defrauding consumers).

Easier to raise money. An LLC has many avenues to raise capital. It can admit new members by selling membership interests, and it can create new classes of membership interests with different voting or profit characteristics. Plus, investors will be assured that they are not personally liable for company debts.

Ease of transfer. Ownership interests in a limited liability company may generally be sold to third parties without disturbing the continued operation of the business. The business of a sole proprietorship or partnership, on the other hand, cannot be sold whole; instead, each of its assets, licenses and permits must be individually transferred. New bank accounts and tax identification numbers are also required.

Disadvantages

Cost. LLC's cost more to set up and run than a sole proprietorship or partnership. For example, there are the initial formation fees, filing fees and annual state fees. These costs are partially offset by lower insurance costs.

Formal organization. Although an LLC requires fewer formalities than a corporation, there is still more paperwork involved than a sole proprietorship or partnership. A sole proprietorship or partnership can commence and operate without any formal organizing procedures; not even a hand written agreement is required.

Separate records. In order to maintain the separate form of the LLC and maintain the liability protection of its members, the owners of the LLC must carefully maintain separate records and keep their personal business separate from the LLC's business. Even more importantly, the LLC's money should never be intermingled with personal money.

Forming an LLC

The life of an LLC begins upon the filing of the articles of organization with the secretary of state's office. Prior to filing the articles, the following issues should be considered.

1. Where should I form the LLC?

An LLC can be formed in any of the 50 states and the District of Columbia.

2. Choosing a name

In general, the name of a limited liability company must end with the words "LLC", "L.L.C.", "Limited Liability Company" or "Ltd. Liability Co." The name of a person may be used as part of the name of the limited liability company. Please note that a name will not be accepted if it is likely to mislead the public or if it too closely resembles the name of another LLC formed in that state.

Before you choose the name, you should do a little research to see if the name is taken. You can search yourself at the Secretary of State of the state in which you wish to form your LLC.

If the name of the LLC is used in connection with goods or services, you may wish to consider obtaining federal trademark protection for the name. This ensures that no one else in the U.S. may use that name in connection with the same general type of goods or services (except in areas where someone else is already using that name).

3. Management by members or managers

A limited liability company may be managed either by (a) the members or (b) one or more managers. A "member" is an owner of the limited liability company. If a limited liability company is managed by the members, then the owners are directly responsible for running the company.

A "manager" is a person elected by the members to manage the limited liability company. In this context, a manager is similar to a director of a corporation. A manager can be, but is not required to be, a member. If a limited liability company is managed by managers, then its members are not be directly responsible for running the company.

Whether an LLC should be managed by members or managers depends on several factors, including:

- The number of owners;
- The type of business;
- Where the owners are located;

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- How involved the members will be in the operations of the LLC.

Management by members is usually the best option for LLC's that have only one member or just a few members, all actively participating in the affairs of the LLC. If there are many members, on the other hand, including some that do not actively participate in the operations of the LLC (such as silent partners), then management by managers may be the best option.

4. **Officers**

Regardless of how a limited liability company is managed, it can still appoint officers to run the day-to-day operations of the company. An LLC is not, however, required to have officers. Officers serve at the pleasure of either (a) the managers, if the limited liability company is managed by managers, or (b) the members, if the limited liability company is member-managed. Members or managers may both be officers. There is no limit on the maximum number of officers, nor is there a limit on the number of offices that a person may hold. In fact, the same person may hold all offices.

5. **Registered Agent**

Each LLC must have a registered agent, the person designated to accept official notice if the LLC is "served" with a lawsuit. A registered agent must be either (1) an adult living in the state of formation with a street address (P.O. boxes are not acceptable) or (2) a company registered with the Secretary of State in the state of formation.

As previously mentioned, one of the advantages of forming an LLC in your home state is that any of the members, managers or officers can act as the registered agent. However, there are some advantages to having another person or company act as your registered agent. First, this adds an extra layer of privacy, since the name and contact information for the registered agent is publicly available. Second, this ensures that if your LLC is named in a lawsuit, no one will surprise you at home on a Sunday night with court papers.

Capital Contributions and Ownership

Ownership in an LLC can be expressed in two ways: (1) by percentage; and (2) by membership units, which are similar to shares of stock in a corporation. In either case, ownership confers the right to vote and the right to share in the profits of the LLC.

Unlike a corporation, an LLC can distribute its ownership interests as it pleases, without regard to how much money or property a member contributes to the company. For example, if Sam contributes \$10,000 to the company and is a silent partner, and Rick contributes no money but runs the company on a daily basis, they could still decide to split the membership interests 50%-50%.

A limited liability company can also be organized with different classes of ownership interests, which provides flexibility for special allocations of profits and voting power. For example, you can create a special class of "super-voting" units that provide 10 votes per unit or pay a certain level of profit before the "regular" units.

The sale of membership interests is subject to federal and state securities laws. Generally though, if you are not advertising the sale and are dealing only with a small number (less than 35) of knowledgeable and sophisticated investors, then you will be exempt from the regulations. If, however, you are seeking to raise a significant amount of money from a large number of investors, it will be necessary to consult an attorney.

Running an LLC

Here are a few things to keep in mind when running your LLC.

1. Keep things separate

As previously mentioned, it's important to keep the business and affairs of the LLC separate from a member's or manager's personal affairs. This means setting up a separate bank account, maintaining separate records, and keeping separate accounts.

2. Meetings

Regular or annual meetings of the members or managers are not required. Even though law does not require it, it may be a good idea to keep records of the actions taken or approved at the meetings.

3. Transfer of ownership interests

Transfer of membership interests generally requires the consent of other members. This is an important issue to consider for any LLC with more than one member. On one hand, you may wish to sell or transfer your membership units to anyone you wish. On the other, if you consider the other members of the LLC your business partners, you may want approval over whether they can transfer their interest and whom they can transfer it to.

4. Tax forms and licenses

Many LLC's are required to obtain a federal tax identification number, which is similar to an individual's social security number. However, there are some situations where an LLC can simply use the social security number of the owner. Single-member LLC's that do not have employees generally do not need a separate federal tax ID. City and county business licenses may also be required. Please check with an accountant about the need for a tax ID number and your city and county to see which types of licenses are needed.

Tax Reporting

By default, LLC's do not pay income tax at the entity level. Instead, the LLC's income is passed through to the members, who must recognize their allocated income or loss on their personal tax returns. For a single-member LLC, this income is reported on the individual owner's Form 1040, Schedule C.

Checklist for Businesses

Forming an LLC is just one step in starting a new business. There are other federal, state, and practical considerations as well. The following is a list of things to do or think about once you have formed a new LLC.

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- Consider registering a DBA if you want to do business under a name other than the official entity name.
- Establish a corporate banking account.
- Contact the state tax board for information about state taxes and obtaining a state tax number.
- Check with the state department of consumer affairs to obtain any required business licenses or permits.
- Contact the Internal Revenue Service for information on filing your federal tax schedules.
- Find out about workers' compensation if you will have employees.
- Check zoning laws.
- Obtain city and/or county business licenses or permits.
- Get adequate business insurance or a business rider to a homeowner's policy.
- Get tax information such as record-keeping requirements, guidelines for withholding taxes
- If you will have employees, information on hiring independent contractors, facts on estimating taxes, forms of organization, etc.
- Have business cards and stationery printed.
- Get an email address.
- Get your website set up.

The United States Small Business Administration (SBA) offers additional information and resources on starting a new business. You can visit them on the Internet at www.sba.gov, or you can contact your local branch office by phone.