

THE BASICS OF LIMITED LIABILITY COMPANIES (LLCs)

Limited liability companies (LLCs) are a popular choice of entity for small businesses and investment activities.

LLC owners are called members.

- Single-member LLCs have one owner, although spouses who jointly own an LLC in a community property state can elect treatment as a single member LLC for federal income tax purposes.
- We will call LLCs with two or more members multimember LLCs.

Key point: LLCs are not corporations. But LLCs can offer similar legal protection to their members (owners).

Here are the most important things to know about LLCs.

LLCs Offer Legal Protection

Using an LLC to conduct a business or investment activity *generally* protects your personal assets from LLC-related liabilities—similar to the legal protection offered by a corporation.

As you know, liabilities can arise from simple things—like the Federal Express guy slipping on the banana peel someone left on your front steps—or in seemingly endless and complicated ways if you have employees.

Key point. As a general rule, no type of entity (including an LLC) will protect your personal assets from exposure to liabilities related to your own professional malpractice or your own tortious acts.

Tortious acts are wrongful deeds other than by breach of contract—such as negligent operation of a motor vehicle resulting in property damage or injuries. The issue of liability protection offered by an LLC is a matter of state law. Seek advice from a competent business attorney for details.

Single-Member LLC Tax Basics

Single-member LLC businesses owned by individuals are treated as sole proprietorships for federal income tax purposes unless you *elect* to treat the single-member LLC as a corporation.

In other words, the *default* federal income tax treatment for a single-member LLC business is sole proprietorship status. Under the default treatment, you simply report all the single-member LLC's income and expenses on Schedule C of your Form 1040.

If the single-member LLC business activity generates net self-employment income, you will report that on Schedule SE of your Form 1040.

Rental. If the single-member LLC activity is a rental activity, you report the rental income and expenses on Schedule E of your Form 1040.

Farm or ranch. You report the numbers for a farming or ranching activity on Schedule F.

Simple. You don't need to file a separate federal income tax return for the single-member LLC. And other things being equal, simple is good.

Three key points

1. The big federal income tax advantage of operating as a single-member LLC is extreme simplicity.
2. The big non-tax advantage is liability protection, under applicable state law.
3. As mentioned, you can elect to treat a single-member LLC as a corporation for federal income tax purposes, but we don't recommend that, for reasons we explain later.

Multimember LLC Tax Basics

Multimember LLCs are treated as partnerships for federal income tax purposes unless you *elect* to treat the LLC as a corporation.

In other words, the *default* federal income tax treatment of a multimember LLC is partnership status. Under the default treatment, you must file an annual partnership federal income tax return on Form 1065.

From the Form 1065 partnership return, the LLC issues an annual Schedule K-1 to each member to report that member's share of the LLC's income and expenses. The member then takes those taxable and deductible amounts into account on the member's own return (Form 1040 for a member who is an individual).

The LLC itself does not pay federal income tax. This arrangement is called *pass-through taxation*, because the income and expenses from the LLC's operations are passed through to the members who then take them into account on their own returns. (The same pass-through taxation concept applies to entities set up as "regular" partnerships under applicable state law.)

Electing to Treat the LLC as a Corporation for Tax Purposes

You have the option of *electing* to treat a single-member LLC or multimember LLC as a corporation for federal income tax purposes. You do that by filing IRS Form 8832, *Entity Classification Election*, to change the default classification of the single-member LLC or multimember LLC to the new classification as a corporation.

If your desire is to have your LLC treated as an S corporation, it can elect S corporation status directly using IRS Form 2553, or it can elect C corporation treatment on Form 8832 and then S corporation treatment on IRS Form 2553.

While there may be valid non-tax reasons for electing to treat an LLC as a corporation, we think tax reasons generally dictate against taking that step.

If you conclude that there are tax advantages to electing corporate status, why not just *actually* incorporate your operation in the first place? That's simpler. Keeping your tax matters simple is generally good policy.

Electing corporate status from the LLC could have unintended tax consequences. For example, you can potentially collect federal-income-tax-free gains from selling stock in a qualified small business corporation (QSBC). But you must own shares and hold them for over five years to cash in on this super-favorable deal. Can an LLC membership (ownership) interest count as QSBC stock for this purpose? Apparently not. It's not stock.

If you are looking for the QSBC stock break, just set up as a corporation in the first place.

Here's another example: a special federal income tax break allows you to annually deduct up to \$50,000 of losses from selling eligible small business stock, or \$100,000 if you're a married joint filer, and treat the loss as a tax-favored ordinary loss instead of a tax-disfavored capital loss.

Can an LLC membership interest count as eligible stock for this purpose? Apparently not. It's not stock. Avoid the problem—set up as a corporation in the first place.