

SWAIM & ASSOCIATES

ACCOUNTANTS AND TAX ADVISORS

39 Broad Street, Suite 210, Charleston, South Carolina 29401

Phone: (843) 722-5264 • Fax: (843) 722-5266 • Email: robert@carolinatax.net • Web: www.carolinatax.net

Should you form an LLC?

LLCs are a bit of a hybrid of other forms of business. Like C corporations and S corporations, LLCs can provide you with some protection against personal liability. But for tax purposes, LLCs are treated more like partnerships.

Characteristics of LLCs include:

- **All members of the LLC have limited liability.** This differs from partnerships, in which a general partner or a limited partner who engages in management activities could be subject to personal liability.
- **Income/losses get reported on members' tax returns.** LLC owners are actually called "members" instead of "partners." However, as with a partnership, an LLC files a Form 1065 with the federal government. Income or losses are reported on the members' own personal tax returns.
- **One-person LLCs get sole proprietor treatment.** If you form an LLC with no other members, you are considered a "see-through" entity for federal tax purposes unless you request to be taxed as a corporation. You'll file a Schedule C as a sole proprietor with your federal income tax return, just as you would if you hadn't formed the LLC. (You'll use the name of your LLC on the Schedule C itself.) Right now, every state except Massachusetts, and the District of Columbia, allows one-owner LLCs.
- **Earnings are subject to self-employment tax.** This is one area where some people will prefer an S corp, in which profits from the corporation are subject to ordinary income tax but not to self-employment tax. (As discussed in a previous column on S corps, owners still must receive appropriate salaries, which are subject to FICA and Medicare tax.) Note: The self-employment tax and how it applies to an LLC member's distributive share of profits — income that does not represent guaranteed payments for services — is still a subject of debate, since final regulations on this question have not been issued by the IRS. You'll want to talk with your tax pro for his or her latest thinking on this issue.

Professional firms use an LLC variation: the LLP. In many states, lawyers, accountants, doctors and other professionals are not allowed to form LLCs. There is an alternative for them: Limited Liability Partnerships (LLPs), which are treated similarly to LLCs for tax purposes.

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Flexibility a key draw

LLCs carry fewer restrictions than other entities. And because they're considered relatively easy to operate, LLCs are often compared favorably to S corps, despite the self-employment tax issue. For example, members can decide how to split profits and losses regardless of how much money or capital they put into the LLC. There's no limit on the number of members that an LLC can have (S corps are restricted to 75 shareholders), nor on the type of entity that can be a member. And LLCs can even opt to be treated as C corporations or S corporations for tax purposes, if they prefer that.

"It's just such a flexible entity," says Mancuso. "You don't have all the trappings of boards and officers and corporate records and worrying about formalities; you don't even need an operating agreement in most

cases. Some of the rules can seem a little strange, but overall it is just far simpler than forming a corporation."

It's not all sweetness and light for LLCs, of course. The self-employment tax issue does turn many entrepreneurs away from this type of entity. In addition, LLCs are formed at the state level, and states do differ in their individual tax treatment. Further, restrictions on what LLCs can do in terms of raising capital and issuing stock make them less appealing for anyone considering taking a company public someday. Some lawyers also have told me that they remain a little leery of LLCs because, despite their widespread acceptance, there is relatively little case law on treatment of LLCs that do business in multiple states. Even so, figure that LLCs will continue to grow in popularity.

"Once you think about capital formation or selling shares of your operation or going into the capital markets, you're going to need to look at a C corporation, but for smaller businesses I see the LLC as pretty much the entity of choice," says Mancuso.