LIMITED LIABILITY COMPANIES (LLCs)

DEFINITION

A Limited Liability Company (LLC) is a form of business that combines certain elements of a corporation and a partnership. The primary characteristic an LLC shares with a corporation is limited liability, and the primary characteristic it shares with a partnership is the availability of pass-through income taxation.

HOW THEY WORK

SETUP

To create an LLC, members must file "articles of organization" with their respective state government. Filing fees range from between $100 to $800 per year. In addition, the members of the LLC should create a written operating agreement. This document does not usually need to be filed with the state, but it is a crucial document since it sets out the LLC members' rights and responsibilities, their percentage interests in the business, and their share of the profits.

TAXATION

An LLC is what the IRS calls a “pass-through entity,” like a partnership or sole proprietorship. Unlike a corporation, an LLC is not considered separate from its owners for tax purposes. This means that business income passes through the business to the LLC members, who report their share of profits or losses on their individual income tax returns. While an LLC itself does not pay taxes, LLCs that have co-owners must file Form 1065, an informational return, with the IRS each year. This form, which partnerships also have to file, states each LLC member's share of the LLC's profits or losses. The IRS reviews this to make sure LLC members are correctly reporting their income.

DEBTS AND LIABILITIES

Unlike a sole proprietorship, LLC members are protected from personal liability for business debts and claims. This “limited liability” means that if the business owes money or is sued, only the assets of the business itself are at risk. Creditors usually cannot reach the personal assets of the LLC members. However, this liability protection is not applicable if the LLC members act illegally or unethically.

CONTINUITY

Depending on the stipulations set forth in an LLC’s operating agreement, when one member wants to leave the LLC, the company may potentially have to dissolve. In that case, the LLC members must fulfill any remaining business obligations, pay off all debts, and divide any assets and profits among themselves. To prevent this, the LLC operating agreement should include a "buy-sell," or buyout, provision that sets up guidelines for what would occur when one member retires, dies, becomes disabled, or leaves the LLC to pursue other interests.