

Is a Limited Liability Company Right for You?

An important element of estate planning is having your business owned in a way that gives you flexibility, control, tax advantages and liability protection. The limited liability company (LLC) is becoming the preferred vehicle to achieve this goal for many people.

Before the LLC, people who wanted to form a business had to structure it as either a sole proprietorship, general partnership or corporation. The choice depended on whether liability protection (for which a corporation would be selected) or pass-through tax treatment (for which a general partnership would be selected) was more important to the owners. A Subchapter S corporation could also offer liability protection with pass-through tax treatment, but only with substantial limitations on structure and organization.

Only recently have all 50 states recognized the LLC, an entity that offers the best features of partnerships and corporations. The Internal Revenue Service's (IRS's) implementation of the "check-the-box" regulations has made the classification of LLCs for federal tax purposes a simple matter, permitting pass-through tax treatment.

Some states now even permit the single-member LLC, which is treated as sole proprietorships for tax purposes unless the owner elects otherwise. For example, a sole proprietor can now form an LLC and gain commercial liability protection without any additional tax filing responsibilities.

So What Is an LLC?

An LLC is a flexible business entity that combines the pass-through tax treatment characteristics of a partnership with the liability protection of a corporation. It can be managed by members (owners) or by managers (who need not be owners). Officers may also be elected and have titles under a corporate structure. An operating agreement -- similar in many respects to a partnership agreement -- is normally adopted to govern the LLC's operation and management.

An LLC that is treated as a partnership for federal income tax purposes may permit owners to structure allocations of income and losses any way they desire, as long as they follow IRS partnership allocation rules. Thus, if one member is contributing more money to cover initial losses, the losses can be allocated to that member alone.

Generally, an LLC does not require annual meetings or minutes -- one less administrative burden. An LLC can be designed to meet the special needs of owners, such as special voting rights, management controls and buyout options. Classes of membership interests can be created, giving different rights to different classes. For example, an LLC can have a preferred membership interest class giving its members the right to distributions before any other class. Alternatively, a preferred voting membership interest could be created giving its holders the right to vote alone on certain actions. The only limit to what can be done is your imagination and, of course, current tax laws.

Self-Employment Tax

Unless an LLC elects otherwise, it will be treated as a partnership for federal tax purposes. In manager-managed LLCs, the managing members generally will be subject to self-employment income tax.

Proposed IRS regulations generally treat LLC members like limited partners in limited partnerships. Consequently, passive members of a manager-managed LLC should not be subject to self-employment tax on their distributive share of LLC income.

If, on the other hand, the LLC elects to be treated as an S corporation for federal tax purposes, shareholder-employees will not be subject to self-employment tax on shareholder income. Instead, the shareholder-employees are responsible only for the employee portion of FICA for their pay. The LLC pays the employer portion of FICA and receives a deduction for it.

Because there is no limit on the Medicare portion of FICA, the entire earnings of a partnership or LLC (where the owners are treated as self-employed) will be subject to Medicare tax. However, in S corporations, only those amounts actually paid as compensation are subject to Medicare tax.

Health and Life Insurance Benefits

Generally, employees can exclude from their gross income amounts paid by their employer for health and certain life insurance benefits. Self-employed individuals are not considered employees for these exclusions, but are permitted to deduct a portion of the amount paid for health insurance. Partners in partnerships and members of LLCs who are treated as self-employed individuals will have to include the cost of insurance benefits in their gross income.

Protection Without Administrative Burdens

LLCs provide better liability protection than do partnerships. Also, the liability protection is much broader than that of limited partnerships and does not come with the additional administrative burdens. Consequently, if you wish to structure a new or existing business as part of your estate planning and limit your liability to the greatest extent possible while maintaining the pass-through tax characteristics of a partnership, an LLC may be for you.

Please call us if you would like to discuss how an LLC may help you achieve your estate planning goals, or to discuss any other estate questions you may have.

When LLC Members Are Subject to Self-Employment Taxes

Under proposed regulations, a member of an LLC will generally be subject to self-employment taxes if any of the following conditions apply:

1. The member has personal liability for the debts or claims against the LLC, as when a member agrees to be responsible for LLC obligations such as a loan or lease,
2. The member has authority to enter into contracts on the LLC's behalf, or
3. The member participates in the LLC's trade or business for more than 500 hours during the tax year.