

6.12: Limited Liability Company (LLC)

Learning Objectives

- Define limited liability company (LLC) as a form of business
- Discuss the advantages and disadvantages of LLCs

A limited liability company (LLC) is a hybrid business structure allowed by state statute. LLCs are attractive to small business owners because they provide the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. *Each state may use different regulations*, and you should check with your state if you are interested in starting a limited liability company.

Owners of an LLC are called members. Most states do not restrict ownership, and so members may include individuals, corporations, other LLCs and foreign entities. There is no maximum number of members. Most states also permit “single-member” LLCs, those having only one owner.

Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are “passed through” the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

Forming an LLC

While each state has slight variations on forming an LLC, they all adhere to some general principles:

Choose a Business Name. There are three rules that your LLC name needs to follow: (1) it must be different from an existing LLC in your state, (2) it must indicate that it’s an LLC (such as “LLC” or Limited Company”) and (3) it must not include words restricted by your state (such as “bank” and “insurance”). Your business name is automatically registered with your state when you register your business, so you do not have to go through a separate process.

File the Articles of Organization. The “articles of organization” is a simple document that legitimizes your LLC and includes information like your business name, address, and the names of its members. For most states, you file with the Secretary of State. However, other states may require that you file with a different office such as the State Corporation Commission, Department of Commerce and Consumer Affairs, Department of Consumer and Regulatory Affairs, or the Division of Corporations & Commercial Code.

Create an Operating Agreement. Most states do not require operating agreements. However, an operating agreement is highly recommended for multimember LLCs because it structures your LLC’s finances and organization, and provides rules and regulations for smooth operation. The operating agreement usually includes percentage of interests, allocation of profits and losses, member’s rights and responsibilities, and other provisions.

Obtain Licenses and Permits. Once your business is registered, you must obtain business licenses and permits. Regulations vary by industry, state, and locality.

Announce Your Business. Some states, including Arizona and New York, require the extra step of publishing a statement in your local newspaper about your LLC formation.

LLC Taxes

In the eyes of the federal government, an **LLC is not a separate tax entity**, so the business itself is not taxed. Instead, all federal income taxes are passed on to the LLC’s members and are paid through their personal income tax. While the federal government does not tax income on an LLC, some states do, so check with your state’s income tax agency.

Since the federal government does not recognize LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. Certain LLCs are automatically classified and taxed as a corporation by federal tax law.

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Advantages of an LLC

- **Limited Liability.** Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation. Keep in mind that limited liability means "limited" liability—members are not necessarily shielded from wrongful acts, including those of their employees.
- **Less Record Keeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S Corporation, there is less registration paperwork and there are smaller start-up costs. However, it is very important to keep proper and separate business financial records. If it appears that the LLC is co-mingling personal and business funds, it can be legally reclassified and end up assuming additional liability.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

Disadvantages of an LLC

- **Possible Limited Life.** When an LLC is formed, the members must decide on the duration of the LLC. If an LLC is formed in a state where perpetual life is not permitted, then the death or disassociation of a member will dissolve the LLC, and the members must fulfill all remaining legal and business obligations to close the business. For this reason, it is important for individuals seeking to use this form of ownership verify the requirements for an LLC in the state in which they intend to operate.
- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

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