



Nolo's Guide to Limited Liability Companies: Forming an LLC



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Especially in tough times, it's important to protect your personal assets in case your business ends up not being able to pay its bills. Having the limited liability of an LLC will prevent creditors and banks from coming after your home and other personal property to pay off your business debts. Setting up your business as an LLC also lends you credibility—it shows lenders, clients, and others that you are serious about your business. But setting up an LLC can be more expensive—in the short term—than starting your business as a sole proprietorship or partnership. Is it worth it?

This guide will teach you about limited liability companies as well as other forms of doing business, so you can decide for yourself whether an LLC is right for you. Many entrepreneurs form LLCs because they provide limited liability, simplicity, and flexibility.

Nolo's LLC Formation Service

Nolo can help you quickly and easily form an LLC. After you answer a few questions online, our LLC formation service will prepare your articles of organization and file them with the appropriate government agency. After your articles are accepted by the state, Nolo can also prepare and send you:

- a customized LLC operating agreement
- a personalized LLC records kit and company seal, and
- a completed IRS Form SS-4, Application for Employer Identification Number.

And your LLC will be up and running! Go to www.nolo.com to get started.

LLC Basics

A limited liability company (LLC) combines attributes from corporations, partnerships, and sole proprietorships: Like a corporation, an LLC provides a personal shield from business debts and liabilities, but its owners pay taxes on the income that comes through the LLC, like partners or sole proprietors. However, running an LLC is significantly easier than running a corporation.

Here are the main features of an LLC:

Limited Personal Liability for LLC Owners

An LLC can have one or many owners, who are called members. Like shareholders of a corporation, all LLC owners are protected from personal liability for business debts and claims. This means that if the business itself can't pay a creditor—such as a supplier, a lender, or a landlord—the creditor can't legally come after any LLC member's house,

car, or other personal possessions. Because only business assets are used to pay off business debts, LLC owners stand to lose only the money that they've invested in the LLC. This feature is often called "limited liability."

Exceptions to LLC Owners' Limited Liability

While LLC owners enjoy limited personal liability for many of their business transactions, this protection is not absolute. (This drawback is not unique to LLCs—the same exceptions apply to corporations.) LLC owners can be held personally liable if they:

- treat the LLC as an extension of their personal affairs, rather than as a separate legal entity (for instance, by commingling personal and business funds)
- intentionally do something fraudulent, illegal, or reckless that causes harm to the company or to someone else
- personally and directly injure someone
- fail to pay state taxes and file statements with the state government
- fail to deposit taxes withheld from employees' wages, or
- personally guarantee a bank loan or a business debt on which the LLC defaults.

The first exception is the most important. If owners don't treat the LLC as a separate business, a court might say that the LLC doesn't really exist and find that its owners are really doing business as individuals, who are personally liable for their acts. To keep this from happening, make sure you and any co-owners:

- **Keep LLC and personal business separate.** Get a federal employer identification number, open up a business-only checking account, and keep your personal finances out of your LLC accounting books.
- **Fund your LLC adequately.** Invest enough cash into the business so that your LLC can meet foreseeable expenses and liabilities.
- **Act fairly and legally.** Don't conceal or misrepresent material facts or the state of your finances to vendors, creditors, or other outsiders.
- **Create an LLC operating agreement.** Having a formal written operating agreement lends credibility to your LLC's separate existence.

LLC Management

The owners of most small LLCs participate equally in the management of their business. This arrangement is called "member management."

There is an alternative management structure—called "manager management"—in which you designate one or more owners (or even an outsider) to take responsibility for managing the LLC. The nonmanaging owners (sometimes family members who have invested in the company) simply sit back and share in LLC profits. In a manager-managed LLC, only the named managers get to vote on management decisions and act

as agents of the LLC. Choosing manager management sometimes makes sense, but it might require you to deal with state and federal laws regulating the sale of securities.

Let's look at some aspects of manager-managed LLCs:

Liability. In a manager-managed LLC, managers and members have personal liability protection.

Authority. In a manager-managed LLC, only managers are authorized to enter into deals and bind the LLC to contracts.

Self-Employment Taxes. Nonmanaging members in a manager-managed LLC may not have to pay self-employment taxes; if you are in this situation, consult a tax adviser.

Securities Registration and Exemptions. Membership interests in a manager-managed LLC might be classified as securities because nonmanaging members may be investing their money in a business in which they are not actively participating. If your LLC's membership interests are considered securities, you must get an exemption from state and federal securities laws before the initial owners of your LLC invest their money. Fortunately, smaller LLCs usually qualify for securities law exemptions. For example, SEC rules exempt the private sale of securities from registration if all owners reside in one state and all sales are made within the state; this is called the "intrastate offering" exemption.

Another federal exemption covers "private offerings." A private offering is an unadvertised sale that is limited to a small number of people (35 or fewer) or to those who, because of their net worth or income earning capacity, can reasonably be expected to be able to take care of themselves in the investment process. Most states have enacted their own versions of these popular federal exemptions.

If you don't qualify for an exemption to the securities laws, you must register the sale of your LLC's ownership interests with the SEC and your state.

Forming an LLC

To create an LLC, you file "articles of organization" (in some states called a "certificate of organization" or "certificate of formation") with the LLC division of your state government. Filing fees range from about \$100 to \$800.

Many states supply an articles of organization form on which you state basic details about your LLC, such as its name and address, as well as contact information for a person called a "registered agent," who will receive legal and tax papers on its behalf. The registered agent is responsible for seeing that the owners receive this correspondence. Some states also require you to list the names and addresses of the LLC members on the articles of organization.

In addition to filing articles of organization, you must create a written LLC operating agreement. While you don't have to file your operating agreement with the state, it's a crucial document because it sets out the LLC members' rights and responsibilities, their percentage interests in the business, and their share of the profits.

Note that forming an LLC doesn't take the place of obtaining a business license, tax registration certificate, or other required business permits. An LLC merely creates an ownership setup that limits the owners' personal liability. You'll still need to take care of getting set up to do business with your local government.

LLC Taxation

Unlike a corporation, the LLC itself is not a separate taxable entity. Instead, an LLC has the same tax treatment as a sole proprietor (for a one-person LLC) or partnership (for an LLC with two or more members). Income "passes through" the LLC to the LLC owners, and the owners report the business's income on their personal income tax returns.

Reporting Federal Income Taxes

Here is how the IRS requires you to report LLC income:

Single-owner LLCs. The IRS treats one-member LLCs as sole proprietorships. This means that the LLC itself does not pay taxes and does not have to file a return with the IRS. As the sole owner of your LLC, you must report all profits (or losses) of the LLC on Schedule C and submit it with your 1040 tax return. Even if you leave profits in the company's bank account at the end of the year—for instance, to cover future expenses or expand the business—you must pay income tax on that money.

How Is an LLC Owned by Spouses Taxed?

When two spouses both run an LLC, they are normally treated as partners and they file a partnership tax return for the LLC. However, there is a special exception to partnership tax treatment, available in several states. Specifically, IRS rules say that a business owned by two spouses as community property in the community property states of Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin can receive sole proprietorship tax treatment by filing Schedule C (to IRS Form 1040) for the business. For more information on spousal businesses, see the paragraph titled "Community Property" in IRS Publication 541, Partnerships, under the section on "Forming a Partnership." In addition, you would also be wise to check with a tax adviser before deciding on the best way to and file and pay taxes for a spousal LLC.

Multi-owner LLCs. The IRS treats co-owned LLCs as partnerships for tax purposes. Like one-member LLCs, co-owned LLCs do not pay taxes on business income; instead, the LLC owners each pay taxes on their lawful share of the profits on their

personal income tax returns (with Schedule E attached). Each LLC member's share of profits and losses, called a distributive share, should be set out in the LLC operating agreement.

Most operating agreements provide that a member's distributive share is in proportion to his or her percentage interest in the business. For instance, if Jimmy owns 60% of the LLC, and Luana owns the other 40%, Jimmy will be entitled to 60% of the LLC's profits and losses, and Luana will be entitled to 40%. However members' distributive shares are divvied up, the IRS treats each LLC member as though the member receives his or her entire distributive share each year. This means that each LLC member must pay taxes on his or her whole distributive share, whether or not the LLC actually distributes all (or any of) the money to the members. The practical significance of this IRS rule is that, even if LLC members need to leave profits in the LLC—for instance, to buy inventory or expand the business—each LLC member is liable for income tax on the member's rightful share of that money.

Even though a co-owned LLC itself does not pay income taxes, it must file Form 1065 with the IRS. This form, the same one that a partnership files, is an informational return that the IRS reviews to make sure that LLC members are reporting their income correctly. The LLC must also provide each LLC member with a Schedule K-1, which breaks down each member's share of the LLC's profits and losses. In turn, each LLC member reports this profit and loss information on his or her individual Form 1040, with Schedule E attached.

Estimating and Paying Income Taxes

Because LLC members are considered self-employed business owners rather than employees of the LLC, they are not subject to tax withholding. Instead, each LLC member is responsible for setting aside enough money to pay taxes on that member's share of the profits. The members must estimate the amount of tax they'll owe for the year and make quarterly payments to the IRS (and to the appropriate state tax agency, if there is a state income tax)—in April, June, September, and January.

Self-Employment Taxes

Because LLC members are not employees, no contributions to the Social Security and Medicare systems are withheld from their paychecks. Instead, most LLC owners are required to pay these taxes—called “self-employment taxes” when paid by a business owner—directly to the IRS.

The current rule is that any owner who works in or helps manage the business must pay this tax on his or her distributive share (rightful share of profits). However, owners who are not active in the LLC—that is, those who have merely invested money but don't provide services or make management decisions for the LLC—may be exempt from paying self-employment taxes on their share of profits. The regulations in this area are a bit complicated, but if you actively manage or work in your LLC, you can expect to pay the self-employment tax on all LLC profits allocated to you.

Each owner who is subject to the self-employment tax reports the amount due on Schedule SE, which must be submitted annually with his or her tax return. LLC owners (and sole proprietors and partners) pay twice as much self-employment tax as regular employees, because regular employees' contributions to the self-employment tax are matched by their employers. (However, they also get to deduct half of the total amount from their taxable income, which saves a few tax dollars.) The self-employment tax rate for 2016 is 15.3% of the first \$118,500 of income and 2.9% of everything over that amount; the amount of income taxed at 15.3% increases each year.

State Taxes and Fees

Most states tax LLC profits the same way the IRS does: The LLC owners pay taxes to the state on their personal returns, while the LLC itself does not pay a state tax. A few states, however, do charge the LLC a tax based on the amount of income the LLC makes, in addition to the income tax its owners pay. For instance, California levies a tax on LLCs that make over \$250,000 per year; the tax ranges from about \$900 to \$11,000.

In addition, some states impose an annual LLC fee that is not income-related. This may be called a "franchise tax," an "annual registration fee," or a "renewal fee." In most states, the fee is about \$100, but California exacts a hefty \$800 "minimum franchise tax" per year from LLCs. Before forming an LLC, find out whether your state charges a separate LLC tax or fee. For more information, check the website of your state's secretary of state, department of corporations, or department of revenue or tax.

For a detailed discussion of LLC taxes, see *Nolo's Quick LLC*, by Anthony Mancuso (Nolo).

Other Types of Ownership Structures

Before you decide how you want to structure your business, you should familiarize yourself with all of your options. Other ways to organize a for-profit business include:

- sole proprietorship
- partnership
- limited partnership
- C corporation, and
- S corporation.

Sole Proprietorships

For some new businesses, the simplest form of ownership structure is a sole proprietorship. A sole proprietorship is a one-person business that is not registered with the state like a limited liability company (LLC) or corporation. You don't have to do anything

special or file any papers to set up a sole proprietorship—you create one just by going into business for yourself.

Legally, a sole proprietorship is inseparable from its owner—the business and the owner are one and the same. This means the owner of the business reports business income and losses on his or her personal tax return and is personally liable for any business-related obligations, such as debts or court judgments.

A sole proprietorship makes sense for a business where personal liability isn't a big worry—for example, a small service business in which you are unlikely to be sued and for which you won't be borrowing much money for inventory or other costs. But if you will be piling up a lot of business debts or have substantial personal assets you want to protect from business creditors, you should consider forming an LLC.

Partnerships

A partnership is simply a business owned by two or more people that hasn't filed papers to become a corporation or a limited liability company (LLC). You don't have to file any paperwork to form a partnership—the arrangement begins as soon as you start a business with another person. As in a sole proprietorship, the partnership's owners pay taxes on their shares of the business income on their personal tax returns and they are each personally liable for the entire amount of any business debts and claims.

In a partnership, any partner can usually bind the entire partnership to a business deal, and each partner is personally liable for 100% of the business's debts—a scary combination. This means that if there aren't enough business assets to pay the debts, creditors could come after your personal assets to pay all of the business's debts, not just your pro rata share of the debts. For this reason, you may want to think twice before forming a partnership, and don't form one unless you have complete faith in your partner.

Limited Partnerships

Limited partnerships are costly and complicated to set up and run, and aren't recommended for the average small business owner. Limited partnerships are usually created by one person or company (the "general partner"), who will solicit investments from others (the "limited partners").

The general partner controls the limited partnership's day-to-day operations and is personally liable for business debts (unless the general partner is a corporation or an LLC). Limited partners have minimal control over daily business decisions or operations and, in return, they are not personally liable for business debts or claims. Consult a limited partnership expert if you're interested in creating this type of business.

C Corporations

The main benefit of a corporation is that, like an LLC, it limits the owners' personal liability for business debts and court judgments against the business. What sets

the corporation apart from all other types of businesses is that a corporation is an independent legal and tax entity, separate from the people who own, control, and manage it. Because of this separate status, the owners of a corporation don't use their personal tax returns to pay tax on corporate profits—the corporation itself pays these taxes. Owners pay personal income tax only on money they draw from the corporation in the form of salaries, bonuses, and the like.

S Corporations

An S corporation is a regular corporation that has elected "S corporation" tax status, which means that the corporation is not a separate taxable entity like a C corporation. Basically, owners pay income taxes as if they were sole proprietors or partners. S corporations are very similar to LLCs, but there are a few key differences.

Restrictions on S corporations. S corporations have several limitations that LLCs do not:

- Each S corporation shareholder must be a U.S. citizen or resident.
- S corporations may not have more than 100 shareholders.
- S corporation profits and losses may be allocated only in proportion to each shareholder's interest in the business.
- An S corporation shareholder may not deduct corporate losses that exceed his or her "basis" in corporate stock—which equals the amount of the shareholder's investment in the company plus or minus a few adjustments.
- Like regular corporations, S corporation owners have to issue stock, hold regular board of directors' and shareholders' meetings, and keep corporate minutes of all meetings.

Differences in S corporation and LLC taxation. S corporation shareholders are not subject to self-employment taxes, while active LLC owners are. Self-employment taxes are made up of the Social Security and Medicare taxes and can add up to more than 15% of one's income. However, on a different tax issue, LLCs can give their owners the tax benefits of most business debt, while S corporations can't. When an LLC takes on debt, the owners' tax basis in the business increases, which is a good thing, because distributions of profits from the LLC are taxable to the owner only when they exceed the owner's tax basis in the company—in other words, the increase in basis means that each LLC owner is less likely to be taxed on profits paid to them. If a company will incur substantial debt for start-up costs or to buy equipment or real estate, owners of an S corporation will be at a disadvantage.

Which Structure Is Right Your Business?

Which business structure is right for your business depends on the type of business you run, how many owners it has, and its financial situation. No one choice suits every business: Business owners have to pick the structure that best meets their needs. Before making a decision, consider:

- the potential risks and liabilities of your business
- the formalities and expenses involved in establishing and maintaining the various business structures
- your income tax situation, and
- your investment needs.

Risks and Liabilities

In large part, the best ownership structure for your business depends on the type of services or products it will provide. If your business will engage in risky activities—for example, trading stocks or repairing roofs—you'll almost surely want to form a business entity that provides personal liability protection (“limited liability”), which shields your personal assets from business debts and claims. A corporation or a limited liability company (LLC) is probably the best choice for you.

Likewise, especially in tough times, all businesses can become laden with debts and bills they can't pay. If you have personal assets you want to protect from being taken to pay your business's debts, you'll want to form a corporation or LLC.

Formalities and Expenses

Sole proprietorships and partnerships are easy to set up—you don't have to file any special forms or pay any fees to start your business. Plus, you don't have to follow any special operating rules.

LLCs and corporations, on the other hand, are almost always more expensive to create and more difficult to maintain. To form an LLC or corporation, you must file a document with the state and pay a fee, which ranges from about \$40 to \$800, depending on the state where you form your business. In addition, owners of corporations and LLCs elect officers (usually, a president, vice president, and secretary) to run the company and keep records of important business decisions.

Income Taxes

Owners of sole proprietorships, partnerships, and LLCs all pay taxes on business profits in the same way. These three business types are “pass-through” tax entities, which means that all of the profits and losses pass through the business to the owners, who

report their share of the profits (or deduct their share of the losses) on their personal income tax returns.

Owners of these unincorporated businesses must pay income taxes on all net profits of the business, regardless of how much they actually take out of the business each year. Even if all of the profits are kept in the business checking account to meet upcoming business expenses, the owners must report their share of these profits as income on their tax returns.

In contrast, the owners of a corporation do not report their shares of corporate profits on their personal tax returns. The owners pay taxes only on profits they actually receive in the form of salaries, bonuses, and dividends.

The corporation itself pays taxes, at special corporate tax rates, on any profits that are left in the company from year to year (called “retained earnings”). Corporations also have to pay profits on dividends paid out to shareholders, but this rarely affects small corporations, which seldom pay dividends.

This separate level of taxation adds a layer of complexity to filing and paying taxes, but it can be a benefit to some businesses. Owners of a corporation don’t have to pay personal income taxes on profits they don’t receive. And, because corporations enjoy a lower tax rate than most individuals for the first \$50,000 to \$75,000 of corporate income, a corporation and its owners may actually have a lower combined tax bill than the owners of an unincorporated business that earns the same amount of profit.

Investment Needs

Unlike other business structures, the corporation allows a business to sell ownership shares in the company through its stock offerings. This makes it easier to attract investment capital and to hire and retain key employees by issuing employee stock options.

But for businesses that don’t need to issue stock options and will never “go public” (most, by far), forming a corporation probably isn’t worth the added expense. If it’s limited liability that you want, an LLC provides the same protection as a corporation, but the simplicity and flexibility of LLCs offer a clear advantage over corporations.

In short, most entrepreneurs starting a small business prefer limited liability companies. Like a corporation, an LLC effectively provides a personal shield from business liabilities, but unlike a corporation, an LLC doesn’t need to hold formal meetings, have a board of directors, or keep detailed minutes of the board’s decisions and actions.

Starting Out Simple

How you set up your business at the beginning doesn’t keep you from changing it later if your needs change or your business grows. You can start out as sole proprietorship or partnership and later, if your business grows or the risk of personal liability increases, you can convert your business to an LLC or a corporation. It is harder, however, to convert an LLC to a corporation and vice versa.

For an in-depth discussion about choosing a form for your business, read *LLC or Corporation? How to Choose the Right Form for Your Business*, by Anthony Mancuso (Nolo).

Converting Your Business to an LLC

Converting a sole proprietorship or a partnership to an LLC is an easy way for sole proprietors and partners to protect their personal assets without changing the way their business income is taxed.

Some states provide a simple form for converting a partnership to an LLC (often called a “certificate of conversion”). Sole proprietors and partners in states that don’t provide a conversion form must file regular articles of organization to create an LLC.

If you are trying to convert a corporation or partnership into an LLC, consult an attorney before doing so. There are some legal and tax ramifications to closing down an existing business and starting a new one that are beyond the scope of Nolo’s service. If you need a lawyer, Nolo’s Lawyer Directory can help you find one. Go to <http://lawyers.nolo.com> to search for a lawyer near you.

Why Your LLC Needs an Operating Agreement

An operating agreement helps your LLC by recording the member’s ownership percentages and voting rights, heading off financial and management misunderstandings, and making sure your business is governed by your own rules—not default rules created by your state (for example, many states have a default rule that requires owners to divide up LLC profits and losses equally, regardless of each member’s investment in the LLC). But the main reason to make an operating agreement is as simple as it is important: It helps ensure that courts will respect your limited personal liability. This is particularly key in a one-person LLC where, without the formality of an agreement, the LLC will look a lot like a sole proprietorship. Having a formal written operating agreement will lend credibility to your LLC’s separate existence.

About Nolo’s Operating Agreement

With Nolo’s LLC formation service, Nolo will customize an operating agreement for your LLC depending on whether you are forming a single member or multi-member LLC and whether your LLC will be managed by its members or managers.

Percentage of Ownership and Profits and Losses

Nolo's operating agreement provides that each member's capital contribution goes into that member's "capital account" and will establish each member's percentage interest. Each member's capital, or percentage, interest is computed as a fraction, the numerator of which is the value of a member's capital account and the denominator of which is the total of all capital accounts of all members.

Your operating agreement will provide that the profits and losses of the LLC will be allocated to members according to each member's percentage interest in the LLC.

Holding Member Meetings

Nolo's operating agreement does not require your LLC to hold regular or annual members' meetings. However, a member can call a meeting at any time by communicating his or her request for a formal meeting to all of the other members, noting the purpose or purposes for which the meeting is called. The member calling the meeting does not need to state a specific reason for the meeting or give notice of what issues are to be discussed or voted on at the meeting.

One of the members, or a person designated at the meeting, should take minutes of the meeting, recording the issues discussed, the votes taken, and the matters approved. A copy of the minutes of the meeting should be placed in the LLC's records binder after the meeting.

Transfer Restrictions

Nolo's multi-member operating agreement provides that a member can transfer or sell his or her capital interest and accompanying membership rights in the LLC only with the written approval of the nontransferring LLC members, who also must unanimously approve the admission of the new member into the LLC.

It also provides that members cannot "encumber" their membership in the LLC unless all of the other members of the LLC agree, in writing. "Encumber" means to offer a membership interest as security for a mortgage or loan or otherwise pledge the membership interest.

These transfer restrictions make it easy for continuing LLC members to keep out potential members they would rather not be in business with and also to protect membership interests from being foreclosed on to pay a bad debt.

Buyout Procedures

Nolo's multi-member operating agreement provides that, in the event of a member's withdrawal, the LLC will buy out the departing member for the fair value of the capital interest, less any amounts owed by the member to the LLC. If the departing and remaining members can't agree on the value of departing member's interest, the operating agreement provides that they will select an appraiser to determine the current value of the departing member's interest. If you wish to incorporate more advanced

provisions such as these into your operating agreement, use Nolo's book *Business Buyout Agreements: A Step-by-Step Guide for Co-Owners* or consult an LLC lawyer.

Where Should You Form Your LLC?

It's usually best to form an LLC in your home state, where you conduct most of your business. If you form an LLC out of state, you'll then have to register and pay fees to do business in your own state, and you may have to hire an out-of-state registered agent to accept legal documents on your behalf.

Forming Your LLC with Nolo

Once you've decided that an LLC is the right ownership structure for your business, Nolo's online service can help you form one. Our clear and straightforward program guides you through a series of questions about you and your business. If you have questions, plain-English legal help is available every step of the way. It's free to create an account and start the process, and you have 90 days to work on your LLC formation documents without purchasing them. Every time you work on your LLC formation through Nolo's Online LLC, your answers are automatically saved in the system. After you've entered all of your information, reviewed it for accuracy, and placed your order, Nolo will file your documents with the proper government agency. You can get started today at www.nolo.com.

What You'll Need to Get Started

You may find it useful to have this information on hand when you begin Nolo's LLC formation process:

- Your LLC name, as well as one or two alternate name selections, in case your first choice is not available.
- Your LLC location.
- The name and street address of your registered agent, the person who will accept legal documents on behalf of the LLC.
- Your LLC business purpose—a statement of your business objectives and goals.
- The names of each owner of the LLC, as well as any spouses.
- The contribution each LLC owner will provide to fund the business (cash, property, or services).

Once you've got that information pulled together, you're ready to go. Good luck! ●