

For Closely-Held Business Limited Liability Company is the Ideal Form

Characterization:

A domestic limited liability company (LLC) is treated as a partnership for federal tax purposes if it has two or more members and is disregarded as a separate entity if it has one owner, unless the LLC elects to be treated as an association taxable as a corporation by "checking the box". For purpose of this outline, it is assumed that the LLC does not elect to be taxed as a corporation.

States generally follow the federal characterization of an LLC for income and franchise tax purposes. That may not be the case for other taxes. For example, the Internal Revenue Service (IRS) has recognized that states may require a disregarded LLC to withhold employment taxes in its own name, and permits the sole member or the LLC to report the withholding.

Advantages over a C Corporation:

As a pass through entity, an LLC is not separately taxable on its own. Rather, the income flows through to the members and is taxed directly on their personal tax returns, whether or not any amount is actually distributed. Distributions of such amounts are not again subject to tax. Corporate profits, on the other hand, are potentially subject to double taxation, once at the corporate level and again upon a distribution to the shareholder.

There are fewer restrictions on a taxpayer's ability to transfer appreciated property to an LLC without income tax. The transferors of property to an LLC are not required to control the LLC immediately after the exchange as they are in the case of a transfer to a corporation.

Although an LLC cannot engage in tax free reorganization under Section 368 (a) (1), it can acquire assets tax free. In addition, the LLC can be incorporated without income tax (provided its liabilities do not exceed the basis in its assets), and that corporation could be the surviving corporation in a tax free reorganization.

Property can be distributed by an LLC to its members without income tax. On the other hand, appreciated property can be distributed out of corporate solution only at the cost of a double tax.

The transferee of a membership interest by purchase or upon the death of a member can obtain a set up in his share of LLC's inside basis in its assets. Although, a corporation that purchases at least 80% of the stock (measured by vote and value) of a subsidiary from the selling parent corporation may elect to treat the purchase, and thereby step up its basis in the assets, either the purchasing corporation or the selling corporation must recognize the gain.

Advantage over an S Corporation:

Unlike an S Corporation, an LLC does not have to qualify as a small business corporation under section 1361 (b). As a result, there is no limit on the number or kind of the members, class of interest or type of business as there is for an S corporation. This permits much greater flexibility in an LLC with respect to members an allocation of income and distributions.

Certain jurisdictions do not recognize S corporations. Others impose a tax at the entity level. On the other hand, every state has an LLC statute, and the number of states that tax LLCs as corporation has been reduced.

Property can generally be distributed by an LLC to its members without tax. The distribution by an S corporation, however, is treated as a taxable sale of property for its fair market value. Although, there is only a single level of tax, it is accelerated.

The insolvency exception does not apply with respect to the cancellation of an LLC's indebtedness unless the member is insolvent. In the case of an S corporation, the insolvency exception is applied at the entity level. The non taxable cancellation of indebtedness income, however, does not increase the shareholder's tax basis in their stock. As a result, the shareholders will ultimately recognize such income upon a sale or liquidation.

As in the case of a C corporation, the S corporation's basis in its assets is not adjusted upon the death of a shareholder.

Although the parties can elect to treat a purchase of at least 80% of the stock of an S corporation as an asset purchase for federal income tax purposes, unless the corporation has been an S corporation since inception or for at least 10 years, such treatment may result in federal income tax at the corporate level. In addition, certain states do not recognize such an election.

Advantages over a partnership:

A LLC not only has all of the flexibility of a partnership, it does so without the need for anyone to have personal liability. As a result, a LLC avoids the more cumbersome structures that utilize shell corporations to effectively limit the liability of the general partners.

LLC also permit the flexibility of having non-member managers. Although, the general partner of a partnership could retain an independent manager, the general partner remains responsible to oversee the manager.

LLC statutes generally permit the members and managers to be indemnified to the same extent permitted for corporate officers and directors.

The information mentioned here in above is of general nature and cannot be regarded as legal or tax advice. For more information, please contact Anne Tahim at 714-772-4744