

## **LLC**

### **Limited Liability Company**

### **The GOOD, the BAD & the UGLY!**



***Knowledge* – One of the Keys  
to Tax Planning Opportunities**

November 16, 2005

Re: *Limited Liability Company*

To Whom It Concerns:

Regardless of the size of your business or how it is structured, all business owners share one common partner: Uncle Sam. Virtually every business transaction has some tax consequence. A business transaction should never be looked upon solely on a pre-tax basis. It is only on an after tax basis that a transaction should be viewed as good or bad.

The best way to deal with Uncle Sam is to arm yourself with knowledge. Simply stated, if you understand basic tax issues, you can avoid some basic tax problems. We want you to acquire the knowledge you need to effectively address certain tax issues.

We want to emphasize that the best way to look at Uncle Sam is as a partner who presents you with opportunities – in particular, opportunities for tax savings that can help boost your profits. The reason I say this is that I've seen too many small businesses let their concern about tax issues and fear of dealing with the IRS result in an ineffective or defensive tax strategy. By examining the tax law in light of both your responsibilities and the opportunities for tax savings, I hope to help you develop an offensive tax strategy that benefits both you and your business.

My focus is on tax planning and I emphasize planning, because planning is what ultimately leads to actions. If you have any questions about this or any other matter, please do not hesitate to call.

Sincerely,

**Young & Company, LLC**

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## What is an LLC?

Limited Liability Companies started in the United States in Wyoming in 1977. Similar entities existed in Germany in the late 1890's. The Wyoming farmers wanted the advantages of corporations (*specifically, limited personal liability*) with the advantages of being unincorporated (*no organizational meetings, By-Laws, accounting requirements*). Since then, all 50 states have adopted various forms of LLC's. Not all states have the same advantages.

That's the **GOOD**.. no organizational meetings, no By-Laws. It is operated the same as a sole proprietor. If there is more than one owner, it is called a multiple member LLC (similar to a partnership).

## If I'm doing business as an LLC, what am I called?

Owners of LLC's are called members. The person in charge is called the manager or managing member (if it is a multiple member LLC).

## What about liabilities?

It is our understanding that the member is as much liable for what happens **within** the LLC as is a corporate officer. Attorneys tell us the advantage of an LLC is that it is exempt from lien from outside sources.

*If Renee owns shares of General Motors or shares of her own "S" corp, those shares are subject to outside lawsuits... Renee loses a lawsuit and Mr. Attorney says "what do you own ?"... she owns stock in General Motors and she owns stock in a Sub S. Those assets can be liened. Seek legal counsel for legalities.*

BUT, the LLC is exempt from that outside lawsuit by statute. That's my understanding of the legal side. Since it is not subject to a lien, that's **GOOD**. You may lose everything else, but you would still have your LLC.

*The LLC, can however, be subject to a "charging order". This means any distributions must be shared with, or perhaps given to, the person or entity that owns the "charging order". Fortunately for the owner of the LLC, and unfortunately for the person or entity holding the "charging order", the person making the decisions (Manager or Managing Member) is not subject to any control. Thus, there is no requirement for a distribution to be made. BUT, the way the tax law works, the person or entity holding the "charging order" is treated like an owner. That means they PAY TAX on the profits which you are never going to give them! Seek legal council for legalities.*

The IRS is taking some exception to this lack of liability when it comes to payroll tax collection issues and what is called 100% penalty assessments. The IRS disregards the disregarded entity and regards it exactly the same as a sole proprietor, thus making the responsible person liable for all unpaid payroll taxes, penalties and interest, not just the trust fund portion. (*There is at least a 20 minute discussion necessary to fully explain this*). *If you ever find yourself in this mess, you'll wish you never heard of "limited liability" because it's not as limited as a corporation when it comes to the IRS and uncollected payroll taxes!*

## How is the LLC income reported?

The IRS considers the single member LLC to be a "disregarded" entity. That means, it is reported for tax purposes exactly the same as a sole proprietor with no additional reporting requirements. That's still a part of the **GOOD**, ease of reporting income.

A multiple member LLC comes under the partnership tax rules. Thus, a partnership tax return is required. In a partnership, partners take draws and do not have the same distribution rules as do "S" corporations. Substitute the word members for partners. That's **GOOD**.

## How is the LLC operating income taxed?

The tax side is way different... **BAD**. A single member LLC is a "disregarded" entity. Thus, the LLC would not do a separate tax return as would a corporation. The owner (now you know to say member) would account for the income exactly as a sole proprietor on a Form 1040 Schedule C. But, the member gives up the opportunity to save on payroll taxes versus self-employment tax (*the main reason for "S" corps*). That's **BAD**.

## How is the LLC taxed when I sell it?

### ENTER THE **UGLY!**

First, let's understand that ordinary income tax is higher than capital gains tax. There is a scenario wherein the member(s) will wish they had never heard of an LLC, and that's if the taxpayer has the opportunity to sell their equity in the entity as opposed to the individual assets.

Let's further explain this. If the business is a corporation, the corporation can sell its individual assets (higher taxes). OR, the shareholder(s) might be able to sell the stock ownership in the corporation (lower taxes).

*We normally advise against the stock purchase on the buyer side because of lack of stepped up basis for depreciation and the acceptance of often unknown liabilities. But, there are excellent reasons to purchase the stock anyway. It happens often in the medical field wherein a doctor wants to buy another doctor's practice which is already tied into the insurance carriers. Doctors cannot just put out a shingle and accept insurances. This creates value. Another example might be where the entity owns lots of real estate. It's may be cheaper to buy the stock in the corporation which owns the real estate then to pay doc stamps and other closing costs by purchasing the individual assets.*

The advantage of **selling the equity (stock)** is capital gains tax treatment.

## ENTER THE **UGLY!**

BUT, **selling the equity in an LLC** requires accounting for the sale as if the individual assets are sold (*true for both single member and multiple member LLC's*). That involves depreciation recapture, accounts receivable, inventory calculations, and a whole bunch of ordinary tax rates prior to being able to use capital gains rates. THAT MEANS HIGHER TAXES. **That's WAY UGLY.**

So, to summarize the above, the LLC probably pays higher taxes in the day to day operations because of self-employment tax, and might pay more tax depending on how and when and the entity is sold.

## NUTS! Why can't I have the best of both the LLC and Sub S?

GOOD NEWS HERE! The BAD UGLY LLC can elect to be taxed as a Sub "S" corp. The member(s) do an entity selection on Form 8832 and a Sub S election at the same time on Form 2553. Thus, the taxpayer appears to have the liability benefits of an LLC plus the tax benefits of a Sub S. So, for a normal operating business, this sounds like a good thing.

## WHAT SHOULD I DO?

Seek legal & tax counsel and consider the annual and up front costs of an LLC vs. Sub S. Keep in mind that if the LLC elects the Sub S, there are separate tax returns required. Weigh the advantage of less self-employment tax versus the ease of an LLC.

And, to further convince you of the advantages of being taxed as a Sub S, read the information titled...

### **Using Comparable Wages in an "S" Corporation to Lower Overall Taxes**



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Thank you,  
*Lonnie Young*