



# How Will My LLC Be Taxed?

Over the last decade limited liability companies have overtaken corporations as the most popular form of entity for small businesses and have exceeded all other types of entities for the ownership of commercial and investment real estate. LLC's offer the shield against personal liability first provided by corporations, along with centralized management, and a simplified method of transferring ownership interests. But the real reason for their popularity is the tax flexibility LLC's can deliver that corporations do not.

An LLC may be treated for tax purposes in four different ways: disregarded entity, partnership, S corporation, and C corporation. If the LLC has only one owner, referred to as a "member," in most cases the IRS considers the LLC a disregarded entity, and it is not taxed at all. In fact, the LLC does not even file a U.S. tax return. If the sole member of the LLC is an individual, he or she treats the LLC as a sole proprietorship and puts all the income and expenses on his or her personal income tax return as though the LLC did not even exist. If the sole member is a corporation, another LLC, or some other legal entity, the LLC is treated as a division or a branch of the member for tax purposes and still does not file its own tax return. Alternatively, the single-member LLC can "check the box" to be treated as either an S corporation or a C corporation discussed below, but it cannot be a partnership for tax purposes.

If there is more than one member of the LLC, you can choose whether the LLC is treated as a partnership, a subchapter S "Small Business Corporation," or a regular C corporation. Most multi-member LLC's choose to be taxed as a partnership. This means that the LLC pays no income tax. It must file a tax return which reports its profit and losses. However, those profits and losses pass through the LLC into the hands of the members in the manner set forth in the LLC's operating agreement. The members receive an IRS Form K-1 which they must account for and include in their own income tax returns.

Some tax advisers may recommend that a client adopt the subchapter S corporation form of taxation for their LLC. A sub S LLC is still a pass-through, tax-reporting, but non-tax-paying entity similar to a partnership. So why choose sub S rather than a partnership form of taxation? One reason has to do with the current 2.9% Medicare portion of the self-employment tax. While the Social Security portion of the tax (currently 10.4% - **2014 = 12.4%**) is limited to the first \$110,100 (**2014 = \$117,000**) of income, there is no such limit on the Medicare portion. Thus, if your partnership-



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taxed LLC allocates to you a high amount of income, you have no recourse but to pay the 2.9% (**2014 = 3.8%**) Medicare tax on the whole amount.

An LLC taxed as a subchapter S corporation, however, can in some cases split the amount of distributions to its members up into part salary (subject to the Medicare tax) and part dividends (not subject to the tax). To do so, it is advisable that the LLC develops a salary or wage policy and compensate in accordance with that policy. The policy should attempt to maintain reasonable levels of compensation in light of an employee's qualifications, nature of work performed, and compensation paid in comparable companies.

To maintain its subchapter S status an LLC must abide by the same rules as a subchapter S corporation. That is, it may only have one class of membership, no more than 100 members, and its members must be natural persons who are U.S. citizens or residents unless they are certain trusts, estates or tax-exempt corporations which meet subchapter S qualifications. Additionally, the profits and losses must be allocated to the members in proportion to their membership interests. While these do not seem to be burdensome requirements to meet, they may discourage some LLC's from being taxed under subchapter S, such as those with a foreign investor or with two classes of membership (e.g., an investor class and an operator class). Flexibility is one of the greatest advantages of an LLC form of entity, and some of that flexibility is lost by taking a subchapter S election.

The fourth way an LLC may be taxed is as a regular C corporation. As such, the LLC will have to pay state and federal corporate income tax on its taxable earnings. The member will also have to pay income tax on the earnings he or she receives, thus triggering the dreaded "double taxation" that one attempts to avoid by having an LLC in the first place. Although this is a possible tax choice of an LLC, any potential benefits it may entail are beyond the scope of this newsletter. Suffice it to say that a regular C corporation LLC is not seen very often, especially in a small business or commercial and investment real estate setting.

The choice of tax treatment of your LLC is an important and nuanced decision. Though the tax forms used to make the choice are not difficult, they must be prepared correctly and timely to adopt the tax treatment you desire. It is highly recommended that you seek the advice of your CPA, attorney or other tax adviser as you create your business plan to make sure you choose the right tax treatment for your LLC and implement it properly to withstand the IRS scrutiny that may come down the road.

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