

# Taxation of LLCs

## Choices on How LLCs are Taxed

### Single member LLCs.

- By default a single member LLC is "disregarded" for the purpose of filing a federal tax return. All LLC income, deductions, credits, etc. are reported on the single member's tax return.
  - If the only member of the LLC is an individual, the LLC income and expenses are reported on Form 1040, Schedule C, E, or F.
  - If the only member of the LLC is a corporation, the LLC income and expenses are reported on the corporation's return, usually Form 1120 or Form 1120S (for S corporations) or if the corporation is a tax exempt nonprofit on Form 990.
- An LLC is disregarded for tax purposes only. It doesn't change the fact that the company is a separate legal entity for all other purposes.
- Under the IRS "check the box" regulations a single member LLC can elect to be taxed as a corporation instead of as a "disregarded entity" by using IRS Form 8832
- Single-member LLCs may not file a partnership return.

### Multiple Member LLCs

By default multi-member LLCs are taxed as partnerships (they must file a partnership tax return, IRS Form 1065).

Under the IRS "check the box" regulations multi-member LLCs can elect to be taxed as a corporation (using Form 8832) instead of as a partnership.

### Electing to be taxed as a corporation

Both single and multiple member LLCs can elect to be taxed as corporations

After making the election the IRS will treat the ownership interests of the LLC members as if they were stock holdings in a corporation.

Once the election has been made the LLC can make a second election to be taxed as an S corporation (using IRS Form 2553). Without making this second election the LLC would be taxed as a "C corporation".

An S corporation is a pass-through entity paying no tax at the corporate (or LLC) level. To be taxed as an S corporation the LLC must meet all IRS requirements for S corporations. These include:

- It may have only one class of members.
- All of its members must be an eligible entities and/or individuals
- It Must not have more than 100 members
- Spouses are automatically treated as a single member. Families, defined as individuals descended from a common ancestor, plus spouses and former spouses of either the common ancestor or anyone lineally descended from that person, are considered a single member as long as any family member elects such treatment
- Members must be U.S. citizens or residents, and must be natural persons, so corporate members and partnership members are generally excluded. However, certain trusts, estates, and tax-exempt corporations, notably 501(c)(3) corporations, are permitted to be members.
- Losses must be allocated to members proportionately to each one's interest in the business.

An LLC that does not meet the above requirements, cannot be taxed as an S corp.

**Self-Employment Taxes:** The self-employment tax is a 15.3% tax that is paid for Social Security and Medicare ("FICA"). It is most commonly paid by individuals who work for themselves but it also applies to the owners of LLCs and S corporations as is outlined below.

Informational Reporting. Employment tax reporting requirements apply to LLCs in much the same way as other types of businesses.

- Formal employees of all LLCs are subject to the withholding of employment taxes.
- Form W-2 (for workers that are employees) and Form 1099 (for workers that are independent contractors) must be filed when required.

The Effect of Electing to be Taxed as a "C" or an "S" Corporation.

- **The Defaults:**
  - Single Member LLCs - By default, a single-member LLC is a disregarded entity for tax purposes and is treated by the IRS as a sole proprietorship. Just like any other sole proprietor, the owner of this type of LLC is considered to be "self-employed" and thus, in addition to income tax, the sole member must pay a the self-employment tax calculated upon the ENTIRE net earnings of the company whether or not those earnings are distributed to the member by the company
  - Multi-member LLCs - By default, multi-member LLCs are taxed as partnerships. Each

partner pays self employment tax calculated on the entire net profit of the company (whether or not distributed) in proportion to their respective ownership share

- **"S" Corporations** If an LLC elects to be taxed as a "S" corporation only the salary paid to the employee-owner is subject to employment tax. The remaining income that is paid as a distribution is not subject to employment tax under IRS rules. Therefore, there is the potential to realize substantial employment tax savings (contrast with LLCs that are taxed as partnership or disregarded entities where the employment tax is paid on all net profits whether actually distributed or not)
- To better understand this it is important to remember that with an S corporation money can be distributed to the owner/members in one of two different ways:
  - 1) Salary for work done as an employee, and
  - 2) distribution of net profits (after deducting salaries and other business expenses)

The member/owners of an LLC taxed as an S corporation typically seek to minimize the salary that is paid to themselves in order to reduce their exposure to self employment taxes. Because salaries are tax deductible this increases the percentage of corporate income that ends up being classified as profits (upon which no FICA is paid).

**Warning** - the IRS generally frowns on companies that are being taxed as S corporations that fail to pay ANY salaries to the owners despite the fact that those owners are doing significant amounts of work for the company (or where the company is only paying them minimal or unreasonably low amounts of salary compared to the amount of work done). Failure to pay a sufficient salary to an owner-employee is a hot area for IRS audits of S corporations. As a general rule the amount paid should correlate to what the company would have to pay a non-owner employee for the same services. During the start-up phase where money is tight, or where the company is not profitable, it may be possible to avoid payment of salaries to owners for a short period of time.

Thus, the potential for employment tax savings may make it attractive to be taxed as an S corporation but bear in mind that you would then have to deal with all the paperwork associated with payroll tax. The payroll tax is a pay-as-you-go tax that must be paid to the IRS regularly throughout the year - on time, or you will incur interest and penalties. The paperwork alone can be an overwhelming task for someone who is not familiar with this; and if you expect to incur losses or otherwise experience a cash flow crunch during the year that would hinder you from paying the payroll tax when due, this could present a problem.

**As a general rule the election to be taxed as an S-Corporation should NOT be made until the LLC is actually generating sufficient revenue to pay the owner/employee(s) a steady salary.**

- **"C" Corporations.** An LLC can elect to be taxed as a "C" corporation. Employees of a "C" corporation pay no self-employment tax. All employees (even if they are owners of the company) pay only half of the FICA tax owing. The other half of the FICA tax is paid by the

employer-corporation. Because the self employment tax is not an issue the primary concern of the owners is typically to structure compensation so as to reduce taxable income on the corporate level, thereby reducing exposure double taxation (S corporations, in contrast, are pass-through entities paying no tax at the corporate level).

### **When an LLC is Taxed Like a Partnership**

- **Have Caution When Setting the Split of Profits:**

When taxed like a partnership an LLC member's distributive share of income, gain, loss, or deduction is allocated in accordance with the provisions in the LLC's operating agreement. As a general rule the IRS regulations require that profits to be split by the same percentage as the percentage of each member's investment in the company. Under limited circumstances a profit split by another percentage is allowable so long as such split has a "substantial economic effect" (an obscure concept defined in the IRS regulations). Having a split of profits by percentage different from the percentage of each member's investment could lead to the IRS disregarding the allocation specified in the LLC's operating agreement. If that were to happen the IRS would reallocate the profits amongst the members in accordance with their actual interest in the partnership as determined from all the facts and circumstances. This could lead to a determination that certain members had underpaid their taxes (accompanied by penalties and interest on the underpaid amount.).

- **"Guaranteed Payments" to Members of an LLC**

When a multi-member LLC is being taxed as a partnership (the default), money paid by the LLC to a member can be classified as either:

- "Distribution" of profits: The payments to members generally made relative to prior or current year's earnings, or in liquidation of a member's interest of the LLC . A "distribution" reduces the member's "capital account", or a
- "Guaranteed payment": A regularly scheduled payment for services rendered by a member, similar to a salary, that is made without to the income of the LLC

Unlike distributions, guaranteed payments are paid out of an operating account not a capital account. Guaranteed payments are deductible expenses (whereas distributions are not) thus reducing the LLC's taxable income.

The member is taxed on the income similar to salary EXCEPT that the member must also pay the self-employment tax. The member receiving a guaranteed payment (as is true for all the members) must pay additional self employment tax based on his or her share of the LLC's net profits (which, of course, have been reduced by the deduction taken for the guaranteed payments). Thus, when guaranteed payments are made the self employment tax obligation of the other members is, in effect, reduced.

Because guaranteed payments are deductible by the LLC as a business expense the amount of LLC net profits available for later distribution to the members is reduced

*Caution: Using cash "distributions" to make regularly scheduled payments to a member (similar to a salary) creates a risk that the IRS may reclassify the distribution as a guaranteed payment and subject the payments to self-employment taxes, penalties and interest.*

A "guaranteed payment" reduces the capital accounts of ALL members (because it is essentially a business expense which reduces the amount of profit allocated to the capital accounts), while a "distribution" reduces ONLY the recipient-member's capital account.

A "distribution" is generally used by members to withdraw funds from an entity as opposed to a salary. A distribution is made from an equity account and is thus shown as a reduction of the member's capital account.

A "guaranteed payment", on the other hand, is used to ensure that a member will receive a certain minimum amount for certain services. The member is given first priority even though a net loss is created for the LLC. This guaranteed payment is not contingent upon earnings such as his distributive share would be. Thus, a guaranteed payment account is an operating expense item.

Assuming that the LLC has not elected to be taxed as a corporation, "guaranteed payments" to worker-members are reported on Schedule K-1 of IRS Form 1065 (the partnership information return)

### **Some Advantages of an LLC Being Taxed as a C Corp**

- Unlike LLC's being taxes as pass through entries, LLCs being taxed as C corporations can offer deferred compensation benefits. Often the sole stock-holder of a C corporation will want reduce his or her "salary" so as to leave more money in the company. This is because corporate tax rates on the first \$75,000 of taxable income are lower than what an employee would pay if it were taken as salary.
- An LLC taxed as C corporation (as opposed to an S corporation, partnership, or disregarded entity) can offer employees nontaxable fringe benefits (such as health insurance and retirement plans) which can be deductible business expenses for the corporation

**Some Pitfalls?** There are two common situations where unintentional errors may occur:

- If you convert an existing business, such as a corporation, into an LLC there may be tax implications, such as:
  - The conversion may result in a taxable gain
  - employment tax wage bases may be affected.

### **Special rules may apply when your LLC has an operating loss:**

- The amount of loss you can deduct may be limited because of your limited liability for LLC debts (IRS

Code Section 465)

- Passive Activity Loss limitation may restrict the amount of loss you can deduct (IRS Code Section 469)
- If either of these situations applies to you, professional advice may be needed.