

LLC Basics

Limited liability companies combine the best parts of partnerships and corporations.

A limited liability company (LLC) offers protection from personal liability for business debts, just like a corporation. However, unlike a corporation, which must pay its own taxes, an LLC is a pass-through tax entity: The profits and losses of the business pass through to its owners, who report them on their personal tax returns just as they would if they owned a partnership or sole proprietorship. Moreover, while setting up an LLC is more difficult than creating a partnership or sole proprietorship, running one is significantly easier than running a corporation.

Here are the main features of an LLC:

Limited Personal Liability

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 cannot legally come after an LLC member's house, car, or other personal possessions. Because only LLC 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 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, however -- the same exceptions apply to corporations. An LLC owner can be held personally liable if he or she:

- personally and directly injures someone
- personally guarantees a bank loan or a business debt on which the LLC defaults
- fails to deposit taxes withheld from employees' wages
- intentionally does something fraudulent, illegal, or reckless that causes harm to the company or to someone else, or
- treats the LLC as an extension of his or her personal affairs, rather than as a separate legal entity.

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This last exception is the most important. If owners don't treat the LLC as a separate business, a court might decide 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 your co-owners:

- **Act fairly and legally.** Do not conceal or misrepresent material facts or the state of your finances to vendors, creditors, or other outsiders.
- **Fund your LLC adequately.** Invest enough cash in the business so that your LLC can meet foreseeable expenses and liabilities.
- **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.
- **Create an operating agreement.** Having a formal written operating agreement lends credibility to your LLC's separate existence.

Additional Protection: Business Insurance

A good liability insurance policy can shield your personal assets when limited liability protection does not. For instance, if you are a massage therapist and you accidentally injure a client's back, your liability insurance policy should cover you. Insurance can also protect your personal assets in the event that your limited liability status is ignored by a court.

In addition to protecting your personal assets in such situations, insurance can protect the LLC's assets from lawsuits and claims. But your LLC won't be protected if it doesn't pay its bills: Commercial insurance usually does not protect personal or corporate assets from unpaid business debts, whether or not they're personally guaranteed.

LLC Taxes

Unlike a corporation, an LLC is not considered separate from its owners for tax purposes. Instead, it is what the IRS calls a "pass-through entity," like a partnership or sole proprietorship. This means that business income passes through the business to the LLC members, who report their share of profits -- or losses -- on their individual income tax returns. Each LLC member must make quarterly estimated tax payments to the IRS.

While an LLC itself doesn't pay taxes, co-owned LLCs must file Form 1065, an informational return, with the IRS each year. This form, which partnerships also have to file, sets out each LLC member's share of the LLC's profits (or losses), which the IRS reviews to make sure LLC members are correctly reporting their income.

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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 -- somewhat awkwardly 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.

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. This office is often in the same department as the corporations division, which is usually part of the secretary of state's office. Filing fees range from about \$100 to \$800. Now, in every state, you can form an LLC with just one person.

Many states supply a blank one-page form for the articles of organization, on which you need only specify a few basic details about your LLC, such as its name and address, and contact information for a person involved with the LLC (usually called a "registered agent") who will receive legal papers on its behalf. Some states also require you to list the names and addresses of the LLC members.

In addition to filing articles of organization, you must create a written LLC operating agreement. You don't have to file your operating agreement with the state, but that doesn't mean you can get by without one. The operating agreement is 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.

Ending an LLC

Under the laws of many states, unless your operating agreement says otherwise, when one member wants to leave the LLC, the company dissolves. In that case, the LLC members must fulfill any remaining business obligations, pay off all debts, divide any assets and profits among themselves, and then decide whether they want to start a new LLC to continue the business with the remaining members.

Your LLC operating agreement can prevent this kind of abrupt ending to your business by including "buy-sell," or buyout, provisions that set up guidelines for what will happen when one member retires, dies, becomes disabled, or leaves the LLC to pursue other interests.