

Basics of limited liability companies

The limited liability company (LLC) has become an increasingly popular business entity across a variety of industries and sectors. An LLC is a hybrid type of legal structure that provides the limited liability protection of a corporation and the operational flexibility and pass-through tax treatment of a partnership or sole proprietorship. While some businesses may be hesitant to get started as an LLC due to lack of familiarity with the structure, an LLC can be formed easily and is similar to a corporation in many ways.

Who owns an LLC?

Ownership interests in a corporation are referred to as "stock" or "shares," and different classes of stock can have different rights of convertibility, preference to distributions, voting and other attributes. Ownership interests in an LLC are generally referred to as "units" and can be structured to have rights just like stock in a corporation.

Rather than "stockholders," owners of units in the LLC are referred to as "members." In a corporation, the "board of directors" is tasked with overseeing the management of the corporation on behalf of its stockholders. The management structure of an LLC is flexible and can also be structured to have a "board of managers" to serve a similar role.

The governing documents of a corporation include the "articles of incorporation" and "bylaws," while the corresponding governing documents of an LLC are referred to as the "articles of formation" and "operating agreement."

When should I use an LLC?

The LLC can offer several distinct advantages to a business. An LLC by default is taxed as a pass-through entity, which means that each LLC member's annual tax return includes his or her portion of the LLC's taxable income or loss. A corporate legal structure, on the other hand, is generally subject to double income tax – once at the corporate level, and again to the shareholders, if and when distributed as dividend income. Members in an LLC, however, will be required to include their share of income currently whether or not cash is actually distributed to the member.

Because LLCs are flexible legal entities, operating agreements can be drafted to permit distributions of sufficient cash necessary for members to pay any taxes related to income of the LLC. Furthermore, in the early stages of a business that generates losses, members may be able to use their share of such losses to offset other income on their tax returns. An LLC also has the flexibility to choose to be taxed as a corporation for federal tax under what is known as the check-the-box entity classification regime.

A primary difference between a corporation and an LLC taxed as a partnership is that members of the LLC will not be treated as "employees" of the LLC for federal tax purposes. Rather than having wages subject to periodic employment tax and income tax withholding, a member who performs services for the LLC may be required to pay self-employment taxes. Additionally, members will not be able to participate in certain tax-favored benefits plans (eg, qualified retirement plans, health and welfare plans, fringe benefit plans) which are only available to employees. However, if this is an important consideration to your business, there are several alternative legal structures that can be used to permit members to retain their status as employees.



When should I avoid the LLC structure?

The LLC has important downsides. Most venture capital firms will refuse to invest in an LLC, and most limited partnership agreements for venture capital firms prohibit the investment into LLCs or other vehicles that could create pass-through income or loss to the VC's limited partners. While this can be mitigated by the deployment of "blocker" corporations, most VC's will not be willing to consider the LLC.

These are only some of the issues to be considered when determining the appropriate legal entity structure for your business. While most states' laws governing LLCs are similar, there may be some differences which could impact your decision. We recommend contacting a member of our team if you have any specific questions regarding your business.

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