What Is an LLC? Here’s How It Works.

Are you a small business owner that has been asked if their company is an LLC, and you don’t know what that means? Or maybe you are an entrepreneur in the initial phases of opening a new business, and your head is swimming with all the options ranging from a sole proprietorship to an LLC to a corporation.

Keep reading for everything you need to know about an LLC and whether it is the right option.

What is an LLC?

A Limited Liability Company (LLC) is a business structure that provides the owners with protections that are usually only available to corporations but keeps the simplicity of a sole proprietorship.

This entity also provides pass-through taxation as it is run through a separate entity that isn’t restricted to a specific number of shareholders and isn’t heavily regulated.

Related: How to Start a Limited Liability Company (LLC) | Entrepreneur

What are the benefits of an LLC?

There are benefits to every business structure. From a corporation, general partnerships and sole proprietorships each offer unique advantages.

The benefit of forming an LLC is that it takes the pros of each business structure and combines them into one.

How can an LLC provide asset protection?

One of the main advantages of an LLC is that it protects your personal assets.

For any business debt or lawsuits that your business may run into, the owner has no personal liability. This ensures that their personal assets cannot be taken as payment as they are completely separate from the company.

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What tax options does an LLC have?

An LLC provides more tax options than other business models.

For tax purposes, they are either taxed as a sole proprietorship or a partnership, depending on the management structure and how many members are involved in the company.

Members report their share of the business income and expenses on their personal tax return and then pay personal income tax on the profit.

Members who also work in the business are then considered self-employed and must state this on their federal income tax return and then pay self-employment taxes on their share of the profits.

If the company doesn’t want to be taxed as a sole proprietorship or partnership, it can also choose to be taxed as an S-corporation (S-corp) or a C-corporation (C-corp).

A C-corp pays corporate tax, and the owners pay tax on their distributions. An S-corp is what is known as a pass-through entity which means it doesn’t pay corporate tax, but each owner does pay personal income tax on their share of the profits.

It is important to note that not all LLCs qualify for S-corp

taxation as they must meet certain IRS (Internal Revenue Service) requirements.

A single-member LLC can also be designated as a disregarded entity. What this means is that it will be disregarded or ignored concerning federal income tax.

Related: The 5 Biggest Tax Differences Between an LLC and Corporation | Entrepreneur

Does an LLC provide flexibility?

As LLCs are not required by law to have annual shareholder meetings or even require a board of directors, they provide greater flexibility than other business models.

Rather, members of an LLC are free to organize the company as they see fit and be member-managed, as administrative requirements like most corporations don't bind them.

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Does an LLC designation make your business more credible?

When you structure your business as an LLC, you receive exclusive rights to use your business name as a business entity.

As most states don't allow a business to use an existing business name, you can create a public record of your name, making it unavailable.

The LLC designation at the end of the company name can also lend credibility to a business.

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How are profits distributed in an LLC?

One main advantage of an LLC is that members can decide how the profits are divided.

Typically, corporations issue dividends, and partnerships usually split the profits among the partners, but owners of an LLC can choose how the profits are divided up.

Remember that the IRS has rules about the special allocation of profits, and you might have to show proof of profit sharing or legitimate economic need to prove it is not simply an attempt to avoid paying taxes.

Are there disadvantages of an LLC?

While an LLC has specific benefits, it also has some notable disadvantages.

The profits are subject to high LLC tax

The profits of an LLC are subject to social security and Medicare taxes. In some cases, owners of an LLC can even end up paying more taxes than a corporation does.

Also, both salaries and profits of an LLC are subject to self-employment taxes which currently equal approximately 15.3%. Whereas with a corporation, only the salaries are subject to taxation, not profits.

This disadvantage hits owners who take a salary of less than $97,500 the hardest.

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An LLC has to immediately recognize its

profits

Unlike a corporation, owners of an LLC have to immediately acknowledge their profits.

A C-corp doesn’t have to distribute its profits immediately to the shareholders. This means a C-corp isn’t always taxed on the company’s profits.

Since an LLC is not subject to double taxation, the company’s profits are then automatically included in the member’s actual income.

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There are fewer fringe benefits available

Employees who receive fringe benefits such as group insurance, medical reimbursement, medical insurance and parking must treat these benefits as taxable income with an LLC. This is also true for employees who own over 2% of an S-corp.

On the other hand, employees of a C-corp who receive fringe benefits do not have to report these as taxable income on their income tax return.

How to set up an LLC

There are seven steps you need to take to start an LLC.

There are different state law requirements from state to state, so it is recommended to talk to a legal professional about the specific requirements where you live.

Choose a business name

The first step to starting an LLC is choosing your business name.

Not only do you need to choose a name that doesn’t already exist, but your state may also have certain requirements it needs to meet.

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Choose a registered agent

The next step is to choose a registered agent. A registered agent receives official and legal documentation on behalf of the company. Once the registered agent receives these documents, they pass them on to the company.

The registered agent has to be at least 18 years old. You are allowed to choose yourself or an employee. The main requirement is the agent must have an address within the state during typical business hours.

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Obtain a copy of your state’s LLC Articles of Organization Form

In most states, you will have to file a document called the Articles of Organization with the state agency that handles business filings to establish your LLC.

Each state has a specific form you will use; some also call it a Certificate of Formation.

Complete the LLC Articles of Organization Form

Every state has specific requirements for individuals trying to create an LLC. Some of the typical information you may need to provide includes:

- The business name.
- The principal address of the business.

- The business’s purpose.
- How the LLC will be managed.
- The registered agent’s contact information.
- The duration of the LLC.

Once you have this form filled out, at least one of the business owners will then need to sign it.

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File the Articles of Organization

Make sure to thoroughly check the Articles of Organization Form before you submit it.

You may also be required to pay a filing fee, which differs from state to state.

Once your form has been approved, the Secretary of State’s office will issue you a certificate to prove that your LLC is formally registered.

You can use this certificate to complete tasks such as setting up a business bank account and registering for a tax ID number.

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Create an LLC Operating Agreement

Now that the state has approved you, it is time to create an Operating Agreement.

An Operating Agreement outlines all the details of the financial, legal and management rights that all members of the LLC are entitled to.

In particular, it includes how the profits will be distributed, how members can leave the LLC and who is required to contribute capital.

You can create your Operating Agreement, especially if you are a single-member LLC. Hiring an attorney may be a good option for more complicated situations, such as with multi-member LLCs.

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Keep your LLC active

Now that your LLC has been created, you need to keep it active.

This means you must ensure you are keeping your business in good standing with your state. This can include the LLC filing an annual report that keeps your company's info up-to-date and paying an annual fee for filing.

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Start an LLC today

With benefits ranging from business flexibility, different taxation options and personal asset protection, creating an LLC might be the next step your business needs to take.

By following the steps above and consulting an attorney in your area, you could soon run your own LLC and reap all its benefits.

Check out Entrepreneur's other articles for more information about LLCs and other financial topics.

https://www.entrepreneur.com/starting-a-business/what-is-an-llc-heres-how-it-works/452708